

Structural and regulatory developments

Initiatives and reports concerning financial institutions

Basel Committee on Banking Supervision (BCBS)

BCBS issues guidance on customer due diligence ...

In October, the BCBS issued guidance to banks and banking supervisors on customer due diligence processes.¹ The BCBS noted that supervisors are increasingly recognising the importance for banks of adequate controls and procedures for customer identification. This is necessary not only to comply with anti-money laundering legal requirements, but from a wider prudential perspective. Without due diligence, banks can become subject to reputational, operational, legal and concentration risks, which can result in significant costs. To guard against these risks, the report recommends that banks develop policies and procedures in key areas such as customer acceptance, customer identification and monitoring of high-risk accounts.

... and publishes working paper on treatment of specialised lending exposures

Also in October, the BCBS published a working paper² proposing a specific internal ratings-based (IRB) treatment of “specialised lending” (SL) exposures.³ An underlying tenet of the proposed IRB approach for corporate exposures is that the source of repayment of the loan is based primarily on the ongoing operations of the borrower, rather than the cash flow from a project or property. In this context, assets pledged as collateral serve as a risk mitigant and as a secondary source of repayment. So defined, the corporate exposure class does not encompass loans whose repayment depends principally on the cash flow generated by the asset rather than the credit quality of the borrower. Banks have pointed out that historical loan performance data for SL exposures are scarce. Many banks therefore face difficulties in establishing credible and reliable estimates of key risk factors, including the probability of default (PD).

¹ See *Customer due diligence for banks*, BCBS, Basel, October 2001. Available at www.bis.org. An earlier version of the report was issued for consultation in January 2001, and a number of comments have been incorporated in the final paper.

² See *Working paper on the internal ratings-based approach to specialised lending exposures*, BCBS, Basel, October 2001. Available at www.bis.org.

³ Referred to as “project finance” in the January 2001 consultative package.

As a result, there is no common industry standard for a rigorous and risk-sensitive approach to economic capital estimation of SL exposures. The proposed IRB framework for SL therefore supplements the Foundation and Advanced IRB methodologies with a simpler methodology based on supervisory estimates of PD as well as loss-given-default and exposure-at-default.

Finally, the BCBS also published in October a working paper on two sets of proposals initially outlined in its January 2001 consultative package.⁴ The first proposal is for an IRB treatment of securitisations, and the second is a general approach to synthetic securitisations. The objective of the BCBS is to develop a comprehensive framework for securitisation that is risk-sensitive and provides banks with the proper incentives to move from the standardised to the IRB approach. The paper was issued to encourage further dialogue with the industry on the development of a minimum capital requirement for securitisations.

In November, the BCBS published the results of a quantitative impact study (QIS2) involving a range of banks across the G10 and beyond.⁵ The objective of the study initiated in April 2001 was to gather the data necessary to allow the BCBS to gauge the impact of the January 2001 proposals for capital requirements. The results of the QIS2 exercise and the feedback received from banks have led the BCBS to consider several modifications to the proposed New Capital Accord. These modifications are intended to help the Committee achieve its objectives of maintaining equivalence on average between current required capital and the revised standardised approach, and providing modest incentives regarding the aggregate level of required capital under the Foundation IRB approach. However, before finally deciding on the modifications to be made, the BCBS will require statistical information on the effect that such revisions would have on different banks. In order to gather this information, the Committee has asked a number of banks to participate in an update to QIS2 (QIS2.5) entailing a recalculation of the Foundation IRB capital requirements to account for the various modifications.

In December, the BCBS announced that it would undertake an additional review aimed at assessing the overall impact of a New Capital Accord on the banking system before releasing its next consultative paper. The Committee's work during this "quality assurance" phase will focus on three issues: balancing the need for a risk-sensitive Accord with sufficient clarity and flexibility to ensure that banks can use it effectively; ensuring that the Accord leads to appropriate treatment of credit to small and medium-sized enterprises; and finalising calibration of the minimum capital requirements to bring about a level

BCBS issues working paper on treatment of securitisations ...

... publishes results of impact study on New Accord proposals ...

... and announces additional review of impact of New Capital Accord

⁴ See *Working paper on the treatment of asset securitisations*, BCBS, Basel, October 2001. Available at www.bis.org.

⁵ See *Results of the second quantitative impact study*, BCBS, Basel, November 2001 and *Potential modifications to the Committee's proposals*, BCBS, Basel, November 2001. Both documents are available at www.bis.org.

of capital that, on average, is approximately equal to the requirements of the present Accord, while providing some incentive to those banks using the more risk-sensitive internal ratings-based system. The BCBS had previously planned to undertake a comprehensive impact study simultaneously with the next consultation period, but now believes that performing the impact assessment first will help to make the consultation period more constructive. This additional review means that the Committee's next consultative paper will not be issued in early 2002, as previously indicated. Instead, the BCBS will first seek to specify a complete version of its proposals in draft form. Once this has been completed, the Committee will undertake a comprehensive impact assessment of the draft proposals. The BCBS will then release these proposals for a further formal consultation period with a view to finalising the Accord. The Committee does not believe that this additional review process will be a lengthy one and therefore has not revised its schedule for completion of the Accord. However, it is prepared to revise its timetable if necessary.

BCBS publishes paper on sound practices for management and supervision of operational risk

Also in December, the BCBS published a paper on the development of sound practices for the management and supervision of operational risk.⁶ The paper outlines a set of principles, which provide a framework for the effective management and supervision of operational risk, for use by internationally active banks and supervisory authorities when evaluating operational risk management policies, procedures and practices. While the approaches to managing operational risk are evolving rapidly, the Committee recognises that there is still much work to be done. For example, progress towards a standard definition is hampered by differences in interpretations across banks. Therefore, the BCBS believes that an active exchange of ideas between supervisors and the industry is key to the development of guidance for managing operational risk exposures.

BCBS/IOSCO/IAIS

Joint Forum issues reports on financial industry rules and practices

In November, the BCBS, the Technical Committee of the International Organization of Securities Commissions (IOSCO) and the International Association of Insurance Supervisors (IAIS) released two reports prepared by the Joint Forum. The first report contains cross-sectoral comparisons of risk management practices and regulatory capital, and the second puts forward core principles developed by the three groups for their respective sectors.⁷ The first report responds to the parent groups' request to compare these approaches to gain a better understanding of current industry practices in all three sectors. The second compares the core principles issued by the three bodies by identifying their common principles and differences.

⁶ See *Sound practices for the management and supervision of operational risk*, BCBS, Basel, December 2001. Available at www.bis.org.

⁷ See *Risk management practices and regulatory capital*, BCBS, IOSCO and IAIS, Basel, November 2001 and *The Joint Forum Core Principles – cross-sectoral comparison*, BCBS, IOSCO and IAIS, Basel, November 2001.

Group of Twenty

In November, at a meeting in Ottawa, the finance ministers and central bank governors of the G20 countries adopted a comprehensive action plan of multilateral cooperation on terrorism financing, which included the following steps: rapid ratification and implementation of UN conventions and resolutions on the suppression of terrorism financing; cooperation with the relevant international bodies in promoting standards to combat abuses of the financial system; enhanced exchange of information between the G20 countries; provision of technical assistance to countries that need help in implementing laws and policies to combat terrorism financing; support to the activities of the UN Counter-Terrorism Committee; and surveillance through the Financial Action Task Force (FATF) and other international bodies.

G20 adopts action plan on terrorism financing

Initiatives and reports concerning financial markets and their infrastructure

FATF

At an extraordinary plenary meeting on the financing of terrorism held in Washington on 29 and 30 October 2001, the FATF expanded its mission beyond money laundering.⁸ It will now also focus its energy and expertise on the worldwide effort to combat terrorism financing. The FATF agreed a set of recommendations on terrorism financing which commits members to: take immediate steps to criminalise the financing of terrorism; freeze and confiscate terrorist assets; report suspicious transactions; provide assistance to other countries' law enforcement investigations; impose anti-money laundering requirements on alternative remittance systems; strengthen customer identification measures; and ensure that entities, in particular non-profit organisations, cannot be misused to finance terrorism. In order to secure a swift and effective implementation of these new standards, the FATF agreed on a comprehensive plan of action.

New emphasis by FATF on combating terrorism financing

International Swaps and Derivatives Association (ISDA)

In October, ISDA reiterated the position expressed in the final draft of the user's guide to the 1999 ISDA Credit Derivatives Definitions that bonds that are convertible at the option of the bondholder satisfy the "not contingent" deliverable obligation clause and should be deliverable under credit default swap contracts.⁹ The issue of deliverability was raised by the refusal of some sellers of protection on Railtrack PLC to accept delivery of the firm's convertible bonds following the UK government's decision to put the company into administration. The issue revolved around a standard provision of

ISDA issues its opinion on deliverability of convertible bonds under credit default swaps

⁸ Measures taken by the US government in October last year were discussed in the December 2001 issue of the *BIS Quarterly Review*, page 74.

⁹ See www.isda.org.

European convertible issues providing trustees with responsibility for exercising conversion rights if the bond's converted equity value exceeds its par value at maturity. Market participants were concerned that such a clause could imply that holders of the bonds did not have full rights over their disposal (making them a "contingent" security) and that the securities would therefore not be deliverable under standard default swap contracts.

ISDA defines successor entity under credit derivatives contracts

In November, ISDA announced that it had finalised and published the supplement relating to successor and credit events to the 1999 ISDA Credit Derivatives Definitions.¹⁰ The supplement revises the definition of successor in the event of a merger, consolidation or transfer by replacing the "all or substantially all" wording in the Definitions with a numerical threshold such that if a reference entity succeeds to 75% or more of the bonds and loans of the original entity, then that entity would be the sole successor. The supplement outlines alternative approaches in the event that the 75% threshold criterion is not met. It also amends the definitions with respect to certain credit events to the effect that only admission in a judicial, regulatory or administrative proceeding or filing constitutes a credit event, meaning that an acceleration of repayment is no longer considered a credit event. This amendment was felt to be necessary to reduce the possibility of moral hazard.¹¹

virt-x

virt-x announces creation of pan-European CCP for equity trading

In October, virt-x, the electronic stock exchange resulting from the merger of Tradepoint PLC and the Swiss Stock Exchange, announced plans for the creation of a pan-European central counterparty for equity trading. The new entity will be formed in cooperation with the London Clearing House (LCH) and x-clear, a subsidiary of Swiss Financial Services Group. x-clear will handle transactions involving Swiss counterparties, while the LCH will process other European transactions.

Committee on Payment and Settlement Systems (CPSS)/IOSCO Technical Committee

Committees issue recommendations for securities settlement systems

In November, the CPSS and the IOSCO Technical Committee released a report setting out 19 recommendations defining minimum standards for securities settlement systems.¹² The recommendations are designed to encompass systems for all types of securities and to cover domestic as well as cross-border trades. They deal with the design, operation and oversight of such systems and aim to promote the worldwide implementation of measures that

¹⁰ See www.isda.org.

¹¹ Banks that purchase protection on some loans they have extended could use the acceleration clause to trigger payment under credit derivatives.

¹² See *Recommendations for securities settlement systems*, CPSS and IOSCO, Basel and Madrid, November 2001. Available on the BIS website (www.bis.org) and IOSCO website (www.iosco.org).

can reduce risks, increase efficiency and provide adequate safeguards for investors.

European Union

In November, the Council of Ministers adopted a proposal to upgrade the EU money laundering directive, the final stage in the EU legislative process.¹³ The new directive extends the scope of the current directive on money laundering by obliging EU member states to combat laundering of the proceeds of all serious crime. The directive currently in force applies only to the proceeds of drug offences. The amendment also extends the coverage of the current directive to a series of non-financial activities and professions that are vulnerable to misuse by money launderers.

European Union upgrades money laundering directive

Also in November, the European Commission published the first of two reports on cross-border clearing and settlement arrangements in the European Union.¹⁴ The objectives of the report are to assess current cross-border arrangements and to identify the main sources of inefficiency. The report concludes that fragmentation in clearing and settlement complicates cross-border securities transactions. Complications arise because of the need to access many national systems, whereby differences in technical requirements/market practices, tax regimes and legal systems act as barriers. Efficiency could be significantly improved by market-led convergence in some of the technical requirements/market practices across national systems. On the other hand, the report notes that removal of barriers related to taxation and legal certainty is the responsibility of the public sector. A second report, scheduled for release by mid-2002, will focus on policy aspects and examine possible models for more efficient clearing and settlement.

European Commission issues report on cross-border clearing and settlement

In December, the Council of Economics and Finance Ministers of the European Union (ECOFIN) adopted two directives on undertakings for collective investments in transferable securities (UCITS). The first directive removes barriers to the cross-border marketing of UCITS by broadening the range of assets in which they can invest. The second directive gives management companies a "European passport" to operate throughout the EU and widens the range of activities they are allowed to undertake. It also introduces the concept of a simplified prospectus, which will provide investors with more easily accessible information.

ECOFIN adopts two directives on cross-border investment

Italian parliament

In November, the Italian parliament approved a decree suspending the imposition of a withholding tax on non-resident holdings of Italian government bonds as of 1 January 2002. However, non-resident investors based in tax

Italian parliament suspends withholding tax on government bonds

¹³ See www.europa.eu.int.

¹⁴ See *Cross-border clearing and settlement arrangements in the European Union* (the Giovannini Report), European Commission, Brussels, November 2001. Available at www.europa.eu.int.

havens will continue to face withholding tax. The elimination of bureaucratic complications in obtaining refund of the withholding tax could encourage investment in Italian government bonds.

US Securities and Exchange Commission (SEC) and Commodity Futures Trading Commission (CFTC)

Regulatory pledge on US security futures

In December, the SEC and CFTC pledged to seek prompt adoption of final rules relating to margins on security futures products and on protection of customer funds, pursuant to authorisation of such products by the Commodity Futures Modernization Act of 2000 (CFMA). The adoption of final rules would allow public security futures trading by the second quarter of 2002. The agencies also agreed to move forward promptly with regard to foreign security index products.

SEC issues cautionary advice on "pro forma" accounting

Separately, the SEC in December issued cautionary advice that companies should consider when releasing "pro forma" financial information. Pro forma reporting departs from Generally Accepted Accounting Principles by allowing companies to exclude certain expenses and gains from their earnings and operating results under certain assumptions or pending contractual obligations not yet completed. Because pro forma accounting can make it difficult for investors to compare an issuer's financial information with other reporting periods and with other companies, the SEC reminded investors that it should be viewed with appropriate scepticism.

European clearing houses and exchanges

EuroCCP offers services for Nasdaq Europe

In December, European Central Counterparty Limited (EuroCCP), a wholly owned subsidiary of The Depository Trust & Clearing Corporation, announced that it was ready to provide clearing, settlement and risk management services for Nasdaq Europe. EuroCCP is the first central counterparty to offer cross-border services on a pan-European basis, including services for US securities traded in Europe.¹⁵ According to its promoters, the netting of transactions through EuroCCP will lower the cost of clearing and settlement and enable members of Nasdaq Europe to reduce their capital requirements. If EuroCCP meets its stated opening target, it will begin its operations before a competing system being developed jointly by virt-x and European clearers.

LSE and LCH plan straight through settlement

Also in December, the London Stock Exchange (LSE) and the London Clearing House (LCH) agreed to develop straight through settlement with Euroclear for LSE trades cleared by LCH. The arrangement will encompass trading, clearing and settlement for both UK and non-UK securities traded on the LSE. The new service, which should be available in the second half of 2002, will increase choice and competition for settlement services, while helping to reduce the cost of cross-border transactions. It will complement the services already offered by CRESTCo to LSE members. Securities transfer

¹⁵ A central counterparty helps manage the costs and risks of trading by standing between buyers and sellers to ensure that money and securities change hands smoothly and efficiently.

with CRESTCo will be a seamless process due to the link already in place between Euroclear and CRESTCo. The agreement between the LSE and the LCH follows the recent decision by rival clearer Clearstream to reject a takeover proposal from Euroclear in favour of exclusive negotiations with Deutsche Börse (DB), which wants to acquire the 50% of Clearstream it does not already own. An eventual agreement between Clearstream and DB would create a “vertically integrated” firm (a “silo” in market parlance) encompassing trading, clearing and settlement. By contrast, the approach favoured by Euroclear involves a process of “horizontal integration” through partnerships with other clearers. Euroclear has already established links with Euronext, virt-x and Nasdaq Europe.

Chronology of major structural and regulatory developments		
Month	Body	Initiative
Oct 2001	BCBS	Issues guidance on customer due diligence
	BCBS	Publishes a working paper on the IRB treatment of specialised lending exposures
	BCBS	Publishes a working paper on the IRB treatment of securitisations
	FATF	Expands its mission beyond money laundering
	ISDA	Reiterates position on the deliverability of convertible bonds under credit default swap contracts
	virt-x	Announces plans for the creation of a pan-European central counterparty for equity trading
Nov 2001	BCBS	Publishes the results of a quantitative impact study of its new proposals for capital requirements
	BCBS, IOSCO Technical Committee and IAIS	Release two reports prepared by their Joint Forum on a cross-sectoral comparison of risk management practices and risk capital
	G20	Adopts a comprehensive action plan on terrorism financing
	CPSS and IOSCO Technical Committee	Release report setting recommendations on minimum standards for securities settlement systems
	EU Council of Ministers	Adopts proposal to upgrade the EU money laundering directive
	European Commission	Publishes report on cross-border clearing and settlement arrangements in the European Union
	ISDA	Announces finalisation and publication of supplement on successor and credit events to 1999 ISDA Credit Derivatives Definitions
	Italian parliament	Approves decree suspending imposition of withholding tax on non-resident holdings of Italian government bonds (as of 1 January 2002)
Dec 2001	BCBS	Announces additional review of the impact of its proposals for a New Capital Accord
	BCBS	Publishes a document on the development of sound practices for the management and supervision of operational risk
	Risk Management Group of the BCBS	Publishes a working paper on the regulatory treatment of operational risk
	US SEC and CFTC	Pledge prompt adoption of rules relating to security futures
	US SEC	Issues cautionary advice concerning pro forma financial information
	ECOFIN	Introduces two new directives on cross-border investment
	European Central Counterparty Limited	Announces readiness to provide clearing, settlement and risk management services for Nasdaq Europe
	London Stock Exchange and London Clearing House	Agree to develop straight through settlement with Euroclear