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Recent initiatives by the Basel-based committees and groups

During the period under review, the Basel Committee on Banking Supervision (BCBS) reported on three new workstreams and took a number of new initiatives. The Committee on the Global Financial System (CGFS) published a report on financial stability and local currency bond markets, the Committee on Payment and Settlement Systems (CPSS) issued a consultative report on reducing foreign exchange settlement risk, and the Financial Stability Forum (FSF) updated its report on highly leveraged institutions. Table 1 provides an overview of these and other developments.

Basel Committee on Banking Supervision

In its *newsletter* released on 7 May 2007, the BCBS reviewed progress and recent initiatives to achieve its strategic objectives:[1] implementation of Basel II, new workstreams, accounting and auditing work, and outreach.

BCBS reports progress on implementation of Basel II …

The BCBS noted that implementation of the Basel II framework continues to move forward around the globe. A significant number of countries and banks had already implemented the standardised and foundation approaches as of the beginning of this year. In many other jurisdictions, the necessary infrastructure (legislation, regulation, supervisory guidance, etc) to implement the framework is either in place or in process, which will allow a growing number of countries to proceed with implementation of Basel II's advanced approaches in 2008 and 2009. This progress is taking place in both Basel Committee member and non-member countries. The Committee's Accord Implementation Group (AIG) and its working groups on validation, operational risk and trading book issues continue to actively share supervisory experiences in Basel II implementation, thereby promoting consistency across jurisdictions.

[1] Last October, the Committee restructured its subcommittees (see under http://www.bis.org/bcbs/organigram.pdf) to better reflect its strategic objectives going forward. These objectives seek to: (i) promote a strong capital foundation at banks; (ii) strengthen supervision and risk management practices in the face of rapid financial innovation; (iii) promote understanding of the links between risk management, disclosure and accounting practices; and (iv) strengthen outreach to non-member countries, industry participants and other constituents.

Main initiatives by Basel-based committees and groups Press releases and publications over the period under review			
Body	Initiative	Thematic focus	Release date
BCBS	*Progress on Basel II implementation, new workstreams and outreach*	• Progress on Pillar 1, focus on other two pillars • New workstreams in the areas of liquidity risk, the definition of capital and economic capital • Outreach to non-member countries and the industry	May 2007
CGFS	*Financial stability and local currency bond markets*	• Benefits achieved by EMEs by developing local currency bond markets • Policy issues and challenges • Data issues	July 2007
CPSS	Red Books on payment systems in *Serbia* and *Turkey*	• Reference works on payment systems in these two countries	June 2007
CPSS	*Progress in reducing foreign exchange settlement risk*	• Assessment of progress made • Recommendations to reduce and control remaining large and long-lasting exposures and to consolidate progress	July 2007
FSF	*Update of FSF's 2000 report on highly leveraged institutions*	• Reassessment of the financial stability issues and systemic risks posed by hedge funds • Recommendations for financial authorities and market participants	May 2007

Source: Relevant bodies' websites (www.bis.org, www.fsforum.org). Table 1

Supervisors have also made strong progress on coordinating home-host implementation issues at the level of individual banks, particularly for Pillar 1 (minimum capital requirements). The AIG is now focusing its attention on Pillar 2 (supervisory review process) and will also begin work on Pillar 3 (market discipline). Many of the home-host issues under review by the AIG are not new but have come to the fore as a result of the rapid globalisation of the banking sector. Basel II has served as a catalyst to encourage greater cooperation and communication between jurisdictions and the industry. The input, both formal and informal, from industry groups, individual firms and other constituents is particularly helpful in guiding this process.

… new workstreams in the areas of funding liquidity risk …

The BCBS reported on three new workstreams in the areas of liquidity risk, the definition of capital, and economic capital. First, the Committee recently initiated a review of jurisdictions' approaches to supervising and regulating funding liquidity risk. Its Working Group on Liquidity is currently conducting a survey of regulatory and supervisory practices. The survey will also assess how liquidity risk is managed under the assumption of stressed market conditions. Based on the results of the project, the BCBS will determine what further action, if any, is needed.

… the definition of regulatory capital …

Second, the BCBS has launched an initiative to review the definition of regulatory capital across jurisdictions, given the remarkable advances in banks' economic capital management frameworks as well as the development of the markets for various capital instruments, notably hybrid products. The Definition of Capital Subgroup is starting with a stocktaking exercise on the current definition of capital in member jurisdictions as well as fact-finding on how market participants, including rating agencies, perceive and value the equity-like characteristics of various capital instruments. This fact-finding work will focus on the fundamental aspects of capital, such as its capacity to absorb losses. The Subgroup will also look at the role of accounting in the calculation of regulatory capital and the relationships between regulatory definitions and firms' own definitions of capital in their internal economic capital models. Third, at its March meeting, the Basel Committee gave its Risk Management and Modelling Group the mandate to assess the range of practice in banks' approaches to economic capital measurement and management. This effort supports supervisors' objective to stay on top of evolving risk management techniques, and reinforces the AIG's work on Pillar 2. Areas of potential emphasis include: new measurement approaches for credit risk, the treatment of diversification effects, the assessment of complex counterparty credit risks, the treatment of interest rate risk, and firms' approaches to validation of internal capital assessments.

… and economic capital

Expanded cooperation with the broader supervisory community and the industry

The BCBS continues to expand its cooperation with the broader supervisory community and the industry as it has benefited significantly from their input on its various initiatives. It recently established the International Liaison Group (ILG) to provide a forum for deepening its engagement with supervisors around the world on a broad range of issues.[2] In addition, the Committee is in the process of identifying practical ways to increase the participation of non-member countries in the work of its other subcommittees. It will engage the industry on financial market, risk management, supervisory and regulatory developments that are forward-looking and of common interest to supervisors and the industry. Input from a range of constituents on these issues is an important contribution to shaping the Committee's future agenda.

Committee on the Global Financial System

On 9 July 2007, the CGFS released a report on *Financial stability and local currency bond markets*. It was prepared by a working group which drew on a series of regional workshops and a statistical survey.

CGFS notes reduction in exposure to currency depreciation

One major finding of the report is that exposure to currency depreciation risk has declined in most emerging market economies (EMEs). Net foreign currency exposures vis-à-vis non-residents (an important part of so-called currency mismatches) have fallen substantially. In addition, the proportion of

[2] New workstreams initiated by the ILG include: a project to assess the range of practice in approaches to risk-based supervision; an information exchange on jurisdictions' approaches to achieving sound provisioning and reserving practices; and an assessment of how the rapidly growing area of microfinance fits into existing supervisory frameworks.

financial contracts and instruments between residents that are denominated in foreign currency (notably domestic bonds and bank deposits or loans) has been reduced. This mainly reflects specific debt management policies designed to reduce risks, although exchange rate appreciation did help in recent years. A stress test conducted for the report shows that several countries previously hit by crises have become much less vulnerable to financial turbulence. There has therefore been a deliberate and substantial reduction in borrowers' exposures to the risk of currency depreciation.

Countries succeed in developing local currency yield curves …

Many countries have succeeded in developing local currency yield curves across the maturity spectrum. The deepening of local currency bond markets across a range of maturities has encouraged increased participation by institutional investors such as insurance companies, pension funds and mutual funds (which in turn contributes to deeper markets). Furthermore, local currency bond markets help agents price and hedge maturity risks. They also foster market discipline, contributing to better policies and governance in the public and private sectors.

Notwithstanding these substantial benefits, the shift in the composition of debt from external foreign currency bonds to domestic local currency bonds raises two possible issues that policies may need to address.

… but potential risks stem from maturity mismatches …

The first issue is that, because the maturity of domestic bonds is on average shorter than the maturity of external bonds, the exposures to interest rate and refinancing risks have increased. Yet the risks from such exposures are probably less serious than those from large currency mismatches.

… and debt servicing costs

A second issue is that higher interest rates on domestic bonds than on external bonds (allowing for exchange rate changes) mean that debt servicing costs are increased. Governments in several countries which had faced major financial crises in the past have been prepared in the initial stages to pay higher interest rates in order to lengthen the maturity of their debt issuance. More effective domestic macroeconomic policies (which have lowered inflation) and a very favourable international environment, however, have contributed to a substantial reduction in medium- and long-term interest rates across the EMEs. This narrowing of the gap between domestic and foreign interest rates has made local currency financing more attractive. Sustaining this virtuous circle requires continued fiscal discipline.

Three policy challenges

The report identifies three policy challenges posed by nascent local currency bond markets, which lack the features that help more mature markets work well even in volatile conditions. The first such challenge is liquidity: bond markets should be liquid enough for exposures to be managed and also to allow the rapid adjustment of portfolios without significant disruption to the market. The second is the fostering of local currency debt issuance by the private sector, and not just by government. The third relates to the risks that could arise if exposures are unduly concentrated.[3]

[3] The report identifies two main aspects of risk concentration. One concerns the concentration of credit and market risks in banking systems, which local currency bond markets make easier to hedge in EMEs. The other pertains to the holding of EME local currency bonds by non-residents, which can stabilise domestic markets but can also accentuate exchange rate and financial market responses to shocks, especially when financial markets in the early stages of

Finally, the report highlights some data issues,[4] together with the need for further analysis on risk exposures, in particular through derivatives markets.

Committee on Payment and Settlement Systems

In July, the CPSS issued a consultative report on reducing foreign exchange settlement risk. In June, it also published two reference documents on payment systems, one on Serbia and one on Turkey.

CPSS notes progress in reducing foreign exchange settlement risk …

The consultative report on *Progress in reducing foreign exchange settlement risk* analyses developments in this area, since the endorsement in 1996 of a comprehensive strategy by G10 central banks to reduce the systemic risks that arose from the arrangements then used to settle foreign exchange trades.[5] The consultative report concludes that the central bank strategy has achieved significant success, evidenced most visibly by the establishment and growth of CLS Bank, which currently settles on average more than $3 trillion each day in FX-related payment obligations. However, at the same time, a notable share of FX transactions is settled in ways that still generate significant potential risk across the global financial system, so further action is needed. The report therefore recommends specific actions by individual institutions, industry groups and central banks to reduce and control remaining large and long-lasting exposures and to guard against a risk of reversing the important progress already made. The recommendations pertain to the use of payment-versus-payment settlement services, bilateral netting and correspondent banking. The report is open for comments until 12 October 2007.

… but highlights remaining risks and makes recommendations

The CPSS periodically publishes reference works on payment systems in various countries, widely known as "Red Books". These are published annually for CPSS member countries and occasionally for non-members. In June, the CPSS published its first Red Book for *Serbia* and its second Red Book for *Turkey*.

Financial Stability Forum

On 19 May 2007, the FSF issued an *update* of the Report of the Working Group on Highly Leveraged Institutions, published in 2000. The update was produced in response to a request by G7 Finance Ministers and central bank Governors.

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development are thin. Market intelligence suggests that holdings of EME local currency bonds by foreign investors are larger than what available data suggest, especially because of exposures through derivatives.

[4] The CGFS has established a sub-working group to assess and recommend changes in data collection.

[5] The strategy endorsed was motivated by the finding that banks' foreign exchange settlement exposures to their counterparties were in many cases extremely large relative to their capital, lasted overnight or longer and were poorly understood and controlled. To support the assessment of progress made, in the second quarter of 2006 the CPSS, together with 27 central banks, organised a survey on the size, duration, concentration and control of FX settlement exposures at 109 institutions worldwide that are active in the FX market.

The report recognises the contribution hedge funds have made to financial innovation and market liquidity, and notes that their activity has expanded rapidly since the FSF's original report. The prime broking and dealing relationships between hedge funds and firms that are core intermediaries, in areas such as OTC derivatives dealing and securities financing, clearing and settlement, have become more central to the robustness of the financial system. While risk management techniques and capacity at hedge funds and core intermediaries have been improving, products and markets have become more complex, resulting in risk management, measurement and operational challenges. Dealer firms' direct current and potential credit exposures to hedge funds are reported to be modest in relation to their capital. However, indirect exposures, such as those via wider market liquidity erosion, are difficult to gauge. Moreover, the diversity of methodologies and measures of risk used by different counterparties, and exposure aggregation challenges, present problems for supervisors. There has been some erosion of counterparty discipline recently (eg declining initial margins), reflecting the strength of the competition for hedge fund business.

FSF reassesses financial stability risks posed by hedge funds

Public policy and private initiatives have encouraged sound practices among hedge fund managers in the areas of risk management and valuation systems, information provision and market conduct controls. These initiatives have also encouraged investors to evaluate the suitability of hedge fund investment in the light of investment objectives, risk tolerance and portfolio diversification. In some areas, market discipline can be buttressed by supervisors and regulators setting norms regarding strengthened counterparty risk management practices, and such work is under way. Rapidly changing products, rising trading volumes and closer market integration underscore the importance of continuing attention to infrastructure improvements, especially in the areas of documentation and settlement procedures for new products, capacity improvements to cope with volume expansions in stress conditions, and connectivity between post-trade derivatives services and other systems.

Strengthening counterparty risk management practices

In the light of the above, the report makes the following recommendations:

Five recommendations for financial authorities and market participants

- Supervisors should encourage core intermediaries to continue to strengthen their counterparty risk management practices.
- Supervisors should work with core intermediaries to further improve their robustness to the potential erosion of market liquidity.
- Supervisors should explore and evaluate the extent to which developing more systematic and consistent data on core intermediaries' consolidated counterparty exposures to hedge funds would be an effective complement to existing supervisory efforts.
- Counterparties and investors should act to strengthen the effectiveness of market discipline, including by obtaining accurate and timely portfolio valuations and risk information.
- The global hedge fund industry should review and enhance existing sound practice benchmarks for hedge fund managers in

the light of expectations for improved practices set out by the official and private sectors.

The report underlines the importance of ongoing cooperation among financial authorities, as well as of continuing dialogue with a range of market participants and actors. The FSF will monitor work on these recommendations and report to the G7 Finance Ministers and central bank Governors on progress made.