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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) issued a statement about the usefulness of its ongoing initiatives in the light of recent financial market developments and continued work in a number of areas. The Financial Stability Forum (FSF) met in New York, formed a working group on market and institutional resilience, and reviewed its offshore financial centres initiative, as well as the implementation of recommendations in the area of highly leveraged institutions. Table 1 provides an overview of these and other developments.

Basel Committee on Banking Supervision

At its October meeting, the BCBS observed the usefulness of its work in various areas in view of the recent financial market turbulence. Also in October, the Committee issued a statement welcoming endeavours to enhance transparency for cover payments, as well as a consultative document on the Guidelines for Computing Capital for Incremental Default Risk in the Trading Book.

Basel Committee's initiatives help address issues and risks arising from recent market turbulence …

At the conclusion of its 8–9 October meeting, Nout Wellink, Chairman of the BCBS, noted that the Committee's ongoing initiatives help address the types of issues and risks arising from the recent financial market turbulence. In particular, the Committee underscored the importance of implementing the Basel II capital framework, strengthening supervision and risk management practices in areas like liquidity risk, and improving the robustness of valuation practices and market transparency for complex and less liquid products. The Committee continues to assess the supervisory and risk management issues arising from recent financial market developments and, where appropriate, will consider supervisory responses that are pragmatic and proportionate.

… by strengthening the capital framework …

With regard to strengthening the capital framework, Committee members agreed that Basel II implementation will help make the capital base more relevant to banks' risk profiles and that the Committee will closely monitor its impact. The framework will also serve to create incentives for better risk measurement and management, including for securitisation exposures and liquidity lines for asset-backed commercial paper programmes. The Committee has also been working to introduce new standards for banks to hold capital against the default risk associated with complex, less liquid credit products in the trading book. It agreed to seek public consultation on the proposed standards and to assess their impact on banks' capital requirements. The Committee also emphasised the key role of Pillar 2 (the Supervisory Review Process).

… through liquidity supervision …

As far as liquidity supervision and regulation is concerned, earlier this year the Committee initiated a review of jurisdictions' approaches to supervising and regulating funding liquidity risk. This work will take account of lessons learned from recent market events, including how liquidity risk is assessed by banks and supervisors under the assumption of stressed market conditions and the risks related to off-balance sheet exposures.

… enhancing bank valuation practices …

Earlier this year the Committee launched an initiative to assess the reliability and auditability of fair value estimates, including the assessment of market liquidity in valuation methodologies. This work builds on its June 2006 guidance on the use of the fair value option and its current work on the trading book.

… and market discipline

Finally, introducing Pillar 3 (Market Discipline) of Basel II will improve quantitative and qualitative information available to the marketplace on the risk profile of banks, including risks associated with securitisation exposures, the nature of such exposures and the risks that have been retained.

Efforts to enhance transparency for cover payments

In a *newsletter* published on 12 October, the Committee issued a statement welcoming the dialogue between the public and private sector over the issue of enhanced transparency for cover payments[1] initiated by the industry through the Wolfsberg Group and the Clearing House Association as well as the proposals under discussion in the SWIFT community to increase the transparency of transfers. A solution improving transparency in international payments should aid anti-crime efforts worldwide. The Committee encourages the industry, which is best placed to design the technical solutions to meet this challenge, to proceed with all the necessary changes in order to implement these solutions for all relevant standards of messages as soon as is feasible. The Committee encourages the effective and genuine use of such solutions. It has also asked its AML/CFT Expert Group to review the supervisory issues related to cover payments and the industry's initiative, in coordination with all interested stakeholders and in particular the FATF, overseers of payment systems and the industry, in order to reach a consensus on principles informing supervisory policies and priorities for the implementation of the transparency rules.

In a consultative paper …

On 12 October, the BCBS also issued for comment a consultative paper on the *Guidelines for Computing Capital for Incremental Default Risk in the Trading Book.* The paper is open for comment until 15 February 2008.

1 Cover payments are used in correspondent banking in particular to execute transfers ordered by customers in foreign currencies. This technique of cover payments has advantages for banks, but the current messaging standards do not ensure full transparency for the intermediary banks on the transfers they are helping to execute. This has in some cases raised concerns about the risk that such a type of message could be chosen on purpose to conceal the names of parties to a transaction and about the ability of the intermediary banks to comply with their obligations.

Main initiatives by Basel-based committees and groups

Press releases and publications over the period under review

Body	Initiative	Thematic focus	Release date
BCBS[1]	*Financial market developments and the work of the Basel Committee*	• Implementing Basel II • Strengthening supervision and risk management practices for liquidity risk • Improving the robustness of valuation practices and market transparency for complex and less liquid products	October 2007
	Transparency in payments messages	• Encourage industry action to enhance information available to intermediary banks processing cover payments • Consensus building on principles informing supervisory policies and priorities for the implementation of the transparency rules	
	Guidelines for computing capital for incremental default risk in the trading book	• Additional guidance on existing general principles • Guidance on supervisory evaluation of internal models	
FSF	*FSF meeting in New York*	• Review of recent financial market turbulence • Review of progress of work in the areas of market and institutional resilience and highly leveraged institutions	September 2007
	Offshore financial centres	• Progress in OFC compliance • Support of ongoing efforts • Continued FSF engagement	
	Market and institutional resilience	• Establishment of working group and identification of workplan • Focus areas to include risk management; valuation, accounting and risk disclosure; credit ratings; supervisory principles	October 2007
	Highly leveraged institutions	• Progress report on implementing recommendations of Highly Leveraged Institutions Update Report	

[1] On 24 September 2007, the Joint Forum's parent organisations, the Basel Committee on Banking Supervision (BCBS), the International Organization of Securities Commissions (IOSCO) and the International Association of Insurance Supervisors (IAIS), announced the appointment of Mr John C Dugan, Comptroller of the Currency in the United States, as Chairman of the Joint Forum.

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

The Basel/IOSCO Agreement reached in July 2005 (The Application of Basel II to Trading Activities and the Treatment of Double Default Effects) contained several improvements to the capital regime for trading book positions. Among the revisions to the Market Risk Amendment was a new requirement for banks that model specific risk to measure and hold capital against default risk that is incremental to any such risk captured in the bank's value-at-risk (VaR) model. The incremental default risk charge (IDRC) was incorporated into the trading book capital regime in response to the increasing amount of exposure in banks' trading books to credit risk embedded in often illiquid products whose risk is not reflected in the VaR. The requirement for the IDRC was set forth in the form of very high-level standards in paragraphs 718(xcii) and 718(xciii) of the Basel II Framework.[2]

The Committee expects banks to develop their own internal models for calculating a capital charge for incremental default risk in the trading book. This paper provides additional guidance on how the general principles in paragraphs 718(xcii) and 718(xciii) may be met and contains both guidance on how supervisors will evaluate internal models and fallback options deemed acceptable by the Committee.

… BCBS provides additional guidance for computing capital for incremental default risk

Banks are expected to fulfil the principles for the IDRC laid out in this document to receive specific risk model recognition. However, banks that have already received the specific risk model recognition under the 1996 Market Risk Amendment do not have to implement the IDRC until 1 January 2010.

Financial Stability Forum

On 25–26 September, the FSF held a *meeting* in New York. Members reviewed recent strains in global financial markets and announced the formation of a working group on market and institutional resilience. They also reviewed the Forum's offshore financial centres (OFC) initiative and heard reports on progress in work to address the recommendations of its May 2007 Highly Leveraged Institutions (HLI) Update Report. The preliminary report of the working group on market and institutional resilience and the HLI progress report were published in October.

In the September meeting, FSF members discussed the implications for financial stability of the recent turbulence in global financial markets and what might need to be done to strengthen financial system stability and resilience. Members noted signs of stabilisation in money and to some extent credit markets, although liquidity remains low in several market segments. They agreed that the process of adjustment may take some time, depending among other things on the restoration of confidence in valuations of credit instruments and in assessments of counterparty creditworthiness. In this context, the FSF would welcome the adoption of common guidelines for valuation, particularly for complex illiquid products. It also welcomed the progress being made with regard to the implementation of Basel II.

At its September meeting, FSF discusses financial stability implications of recent market turbulence …

Members agreed that the global macroeconomic backdrop generally remains strong, underlying credit problems have been limited to a small

[2] The Basel Committee set up the Accord Implementation Group on the Trading Book (AIGTB) primarily to conduct the work on further clarification, as well as to provide a forum for supervisors to share their experience in overseeing banks' implementation of the trading book capital regime. As there is no clear industry standard for measuring incremental default risk for the trading book, the AIGTB has worked closely with industry groups in developing principles for implementing the new charge that build off the principles in banks' internal approaches. To evaluate the quantitative impact of the guidelines on banks' portfolios, the Basel Committee is currently conducting a data collection exercise.

proportion of credit instruments, and the capital of regulated institutions has remained at sound levels.

… and announces working group on market and institutional resilience

FSF members noted that the turmoil in global financial markets in recent months has raised important concerns that require careful consideration by financial policymakers. Some weaknesses will be addressed through adjustments in the private sector. In other areas authorities will need to prompt or take action. To help formulate an appropriate and coordinated international response, and following a request by the G7 Finance Ministry Deputies, the FSF announced the formation of a Working Group composed of national authorities and chairs of the relevant international bodies. The Working Group, chaired by FSF Chairman Mario Draghi, set out to analyse the underlying causes of the recent market turbulence and to make proposals to enhance market and institutional resilience.

Workplan to focus on …

The Working Group issued a *preliminary report* on 15 October, setting out the Group's workplan and identifying some of the areas that the Group will focus on. Drawing on planned and ongoing work of the relevant international supervisory, regulatory and central bank committees, the Group will develop a diagnosis of the causes of recent events, identify the weaknesses that merit attention from policymakers and recommend actions needed to enhance market discipline and resilience. With respect to risk management practices, the report noted that turmoil has brought to light interactions between credit, market liquidity and funding liquidity risks that many regulated financial institutions did not anticipate. On valuation, risk disclosure and accounting, the recent turmoil has exposed shortcomings in the transparency and valuation of complex products. It has also posed questions about principles and practices for the consolidation of related off-balance sheet entities. Regarding the role of credit rating agencies, issues have been raised about potential conflicts of interest in their activities, their role in the development of structured finance products and investors' uses of ratings of these products. The Group will also consider what lessons to draw for the regulation and supervision of liquidity management and off-balance sheet risk exposures, and will identify any other areas in which supervisory oversight might need to be adapted to strengthen the financial system. Regarding the authorities' capacity to respond to episodes of market turbulence (in terms of the instruments available to central banks and supervisors in times of distress and coordination between them at the national and international level), the Working Group will take stock of the current initiatives and identify the key issues meriting attention.

… risk management practices …

… valuation, risk disclosure and accounting …

… the role of credit rating agencies …

… and supervisory principles

FSF considers OFC initiative …

At the September meeting, the FSF also considered its OFC initiative, based on a recent review conducted by its OFC Review Group that drew on input and contributions from member bodies.[3] First, members noted that, owing not least to the FSF initiative and efforts of its members, significant progress has been observed by the IMF in its assessments of OFCs'

3 At its meeting in Tokyo in March 2005, the FSF announced a new process to promote further improvements in OFCs. This reflected the need to address remaining problems in several OFCs, notably in the areas of effective cross-border cooperation and information exchange and adequacy of supervisory resources. At the time, the FSF agreed to review the adequacy of its initiative in addressing the current concerns held by its members in two years' time.

compliance with international standards and by IOSCO in its engagement with selected jurisdictions on cooperation and information exchange practices. However, a few concerns remain. Second, the FSF considered that it should continue to support the ongoing efforts of FSF members, which are appropriate to the concerns that are felt to exist. Third, the FSF's interest in fostering compliance with international standards in onshore and offshore jurisdictions, including better cooperation and information exchange, remains undiminished. Therefore the Review Group should remain ready to consider material problems, or potential problems, that members say they cannot resolve bilaterally and to recommend to the FSF ways in which it can support its members' efforts. The range of potential follow-up actions identified in 2005 remains available to be used. Looking ahead, the FSF's interest in the OFC initiative should be increasingly risk-focused,

While the hedge fund sector has not been the primary source of the recent market turmoil, the severity of market problems has highlighted the importance of ensuring sound counterparty risk management at regulated institutions and fostering the exchange of relevant information between hedge funds and their counterparties. The FSF's May 2007 Highly Leveraged Institutions Update Report examined important issues in these areas and made a series of recommendations.

… and hears progress report on work to address recommendation of HLI Update Report

At the September meeting, the FSF received a *progress report* (published on 15 October) on work to address these recommendations. A first set of recommendations in the Update Report pertained to strengthening core firms' risk management practices. Over the summer, supervisors made good progress in their collaborative review of the management of counterparty exposures at the core global financial intermediaries, including as they relate to hedge funds. The review of the current state of practice was completed before the summer. The second phase is delving more deeply into a narrower set of issues to identify the scope for enhancements and to formulate recommendations. Another recommendation of the Update Report related to improving data on core intermediaries. Supervisors in the largest financial centres are discussing at working level what survey data, both quantitative and qualitative, on counterparty exposures it would be feasible and useful to collect from intermediaries on a consistent basis across jurisdictions. Finally, the Update Report recommended action by investors and hedge funds to strengthen transparency, market discipline and sound practice standards. A number of private sector initiatives are now under way in this domain.[4]

[4] A working group of 14 leading hedge fund managers based mainly in the United Kingdom was formed in June to review best industry practice. On 10 October, the Hedge Fund Working Group issued a consultation document proposing 15 best practice standards covering fund governance, valuation, risk management, disclosure to investors and counterparties, and "activism".