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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) released a paper on the management and supervisory challenges related to liquidity risk. Several committees and groups collaborated through the Financial Stability Forum (FSF) on initiatives aimed at enhancing the resilience of the financial system. In this context, the BCBS announced steps to strengthen the banking system, and the Joint Forum published an updated version of its 2005 report on credit risk transfer. The FSF released a report bringing together these and other initiatives to enhance market and institutional resilience. Table 1 provides an overview of these and other developments.

Basel Committee on Banking Supervision

BCBS releases paper on liquidity risk management and supervisory challenges …

On 21 February, the BCBS released a paper entitled *Liquidity risk: management and supervisory challenges*. The paper draws on the work of the Committee's Working Group on Liquidity, established in December 2006 to review liquidity supervision practices in member countries. This mandate included an evaluation of the type of approaches and tools used by supervisors to assess liquidity risk and banks' management of liquidity risks arising from financial market developments.

The market turmoil that began in mid-2007 has highlighted the crucial importance of market liquidity to the banking sector. The contraction of liquidity in certain structured product and interbank markets, as well as an increased probability of off-balance sheet commitments coming onto banks' balance sheets, led to severe funding liquidity strains for some banks, and to central bank intervention in some cases. In response to these market events, the Working Group's original mandate was expanded and it has also made initial observations on the strengths and weaknesses of liquidity risk management in times of difficulty. These observations, together with those provided by the review of national liquidity regimes, formed the basis of the report, which was submitted to the Basel Committee in December 2007.

… highlighting factors affecting liquidity risk management …

The report highlights financial market developments that affect liquidity risk management, paying particular attention to the liquidity management challenges posed by increasingly complex financial instruments, the rapid growth of securitisation, collateral usage, intraday liquidity needs and cross-border flows. The paper subsequently discusses national supervisory regimes and their components, focusing on their key features, the diversity in liquidity regimes and the implications of diverse regimes for supervisors and cross-border firms. Initial observations from the current period of stress are then recorded. Finally, the report outlines potential future work related to liquidity risk management and supervision, including an update to the BCBS's *Sound practices for managing liquidity in banking organisations*. Possible areas of focus here comprise: the identification and measurement of the full range of liquidity risks, stress testing, the role of supervisors, the management of intraday liquidity risks arising from payment and settlement obligations (working with the Committee on Payment and Settlement Systems (CPSS)), the management of cross-border flows and the role of disclosure.

… describing national supervisory regimes …

… and outlining potential future work

On 16 April, the BCBS announced a series of *steps* to help make the banking system more resilient to financial shocks. These include:

BCBS announces enhancements to Basel II and other measures …

- Enhancing various aspects of the Basel II Framework, including the capital treatment of complex structured credit products, liquidity facilities to support asset-backed commercial paper (ABCP) conduits, and credit exposures held in the trading book. At the same time, the Committee noted the importance of prompt implementation of the Basel II Framework, as this will help address a number of the shortcomings identified by the financial market crisis.
- Strengthening global sound practice standards for liquidity risk management and supervision, which the Committee will issue for public consultation in the coming months.
- Initiating efforts to strengthen banks' risk management practices and supervision related to stress testing, off-balance sheet management, and valuation practices, among others.
- Enhancing market discipline through better disclosure and valuation practices.

These measures will be introduced in a manner that promotes long-term bank resiliency and strong supervision, while seeking to avoid potentially adverse near-term impacts as the process of repricing of risk and deleveraging continues in financial markets. The Committee's actions are also aimed at supporting the FSF's Working Group on Market and Institutional Resilience, which on 12 April released its report to the G7 Finance Ministers and central bank Governors (see Financial Stability Forum section below).

… with a view to making the banking system more resilient to financial shocks …

The Committee reiterates the importance of implementing the Basel II Framework as it better reflects the types of risks banks face in an increasingly market-based credit intermediation process. Basel II is just now being implemented in most Basel Committee member countries and many jurisdictions around the globe.

… while reiterating the importance of Basel II implementation in this context

The market turmoil has already provided important lessons that will help guide the Committee in further strengthening certain aspects of the Framework. The BCBS is introducing a number of measures to help ensure sufficient capital, to capture off-balance sheet exposures more effectively and to improve regulatory capital incentives.

Initiatives by Basel-based committees and groups Press releases and publications over the period under review			
Body	Initiative	Thematic focus	Release date
BCBS	*Liquidity risk: management and supervisory challenges*	• Financial market developments that affect liquidity risk management • National supervisory regimes and their components • Initial observations from the current period of stress • Potential future work	February 2008
	Steps to help make the banking system more resilient to financial shocks	• Enhancing certain aspects of Basel II • Strengthening liquidity risk management and supervision • Strengthening banks' risk management practices • Enhancing market discipline	April 2008
Joint Forum	*Credit risk transfer – developments from 2005 to 2007*	• Update of 2005 report to reflect continued growth and rapid innovation in the CRT markets	April 2008
	Cross-sectoral review of group-wide identification and management of risk concentrations	• Expansion on previous reports • Assessment of progress made in the identification and management of firm-wide risk concentrations	
	Customer suitability in the retail sale of financial products and services	• Survey of how supervisors and firms deal with the risks posed by the mis-selling of retail financial products	
Markets Committee	*Monetary policy frameworks and central bank market operations*	• Update of the December 2007 version	April 2008
CPSS	*Statistics on payment and settlement systems in selected countries*	• Statistics for 2006	March 2008
FSF	*FSF meeting in Rome*	• Current challenges in financial markets • Steps being taken to address them • Policy options going forward	March 2008
	Report on enhancing market and institutional resilience	• Factors and weaknesses underlying the current market turmoil • Recommendations in five areas	April 2008

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

In particular, the Committee will revise the Framework to establish higher capital requirements for certain complex structured credit products, such as so-called "resecuritisations" or collateralised debt obligations referencing asset-backed securities (ABS CDOs), which have produced the majority of losses during the recent market turbulence. The Committee will also strengthen the capital treatment of liquidity facilities extended to support off-balance sheet vehicles such as ABCP conduits. More detailed proposals will be published later this year. Finally, the BCBS will strengthen the capital requirements in the trading book, where the current value-at-risk based treatment for assessing capital for trading book risk does not capture extraordinary events that can affect many exposures to complex, less liquid structured products.

BCBS to monitor Basel II requirements and capital buffers over the credit cycle

The BCBS will monitor Basel II minimum requirements and capital buffers over the credit cycle. To the extent that this analysis reveals any shortcomings in capital cushions, the Committee will take appropriate measures to help ensure Basel II provides a sound capital framework for addressing banks' evolving and complex risk profiles.

Pillar 2 guidance to be issued

The market turmoil has revealed significant risk management weaknesses at banking institutions. Pillar 2 (the supervisory review process) provides supervisors with additional tools to assess banks' risk management and internal capital management processes. The Committee will issue Pillar 2 guidance in a number of areas to help strengthen risk management and supervisory practices. These relate to the management of firm-wide risks; banks' stress testing practices and capital planning processes; the management of off-balance sheet exposures and associated reputational risks; risk management practices relating to securitisation activities; and supervisory assessment of banks' valuation practices.

Towards global sound practice standards for the management and supervision of liquidity risk

Banks need to have strong liquidity cushions to weather prolonged periods of financial market stress and illiquidity. In July, the BCBS will publish for consultation global sound practice standards for the management and supervision of liquidity risk. These standards will address many of the shortcomings witnessed in the banking sector. Among other weaknesses, these relate to stress testing practices, contingency funding plans, and management of on- and off-balance sheet activity as well as contingent commitments. The Committee will coordinate rigorous follow-up by supervisors to ensure banks adhere to these fundamental principles. The Committee has also launched an initiative to review the need for more consistency in global liquidity regulation and supervision of cross-border banks as a way to enhance their resiliency to financial market stress.

Weaknesses in bank transparency and valuation practices for complex products have contributed to the build-up of concentrations in illiquid structured credit products and the undermining of confidence in the banking sector. The Committee is taking concrete action to promote stronger industry practices in this area.

Joint Forum

The Joint Forum released three publications in April: an update of its 2005 report on credit risk transfer, a cross-sectoral review of group-wide identification and management of risk concentrations and a report on customer suitability in the retail sale of financial products and services.

Joint Forum issues update of its 2005 report on credit risk transfer …

Credit risk transfer (CRT) has grown quickly, often with complex products, and provides concrete benefits to the global financial system. The benefits of CRT are well understood and have not changed since the Joint Forum's first

CRT report in 2005.[1] CRT allows credit risk to be more easily transferred and potentially more widely dispersed across the financial market. It has made the market pricing of credit risk more liquid and transparent. At the same time, however, CRT also poses new risks, and a failure to understand and manage some of these risks contributed to the market turmoil of 2007.

Like the Joint Forum's 2005 report, this *report* focuses on the newest forms of CRT, those associated with credit derivatives. These provided the impetus for the 2005 report, and their continued evolution and growth motivated this update.

Several developments in CRT markets are important for understanding the evolving risks of CRT and its role in the market turmoil of 2007. Since 2005, CRT activity has become significant in two new underlying asset classes: asset-backed securities (ABS) and leveraged loans. Investor demand for tranched CRT products, such as ABS CDOs and collateralised loan obligations (CLOs), has been high. This demand has encouraged substantial origination and issuance of products in these underlying asset classes. ABS CDOs have focused their portfolios on US subprime residential mortgage-backed securities (RMBS), while CLOs have focused on leveraged loans sourced from corporate mergers and acquisitions and leveraged buyouts.

… noting the growth of indices …

Across all CRT asset classes, the growth of indices since 2005 is an important development. Indices now represent more than half of all credit derivatives outstanding, up from virtually nothing in 2004. They are widely used to trade investment grade corporate credit risk across the major markets (Asia, Europe and North America), and have also been created in the ABS and leveraged loan markets, in the form of the ABX and LCDX, respectively. In each of these markets, indices provide a relatively liquid and transparent source of pricing, though the corporate versions are much more liquid than those in other market segments. Market participants have come to view credit derivative indices as a key source of pricing information on these markets. The liquidity and price transparency that indices provide has enabled credit risk to become a traded asset class.

… and the growing complexity of CRT products …

The 2005 report noted the growing complexity of CRT products, and this trend has continued. The report discussed in some detail the complex risks of CDOs, with a particular focus on investment grade corporate CDOs. The 2008 report focuses to a significant degree on ABS CDOs, which are an order of magnitude more complex than investment grade corporate CDOs, since their collateral pool consists of a portfolio of ABS. Each of these ABS is itself a tranche of a securitisation whose underlying collateral is a pool of hundreds or thousands of individual credit assets. Referring to this complexity, one market participant described ABS CDOs as "model risk squared".

As CRT products have become more complex, investors in CRT have grown more diverse and global. More market participants have become comfortable investing in CRT, which is an important factor explaining its growth. On balance, CRT activity has transferred credit risk out of the United

[1] See "Recent initiatives by Basel-based committees and the Financial Stability Forum", *BIS Quarterly Review*, June 2005, pp 93–9.

States into global markets. In addition, since 2005, hedge funds have become an important force in CRT markets.

… which raise issues for rating agencies

The combination of complex products and new investors has presented a business opportunity for credit rating agencies. For a number of years, rating agencies have rated CRT products using the same letter ratings (AAA, AA and so on) originally developed for corporate bonds. Riding the wave of growth of CRT, in recent years structured finance securities have contributed an increasing share of rating agencies' earnings.

All these factors together set the stage for the market turmoil of 2007. Market discipline had been weak as investors in ABS CDOs failed to penetrate complex CRT structures sufficiently to see the underlying risk exposures to the subprime mortgage market. In some cases, investors were too willing to rely solely on credit ratings as a risk assessment tool. Originators saw little incentive, financial or reputational, to monitor the quality of subprime mortgages that could be sold so easily into the securitisation market. It was not until the subprime mortgage market came under stress due to weakening house prices that investors in ABS CDOs became aware that they were also at risk.

Recommendations for market participants and supervisors

Supervisors remain concerned about several aspects of the CRT market: these include complexity and valuation issues, as well as liquidity, operational and reputational risks, and the broader effects of the growth of CRT. To address these concerns and other issues, the report concludes with recommendations directed at market participants and supervisors, with the intention that they use them and the recommendations from the 2005 report as a single package to improve risk management, disclosure and supervisory approaches for credit risk transfer.

Joint Forum review of group-wide identification and management of risk concentrations

On 25 April, the Joint Forum published a *Cross-sectoral review of group-wide identification and management of risk concentrations.* The paper expands on previous reports[2] and explores the extent to which financial conglomerates active in two or more of the banking, securities and insurance sectors currently identify and manage risk concentrations at the firm-wide level. The report also discusses how current and emerging risk techniques, including stress testing and scenario analyses, are employed to identify potential concentrations. It should be noted that the bulk of the work undertaken in compiling this report took place before the market turmoil in the latter half of 2007. Specific

[2] In December 1999, the Joint Forum published its *Risk Concentrations Principles*, which provided supervisors with principles for ensuring the prudent management and control of risk concentrations in financial conglomerates through the regulatory and supervisory process. In November 2001, the Joint Forum published *Risk management practices and regulatory capital: cross-sectoral comparison*. This report noted a trend towards convergence of sectoral approaches to risk management and capital, while remaining neutral as to the extent to which such convergence would increase in the future. The Joint Forum's August 2003 publication, *Trends in risk integration and aggregation*, observed two important trends: (i) a greater emphasis on the management of risk on an integrated firm-wide basis; and (ii) related efforts to aggregate risks through mathematical risk models. However, the 2003 paper noted that firms varied considerably in the practical extent to which important risk management decisions were centralised and that risk aggregation methods were still in the early stages of development.

comments on these events are provided in boxes but the focus of the report is on the management of risk concentrations more generally.

The Joint Forum notes that risk concentrations at most financial conglomerates are still chiefly identified, measured and managed within separate risk categories and within business lines. For instance, credit exposures are considered within banking business units, catastrophe risk concentrations within an insurance business unit and so on. This can be characterised as "silo management".

The report makes two other broad observations: first that, when compared with other risk types, the management of liquidity risk tends not to be as well integrated in a scheme of cross risk analysis (probably because it is not measured in the same way as other risks); and second, that insurance-led conglomerates seem to be somewhat more experienced in undertaking the design of integrated cross risk scenario analysis, perhaps because the nature of insurance business risks, particularly in the property and casualty business, makes them less readily amenable to linear analysis.

Joint Forum paper on customer suitability in the retail sale of financial products and services …

On 30 April the Joint Forum released a paper on *Customer suitability in the retail sale of financial products and services*. The report considers how supervisors and regulated firms across the banking, securities and insurance sectors deal with the risks posed by the mis-selling of retail financial products, including related regulatory requirements, both with regard to disclosure of information to retail investors and requirements for firms to determine whether recommended investment products are suitable for such investors.

… based on a survey of some 90 institutions

Based on a survey of some 90 financial firms around the world, a key finding of the report is that the notion of suitability is recognised in regulatory requirements across all sectors, but to a varying extent. An interesting observation is that disclosure requirements for conflicts of interest (for example, ownership structures of the sales agent, or remuneration to be received) are generally less rigorous for sales of insurance than for other products. The survey further discusses, by country and institution type, issues such as the identity of the entity liable for the mis-selling of products, dispute resolution procedures and the application of robust suitability policies.

Financial Stability Forum

FSF discusses policy options at its 19th meeting …

At its *19th meeting* in Rome on 28–29 March, the FSF discussed the current challenges in financial markets, the steps being taken to address them and policy options going forward. It reviewed the report delivered to G7 Finance Ministers and central bank Governors on enhancing market and institutional resilience (see below). It also took stock of efforts by the hedge fund industry to review and enhance sound practice benchmarks, in particular those of the UK-based Hedge Fund Working Group and the US-based Asset Managers' Committee and Investors' Committee, with a view to increasing transparency and improving risk management practices. Finally, the FSF discussed work under way at the IMF and OECD with regard to sovereign wealth funds (SWFs), consisting of efforts to identify a set of voluntary best practice guidelines relating to the governance, institutional arrangements and transparency of SWFs.

On 12 April the FSF Chairman presented the *Report of the Financial Stability Forum on enhancing market and institutional resilience* to the G7 Finance Ministers and central bank Governors. The report identifies the factors and weaknesses underlying the current market turmoil and makes recommendations in five areas.[3]

… and releases report on enhancing market and institutional resilience …

The report's findings and recommendations are the product of an intensive collaborative effort of the main international bodies and national authorities in key financial centres. They draw on a large body of coordinated work, comprising that of the BCBS, the International Organization of Securities Commissions (IOSCO), the International Association of Insurance Supervisors (IAIS), the Joint Forum, the International Accounting Standards Board (IASB), the CPSS, the Committee on the Global Financial System (CGFS), the IMF, the BIS and the national authorities. Insights were also gained from private sector market participants.

The report sets out to identify the causes underlying the current financial market turmoil. It summarises how a weakening in the US housing market led to a steady rise in delinquencies and, from early 2007 onwards, sharply falling prices for indices based on subprime-related assets, acting as a trigger for a broad reversal in market risk-taking. This entailed a severe contraction of activity in the term interbank market, a substantial rise in term premia (especially in the United States and Europe) and dysfunction in a number of related short-term financial markets. As the turmoil spread, increased risk aversion, reduced liquidity, market uncertainty about the soundness of major financial institutions, questions about the quality of structured credit products, and uncertainty about the macroeconomic outlook fed on each other. Both bank-based and capital market channels of credit intermediation slowed. At the time of writing, eight months after the turmoil broke out, deleveraging continues to pose significant challenges for large parts of the financial system in a number of countries.

… identifying causes …

The report identifies the following underlying financial system weaknesses as having contributed to the financial turmoil: poor underwriting standards (especially in the US subprime sector); shortcomings in firms' risk management practices; poor investor due diligence; poor performance by credit rating agencies in respect of structured credit products; incentive distortions, especially for originators, arrangers, distributors and managers in the originate-to-distribute (OTD) chain, as well as with respect to compensation schemes in financial institutions; weaknesses in disclosure; feedback effects between

… and weaknesses underlying the recent financial market turmoil

[3] In September 2007, the G7 Finance Ministers and central bank Governors asked the FSF to undertake an analysis of the underlying causes and weaknesses behind the recent market turmoil and to set out recommendations for increasing the resilience of markets and institutions going forward (see "Recent initiatives by the Basel-based committees and groups", *BIS Quarterly Review*, December 2007, pp 97–102). An interim report was published in February 2008 (see "Recent initiatives by the Basel-based committees and groups", *BIS Quarterly Review*, March 2008, pp 103–6).

valuation and risk-taking; and weaknesses in regulatory frameworks and other policies.

To address these weaknesses, the report makes a number of recommendations, focusing on five main areas: strengthened prudential oversight of capital, liquidity and risk management; enhancing transparency and valuation; changes in the role and uses of credit ratings; strengthening the authorities' responsiveness to risks; and robust arrangements for dealing with stress in the financial system.

Recommendations in respect of implementing and enhancing Basel II …

In order to strengthen the prudential oversight of capital, liquidity and risk management, the report urges prompt implementation of the Basel II Framework. It also outlines specific proposals with respect to strengthening aspects of the framework dealing with securitisation and off-balance sheet activities (see section above on the BCBS) and makes a number of recommendations for improving the operational infrastructure for OTC derivative instruments.

… improving transparency and valuation …

In an effort to enhance transparency and valuation, the FSF strongly encourages financial institutions to make robust risk disclosures at the time of their mid-year 2008 reports using the leading disclosure practices summarised in the report. Further guidance to strengthen disclosure requirements under Pillar 3 of Basel II will be issued by 2009, including standards for disclosures regarding off-balance sheet vehicles and valuations. In addition, standard setters will take urgent action to improve and converge financial reporting standards for off-balance sheet vehicles, and develop guidance on valuations when markets are no longer active, establishing an expert advisory panel in 2008. Particular attention will be paid to transparency in structured products, as market participants and securities regulators will expand the information provided about securitised products and their underlying assets.

… credit ratings …

In respect of changes in the role and uses of credit ratings, the report recommends that rating agencies implement the revised IOSCO Code of Conduct Fundamentals for Credit Rating Agencies to manage conflicts of interest in rating structured products and improve the quality of the rating process. It further proposes that they differentiate ratings on structured credit products from those on bonds and expand the information they provide. Regulators will review the roles given to ratings in regulatory and prudential frameworks.

… authorities' responsiveness …

Among actions to strengthen the authorities' responsiveness to risks, a college of supervisors will be put in place by end-2008 for each of the largest global financial institutions.

… and arrangements for dealing with stress

Finally, within the context of establishing robust arrangements for dealing with stress in the financial system, central banks will enhance their operational frameworks and authorities will strengthen their cooperative arrangements for dealing with stress.