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V. Structural and regulatory developments

Initiatives and reports concerning financial institutions

April

The Basel Committee on Banking Supervision (BCBS) issued a summary report on its review of standards developed by the International Accounting Standards Committee (IASC).[18] This review was undertaken at the request of the G7 finance ministers and central bank governors.[19] The BCBS reviewed the standards from the perspective of banking supervisors, confining itself to the 15 international accounting standards that have a significant effect on banks. Two standards in particular attracted the Committee's attention. First, it identified several areas where the special standard for bank disclosure (IAS 30, Disclosures in the Financial Statements of Banks and Similar Financial Institutions) could be updated to better reflect the recent evolution of market practices. Second, the BCBS devoted significant attention to the standard that covers the accounting treatment of banks' assets and liabilities (IAS 39, Financial Instruments: Recognition and Measurement). The BCBS suggested approaches that would permit banks to use the IAS 39 hedge accounting framework in ways that are more consistent with their portfolio-based risk management practice. It is worth noting that the BCBS does not believe that the time is right yet to prescribe full fair value accounting in the primary financial statements for all financial instruments. The BCBS dialogue with the IASC on IAS 39 resulted in the establishment by the IASC of a special IAS 39 Implementation Guidance Committee, in which the BCBS as well as the banking industry will be represented.

May

The BCBS published a summary of comments received on *Credit Risk Modelling: Current Practices and Applications*, a report published by its Models Task Force in April 1999.[20] The 1999 report analysed current practices and issues in credit risk modelling and assessed the potential use of credit risk models for supervisory and regulatory purposes.[21] The responses given to the Basel Committee acknowledged that the report addresses the relevant issues in a balanced manner. They also recognised

[18] See *Report to G7 Finance Ministers and Central Bank Governors on International Accounting Standards*, Basel Committee on Banking Supervision, Basel, April 2000 (available on www.bis.org).

[19] In their declaration of 30 October 1998, the G7 finance ministers and central bank governors requested the International Organization of Securities Commissions (IOSCO), the International Association of Insurance Supervisors (IAIS) and the Basel Committee to carry out a timely review of the IASC's standards.

[20] See *Summary of responses received on the report "Credit Risk Modelling: Current Practices and Applications"*, Basel Committee on Banking Supervision, Basel, May 2000 (available on www.bis.org).

[21] It concluded that credit risk modelling could result in better internal risk management, and had the potential to be used in the supervisory oversight of banking organisations. However, before a portfolio modelling approach could be used for regulatory capital requirements, regulators would have to be confident not only that models were being used to actively manage risk but also that they were conceptually sound, empirically validated and produced capital requirements that were comparable across institutions. Significant hurdles, principally concerning data availability and model validation, still needed to be cleared before these objectives could be met, and the BCBS saw difficulties in overcoming them in the timescale envisaged for amending the Capital Accord.

that data shortages make parameter estimation difficult, particularly as regards the tails of distributions, correlations and losses given default. Some respondents challenged the report on certain issues, such as validation, where it was felt that the Committee was searching for a market risk-style backtesting framework. Some respondents also took the report to indicate a wish for uniformity of outputs, arguing that this was neither achievable nor desirable. In response to the comments, the Committee stated that at this stage a robust validation process would be needed to ensure the integrity of any future internal model-based regime. On the comparability of outputs, the Committee noted the points made by respondents but mentioned that any new capital regime would need to provide a level playing field for banking organisations.

The Japanese Financial Reconstruction Commission and Financial Supervisory Agency announced a draft of the basic outline of their plans for the entry of non-financial commercial entities in the banking industry and a draft of the guidelines concerning the licensing of banks established by commercial firms for public comment. The guidelines require banking subsidiaries to: ensure independence of bank management; segregate risks stemming from the parent commercial firm; protect private information of customers; manage risks and ensure an amount of profit and capital best fitting a financial institution's balance sheet structure; and protect customers when offering internet or automated teller machine services.

Initiatives and reports concerning financial markets

May

Following an assessment of the accounting standards issued by the IASC, IOSCO recommended that its members allow multinational issuers to use IAS 30 standards (as supplemented by reconciliation, disclosure and interpretation where necessary to address outstanding substantive issues) at a national or regional level. IOSCO said that its recommendation would facilitate cross-border offerings and listings by multinational enterprises and would promote the further development of internationally accepted accounting standards.

June

The US Commodity Futures Trading Commission (CFTC) proposed a broad revision of its regulatory framework for futures markets. The proposal would replace the current "one size fits all" regulation with broad, flexible core principles, and establish three regulatory tiers: recognised futures exchanges, derivatives transactions facilities and exempt multilateral transactions facilities. The three tiers would match the degree of regulation to the varying nature of the products and the sophistication of the customers that trade in the market. The Commission is also proposing a regulatory framework for clearing organisations designed to reduce systemic risk. The proposed rules would permit clearing organisations overseen by the CFTC, US banking regulators or the Securities and Exchange Commission to clear transactions executed on exempt multilateral transactions facilities as well as bilateral transactions. In order to provide greater legal certainty to the OTC derivatives markets, the Commission proposed to expand and clarify the operation of its Part 35 Exemption for Swap Agreements.

The US Financial Accounting Standards Board (FASB) announced that its new rules on derivatives and hedge accounting would become effective for all publicly traded companies with a fiscal year ending on 15 June 2000 or after. FASB Statement No. 133 requires companies to record derivatives on their balance sheets as assets or liabilities that will be measured at fair value. Companies have to record in the income statement or in other comprehensive income any changes in the value of such instruments designated as hedges that do not closely offset changes in the value of the underlying assets. Responding to companies' comments on its draft proposals, the FASB issued FASB Statement No. 138, which makes a number of amendments to FASB Statement No. 133. These include the ability of companies to hedge the "risk-free" interest rate with either US Treasury or Libor-based benchmarks and the use of intercompany derivatives hedges for foreign currency risk. The objective of the statement is for firms to disclose the market risk potential of derivative contracts.

Initiatives and reports concerning market infrastructure

April

The London Clearing House (LCH) and Clearnet SA, the clearing subsidiary of Paris Bourse, announced plans for the creation of a consolidated European clearing house. The new entity, which should be operational by early 2001, will be user-governed and open to all markets, systems and/or users requiring clearing services. It will use a single set of clearing and netting systems, based on Clearing 21, a technology adapted by Paris Bourse from the Chicago Mercantile Exchange's original software. According to its backers, the merged entity will be the largest central counterparty in Europe for capital, energy and commodity markets, cash and derivatives, traded on regular exchanges and/or on the OTC market. The initiative will further the current wave of consolidation between European exchanges and their securities settlement systems. This consolidation should help reduce the cost of pan-European securities trading. It should also diminish the settlement risks faced by individual firms and the financial system as a whole.

May

The second quarter witnessed several initiatives addressing the systemic, fiscal and law enforcement issues raised by offshore financial centres (OFCs).

The first of these initiatives was the publication by the Financial Stability Forum (FSF) of a set of three categories of OFCs. The assignment of OFCs[22] to the categories was based on the results of a survey of banking, insurance and securities supervisors in both onshore and offshore jurisdictions conducted by the FSF. For each OFC, respondents were asked to assess the quality of supervision and the degree to which it cooperated with other jurisdictions.

The groupings (shown in the box on the next page) were published by the Forum in the hope that OFCs will rapidly take steps to raise the quality of their supervision and cooperation. The release of the groupings follows the publication in March 2000 of a report on offshore financial activities by the Working Group on Offshore Financial Centres of the FSF.[23] The report noted that some OFCs were well supervised and cooperated with other jurisdictions. At the same time, it concluded that OFCs that were unable or unwilling to adhere to internationally accepted standards for supervision, cooperation and information-sharing created a potential systemic threat to global financial stability. Such OFCs constituted weak links in an increasingly integrated international financial system and hindered broader efforts to raise global standards of soundness and transparency.

To address the concerns posed by some OFCs, the report recommended a framework to encourage such jurisdictions to adhere to relevant international standards. The framework identifies priority standards for OFCs, recommends that the IMF take responsibility for managing the process of assessing OFCs' adherence to these standards, and proposes a menu of incentives that could be applied to encourage such adherence. The framework endorsed by the Forum outlines several steps through which OFCs can demonstrate their commitment to achieve high standards of supervision and cooperation with other authorities. These include a declaration of intent by a jurisdiction to implement relevant standards, completing self-assessments of adherence to these standards, addressing identified shortfalls, and undergoing an external assessment.

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[22] See the FSF release of 26 May 2000 (available on www.fsforum.org/Press/Home.html).

[23] The Working Group's report is available on www.fsforum.org.

Categories of offshore financial centres

Group I

The jurisdictions in this category are generally perceived as having legal infrastructures and supervisory practices, and/or a level of resources devoted to supervision and cooperation relative to the size of their financial activities, and/or a level of cooperation, that are largely of good quality and better than in other OFCs.

These jurisdictions are Hong Kong SAR, Luxembourg, Singapore and Switzerland. Dublin (Ireland), Guernsey, the Isle of Man and Jersey are also generally viewed in the same light, though continuing efforts to improve the quality of supervision and cooperation should be encouraged in these jurisdictions.

Group II

The jurisdictions in this category are generally perceived as having legal infrastructures and supervisory practices, and/or a level of resources devoted to supervision and cooperation relative to the size of their financial activities, and/or a level of cooperation that are largely of a higher quality than Group III, but lower than Group I.

These jurisdictions are Andorra, Bahrain, Barbados, Bermuda, Gibraltar, Labuan (Malaysia), Macau SAR, Malta and Monaco.

Group III

The jurisdictions in this category are generally perceived as having legal infrastructures and supervisory practices, and/or a level of resources devoted to supervision and cooperation relative to the size of their activity, and/or a level of cooperation, that are largely of a lower quality than in Group II.

These jurisdictions are Anguilla, Antigua and Barbuda, Aruba, Belize, the British Virgin Islands, the Cayman Islands, the Cook Islands, Costa Rica, Cyprus, Lebanon, Liechtenstein, the Marshall Islands, Mauritius, Nauru, the Netherlands Antilles, Niue, Panama, St Kitts and Nevis, St Lucia, St Vincent and the Grenadines, Samoa, Seychelles, the Bahamas, the Turks and Caicos Islands and Vanuatu.

The Deutsche Börse (DB) and the London Stock Exchange (LSE) announced a merger of their operations. The new entity, called iX, will pool the exchanges' business in equity and derivative instruments, with Xetra, the DB's electronic trading system, becoming the common trading platform. The two exchanges also announced that they had signed a letter of intent with Nasdaq to create a separate joint venture for growth stocks. Trading in blue-chip stocks will be conducted in London, while that in growth stocks will be based in Frankfurt. The exchanges envisage separate regulatory regimes. They will also retain their existing clearing and settlement arrangements. The merger will create the third biggest stock market by turnover after the New York Stock Exchange and the Tokyo Stock Exchange. The new entity could further expand its global market share if other European exchanges decide to join.[24]

June

The Organisation for Economic Co-operation and Development (OECD) issued a report setting out the progress made in identifying and curtailing harmful tax practices both within and outside the OECD.[25] The report identifies potentially harmful preferential regimes in OECD member countries, identifies jurisdictions meeting the criteria for being tax havens, and provides an update on work with economies outside the OECD area. The report was a first response to the 1998 ministerial mandate to curb harmful tax competition.[26]

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24 The Milan and Madrid bourses have already signed a memorandum of understanding to join iX.

25 See *Progress in Identifying and Eliminating Harmful Tax Practices*, OECD, Paris, June 2000.

26 See *Harmful Tax Competition*, OECD, Paris, April 1998.

After a process of self and peer reviews, the OECD identified 47 preferential tax regimes of member countries as potentially harmful. It will develop guidance to help countries determine whether their potentially harmful regimes are actually harmful in practice. OECD member countries are committed to removing the harmful features of preferential tax regimes by April 2003.

In line with the ministerial mandate on tax havens, the OECD also began a review of a number of other jurisdictions and set out to engage in a dialogue with them. The report identifies 35 jurisdictions meeting the technical criteria for being tax havens.[27] The 35 will be given the opportunity over the next 12 months to determine whether they wish to work with the OECD to eliminate harmful features of their regimes by the end of 2005. Noting that six jurisdictions (Bermuda, the Cayman Islands, Cyprus, Malta, Mauritius and San Marino) have already made a commitment to eliminate harmful tax practices, the OECD is confident that a significant number will choose this direction. The OECD is prepared to help these jurisdictions reach international tax standards but will also consider defensive measures in the case of countries choosing not to commit to eliminate harmful tax practices. The application of such measures would be based on an OECD list of uncooperative tax havens to be completed by 31 July 2001.

The Financial Action Task Force (FATF)[28] announced that it had finalised the assessment of 29 countries and territories according to a set of publicly stated criteria and identified 15 jurisdictions as non-cooperative in the fight against money laundering.[29] The report contains a brief explanation of the deficiencies identified and of the remedial actions that need to be taken to eliminate them.[30]

At its summit in Feira, Portugal, the European Union ended a three-year stalemate over the taxation of non-resident savings by agreeing to exchange information on non-residents’ savings accounts. The agreement was reached after Austria and Luxembourg abandoned their objections to providing such information, requiring them to amend their banking secrecy laws.[31] The UK-led initiative will greatly improve cooperation between EU states in the fight against tax evasion and money laundering. However, its ultimate success will depend on whether other large financial centres (such as Switzerland and the United States) and offshore centres can be persuaded to join in the sharing of information. It should also be noted that the enabling legislation will require the unanimous support of all EU governments and will not be implemented before the year 2002 at the earliest. Moreover, the legislation will not take full effect for another seven years. The agreement led to the abandonment by the European Commission of an original draft directive that would have required EU countries to impose a withholding tax on interest income paid to EU citizens.

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[27] These are: Anguilla, Andorra, Antigua, Aruba, the Bahamas, Bahrain, Barbados, Belize, the British Virgin Islands, the Channel Islands of Guernsey, Sark and Alderney, the Cook Islands, Dominica, Gibraltar, Grenada, the Isle of Man, Jersey, Liberia, Liechtenstein, the Maldives, the Marshall Islands, Monaco, Montserrat, Nauru, the Netherlands Antilles, Niue, Panama, St Kitts and Nevis, St Lucia, St Vincent and the Grenadines, Seychelles, Tonga, the Turks and Caicos Islands, the US Virgin Islands, Vanuatu and Western Samoa.

[28] The FATF is an independent international body set up in 1989 for the purpose of promoting policies to combat money laundering. Its membership of 29 countries includes the major financial centres of Europe, North America and Asia. Its secretariat is located at the OECD.

[29] The countries in question are the Bahamas, the Cayman Islands, the Cook Islands, Dominica, Israel, Lebanon, Liechtenstein, the Marshall Islands, Nauru, Niue, Panama, the Philippines, Russia, St Kitts and Nevis, and St Vincent and the Grenadines.

[30] See *Financial Action Task Force on Money Laundering 1999-2000 Report,* Financial Action Task Force, OECD, June 2000.

[31] The two countries will be allowed to operate a withholding tax system during a transition period.

Chronology of major structural and regulatory developments

Month	Body	Initiative
April 2000	Basel Committee on Banking Supervision	• Releases *Report to G7 Finance Ministers and Central Bank Governors on International Accounting Standards*
	London Clearing House and Clearnet	• Announce plans for the creation of a consolidated European clearing house
May 2000	Basel Committee on Banking Supervision	• Releases *A summary of responses received on the report "Credit Risk Modelling: Current Practices and Applications"*
	International Organization of Securities Commissions	• Recommends that its members allow multinational issuers of securities to use IASC standards at national or regional level
	Financial Stability Forum	• Publishes a set of three categories of offshore financial centres based on the perceived quality of their banking supervision and international cooperation
	Deutsche Börse and London Stock Exchange	• Announce a merger of their operations
	Japanese Financial Reconstruction Commission and Financial Supervisory Agency	• Issue basic outline of plans for entry of non-financial commercial entities in the banking industry and draft of guidelines concerning the licensing of banks established by commercial firms
June 2000	US Commodity Futures Trading Commission	• Proposes a broad revision of its regulatory framework for futures markets
	US Financial Accounting Standards Board	• Publishes its final rules on derivatives and hedge accounting
	Organisation for Economic Co-operation and Development	• Releases *Progress in Identifying and Eliminating Harmful Tax Practices* identifying 35 tax havens
	Financial Action Task Force	• Identifies 15 jurisdictions it considers uncooperative in the fight against money laundering
	European Union	• Ends stalemate over the taxation of non-residents' savings through an agreement to introduce an exchange of information on non-residents' savings accounts