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IV. Structural and regulatory developments

Initiatives and reports concerning financial institutions

October

The Electronic Banking Group (EBG) of the Basel Committee on Banking Supervision (BCBS) released a discussion note and a series of white papers exploring cross-border supervisory challenges related to electronic banking activities.[17] In the document, the EBG noted that e-banking was based on a technology designed to expand the "virtual" geographic reach of banks and customers without necessarily requiring a commensurate "physical" expansion. Such expansion could extend beyond national borders. The EBG highlighted that many cross-border issues arising from the rapid expansion of e-banking activities were not contemplated when the Basel Committee's existing guidance was developed. It pointed out the particular need for international cooperation among supervisors to address the cross-border challenges created for bank supervision and identified four action items:

The EBG stresses supervisory cooperation on cross-border e-banking

(i) Building upon work conducted to date and developing guiding principles for the prudent risk management of e-banking activities.
(ii) Identifying if and where existing Basel Committee guidance needs to be adapted to facilitate the sound supervision of cross-border e-banking activities.
(iii) Promoting international cooperation within the banking industry and between the public and private sectors to identify both e-banking risk issues and sound practices needed to deal with them.
(iv) Encouraging and facilitating the exchange of material developed by bank supervisors and of available information on e-banking training programmes.

[17] See *Electronic Banking Group Initiatives and White Papers*, Basel Committee on Banking Supervision, Basel, October 2000. Available at www.bis.org.

November

A group of large banks agrees on principles against money laundering

A group of 11 international banks agreed on the Wolfsberg principles, a set of common voluntary guidelines against money laundering.[18] The rules cover banks' relationships with high net worth individuals and include guidance concerning the acceptance of clients, situations requiring special attention, means of identifying unusual or suspicious activities, beneficial ownership of accounts and education of bank staff. Other banks have been encouraged to adopt the guidelines but no mechanism has been agreed for dealing with institutions breaking the rules.

US regulators call for public comment on simplified capital requirements for non-complex financial institutions

US federal bank and thrift regulatory agencies requested public comment on an advance notice of proposed rulemaking that considers the establishment of a simplified regulatory capital framework for non-complex financial institutions.[19] Such a framework would conform to the underlying principles of a revised Basel Capital Accord but would relieve the regulatory burden on non-complex supervised entities. The advance notice solicits comment on the following issues: definition of a non-complex institution; identification of the eligibility criteria for a simplified capital framework; setting of an appropriate minimum capital threshold for non-complex institutions; consideration of additional options for measuring regulatory capital at non-complex institutions and resolution of the implementation issues associated with a simplified framework.

Initiatives and reports concerning financial markets and their infrastructure

October

The Swiss government announced a reduction in stamp duties effective from 1 January 2001. Domestic banks trading Swiss securities on non-Swiss exchanges will not have to pay stamp duties on such transactions. Institutional investors conducting proprietary trades will also be exempted.

The largest US dealers agree to remove restructuring clauses from default swaps

The largest US dealers in credit derivatives agreed to remove restructuring clauses from standard credit default swap contracts written on US corporate entities.[20] The change was prompted in large part by the losses faced by sellers of default swaps on the US insurance company Conseco. The firm's loss of access to the commercial paper market forced it to use its backstop loan facility. A subsequent restructuring of the company's debt, which included a one-year extension of the backstop facility, triggered payment of default swaps written on it. The dealers involved felt that such an event gave buyers of protection an unjustified windfall profit, particularly given that no

18 See www.wolfsberg-principles.com.

19 See www.federalreserve.gov.

20 However, default swaps paying in the event of a debt restructuring will still be offered.

default had occurred. Since then dealers have become concerned about the possible exercise of default swaps in debt restructuring, particularly when no economic default is actually experienced. One of the consequences of the initiative taken by US dealers could be to affect liquidity in the credit derivatives market since European banks continue to use the restructuring clause.

The ESF announces plans for the creation of a single European counterparty

The European Securities Forum (ESF) announced plans for the creation of a single European counterparty and netting facility for all European equities.[21] The ESF said that it would seek bids from outsiders to operate the facility but, if the bidding process did not yield an acceptable solution, it would set up the operation itself. The ESF believes that the future development of securities trading systems makes vertical ownership structures inappropriate for a pan-European capital market. Furthermore, the present fragmentation of post-trade processing makes European capital markets less cost-efficient and competitive. The initiative was prompted by the failure of existing market participants to come to an agreement concerning the creation of a European facility for the clearing of equities.

The DTCC calls for a global clearing facility

The Depository Trust and Clearing Corporation (DTCC), the world's largest securities clearance and settlement entity, called on the financial services industry to develop a global clearing solution to lower costs, reduce risk and facilitate the growth of financial instruments trading worldwide. In a white paper, the DTCC announced the sponsoring of a global conference in early 2001 to address these issues.[22] The paper does not prescribe a single central counterparty solution but rather identifies a number of issues requiring discussion, a shared understanding and mutual agreement across the industry, including: standards for communications and technology; agreements on cross-collateralisation and cross-margining among central counterparties; shared technology investments; and coordinated business policies and plans.

The London Clearing House announced plans to expand its clearing services for OTC derivative instruments. OTCDerivNet, a new company established with eight leading derivatives dealers, will build on the SwapClear service established in 1999 to clear interest rate swaps. The new facility will conduct clearing, netting and daily margining of an extended range of OTC products in a wider variety of currencies.

November

European finance ministers reached an agreement to curb tax evasion in the European Union.[23] Under the agreed rules, most EU states will share

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[21] The European Securities Forum, which comprises the major users of European clearing and settlement facilities, was established in 1998 to facilitate rapid progress towards an efficient European capital market infrastructure. See *ESF's Blueprint for a Single Pan-European Central Counterparty*, European Securities Forum, Frankfurt and London, December 2000. Available at www.eurosf.com.

[22] See *Central Counterparties: Development, Cooperation and Consolidation*, Depository Trust and Clearing Corporation, New York, October 2000 (available at www.dtcc.com).

[23] See www.europa.eu.int.

European finance ministers agree to share information on non-resident savings income

information on non-resident income from savings, enabling the home country of a non-resident investor to receive the tax proceeds generated by such income. Countries opposed to a rapid introduction of information exchange (Austria, Belgium and Luxembourg) will be granted a seven-year transition period allowing them to impose withholding tax on savings income at a rate of 15% for the first three years and 20% for the remaining four years. The agreement provides for three quarters of the tax revenue to be transferred to the home country of the non-resident investor. After the transitional period, all EU countries will be required to swap information. However, fearful that such an agreement could trigger a damaging flight of savings from the European Union, Austria and Luxembourg stressed that their eventual signature, and therefore the coming into force of the savings tax directive in early 2003, would hinge on the acceptance of the information exchange scheme by several non-EU financial centres.

The Committee of Wise Men calls for a new regulatory system for Europe's financial markets

The Committee of Wise Men on the Regulation of European Securities Markets published its interim report.[24] The document identifies a number of deficiencies in the European Union's financial markets and states that the Financial Services Action Plan endorsed by the EU heads of state and government in March 2000 contains the key elements required for the further integration of the European financial services market.[25] However, it also argues that the current legislative process is slow and inconsistent, and therefore calls for a new type of regulatory system that could adjust rapidly and flexibly to developments in financial markets. It makes four central recommendations: (i) that only a framework of broad principles for securities legislation should be enacted at the EU level in accordance with normal EU legislative procedures; (ii) that detailed implementation procedures should be delegated to a new EU Securities Committee supported by EU regulators; (iii) that member states should implement EU law within a new framework of enhanced cooperation to ensure consistent transposition of legislation; and (iv) that enforcement of EU rules should be strengthened through more vigorous action by the Commission and enhanced cooperation between member states and their regulators. A crucial element of the report is the suggestion that, wherever possible, proposals be agreed through existing "fast track" procedures and that regulations rather than directives be used to transpose and implement the new rules.[26] At the same time, the Committee did not recommend the creation of a single pan-European regulatory agency, arguing that: (i) the basic harmonised

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24 The Committee, under the Chairmanship of Alexandre Lamfalussy, was established by ECOFIN in July 2000 with the mandate of assessing current conditions for the implementation of the regulation of securities markets in the European Union. The *Initial Report of the Committee of Wise Men on the Regulation of European Securities Markets* is available at www.europa.eu.int. The Committee's final report will be released in mid-February 2001.

25 The Plan aims to complete the single market in financial services by 2005.

26 Regulations are legislative acts that, once agreed by the Council of Ministers and the European Parliament, do not need member state transposition. Directives require transposition by member states, which can take up to 18 months or more.

rules necessary for the appropriate functioning of an integrated market were not yet in place; (ii) speedy action was needed to correct the shortcomings of the present regulatory framework; and (iii) some time would be needed to ascertain whether any such reforms delivered or failed to deliver results. If approved by EU governments in early 2001, the proposed system could start functioning at the beginning of 2002.

The European Commission announces a review of the Investment Services Directive

Shortly after the publication of the Wise Men's report, the European Commission announced an extensive review of the Investment Services Directive (ISD).[27] The aim of the review is to consider how legislation could best be updated to reflect the profound changes taking place in the investment services industry and in the trading infrastructure of European securities markets. This move follows a widespread recognition that the existing "single passport" rules allowing firms to sell investment services across the European Union are currently not functioning well because some member states continue to impose restrictions in the name of investor protection (see the box on pages 13-14). The process calls for a consultation period lasting until end-March 2001. This consultation will focus on how the single passport can be made fully operational and how an appropriate regulatory framework for market infrastructure can be developed. The revision should create the legal environment in which the passport could become more effective for inter-professional business and be progressively extended to cover services to retail investors. With respect to the trading infrastructure, the Commission highlighted the fact that EU securities legislation provides for "regulated markets" to serve investment firms in other member states but does not properly provide for safeguards in relation to disclosure, transparency, integrity and stability. This potentially distorts competition between exchanges and trading systems, raising the question of whether it would be useful to apply common principles to trading systems (including new electronic trading arrangements) and, if so, what these principles should be. The Commission is also seeking to stimulate the debate on the need for common regulatory and supervisory responses to the consolidation of clearing and settlement systems. The consultation process, which forms part of the Financial Services Action Plan, will take into consideration the conclusions reached by the Wise Men's final report.

The OECD removes the threat of economic sanctions for cooperating offshore centres

The Organisation for Economic Co-operation and Development (OECD) announced that it would remove the threat of economic sanctions for offshore financial centres that sign a collective commitment to transparency and cooperation. In June 2000, the OECD had published a list of countries with harmful tax practices as part of a multi-pronged international crackdown on tax evasion.[28] Such countries were warned that they could face punitive action

[27] See www.europa.eu.int.

[28] See the August 2000 issue of this commentary for more details.

unless they agreed to cooperate by July 2001. One of the most contentious requirements is that offshore centres introduce mechanisms allowing for the exchange of information with OECD fiscal authorities. The move is aimed at countering offshore centres' complaints that the OECD is forcing them to adopt standards that are higher than those of some of its own member countries.

Euroclear and Clearstream, the two large international clearing companies, announced that they had agreed to set up a "daylight" bridge between their settlement systems. The initiative, which follows an earlier overnight arrangement between the two entities, is designed to offer multiple intraday exchanges of securities and cash deliveries.

Commercial banks operating in the euro zone launched a cross-border retail payment system that should shorten processing time and reduce associated costs. The STEP1 facility will offer straight through processing of retail payments on the Euro1 clearing platform already used by a large number of major international banks. An important benefit of the new system will be a reduction in processing time to about three days from the up to seven days now prevailing.

The European Central Securities Depositories Association (ECSDA) agreed on a number of standards to facilitate the cross-border settlement of equities.[29] Such standards will allow national depositories to link up directly with each other. The ECSDA also agreed to implement a delivery-versus-payment standard that would enable the simultaneous exchange of cash and securities between buyers and sellers of securities at the time of settlement.

OM Gruppen AB of Sweden and Morgan Stanley Dean Witter & Co. launched Jiway, an online stock exchange aimed at giving retail investors greater access to European and US stock markets. Its services, however, are not directly offered to the retail public but are available only to brokers, financial advisers and other intermediaries.

December

New legislation to enhance the regulation of futures trading is signed

The President of the United States signed the Commodity Futures Modernization Act of 2000.[30] The legislation, which extensively revises the Commodity Exchange Act, creates a flexible structure for the regulation of futures trading, codifies an agreement between the Commodity Futures Trading Commission (CFTC) and the Securities and Exchange Commission (SEC) to repeal the 18-year-old ban on single stock futures, and provides legal certainty for the over-the-counter derivatives markets (given that certain contracts will not be deemed illegal futures contracts). Under the new framework for futures markets, existing "one size fits all" regulations will be

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[29] The ECSDA was formed in 1997 to provide a forum for national central securities depositories to exchange views and take forward projects of mutual interest. Its work has focused on the delivery of secure delivery-versus-payment cross-border settlement. See www.ecsda.com.

[30] See www.cftc.gov.

replaced by broad, flexible Core Principles. In addition, three regulatory tiers will be established for the markets: recognised futures exchanges (RFEs), derivatives transactions facilities (DTFs), and exempt multilateral transaction execution facilities (MTEFs). The three tiers will match the degree of regulation more closely to the nature of products and customers. Moreover, clearing organisations overseen by the CFTC, US banking regulators, the SEC or foreign regulators will be permitted to clear transactions executed on exempt MTEFs and to clear bilateral transactions. The law, which reauthorises the CFTC for five years, also clarifies the Treasury Amendment exclusion and specifically grants the CFTC authority over retail foreign exchange trading.

The ESF modifies its strategy on a single European counterparty

The ESF decided not to put out to tender the contract for the provision of central counterparty services. It will instead issue a blueprint for a single pan-European clearing house. European clearing houses will be asked to respond to the blueprint and propose workable solutions to the ESF. A formal request for a proposal will not be issued as long as rapid progress with service providers is achieved.

Blackbird Holdings Inc. launched an electronic trading platform for European interest rate swaps. The company, which was launched last autumn as a dealer-to-dealer platform for simple interest rate derivative products, initially focused on Canadian and US dollar interest rate swaps. The European platform will trade swaps denominated in euros, sterling and Swiss francs.

The New Basel Capital Accord

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In January 2001, the Basel Committee on Banking Supervision issued a second round of proposals for a New Basel Capital Accord that, once finalised, will replace the current 1988 Accord. The 1988 Accord has helped strengthen the soundness and stability of the international banking system and enhance competitive equality among internationally active banks. However, the financial marketplace has developed dramatically during the past decade, to the point where the Accord's standard capital ratio has become a less accurate indicator of a bank's financial condition and created some perverse incentives.

The new framework is intended to align regulatory capital requirements more closely with underlying risks, to recognise improvements made in risk measurement and control, and to provide banks and their supervisors with several options for the assessment of capital adequacy so as to make the Accord suitable for use by all classes of bank. In putting forward these proposals, the Committee believes that it has laid the groundwork for a flexible framework that has the capacity to adapt to changes in the financial system and to enhance its safety and soundness.

The comments received on the proposals set out in the Committee's first consultative paper, issued in June 1999 (see the *BIS Quarterly Review* of August 1999), and ongoing dialogue with the industry and supervisors worldwide greatly assisted it in developing the new proposals. The Committee recognises that the New Accord is more extensive and complex than the 1988 Accord, as a natural reflection of innovation in the financial marketplace and the resulting need for a more risk-sensitive framework. The key aspects of the proposals are briefly highlighted below. For a more extensive treatment, readers are encouraged to refer to the package of documents released by the Basel Committee Secretariat.[1]

The proposals are based on three mutually reinforcing pillars that allow banks and supervisors to evaluate properly the various risks that banks face. The New Accord focuses on: minimum capital requirements, which seek to refine the measurement framework set out in the 1988 Accord; supervisory review of an institution's capital adequacy and internal assessment process; and market discipline through effective disclosure.

Pillar 1

In the proposals for Pillar 1 – minimum capital requirements – the Committee intends to replace the "one size fits all" framework set out in the 1988 Accord with a variety of options. The New Accord sets out those options from which banks, with the authorisation of their supervisor, can choose depending on the complexity of their business, as well as the quality of their risk management. This framework is designed to motivate banks to improve continuously their risk management capabilities so as to make use of the more risk-sensitive options and, thus, produce more accurate capital requirements. The Committee is also placing greater emphasis on banks' own assessment of the risks to which they are exposed in the calculation of regulatory capital charges.

For credit risk, a standardised approach building upon the 1988 Accord and introducing the use of external credit assessments will be available for less complex banks. Banks with more advanced risk management capabilities, which can meet rigorous supervisory standards, can make use of an internal ratings-based approach. Under this approach, some of the key elements of credit risk, such as the probability of default of the borrower, will be estimated internally by a bank. The Committee is also proposing an explicit capital charge for operational risk. A number of possible options for this calculation are elaborated on in the consultative package. The approach to market risk remains largely unchanged.

With respect to the overall level of capital, which will be determined by summing separately calculated charges for credit, market and operational risk, the Committee's primary goal is to

[1] See in particular *The New Basel Capital Accord: an explanatory note* for a general description of the contents of the consultative package. Available on the BIS website at www.bis.org.

deliver a more risk-sensitive methodology that on average neither raises nor lowers regulatory capital for banks, after including the new operational risk capital charge. Naturally, capital requirements may increase or decrease for an individual bank depending on its risk profile.

Pillar 2

The Committee's ongoing work has also affirmed the importance of the supervisory review process as a critical complement to the minimum capital requirements. The New Accord therefore proposes procedures through which supervisors can ensure that each bank has sound internal processes in place to assess the adequacy of its capital and set targets for capital that are commensurate with the bank's specific risk profile and control environment. This internal process would then be subject to supervisory review and intervention where appropriate.

Pillar 3

The Committee believes that the disclosure requirements and recommendations set out in the package will contribute to market discipline by allowing market participants to assess critical information describing the risk profile and capital adequacy of banks. The proposals provide more detailed guidance on the disclosure of capital structure, risk exposures and capital adequacy.

Similarities and differences relative to the June 1999 proposals

The basic concepts and the design of the two sets of proposals remain the same. Thus, the three-pillar approach has been retained; several options are allowed for each measure under Pillar 1; banks are offered incentives to move to more accurate risk measures; there is a greater risk sensitivity of risk weights (the "OECD club" approach to such weights has been abandoned); and an explicit operational risk charge has been introduced.

However, a number of significant amendments have been made. First, there is a much greater degree of detail in every aspect of the package. Second, the standardised approach to credit risk measurement will more closely align the various risk buckets to the underlying risk (in part through the addition of a new risk bucket for corporate exposures – see the table below). Third, two options (foundation and advanced) are provided under the internal ratings-based approach, so that it can now be used by many more banks. Fourth, the focus of the measurement of other risks has been changed, with interest rate risk shifted from Pillar 1 to Pillar 2, but operational risk remaining in Pillar 1. Lastly, far more specific criteria have been provided for Pillars 2 and 3.

Risk weighting for corporates under the standardised approach

June 1999		January 2001	
AAA to AA-	20%	AAA to AA–	20%
A+ to B–	100%	A+ to A–	50%
Below B–	150%	BBB+ to BB–	100%
Unrated	100%	Below BB–	150%
		Unrated	100%

Further work and implementation

Following a final round of comments to be submitted by 31 May 2001, the Committee intends to finalise the New Accord by the end of the year and implement it in member jurisdictions in 2004. This timetable will accommodate national rulemaking procedures and allow adaptation of banks' internal systems, supervisory processes and regulatory reporting. The Committee has consulted with supervisors worldwide in developing the new framework, and expects the New Accord to be adhered to by all significant banks around the globe after a certain period of time. The Committee recognises that implementation of these proposals will in many cases require supervisors to augment their resources. It nonetheless believes that a capital adequacy framework that is more sensitive to risk and promotes strong risk management practices justifies any required additional resources. The Committee and the BIS's Financial Stability Institute stand ready to provide assistance and together will serve as a forum for information dissemination and exchange among supervisors.

Chronology of major structural and regulatory developments

Month	Body	Initiative
October 2000	Electronic Banking Group of the Basel Committee on Banking Supervision	Releases a discussion note and a series of white papers on the implications of electronic banking for banking supervision
	US dealers in credit derivatives	Agree to remove restructuring clauses from standard default swap contracts
	European Securities Forum	Announces plans for the creation of a single European counterparty and netting facility for European equities
	Depository Trust and Clearing Corporation	Calls for the development of a global clearing solution
	London Clearing House	Announces plans to to expand its clearing services for OTC derivative instruments
November 2000	Group of internationally active banks	Agrees on the Wolfsberg anti-money laundering principles
	US regulatory agencies	Call for public comment on simplified capital requirements for non-complex financial institutions
	European finance ministers	Agree to curb tax evasion through a programme of exchange of information on non-residents' savings income
	Committee of Wise Men on the Regulation of European Securities Markets	Publishes *Initial Report of the Committee of Wise Men on the Regulation of European Securities Markets*
	European Commission	Announces an extensive review of the Investment Services Directive
	Organisation for Economic Co-operation and Development	Announces the removal of the threat of economic sanctions for offshore centres that sign a commitment to transparency and cooperation
	Euroclear and Clearstream	Announce the setting-up of a daylight bridge between their settlement systems
	Group of commercial banks in the euro zone	Launches a cross-border retail payment system
	European Central Securities Depositories Association	Agrees on standards to facilitate the cross-border settlement of equities
	OM Gruppen AB and Morgan Stanley Dean Witter & Co.	Launch Jiway, an online stock exchange aimed at retail investors
December 2000	President of the United States	Signs the Commodity Futures Modernization Act of 2000
	European Securities Forum	Modifies its strategy with respect to the creation of a central European counterparty for equities
	Blackbird Holdings Inc.	Launches an electronic trading platform for European interest rate swaps