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Structural and regulatory developments

Initiatives and reports concerning financial institutions

January

BCBS issues new capital adequacy proposals

The Basel Committee on Banking Supervision (BCBS) issued a second round of proposals for a new Capital Accord that, once finalised, will replace the current 1988 Accord. The proposals were summarised in the previous issue of the *BIS Quarterly Review*.[29]

G10 working party reports on financial sector consolidation

A working party of the Group of Ten released a report on the implications of consolidation in the financial sector.[30] Reviewing developments in 13 countries, the working party found that consolidation had the potential to improve operating efficiency in merged institutions but that the overall evidence in favour of efficiency gains was weak. It suggested that central bankers should remain alert to developments that might reduce the competitiveness of the markets most important for monetary policy. Moreover, it noted that consolidation could increase the challenge of winding down large and complex financial organisations, particularly since non-bank financial institutions were also potential sources of systemic risk. It further indicated that consolidation in payment and settlement systems might require increased cooperation between banking and payment system supervisors, both domestically and internationally.

US FASB recommends accounting changes for financial instruments

The US Financial Accounting Standards Board (FASB) published a report prepared by the Financial Instruments Joint Working Group of standard setters recommending far-reaching changes to the accounting treatment of financial instruments.[31] These changes include: (a) the measurement of virtually all financial instruments at fair value; (b) the recognition of almost all gains and losses resulting from changes in fair value in the income statement in the period in which they arise; (c) the elimination of special accounting for financial

29 See “The New Basel Capital Accord”, *BIS Quarterly Review*, Basel, March 2001, pp 61-2.

30 See *Report on consolidation in the financial sector*, Group of Ten, Basel, Paris and Washington, January 2001. Available at www.bis.org, www.imf.org and www.oecd.org.

31 The report is available at www.fasb.org.

instruments used in hedging; (d) the adoption of a components approach under which parts of certain transferred financial assets are derecognised, while others continue to be recognised; and (e) the expansion of disclosures about financial instruments, risk positions and income statement effects.

February

European Commission launches consultations on new capital standards

The European Commission launched a second round of consultations on a new capital adequacy framework for banks and investment firms. Interested parties have been invited to comment on a consultative paper by the end of May 2001.[32] The paper is designed to be read in conjunction with related documents issued by the Basel Committee in January 2001, while also concentrating on issues of particular concern to EU firms.

March

BCBS and IOSCO review issues related to HLIs

The BCBS and the International Organization of Securities Commissions (IOSCO) published a review of issues related to banks' and securities firms' dealings with highly leveraged institutions (HLIs).[33] The Joint HLI Working Group was encouraged by financial firms' progress in implementing the sound practice recommendations made by the BCBS and IOSCO in 1999. Senior management at many firms had strengthened their oversight of HLI activities through improved policies and a clearer definition of overall risk appetites. Notwithstanding these advances, the Working Group identified a number of areas where additional progress was needed, including some difficult areas where progress was likely to be gradual. In particular, it remained important for financial firms to continue to enhance their methodologies to measure exposures. Firms should devote resources to enhancing their stress testing capabilities for assessing the combined impact of large market moves, counterparty credit exposures and collateral values. While the availability of information from HLI counterparties had improved over the last two years, progress had been inconsistent, particularly in the provision of quantitative information. Lastly, firms had generally been able to strengthen contractual provisions with respect to the HLI sector, but competitive pressures continued to affect their ability to insist on an optimal set of measures to mitigate risk.

32 Available at www.europa.eu.int.

33 See *Review of issues relating to highly leveraged institutions*, BCBS and IOSCO, Basel and Montreal, March 2001. Available at www.bis.org.

Initiatives and reports concerning financial markets and their infrastructure

January

CGFS releases report on electronic trading and financial markets

The Committee on the Global Financial System (CFGS) released a report by a working group on the implications of electronic trading in financial markets.[34] The working group was asked to investigate how electronic trading systems functioned in the wholesale markets most relevant to central banks, and their actual and potential impact on market structure, price dynamics and overall financial intermediation. It found that electronic trading offered great scope for cost reduction but that this had yet to be fully realised in most markets. It also noted that the spread of electronic trading might have affected the business of some dealers, and might have led to a diminished commitment to market-making. However, there was so far no firm indication that liquidity had suffered from its introduction nor that trading had moved away from electronic platforms in times of stress.

CPSS sets out core principles for systemically important payment systems

The Task Force on Payment Systems Principles and Practices of the Committee on Payment and Settlement Systems (CPSS) released a report setting out core principles for systemically important payment systems.[35] The core principles fulfil the public policy objectives of reducing risk, achieving safety and increasing efficiency in systemically important payment systems by outlining a common set of international standards. They detail the key characteristics that all payment systems should satisfy. The principles are to be used by countries wishing to assess their own systems and to develop appropriate strategies for compliance.

CPSS and IOSCO draw up recommendations for securities settlement

The CPSS and IOSCO released a joint consultative report containing recommendations for the design, operation and oversight of securities settlement systems.[36] The report identifies minimum requirements that securities settlement systems should meet and the best practices that systems should strive for. The recommendations are designed to cover systems for all types of securities issued in industrialised or emerging economies. They also aim to cover settlement of both domestic and cross-border trades.

WGPD recommends enhanced disclosure

The Working Group on Public Disclosure (WGPD) released a report recommending enhanced and more frequent public disclosure of financial

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[34] See *The implications of electronic trading in financial markets*, CGFS, Basel, January 2001. Available at www.bis.org.

[35] See *Core principles for systemically important payment systems*, CPSS, Basel, January 2001. Available at www.bis.org.

[36] See *Recommendations for securities settlement systems*, CPSS and IOSCO, Basel and Montreal, January 2001. Available at www.bis.org and www.iosco.org.

information by banking and securities organisations.[37] According to the Group, market risk information that had hitherto been disclosed annually should be disclosed on a quarterly basis and the content of disclosed information should be improved. Additional credit risk information on wholesale exposures should also be made available quarterly.

US IRS introduces new withholding tax rules

The US Internal Revenue Service (IRS) introduced new withholding tax rules that may have implications for both US and non-US individuals and financial institutions investing in the US market. The IRS will impose a withholding tax of 31% on dividends, interest rate payments and gross proceeds of securities sales on all US securities transactions not carried out by "qualified intermediaries".[38]

FOMC extends use of expanded list of eligible securities

The Federal Open Market Committee (FOMC) voted to approve a temporary extension, up to the first scheduled meeting of 2002, of the expanded list of securities eligible as collateral in repurchase transactions undertaken by the Federal Reserve Bank of New York (FRBNY) in the management of banking system reserves.[39]

February

FATF discusses progress in combating money laundering

The Financial Action Task Force (FATF) reported that significant additional progress had been made by most of the 15 jurisdictions it had identified in June 2000 as "non-cooperative" in the global fight against money laundering. It stated that a number of non-cooperative countries had made impressive strides towards improving their financial regimes, as reflected in legislation introduced by various parliamentary bodies. The FATF noted with particular satisfaction that seven jurisdictions (the Bahamas, the Cayman Islands, the Cook Islands, Israel, Liechtenstein, the Marshall Islands and Panama) had enacted most if not all legislation needed to remedy the identified deficiencies. It highlighted that the enactment of the necessary legislation and the promulgation of

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[9] The WGPD, which was established in April 2000 by the Board of Governors of the US Federal Reserve System, gathered participants from leading private sector firms active in US financial markets. Its mandate was to evaluate the use of enhanced public disclosure as a means of improving the ability of markets to assess the risk exposure and management practices of large and complex financial services organisations.

[38] Financial institutions and brokers which are not already qualified intermediaries can obtain such status by meeting certain requirements, including a demonstration that they have adequate knowledge of their clients and can correctly assess tax liabilities. Intermediaries that do not obtain qualified intermediary status will still be allowed to shield their investors from tax provided that they identify their clients to the IRS. However, if investors fail to identify themselves, they will be subject to withholding tax even if they are not US citizens or are not subject to US tax. While the new rules aim at preventing US citizens from avoiding their tax obligations, the requirement that non-US investors trading on US markets identify themselves will also affect them.

[39] At its 24 August 1999 meeting, the FOMC had approved the use of an expanded list of eligible collateral in order to improve the FRBNY's ability to address expanded reserve needs anticipated for the fourth quarter of 1999. The principal effect of this expansion was the inclusion of pass-through mortgage securities of the GNMA, FHLMC and FNMA, STRIP securities of the US Treasury and stripped securities of other government agencies.

associated regulations were fundamental first steps for jurisdictions to be removed from the list.

ISDA creates task force on credit events for default swaps

The International Swaps and Derivatives Association (ISDA) created a task force that will look at the precise type of negative credit events that should be included in the documentation used for credit default swaps. Since mid-2000 an intense debate has taken place among participants in the credit derivatives market over whether loan restructurings should trigger payouts under a credit default swap.[40] Recent debt restructurings had created doubts in the minds of the sellers of credit protection about the value of assets delivered under credit default swaps. Such credit events have sometimes led to bonds trading at a lower value than bank loans, which meant that investors holding exposure to the underlying credits took delivery from protection buyers of the lower-value bonds rather than the bank loans they expected to receive. Some market participants believe that the issue could be resolved by improving the definition of loan restructurings and better specifying the assets that could be delivered following such credit events. The restructuring issue also created uncertainty in the financial and regulatory communities about the capital relief that could be obtained through such derivatives.[41]

March

FSF discusses vulnerabilities in international financial system

The Financial Stability Forum (FSF) held its fifth meeting on 22-23 March 2001 at the World Bank in Washington, D.C. Members exchanged views on vulnerabilities in the international financial system and considered the progress made in implementing its earlier recommendations. Concerning the latter point, the FSF reviewed the actions taken so far to address concerns raised in the report of its Working Group on HLIs. Members welcomed the completion of the work of the Multidisciplinary Working Group on Enhanced Disclosure and urged taking this initiative forward. They were encouraged by the development of trading principles for foreign exchange market activities by significant private sector participants and underscored the importance of their application.[42] The FSF noted the actions to improve supervisory and information practices in offshore financial centres.

CGFS releases report on collateral in wholesale markets

A working group of the CGFS released a report on the management of collateral in wholesale financial markets.[43] The group was asked to assess recent trends in the demand for and supply of collateral, with a special

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[40] See the previous issue of the *BIS Quarterly Review*.

[41] The new capital adequacy proposals issued by the BCBS would require a matching of contract maturity and the inclusion of a restructuring clause for the granting of capital relief.

[42] In February, a group of 16 banks active in the global foreign exchange market released a set of voluntary guidelines for good trading practices in response to the recent currency crises in Asia and Russia. See Tom Buerkle, “A code of conduct for currency traders”, *International Herald Tribune*, 23 February 2001.

[43] See *Collateral in wholesale financial markets: recent trends, risk management and market dynamics*, CGFS, Basel, March 2001. Available at www.bis.org.

emphasis on the role of collateral in influencing market price dynamics and liquidity. The report concluded that the rapid growth of collateral usage relative to supply was likely to continue, but that markets had the capacity to adjust through pricing, generating new supply and using a broader range of assets as collateral. Under these circumstances, the transparent use of collateral and the use of appropriate risk management practices were the key prerequisites for fully exploiting the benefits of collateral as a risk mitigation technique.

European Commission proposes uniform legal framework for collateral

The European Commission proposed a directive that would create a uniform EU legal framework to limit credit risk in financial transactions through the provision of securities and cash as collateral.[44] Current rules applied to the use of collateral throughout the EU were complex and impractical, resulting in uncertainty regarding the effectiveness of collateral as protection in cross-border transactions. Creation of a clear and uniform pan-EU legal framework for the use of collateral would contribute to the greater integration and cost-efficiency of European financial markets by encouraging cross-border business and creating a more competitive market.

EU Council of Ministers extends tax shelter for international bonds

The EU Council of Ministers agreed to extend a clause providing shelter to outstanding international bonds from withholding tax regulations forming part of a directive on the taxation of savings income agreed in November 2000.[45] Under the original directive, interest paid on all international bonds issued after 1 March 2001 would have been subject to new withholding tax rules, making it impossible to launch additional tranches of existing issues.[46] The agreement will extend by one year the “grandfathering” clause exempting interest paid on new tranches. It specifies that if the first issue of a bond occurred before 1 March 2001 (or the original prospectus was certified before that date), the bonds would be grandfathered (ie the directive would not apply), provided that the last tap took place before 1 March 2002. A failure to extend grandfathering would have posed problems for sovereign and other borrowers since they often tap into existing bond issues rather than issue new bonds.

BOTCC and GSCC reach cross-margining agreement

The Board of Trade Clearing Corporation (BOTCC), which clears transactions in US exchange-traded derivatives, and the Government Securities Clearing Corporation (GSCC), the main clearer for government bond and repurchase markets, reached a cross-margining agreement for cash US government securities and related exchange-traded derivatives contracts. The agreement will help investors and trading firms to aggregate risk positions in the cash and futures markets, with those holding offsetting positions being able to enjoy lower margin and collateral requirements. The agreement, which has been submitted to regulatory authorities, is expected to take effect in the third quarter of 2001.

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[44] Detailed information available at www.europa.eu.int.

[45] See the previous issue of the *BIS Quarterly Review* and www.europa.eu.int.

[46] Essentially because differences in the tax language would have prevented the fungibility of the issues.

Final report of the Committee of Wise Men on the Regulation of European Securities Markets

Serge Jeanneau

In February 2001, the Committee of Wise Men on the Regulation of European Securities Markets published its final report.[1] The document broadly confirms the approach taken in the initial report, but the subsequent consultation process resulted in a number of amendments. In particular, the final report attempts to address the European Parliament's concerns about the implications of the proposed regulatory structure. It refines the Committee's initial ideas, including a number of new proposals and safeguards, to ensure that there is a proper and fair inter-institutional balance. The importance of full transparency, flanked by an open consultation process for both market participants and consumers, is also given much greater prominence.

The proposals centre around a four-level approach to the regulation of European securities markets. Under Level 1, legislative acts would concentrate on the core political principles of each directive or regulation. In other words, the Council and the European Parliament, acting on a proposal from the Commission, would agree on the key political direction and orientation for each subject that would be transmitted to the next level. Under Level 2, the European Commission, after consulting a new European Securities Committee (made up of representatives of the European Commission and of member states), would request advice from a new European Securities Regulators Committee (with advisory functions) on the rapid and detailed implementation of Level 1 directives or regulations. Under Level 3, the European Securities Regulators Committee would work on joint interpretation and common standards in order to ensure consistent implementation and application of Level 1 and Level 2 legislation. Under Level 4, the European Commission would verify whether member states were in compliance with EU legislation and would ensure a more vigorous enforcement of Community law.

The Committee did not feel that it was necessary to introduce a parliamentary override provision, believing that the European Parliament would maintain a significant degree of control over the Level 2 decision-making process. It also argued that if the European Commission exceeded its implementing powers, the European Parliament could always pass a resolution requiring it to re-examine its proposal. The report suggested several deadlines for a rapid implementation of its proposals. First, the main elements of the Financial Services Action Plan should be adopted by the end of 2003. These include the creation of a single prospectus for securities issuers, home country control for all wholesale members, modernised investment rules for institutional investors and a single passport for recognised stock exchanges. Second, the report called for a full and open review of the four-level process ahead of an Intergovernmental Conference to be held in 2004 (and one year ahead of the European Commission's own deadline for the Financial Services Action Plan). If the review were to reveal that the approach did not have any prospect of success, a Treaty change might be appropriate, including the creation of a single EU regulatory authority for financial services.

In March, the European Council of Heads of State and Government adopted a resolution in Stockholm based on the Committee of Wise Men's recommendations. It asked for every effort to be made by all parties concerned to achieve an integrated securities market by the end of 2003. This meant giving priority to securities market legislation provided for in the Financial Services Action Plan, including those steps endorsed in the report by the Committee of Wise Men. However, the Council stated that if the draft measures submitted by the Commission were seen by the European Parliament to exceed the implementing powers of the framework legislation, the Commission would have to commit itself to re-examine those draft measures, taking account of the Parliament's position and stating its reasons for the action it intended to take. The Council also noted that the Commission had committed itself to avoid going against predominant views emerging within the Council in the case of sensitive issues.

[1] 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 *Final report of the Committee of Wise Men on the Regulation of European Securities Markets* is available at www.europa.eu.int. The previous issue of the *BIS Quarterly Review* discusses the key elements of the initial report.

Chronology of major structural and regulatory developments

Month	Body	Initiative
January 2001	Basel Committee on Banking Supervision	Issues a second round of proposals for a new Capital Accord
	Working Party of the Group of Ten	Releases a report on the possible effects and implications of consolidation in the financial sector
	Committee on the Global Financial System	Releases a report on the implications of electronic trading in financial markets
	Committee on Payment and Settlement Systems	Releases a report on core principles for systemically important payment systems
	Committee on Payment and Settlement Systems and International Organization of Securities Commissions	Release a joint report containing recommendations for the design, operation and oversight of securities settlement systems
	Working Group on Public Disclosure	Releases a report recommending enhanced disclosure of information by banking and securities organisations
	US Internal Revenue Service	Introduces new withholding tax rules for investors
	US Federal Open Market Committee	Approves a temporary extension of the expanded list of securities available as collateral
	US Financial Accounting Standards Board	Publishes a report recommending far-reaching changes to the accounting treatment of financial instruments
February 2001	Committee of Wise Men on the Regulation of European Securities Markets	Publishes its final report on the regulation of European securities markets
	European Commission	Launches a second round of consultations on a new capital adequacy framework
	Financial Action Task Force	Discusses progress made by offshore financial centres in the global fight against money laundering
	International Swaps and Derivatives Association	Creates a new task force to look at the precise type of credit events that should be included in the documentation for credit swaps
March 2001	Basel Committee on Banking Supervision and International Organization of Securities Commissions	Publish a review of issues related to banks' and securities firms' dealings with highly leveraged institutions
	Financial Stability Forum	Holds its fifth meeting
	Committee on the Global Financial System	Releases a report on the management of collateral in wholesale markets
	EU Council of Ministers	Extends shelter of outstanding international bonds from withholding tax
	European Commission	Proposes a directive that would create a uniform European framework for collateral
	Board of Trade Clearing Corporation and Government Securities Clearing Corporation	Reach a cross-margining agreement for cash US government securities and exchange-traded derivatives