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Structural and regulatory developments

Initiatives and reports concerning financial institutions

July

BCBS publishes industry submissions on New Capital Accord

The Basel Committee on Banking Supervision (BCBS) published on the BIS website all the non-confidential submissions made by the financial industry on its January 2001 proposals for a New Basel Capital Accord.[1] Various working groups and committees of the BCBS are conducting an extensive review of the comments with the aim of refining the proposals.

BCBS publishes working paper on IRB treatment of expected losses and future margin income

The BCBS published a working paper prepared jointly by the Accounting Task Force and the Models Task Force on the internal ratings-based (IRB) treatment of expected losses and future margin income.[2] The IRB approach as outlined in the January 2001 consultative package involves calculating regulatory capital charges to cover both unexpected and expected credit losses in loan portfolios. Although a capital charge for unexpected losses (UL) is uncontroversial, the banking industry's reaction to a capital charge for expected losses (EL) has generally been negative. In its paper, the working group presents a pragmatic approach in which capital requirements would continue to be calibrated towards the sum of UL and EL, albeit in combination with a recognition of provisions actually made and, for the retail portfolio, also of future margin income.

European Commission launches new consultation on capital adequacy

The European Commission launched a round of consultation with the banking industry concerning the application of new capital adequacy rules.[3] In the first few months of 2002, in parallel with the consultation organised by the BCBS, the Commission will publish a document setting out the details of how the new capital adequacy regime should be applied in the framework of EU law.

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1 See www.bis.org/bcbs/index.htm. In addition, the box on pages 61-2 of the March 2001 issue of the *BIS Quarterly Review* contains a summary of the proposals.

2 See *Working paper on the IRB treatment of expected losses and future margin income*, BCBS, Basel, July 2001. Available at www.bis.org.

3 See www.europa.eu.int.

August

BCBS publishes working paper on equity exposures

The BCBS published a working paper prepared by the Models Task Force on the IRB treatment of equity exposures in the banking book.[4] The paper develops a number of issues contained in a supporting document on the IRB approach published in January 2001, taking into account further discussions with industry participants.[5]

BCBS issues paper on internal audit

The BCBS issued a paper on internal audit in banking organisations and the relationship of the supervisory authorities with internal and external auditors.[6] The principles set forth in the paper, which are of general application, state that adequate internal controls within banking organisations must be supplemented by an effective internal audit function that independently evaluates internal control systems.

September

FSF discusses international financial issues at sixth meeting

The Financial Stability Forum (FSF) held its sixth meeting on 6-7 September 2001 in London. It reviewed how key financial systems and markets were responding to the world economic slowdown. Members generally considered that most major markets and financial institutions, which had earlier built up strong financial positions, had absorbed well the financial strains associated with the slowdown. In addition, many of the efforts made in recent years to strengthen the international financial system were helping to mitigate contagion effects. Nevertheless, the interaction of slower economic growth and possible financial vulnerabilities called for vigilance, as pressures tended to build over time. Members agreed that continued intense supervisory oversight and cooperation would be important. The FSF also discussed a range of other international financial issues, including those relating to accounting and provisioning at financial institutions, market dynamics and large and complex financial institutions. Moreover, participants highlighted a number of potential issues linked to the increased use of mechanisms for risk transfer, including across financial sectors, and looked forward to further exploration of the supervisory and systemic implications of these innovations. The FSF discussed the final reports of two working groups, one on incentives to foster the implementation of international standards for stronger financial systems and

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4 See *Working paper on risk sensitive approaches for equity exposures in the banking book for IRB banks*, BCBS, Basel, August 2001. Available at www.bis.org.

5 The document had set out key issues in developing capital approaches to equity exposures for banks implementing the IRB approach to credit risk, inviting feedback on ways of implementing market-based and probability-of-default/loss-given-default approaches to equity exposures.

6 See *Internal audit in banks and the supervisor's relationship with auditors*, BCBS, Basel, August 2001. Available at www.bis.org.

the other on the provision of guidance for the development of effective deposit insurance systems.[7]

BCBS abandons plans for additional capital charge for residual risk ...

The Capital Group of the BCBS, which is responsible for the development of the standardised approach to capital adequacy and the treatment of credit risk mitigation techniques, released an update about work under way on the New Basel Capital Accord.[8] Following an analysis of comments received from the financial industry, the group announced that it was abandoning plans to impose an additional capital charge on collateral, credit derivatives and bank guarantees. Under the original blueprint for a New Capital Accord, the BCBS had envisaged the imposition of a 15% charge (the so-called "W" factor), meaning that such instruments would have received an 85% recognition for credit risk mitigation. The imposition of such a charge was to account for residual risks arising from the possibility that the process by which credit protection was realised might not function as the protection buyer expected. The Capital Group said that the most effective way forward would be to treat this residual risk under the proposed framework's second pillar (ie the supervisory review process) rather than under the first pillar (ie minimum capital risk requirements).[9]

... and proposes reduction in capital charge for operational risk

The Risk Management Group of the BCBS released a working paper on the regulatory treatment of operational risk.[10] The paper contains an overview of the Group's work, which refines proposals for a minimum regulatory capital requirement for operational risk under the first pillar. This work has resulted in a number of significant changes to the January 2001 proposals, including a reduction in the overall level of the operational risk charge, an extension of the "internal measurement approach" to include a variety of advanced measurement techniques and a consideration of the role of insurance as a risk mitigant. Concerning the first element, a review of the data submitted by banks has led the BCBS to propose a reduction in the minimum capital charge from 20% to 12%. The BCBS believes that this lower level would produce capital amounts more in line with the operational risks actually faced by large and complex banking organisations.

BCBS publishes new set of disclosure requirements

The Transparency Group of the BCBS published a revised set of disclosure requirements under the third pillar of the New Basel Capital

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[7] See *Final Report of the FSF Follow-Up Group on Incentives to Foster Implementation of Standards*, and *Guidance for developing effective deposit insurance systems*, FSF, Basel, September 2001. Both reports are available on the FSF website at www.fsforum.org. A special feature discussing international standards was published in the March 2001 issue of the *BIS Quarterly Review*.

[8] See *Update on work on the New Basel Capital Accord – Basel Committee Newsletter no 2*, Basel, September 2001. Available at www.bis.org.

[9] The New Basel Capital Accord is based around three complementary elements or "pillars". Pillar 3 recognises that market discipline has the potential to reinforce minimum capital standards (Pillar 1) and the supervisory review process (Pillar 2).

[10] See *Working paper on the regulatory treatment of operational risk*, BCBS, Basel, September 2001. Available at www.bis.org.

Accord.[11] The new proposals, which are grouped in three broad categories (scope of application of the Accord, capital adequacy, and risk exposure and assessment), significantly reduce the amount of disclosure relative to the document published in January 2001.

Initiatives and reports concerning financial markets and their infrastructure

July

European Commission launches ISD consultation

The European Commission launched an open consultation on potential adjustments to the Investment Services Directive (ISD). The three-month consultation period was driven by the need to clarify and amplify existing provisions, guarantee a homogeneous and high level of protection for investors and reinforce existing ISD provisions. The ISD, which came into force in 1996, introduced a "single licence" for investment firms and regulated markets. Although it did much to create an EU-wide level playing field, further harmonisation is required to reach a fully integrated securities market. This was the second open consultation undertaken by the Commission since the publication of the Lamfalussy Report in February 2001 (see the box on page 69 of the June issue of the *BIS Quarterly Review*).

European Parliament rejects directive on takeovers

The European Parliament rejected a proposed directive on common rules for takeovers in the European Union. The proposed legislation, introduced for the first time in 1989, would have guaranteed legal certainty for takeovers by setting minimum guidelines for corporate conduct. One of the objectives of the legislation was to ensure an adequate level of protection for minority shareholders throughout the European Union when control of a company changed hands.

ESF abandons plans for European central counterparty

The European Securities Forum (ESF), a grouping of leading investment banks, announced in a statement that it had made little progress with its plan to build a central counterparty and netting facility for all European equities. The ESF chairman noted that profound legal, regulatory, technological and commercial obstacles had made immediate progress towards a single European counterparty unlikely. In particular, the ESF said that taking the project forward would have required an injection of resources that banks were not prepared to make in the current climate. Moreover, the demutualisation of stock exchanges had also become an obstacle since a significant share of their revenues was now derived from their clearing and settlement activities.

The world's principal clearing organisations announced the formation of a new association, CCP 12, dedicated to improving global clearing, netting and central counterparty services. Member organisations identified a broad range of issues that they will informally try to address. These include improved information sharing, enhancement of collateral usage, development of

[11] See *Working paper on Pillar 3 – market discipline*, BCBS, Basel, September 2001. Available at www.bis.org.

collaborative opportunities and identification of minimum standards for risk management practices.

Financial institutions aim to ensure integrity of research

In the wake of guidelines issued by the Securities Industry Association in June 2001 (see page 69 of the September issue of the *BIS Quarterly Review*), two financial institutions announced measures aimed at ensuring the integrity of securities research. The measures, which impose a number of restrictions on the holding by analysts of stocks that they also cover, come in response to concerns that the work of analysts is subordinated to the need to win underwriting mandates or corporate finance business.

August

CTFC and SEC adopt joint rules on trading of security futures

The US Commodity Futures Trading Commission (CFTC) and the Securities and Exchange Commission (SEC) adopted the first joint rules permitting the trading of security futures products in the United States. The rules, which implement provisions of the Commodity Futures Modernization Act of 2000, lift the 19-year ban on the trading of single stock and narrow-based stock index futures. They also establish a method for deciding whether an index is narrow- or broad-based. Futures on indices that are narrow-based are considered as security futures products and therefore regulated jointly by the CFTC and the SEC. Futures on broad-based indices are regulated solely by the CFTC.

September

FATF makes public its discussions on non-cooperative jurisdictions

The Financial Action Task Force on Money Laundering (FATF) made public the results of its discussions on "non-cooperative" jurisdictions since the publication of its second report on non-cooperative countries and territories (NCCTs) in June 2001.[12] The FATF announced that sanctions on Russia would not be necessary following passage by that country of legislation addressing deficiencies in the fight against money laundering but that effective implementation of the new legislation would be required for a removal of the country from the list of NCCTs. However, it noted that countermeasures would be taken against Nauru if it did not remedy deficiencies in its legislation and against the Philippines if it did not adopt adequate legislation. Lastly, the FATF added Grenada and Ukraine to the list of NCCTs because of their failure to implement comprehensive money laundering legislation.

CFTC and SEC propose margin rules for security futures

The CFTC and SEC proposed rules on the implementation of further provisions of the Commodity Futures Modernization Act of 2000. The rules govern the collection of customer margins for security futures and eliminate duplicative and conflicting regulations relating to the protection of customer property.

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[12] The FATF is an independent international body and its secretariat is housed at the OECD. More information is available at www.fatf-gafi.org.

Fight against money laundering intensifies following the 11 September attacks

In the wake of the terrorist attacks that took place against targets in New York and Washington on 11 September, the US and other governments took a number of measures aimed at identifying the sources of funding used to underwrite such attacks and at dismantling the financial infrastructure of suspected terrorist groups.

The President of the United States signed an Executive Order under the authority of various statutes, including the International Emergency Economic Powers Act, blocking the US assets of terrorist organisations, specific individuals and certain charitable, humanitarian and business organisations that finance or support terrorism. The US assets of any foreign financial institution that provides services to the designated organisations or individuals anywhere in the world could be frozen.

Recent legislation also gives the US government greater law enforcement powers to prevent terrorism financing, such as expanded wire-tapping and asset seizure authority. The legislation provides the government with the authority to mandate increased reporting and record-keeping by financial institutions. Moreover, it imposes heightened due diligence requirements when dealing with institutions or accounts that could be used to conceal transactions connected with terrorist activities.

The US government also took steps to secure international cooperation in the freezing of terrorism-linked accounts in other jurisdictions. Following such steps, many countries in the industrialised and developing world announced plans to block the assets of terrorists and their associates. Of note, the G7 finance ministers issued a statement stressing the importance of a more vigorous implementation of UN sanctions on terrorism financing and called on the FATF to encompass such financing in its activities. At an extraordinary plenary session at the end of October, the FATF expanded its mission beyond money laundering and issued a number of new recommendations aimed at countering the financing of terrorism.

The Department of the Treasury, in consultation with the Department of Justice, announced the implementation of the 2001 Money Laundering Strategy, a comprehensive plan that will focus on the prosecution of major money laundering organisations and terrorist groups moving funds into the United States for illicit or terrorist purposes. The strategy calls inter alia for the organisation of two new specialised money laundering task forces located in Chicago and San Francisco. The US Treasury also established the Foreign Terrorist Asset Tracking Center, a unit that will be dedicated to the identification and curtailment of the financial infrastructure of terrorist organisations worldwide.

Chronology of major structural and regulatory developments

Month	Body	Initiative
July 2001	Basel Committee on Banking Supervision	Publishes on its website submissions by the financial industry on the January 2001 proposals for a New Basel Capital Accord
	Joint Accounting Task Force and Models Task Force of the BCBS	Publish a working paper on the internal ratings-based treatment of expected losses and future margin income
	European Commission	Launches a new round of consultation on the application of new capital adequacy rules
	European Commission	Launches an open consultation on adjustments to the Investment Services Directive
	European Parliament	Rejects a proposed directive on common rules for takeovers in the European Union
	European Securities Forum	Announces that it has made little progress with its plans to build a European central counterparty and netting facility for European equities
	Major clearing organisations	Announce the formation of CCP 12 to improve global clearing, netting and CCP services
	Private financial institutions	Announce measures aimed at ensuring the integrity of securities research
August 2001	Models Task Force of the BCBS	Publishes a working paper on the internal ratings-based treatment of equity exposures in the banking book
	Basel Committee on Banking Supervision	Issues a paper on internal audit in banking organisations
	US Commodity Futures Trading Commission and Securities and Exchange Commission	Adopt the first joint rules on US security futures products
September 2001	Financial Stability Forum	Holds its sixth meeting in London
	Capital Group of the BCBS	Releases an update about work under way on the New Basel Capital Accord
	Risk Management Group of the BCBS	Publishes a working paper on the regulatory treatment of operational risk
	Transparency Group of the BCBS	Publishes a revised set of disclosure requirements
	Financial Action Task Force on Money Laundering	Makes public the results of its discussions on “non-cooperative” jurisdictions
	US Commodity Futures Trading Commission and Securities and Exchange Commission	Publish proposed rules on the implementation of provisions of the Commodity Futures Modernization Act of 2000