Response of the Basle Committee on Banking Supervision and of the International Organization of Securities Commissions

to the

Request of the G-7 Heads of Government at the June 1995 Halifax Summit

Montreal, May 1996

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[1] Basle Committee on Banking Supervision.

[2] International Organization of Securities Commissions (IOSCO).

Part 1

Section 1.1

Basle Committee
on
Banking Supervision

OICV / IOSCO

April 16, 1996

Mr. Jean Arthuis
Ministre de l'Économie
et des Finances
139 Rue de Bercy
F-75572 Paris FRANCE

Dear Mr. Arthuis,

In response to correspondence from Minister Martin following the Halifax Summit, we attach a set of papers which have been prepared by the International Organization of Securities Commissions and the Basle Committee on Banking Supervision. The first document consists of a Joint Statement which identifies the major principles guiding our efforts and which announces a new joint initiative by the two organisations. This is accompanied by two longer documents which give more detailed accounts of the past activities and future work programmes of the Basle Committee and IOSCO respectively. These have been prepared by each organization in recognition of the differences in their historical backgrounds and the traditional perspectives and responsibilities of bank and securities regulators. We would not plan to release these papers publicly until May 20 at the earliest.

The Basle Committee on Banking Supervision and the International Organization of Securities Commissions have consulted and undertaken cooperative work together for several years in an effort to anticipate and respond to concerns such as those noted in the Halifax Summit Review of Financial Institutions. This effort has intensified in the last two years and has become a key focus of each organization's agenda. The work programme has been demanding and significant progress has been made.

Each of the efforts described in the attached materials is important on its own insofar as it addresses a key element of the overall regulatory or operational framework. The aggregate effort has enabled the relationship between the Basle Committee and IOSCO to mature to a point where the two organisations have determined to develop a more comprehensive approach to assisting regulators in supervising the increasingly complex trading activities of internationally active financial

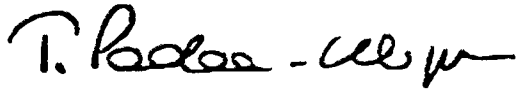
institutions, which increasingly do not conform to the geographic or functional boundaries that tend to define the authority of domestic regulators.

The challenge is to improve regulatory efficacy in this new market environment. The key will be the establishment of effective arrangements for information exchange and coordination between multiple regulators of any particular financial institution.

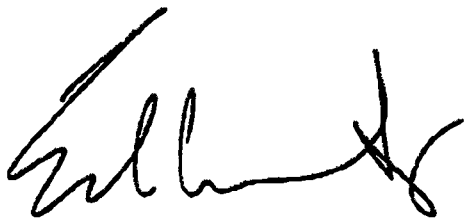
The initiative described in the Joint Statement attached is particularly ambitious and could lead to proposals for domestic legislative reform. For example, existing secrecy legislation in many jurisdictions restricts the ability of regulators to assist their counterparts, both domestically and internationally, by sharing information with respect to institutions within their own scope of responsibility.

We welcome your collective interest in our efforts to address systemic risk in global financial markets. We look forward to your support, where required, to ensure that public confidence and the integrity of the regulatory operational frameworks upon which global capital markets rely is maintained.

Yours sincerely,



Tommaso Padoa-Schioppa
Chairman of the
Basle Committee on Banking Supervision



Edward J. Waitzer
Chairman of the
Technical Committee of IOSCO

Section 1.2

BASLE / IOSCO Joint Statement

Introduction

The Halifax Summit Review of International Financial Institutions (the Communiqué) identifies issues of critical concern for supervisors and market participants in the financial services sector. Globalization of capital markets, integration of financial services and the exponential rate of technological and financial innovation, including notably the increased use of derivative products, permit significant enhancements to risk management procedures. They also pose the challenge of potentially greater risk. The ability of markets and their supervisors to respond flexibly to firms' failures and other disruptions is encouraging. Nevertheless, regulators cannot afford to be complacent. Close international cooperation is crucial to continued success in meeting the challenge of the future.

Responding to the Challenge

The Basle Committee on Banking Supervision (the Basle Committee) and the International Organization of Securities Commissions (IOSCO) recognize that the process of globalization and innovation leads to more efficient allocation of capital and contributes to economic growth. Both organizations share the *common goal of improving the quality of supervision worldwide and responding to financial market developments* in a timely, effective and efficient manner. However, they remain aware that efficient global markets may accelerate the transmission of financial disturbances. The occasional failure of individual market participants is an unavoidable feature of an efficient market system. The ultimate objective of supervision cannot be to avoid all such failures.

In pursuit of their common goal, the Basle Committee and IOSCO have identified the following *eight major principles* which will guide their efforts and which their members agree to promote:

- cooperation and information flows among supervisory authorities should be as free as possible from impediments both nationally and internationally;

- all banks and securities firms should be subject to effective supervision, including the supervision of capital;

- geographically and / or functionally diversified financial groups require special supervisory arrangements;

- all banks and securities firms should have adequate capital;

- proper risk management by the firm is a prerequisite for financial stability;

- the transparency and integrity of markets and supervision rely on adequate reporting and disclosure of operations;

- the resilience of markets to the failure of individual firms must be maintained;

- the supervisory process needs to be constantly maintained and improved.

The Basle Committee and IOSCO are fully resolved to *work actively together*, as they have been doing, to promote these principles. They will anticipate and respond to concerns such as those noted in the Communiqué, albeit determining their priorities in addressing these concerns according to their respective perspectives and responsibilities as banking and securities regulators. Since 1995 a *Coordinating Committee* of representatives of the Basle Committee and IOSCO has been meeting

and work programmes of the Basle Committee and IOSCO are set out in the two documents accompanying this statement.

Completed and Ongoing Initiatives

In line with the above principles, the work programme of the Basle Committee and IOSCO in the recent past has aimed to establish *concrete international understandings* on safeguards, standards and transparency. The results have included initiatives in the following areas, many of which have been developed jointly:

(a) Internal Management Control Systems. In order to encourage strong *internal management control systems* within the firms, in July 1994, IOSCO and the Basle Committee issued guidance papers concerning risk management of derivatives activities and have since kept this issue under review, in close collaboration with industry groups. Both IOSCO and the Basle Committee are committed to further efforts to encourage financial institutions to implement effective internal control and audit systems.

(b) Capital Adequacy. An Amendment to the Basle Capital Accord issued by the Basle Committee this January will allow banks to use the results of proprietary "value at risk" models (subject to strict qualitative and quantitative standards) as a basis for measuring the *market risk* element of their regulatory capital requirements. IOSCO has also published papers on capital standards for securities firms and on the implications of increased use of value at risk models by securities firms and is working with the Basle Committee (and a number of major financial institutions) to test such models against a wide range of securities portfolios.

(c) Reporting, Disclosure and Accounting. With the objective of promoting market transparency, in November 1995 the Basle Committee and IOSCO jointly issued a report on *the public disclosure of trading and derivatives activities* of banks and securities firms. Compliance with a common minimum reporting framework identified in a joint report issued in May 1995 (as well as with other

quantitative and qualitative disclosure requirements) is being actively monitored and it is expected that standards will continue to evolve rapidly. These efforts complement work being undertaken in other fora, as well as national efforts, to promote market transparency by improving the quality of global market data.

IOSCO is working closely with the International Accounting Standards Committee and the International Auditing Practices Committee to promote the development and implementation of *global accounting and auditing standards* for international securities issuers as alternatives to the use of national standards.

(d) Financial Conglomerates. Significant work continues on developing procedures for the effective supervision of *international financial conglomerates.* A discussion paper was published in July 1995, the conclusions of which are now being addressed by the Joint Forum of representatives from IOSCO, the Basle Committee and the International Association of Insurance Supervisors.

(e) Operational and Settlement Systems. *Cooperation among authorities charged with prudential supervision and payment systems oversight* can strengthen the operational and settlement systems upon which financial markets are based. Effective management of credit and liquidity risks and strong internal controls within banks and securities firms are essential, as are appropriate risk management procedures for netting arrangements, clearing houses, and other settlement systems. Substantial work is being done in these areas as evidenced by reports of the Basle Committee and the BIS Committee on Payment and Settlement Systems (CPSS) and by the May 1995 *Windsor Declaration* which is being implemented by IOSCO. Future work by IOSCO on selected projects will be undertaken in consultation with the CPSS, and work on bank supervision / payment system issues will continue to benefit from cooperation between the CPSS and the Basle Committee.

worldwide. Both also have established procedures to embrace input from market authorities and participants.

(g) Market Emergencies. The global market enhances banking and financial markets sensitivity to crises wherever originated, calling for prompt exchange of information and immediate, coordinated action among relevant authorities. Banking and securities supervisors continue to develop contact and communication procedures to *strengthen their ability to react effectively* at times of market emergencies.

Strengthening Cooperation Between the Regulators of Diversified Financial Groups

The collaborative efforts described above address key elements in supervision and regulation and represent positive developments in the overall regulatory and operational framework. In light of the evolving market place and the risks associated with new trends in global trading, the Basle Committee and IOSCO continually review supervisory practices and procedures in order to ensure that these remain effective and that supervisors are in a position to deal with market disruptions should they occur. A particular concern is to develop satisfactory arrangements for oversight of *diversified financial groups* which offer a wide range of financial services on a global basis. The two organizations are resolved to foster arrangements that promote:

- an improved understanding of the roles, powers and responsibilities of the different regulators of such groups;

- access by each regulator of such a group directly or through a coordinating authority to the information needed to fulfil its responsibilities, including making meaningful assessments of the risks to the relevant entities within the group and to those entities taken together; and

- communication lines that will maintain and enhance regulators' abilities to react to market developments in a timely and effective manner.

The Basle Committee and IOSCO have therefore agreed to pursue a *joint initiative* to promote additional cooperative and collaborative arrangements, including effective lines of communication, in the supervision of diversified financial groups. It will build on the ongoing efforts of banking and securities regulators on a national, bilateral and multilateral basis, as described above. The principal focus of this initiative will be:

- the types of groups or institutions for which such arrangements would be useful and appropriate;

- the types of information that may need to be exchanged;

- ways to facilitate the resolution of possible legal, confidentiality, policy or practical issues that may arise; and

- any additional arrangements that may be appropriate to coordinate the activities of the relevant supervisors.

A particular aspect of this initiative will be to consider the need for and feasibility of *additional coordinating arrangements* in order, for example, to facilitate the exchange of information between the relevant regulators of the group, both in normal and emergency situations. This exercise will support the work of the Joint Forum of banking, securities and insurance supervisors and the practical arrangements will be consistent with the Joint Forum's mandate. In addition, the exercise may need

The joint Basle / IOSCO initiative is aimed at promoting more effective cooperation between banking and securities regulators, and will *enhance the ability of regulators* to fulfil their responsibilities more effectively. It should be emphasized, however, that any arrangements to improve coordination and cooperation at the international level will not in any way reduce the powers and responsibilities of any authority that is responsible for regulation of the different parts of a group as defined in national law.

Conclusion

The Basle Committee and IOSCO appreciate the opportunity to provide the G-7 Finance Ministers with this review of their current work programmes and arrangements to strengthen cooperation. Although the work has been demanding, progress has been substantial. Indeed, these initiatives are required to keep pace with the evolution of capital markets and the international financial services sector. Looking forward, both organizations are *committed to increasing the effectiveness of banking and securities supervision* without stifling innovation and efficiency.

April 1996

Section 1.3

Responding to the Challenge

Supervising Global Financial Markets

Basle Committee on Banking Supervision

I. Globalization of Markets and Risks

The liberalization of capital markets, technological change and financial innovation are fundamentally transforming the international financial landscape:

- *Geographic* restrictions around the globe are rapidly being dismantled as governments eliminate foreign exchange controls, liberalize capital movements and pursue financial deregulation;

- *Functional* frontiers are being expanded as technology permits the creation of increasingly complex contractual instruments, the unbundling of the components of risk into separate financial products, the increased marketability of financial contracts, and a dramatic growth in derivatives activities; and

- *Institutional* partitions are falling, resulting in the rapid growth of diversified financial groups and conglomerates offering banking, securities, and insurance products on a cross-border basis.

This threefold process of transformation enables more efficient capital allocation and increased economic growth. The growth and integration of global capital markets also create enormous opportunities as well as posing new challenges for the supervision and regulation of financial markets. Efficient and dynamic global markets may result in financial disturbances being

transmitted rapidly. The occasional failure of individual market participants is also an unavoidable aspect of innovative and competitive industries.

II. Basle Committee Responding to the Challenge

The Basle Committee on Banking Supervision[1] provides an important vehicle for bank supervisors to keep pace with the challenges posed by global integration, and its members share the firm belief that closer international cooperation in the regulation and supervision of financial institutions and markets is necessary to safeguard the financial system and prevent erosion of prudential standards. The Committee's own creation over twenty years ago was rooted firmly in this belief.

The Basle Committee's goal is straightforward: to improve supervisory cooperation, to improve the quality of supervision worldwide and to close gaps in supervisory coverage. It seeks to accomplish this goal in three principal ways: by exchanging information and expertise; by developing improved supervisory approaches and techniques; and by setting minimum standards where needed.

Although the Committee's focus is on the supervision of internationally active banks within the G-10 countries, its conclusions are generally applicable for all banks no matter where they are located and its recommendations have become the norm for good supervisory practice throughout the world. In reaching its conclusions, the Committee builds upon the strengths and experiences of individual supervisors and seeks pragmatic solutions consistent with market discipline and best industry practices.

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[1] The Basle Committee on Banking Supervision is a Committee of banking supervisory authorities which was established by the central bank Governors of the

Present and future work of the Committee is focused on three fundamental pillars:

- Ensuring that no bank escapes effective supervision;
- Ensuring that banks have adequate capital; and
- Improving market practices and discipline.

III. Ensuring that No Bank Escapes Effective Supervision

With today's instant communications, events anywhere can be quickly felt around the world. Similarly, the impact of financial developments (and difficulties) flows from the global to the local marketplace and from the local to the global marketplace. As a consequence, all banks (and other regulated financial institutions), wherever located, should be subject to effective supervision. In furtherance of this goal, the Committee is fostering improved supervisory standards on a worldwide basis, including principles for the supervision of cross-border banking and diversified financial groups.

Fostering Improved Supervisory Standards on a Worldwide Basis

The Basle Committee has been instrumental in developing a network of over a dozen regional groups of banking supervisors, consisting of well over one hundred countries, which now cover the world. These groups are a vital link to the universal implementation of strong supervisory standards by enabling members to learn from each others' experiences, by exerting peer-group pressure to develop sound practices, and by providing efficient platforms for training. Representatives of the Committee participate in most meetings of these groups and the Committee participates in, or organizes, training courses on behalf of the various regional groups.

The Committee also sponsors a biennial world conference of bank supervisors which provides participants with an opportunity to learn about new supervisory techniques, including recent work by the Committee, and to develop personal contacts. The next conference is being held in Sweden in June 1996.

From a still broader perspective, the Basle Committee actively seeks to develop and improve relationships with banking and other financial regulators around the globe by organizing and assisting in conferences and training, by sharing its expertise and policy papers, and by maintaining a *contact list* of key bank supervisors in over one hundred and fifty countries.

Developing Principles for the Supervision of Cross-Border Banking

Much of the framework supporting international cooperation among bank supervisors around the world is based upon principles developed by the Basle Committee. The Basle Committee's 1975 *Concordat*, as revised in 1983, stresses the principle of consolidated supervision. Under this principle, supervisory authorities cannot be fully satisfied about the soundness of individual banks unless they can examine the totality of each bank's business worldwide including an assessment of overall capital adequacy, risk exposures, concentrations, and asset quality. The Concordat also establishes the respective supervisory responsibilities of both the host country authority, who licenses and supervises cross-border offices of an international bank, and the home country authority who, as the supervisor responsible for the parent bank or head office, is best placed to supervise the banking group as a whole.

Many of these points were reformulated by the Basle Committee into *Minimum Standards for the Supervision of International Banking Groups and Their Cross-Border Establishments* (1992). These

- All international banks should be supervised by a home-country authority that capably performs consolidated supervision and has the right to prohibit corporate structures which impede supervision;

- The creation of a cross-border banking establishment should receive the prior consent of both the host-country and the home-country authority;

- Home-country authorities should possess the right to gather information from their cross-border banking establishments; and

- If the host-country authority determines that any of these three standards is not being met, it could impose restrictive measures or prohibit the establishment of banking offices.

Each G-10 member country is committed to implement these standards; others are encouraged to do so. The Committee, in association with bank supervisors in off-shore centres, is presently reviewing various implementation issues and is developing recommendations addressing effective consolidated supervision, procedures for cross-border inspections, and the need for legislative changes in certain jurisdictions to remove impediments to supervisory cooperation.

Building Working Relationships with Securities and Insurance Supervisors

The first formal contacts between banking and securities regulators took place in 1988. This led to the issuance in April 1990 of a joint paper on exchanges of information between banking and securities supervisors and the recommendation that information "gateways" be created at both the national and international level. Since its establishment in 1991, contact with the Technical Committee of the International Organization of Securities Commissions (IOSCO) has steadily intensified.

The Basle Committee has also held several annual meetings with selected insurance supervisors attending in their personal capacity to discuss issues of common regulatory interest such as financial conglomerates, capital requirements and efforts to counter money-laundering. The creation in 1995 of the International Association of Insurance Supervisors (IAIS), with membership from over seventy countries, opens new perspectives for cooperation. Insurance regulators now actively participate in the *Joint Forum* on financial conglomerates described below and will be working with the Basle Committee on derivatives.

Supervision of Diversified Financial Groups

A notable outcome of the deregulation and globalization of financial markets is the emergence of corporate groups offering a comprehensive range of financial services, including banking, securities and insurance services. The supervision of these diversified financial groups poses particular problems:

- Several supervisors may have competence for different activities of a group;
- Measurement of risk is very difficult for a composite group with many interlocking parts;
- Financial groups can be structured to minimize or avoid regulatory oversight; and
- Such groups may consist of unregulated industrial or commercial interests as well as regulated financial entities.

At the initiative of the Basle Committee, an informal *Tripartite Group* of bank, securities and insurance regulators was formed in early 1993 to consider the supervisory issues associated with the emergence of large international financial groups and conglomerates. The July 1995 report of the Group identifies a number of areas where practical approaches among supervisors in the three disciplines could be further developed, including the:

- Application of either a consolidated or a "solo-plus" approach to supervision and capital adequacy;

- Importance of intensive cooperation between supervisors responsible for the different entities within a conglomerate, and the possible value of appointing a lead "regulator" or "convenor;" and

- Need for supervisors to have the necessary authority to obtain adequate information regarding managerial and legal structure and, if necessary, to prohibit group structures which impair adequate supervision.

To continue this work further, the Basle Committee, together with IOSCO and the IAIS, have established a new *Joint Forum* comprised of senior bank, securities and insurance supervisors. The Joint Forum is pursuing practical means to facilitate the exchange of information, at both the domestic and international level, between supervisors within their own sectors and among supervisors in different sectors. This includes the investigation of legal impediments and other barriers to such exchanges of information. It is examining the possibility of establishing criteria to identify a lead regulator and the role and responsibilities of such a lead regulator. It is also developing principles to guide the future supervision of financial conglomerates.

IV. Ensuring that Banks Have Adequate Capital

Adequate capital is fundamental to the safety and soundness of individual institutions and to systemic stability because it provides a buffer against losses and serves to protect depositors and taxpayers. Moreover, by putting their own money at risk, it gives shareholders a strong incentive to ensure that sound risk management policies are pursued.

Basle Capital Accord

To counter a serious erosion in the capital ratios of the main international banks in the 1980s, the Basle Committee released in July 1988 its *International Convergence of Capital Measurement and Capital Standards.* This Capital Accord sets a **minimum** capital standard for all internationally active banks incorporated in the G-10 countries.

The Accord's emphasis on sound capital standards has strengthened the soundness and stability of the international banking system and is playing an important part in reducing competitive inequalities between banks in different countries. Nearly all non-G-10 countries with international banks of any significant size have introduced, or are in the process of introducing, similar risk-based capital standards.

Evolution of the Accord

The 1988 Accord specifically addresses credit risk, which has been and remains the principal cause of banking losses. However, it is not intended to be a static document, but to evolve over time to incorporate other types of risks and in response to market developments. It has since been amended

Market Risk

At the end of 1995, the Committee announced a major amendment to the Capital Accord to incorporate capital charges for the market risk arising from banks' trading activities and from their open positions in foreign exchange and commodities. A two-year implementation period is being permitted before the introduction of explicit capital charges at end-1997.

The introduction of these capital requirements has become increasingly relevant as firms develop their trading businesses and manage the associated risks, and is an important further step in strengthening the soundness and stability of the international banking system and of financial markets generally.

Earlier technical discussions with securities supervisors helped develop the intellectual basis for not only this amendment, but also for the European Union's Capital Adequacy Directive. Further refinements based upon comments received during an extensive period of consultation with the industry have been incorporated into the amendment.

Most significantly, the amendment now permits banks to use their own internal models as a basis for measuring market risk as an alternative to using a standardized measurement framework. In order to use models, banks must not only adhere to a set of strict, technical quantitative standards, but must assure that proper risk management controls and systems are in place. Permitting the use of models represents a significant innovation in supervisory methods and demonstrates the Committee's commitment to reduce regulatory burden and to develop supervisory approaches reflective of market practices.

V. Improving Market Practices and Discipline

Market practices and discipline are an integral part of supervision, particularly in today's complex trading environment. Supervisors are actively working to improve internal management control systems and to increase market transparency through improvements in disclosure standards.

Strengthening Internal Management Control Systems

Proper risk management is central to the safety and soundness of individual banks. This importance is underscored by the trading losses suffered by a number of market participants due to inadequate management control.

The Basle Committee works closely with the industry to monitor and shape the most advanced risk management techniques, and has issued a number of guidelines over the years addressing various aspects including management of foreign exchange, liquidity, and off-balance-sheet risks. Much of the Committee's recent work has focused on fostering the safety and soundness of trading and derivatives activities.

Although the management and control of banking risks has become progressively more complex due to the forces shaping the modern financial world, technological developments have also increased the ability to manage these risks. In addition, the development of innovative hedging instruments enable financial market participants to "unbundle" complex risks and manage them individually.

Guidance papers issued jointly by the Basle Committee and IOSCO to the banking and securities industries in 1994 reinforced the need for firms to have sound risk management systems in place.

- Boards of directors and senior management need to be actively involved in the risk control process;

- A risk control system, both conceptually sound and implemented with integrity, must be in place; and

- Each control system needs to be backed up by strong internal and external validation and testing procedures.

Risk management is also an important focus of on-site examination and external audit processes. The market risk amendment to the Capital Accord places further emphasis on risk management as banks wishing to base their capital requirements on their internal models are subject to strict qualitative risk management standards. The Committee is continuing its work on models, including a thorough review of banks' internal audit processes as they apply to their validation and integrity.

Increasing Market Transparency Through Disclosure

Adequate information is crucial not only to effective supervision, but also to market discipline. Effective supervision relies upon the integrity of information reported to supervisors. Public disclosure of financial information is also a critical element for enhancing market discipline and for using this discipline to reinforce basic supervisory principles.

Trading and derivatives activities pose a special challenge. The exploding volume and increasing globalization of such activities has generally far outpaced the degree of disclosure made by many firms, who may be reluctant to disclose information that is not being disclosed by their competitors.

In 1995, building on work done by the BIS Eurocurrency Standing Committee, the Basle Committee and IOSCO jointly issued *Public Disclosure of the Trading and Derivatives Activities of Banks and Securities Firms.* This report reviews current practices and makes recommendations for improved

disclosure of both qualitative and quantitative information related to trading activities. Enhanced disclosures, for example, should be based on information drawn from an institution's internal risk measurement and management system and enable financial statement users to assess a firm's performance in managing material exposures to credit risk, market risk, and liquidity risk, as well as the impact of trading and derivatives activities on earnings.

The disclosure recommendations themselves are broadly based on *a Framework for Supervisory Information about the Derivatives Activities of Banks and Securities Firms* developed by the Basle Committee and IOSCO earlier in 1995. The framework's objective, mindful of the trade-offs between the benefits and costs of mandated supervisory reports and public disclosure of data and information, is to improve reporting coverage and make national requirements as consistent as possible so that firms do not need to develop multiple reporting systems.

Work in this area is being taken forward by monitoring and encouraging further improvements in the quality and quantity of disclosure, and in the consistency of accounting rules applicable to banks with respect to their derivatives and trading activities. Another goal is to expand the supervisory reporting framework so as to incorporate market risk exposures in greater detail, including the reporting of "value at risk" measures.

VI. Other Steps Taken to Make Supervision More Effective

In addition to the specific areas addressed above, bank supervisory authorities are constantly striving to keep pace with market developments and to generally improve their supervisory processes and techniques. This section briefly reviews some of these efforts being undertaken at the international level by the Basle Committee.

(1988) establishes the principles that banks should put in place effective procedures to ensure that all persons conducting business with the bank are properly identified; that transactions not appearing to be legitimate are refused; and that cooperation is undertaken with law enforcement agencies. These principles were later incorporated by the Financial Action Task Force[2] as an integral part of its recommendations to combat money laundering.

In addition to the "best practices" papers and minimum standards referred to earlier in this document, the Basle Committee develops improved supervisory practices on a wide range of other topics, working through its task forces of technical experts. The Committee's recommendations are phrased in terms of policies and approaches, leaving the details for each country to implement, taking into account its own legal, institutional and accounting framework. Recommendations, for example, address:

- ***Credit Concentration Risk.*** Recognizing that many of the biggest bank failures have been due to the default of one or more large creditors, *Measuring and Controlling Large Credit Exposures* (1991) recommends that a large exposure limit for a single borrower be set at 25% of total consolidated bank capital; that all large loans over 10% of capital be reported to the supervisor; and that lending to persons connected to the bank as well as geographic and industry concentrations be carefully monitored;

- ***Interest Rate Risk.*** The Basle Committee is presently developing guidelines for the sound management of interest rate risk. These are likely to include general principles for risk measurement and guidance to banks and supervisors

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2 The Financial Action Task Force (FATF) was created in 1989 to combat money laundering and is based at the Organization for Economic Cooperation and Development (OECD).

on the factors which should be considered in developing more sophisticated interest rate risk measurement systems; and

- ***Liquidity.*** *A framework for measuring and managing liquidity* (1992) reviews the practices and techniques employed by internationally active banks to measure and manage liquidity and suggests sound liquidity management practices for supervisors and banks.

The Basle Committee is investigating the challenges associated with telecommunications and electronic data processing developments, including electronic money and the growing use of the Internet. Earlier, *Risks in Computer and Telecommunications Systems* (1989) addressed other risks in this area, including the improper disclosure of information, error, fraud, interruption of business due to hardware or software failure, ineffective planning and risks associated with end-user computing operations.

Finally, one of the vital strengths of the Basle Committee is the opportunity for supervisors to exchange views, in a confidential and frank manner, on developments and innovations taking place in the major financial markets. This enables members to draw appropriate lessons for their own supervisory arrangements, often without the need to develop explicit recommendations or approaches. Such discussions, for example, have addressed commercial real estate problems, emerging markets, resolution of problem institutions, mergers and acquisition activity, and fit and proper tests for bank owners, controllers and managers.

VII. Conclusion

The Basle Committee on Banking Supervision has played an important role in this transformation since its creation over twenty years ago. Its *Concordat* and *Minimum Standards for the Supervision of International Banking Groups and Their Cross-Border Establishments* establish the basic principles which guide the supervision of international banks. Safer and fairer competition among banks has been achieved through the harmonized standards of the *Basle Capital Accord.* Committee guidelines promote the most advanced risk management techniques.

The pace of change will only increase as will its complexity, and the Basle Committee fully acknowledges the scale of the challenge ahead. The supervision of large, internationally diversified financial conglomerates will require new approaches and ever closer cooperation with IOSCO, the IAIS, and other regulators.

April 1996

Section 1.4

Responding to the Challenge

Supervising Global Financial Markets

International Organization of Securities Commissions

I. Introduction

The International Organization of Securities Commissions (IOSCO) fully shares the observations in the Halifax Summit Review of International Financial Institutions (the Communiqué) that the growth and integration of global capital markets create enormous opportunities as well as posing new risks and new challenges for the supervision and regulation of financial markets. IOSCO welcomes this opportunity to inform the G-7 Finance Ministers of the steps which it has undertaken recently as well as its current work programme to enhance the safeguards, standards, transparency and system of internal controls which are necessary to reduce systemic risk.

II. Globalisation of Markets and Risks

As noted in the Communiqué, the liberalisation of capital markets, technological change and financial innovation are fundamentally transforming the nature of international financial markets. In the past ten years, securities markets have experienced remarkable growth, with the capitalisation of equity markets worldwide more than tripling. These markets have been made all the more dynamic by the rapid growth of trading in futures and options and the proliferation of new products traded on a cross-border basis. Moreover, growing worldwide demands by individual and institutional investors have stimulated the expansion of global trading activities by securities firms and banks alike.

Financial institutions and market structures both foster and benefit from the growth and development of international markets. For the institutions, opportunities rather than national boundaries define the scope of their operations. Regulators must therefore be equipped to supervise institutions and markets based in their jurisdictions that are involved in international activities.

IOSCO concurs with the assessment in the Communiqué that these developments are to be welcomed in that they lead to a more efficient allocation of capital and thereby contribute to economic growth. However as a number of events in recent times have shown, they also create new risks for market participants and carry the potential for accelerating the transmission of financial disturbances. This poses new challenges for the supervision and regulation of financial markets. IOSCO recognises the critical importance of ensuring that its work programmes and procedures respond in a timely and effective manner to these developments.

III. Responding to the Regulatory Challenge

The primary objective of IOSCO is to facilitate the development on a worldwide basis of high standards of financial market regulation. The main focus of IOSCO's work is in the following areas:

- promoting arrangements to improve cooperation and communication flows between regulatory authorities;

- promoting the development of effective supervisory arrangements for securities firms and in particular for internationally active and diversified

- contributing to the fight against financial fraud and ensuring that the regulatory system responds in a timely and effective manner to new regulatory challenges.

Sections IV-VII below set out the work which IOSCO has been undertaking and currently has planned both separately and jointly with the Basle Committee in these four areas. Section VIII then identifies certain concerns which IOSCO has about the constraints which restrict the ability of securities regulators to achieve their objectives.

IV. Promoting Cooperation Between Regulators

IV.a Communication Between Securities Regulators

IOSCO has always held the promotion of effective cooperation between securities regulators as a primary objective. IOSCO has a membership representing some 121 regulatory bodies from 74 countries, including both public securities commissions as well as exchange authorities and other self-regulatory bodies. The mechanisms which IOSCO has established to communicate with its membership and to foster high standards of securities regulation worldwide were outlined in a letter to Finance Ministers dated October 3, 1995.

In addition, IOSCO has undertaken a considerable body of work to facilitate arrangements for the exchange of information between securities regulators. In particular *Principles for Memoranda of Understanding (1991)* establishes a framework for facilitating comprehensive information sharing between securities regulators on the principle that such sharing should be the norm rather than the exception. The success of this initiative is underlined by the fact that although the first such Memorandum of Understanding was only signed in 1986, there are currently over 300 such arrangements in place throughout the world.

Nevertheless, considerable difficulties still exist in facilitating the flow of information between regulators. *Report on Issues Raised for Securities Regulators by Under-Regulated and Uncooperative Jurisdictions (1994)* recommends ways to overcome the obstacles hampering access to information by regulators. Following the publication of this report, IOSCO adopted a resolution calling on all members to assess their ability to provide assistance to foreign securities and futures regulators. This self-assessment exercise is scheduled for completion in the course of 1996. Where problems are identified with existing national laws, national regulators may require the assistance of Ministers in resolving them.

A further concern is that there should be effective mechanisms for communication between markets and market authorities in different countries. An IOSCO report *Mechanisms to Enhance Open and Timely Communication Between Market Authorities of Related Cash and Derivatives Markets During Periods of Market Disruption (1993)* provides guidance in this area. In addition in 1983 a number of major securities exchanges responded to the need for market to market information sharing and the coordination of regulatory efforts among market centres by forming the *Inter Market Surveillance Group (ISG)* ISG membership is open to markets that are willing and legally able to share information with their counterparts and has expanded significantly over time.

The issue of market to market information sharing between futures exchanges was also a particular issue at the time of the collapse of Barings. Last month, forty-nine futures exchanges and clearing houses signed a *Memorandum of Understanding* under which they will exchange information about large exposures which may affect other markets. At the same time a number of securities commissions declared their intention to lend whatever statutory powers they may have at their disposal to give effect to the exchanges' agreement.

IV.b Cooperation with Banking and Insurance Supervisors

IOSCO has in recent years established a close working relationship with the *Basle Committee on Banking Supervision* on issues related to the supervision of internationally active banks and securities firms. This cooperation has led to the announcement of a new initiative to progress jointly work on the supervision of global trading firms which are supervised by both banking and securities regulators in a number of different jurisdictions. A Coordinating Committee of the two organisations meets regularly to review this work and to discuss other matters of mutual interest. In addition, both organisations together with the *International Association of Insurance Supervisors* are represented on the Joint Forum on Financial Conglomerates.

Further details of the work undertaken with these two organisations is set out in Sections V.b below.

IV.c Cooperation with Other Bodies

IOSCO also recognises that there are a number of other bodies which have an interest in improving the regulatory framework for international financial markets, and arrangements are also in place to strengthen relations with these bodies. In particular, these include the *Eurocurrency Standing Committee of the BIS* in relation to efforts to improve the transparency of international financial markets; the *BIS Committee on Payments and Settlements System* in relation to measures to strengthen the integrity of international payment and settlement systems; the *International Accounting Standards Committee* and the *International Auditing Practices Committee* in relation to the development of global accounting and auditing standards for international securities offerings; and the *Financial Action Task Force* in relation to efforts to combat financial fraud.

V. Supervision of Securities Firms and Groups

V.a Supervision of Securities Firms

A key component of any system of investor protection is that all securities firms should be subject to appropriate supervision. The primary goal of securities regulators in this context is to ensure that investors are not disadvantaged by the failure of a broker dealer, and that the impact of any such failure on the market can be minimised by an orderly winding down of the positions of the failing firm.

Consequently, securities regulators seek to ensure:

- that the capital available to support a securities firm is proportionate to the risks which the firm faces;
- that the firm has effective management controls in place in order to protect the firm against the risk of loss which may have a material impact on the firm's viability; and
- that the regulators and the market have appropriate information in order to assess accurately the risks which the firm faces.

V.b Supervision of Financial Groups

IOSCO has also recognised for some time the importance of ensuring that securities firms

supervision of regulated securities firms which are part of a larger group to be complemented by group-based risk assessment. It also notes that it may be desirable to identify one regulator who will have primary responsibility for undertaking this activity, and which is likely to act as the lead regulator when serious concerns arise about a particular conglomerate. The paper contemplated that such regulator's main role would be to ensure that relevant regulatory information about the group is shared appropriately. In this context, the paper suggests a number of functions which it would be appropriate for the lead regulator to undertake on an ongoing basis in order to facilitate supervisory cooperation in times of crisis. These include:

- maintaining an up-to-date organisation chart for the group;
- undertaking a qualitative assessment of the risk in the group as a whole;
- acting as a focal point for concerns which other regulators may have about the group; and
- promoting good communications and information flows between the regulators concerned.

In furtherance of the objectives outlined in this paper, IOSCO has prepared a list of internationally active securities dealers together with the identification of their home country supervisor which has been circulated to the members of the Joint Forum on the Supervision of Financial Conglomerates.

The recent emergence of internationally active groups which undertake both banking and securities and derivatives trading activities and which are increasingly managed on a global basis has made this issue one of particular significance for joint work between IOSCO and the Basle Committee. In this context, the two organisations have announced in the accompanying Joint

Statement a *new initiative to improve the supervisory arrangements with respect to global trading groups.*

A further concern in this area is the emergence of groups which now offer a comprehensive range of financial services, including banking, securities and insurance. This poses particular challenges not only because of the number of different supervisory authorities which may be involved with the group, but also because of the complexities involved in the measurement of risk and assessment of control techniques in a composite group. *A Tripartite Group of bank, securities and insurance regulators* was formed in early 1993 to consider these issues. In July 1995, the group produced a discussion document which examined issues associated with the measurement of capital adequacy on a group wide basis, group structures, the contagion effect of group wide exposures and several other issues. It also discussed the possibility of establishing a lead regulator or 'convenor' for each conglomerate.

Following the publication of the report, the Basle Committee and IOSCO together with the International Association of Insurance Supervisors have established a new *Joint Forum* comprised of senior bank, securities and insurance supervisors. The mandate of the Joint Forum is to seek practical means at domestic and international levels to facilitate the exchange of information between supervisors within their own sectors and by supervisors in different sectors and to investigate any legal or other barriers which could impede the exchange of information with supervisors within their own sectors and between supervisors in different sectors. It will also examine the possibility of establishing criteria to identify and define the responsibilities of a lead regulator or "convenor"; and will work towards developing principles towards the supervision of financial conglomerates.

These principles remain valid. However, IOSCO also recognises that where securities firms compete internationally, (whether with other securities firms or with banks), the need for high quality risk based prudential capital standards increases in order to avoid competitive inequities or domestic pressures for the undue relaxation of capital standards.

In this context, IOSCO recognises the importance of the decision by the Basle Committee to introduce a capital standard for the market risk assumed by banks, which will require banks for the first time to hold additional capital against such risks, and will permit banks to use their own internal value at risk models to assess such requirements. In *The Implications for Securities Regulators of the Increased Use of Value at Risk Models by Securities Firms* (1995) IOSCO recognises the role which firms' internal value at risk models play both in improving internal controls and potentially in setting risk based capital standards for securities firms. The use of value at risk models is also a key feature of the report of the Derivatives Policy Group which represents the six largest non-bank derivatives dealers in the United States. IOSCO is continuing to evaluate the implications of the use of value at risk models, and is collaborating with the Basle Committee in a joint exercise which is designed to enhance regulators' understanding of such models and to assess their relevance both to internal controls within firms and to capital requirements.

V.d Management Controls

As securities firms engage in larger and more complex securities and derivative trading activities, the importance of effective internal controls becomes even more critical. The consequences of inadequate internal controls within firms has been clearly illustrated by recent experience.

This has been an important area of common concern for IOSCO and the Basle Committee and led to simultaneous issue by both organisations in July 1994 of guidance papers on the importance of internal control mechanisms within authorised firms. The papers which both organisations have subsequently issued on value at risk models also emphasise the importance

for regulators of assessing the role which such models play within the overall control environment at authorised firms. There have also been a number of bilateral and industry led initiatives recently which seek to promote enhanced management controls within securities firms which should serve to stimulate and inform further multilateral efforts.

V.e Reporting and Disclosure

A further aspect of the supervision of internationally active securities firms is to ensure that supervisors have access to appropriate and timely information about the firm's activities, and that information is made available by such firms to the market in a manner which will enable market counterparties to make informed judgements about the risks which the firm is assuming. As with internal controls, this is a supervisory concern which is fully shared by both banking and securities regulators.

Accordingly IOSCO and the Basle Committee have worked closely together recently, and have issued two important papers:

- *Framework for Supervisory Information about the Derivatives Activities of Banks and Securities Firms* (1995) set out the type of information which regulators should seek to obtain from authorised firms in order to form a judgement as to the risks associated with the firm's derivative and trading activities. The paper also set out for the first time a common framework for reporting on such activities, with the objective of improving reporting coverage and of making national requirements as consistent as possible in order to reduce the need for multiple reporting systems.

recommendations for improved disclosure of both quantitative and qualitative information about their trading activities.

In addition, IOSCO and the Basle Committee are working with the *Eurocurrency Standing Committee of the BIS* to develop a framework for collecting and publishing regular aggregate data on activity in the OTC derivatives markets, and have recently produced a joint report on a proposal submitted to the Halifax Summit for a Central Derivatives Register.

VI. Improving Market Processes

Securities regulators have long recognised the importance of high standards of market transparency and of disclosure by issuers of securities. With this objective in mind IOSCO has been working with the *International Accounting Standards Committee (IASC)* to establish a comprehensive set of high quality international accounting standards that would be acceptable to all securities markets regulators in cross border securities offerings. In July 1995 an agreement was announced with the IASC on a joint programme of work to be completed by 1999 which will review existing standards and develop new ones as necessary. More recently following further discussions with IOSCO, the IASC has announced an accelerated timetable for this work with a target date for completion of March 1998.

IOSCO also recognises that the increasing globalisation of trading in securities and derivatives requires increased regulatory attention to be paid to the reliability and resilience of market processes and of payment and settlement systems. In response to these developments, IOSCO has undertaken a number of initiatives designed to enhance the ability of regulators and market participants to address the safety and soundness of market processes. Work in this area includes:

- a report on *Contract Design of Derivatives Products on Stock Indices and Measures to Minimise Market Disruption (1992)* which identifies issues that market authorities should consider in designing and approving a derivative

product to reduce the risk that the product will impair orderly pricing or be susceptible to manipulation or other market disruptions. It also examines various regulatory measures such as circuit breakers, shock absorbers and price limits to minimise the adverse effects of market disruptions on both cash and derivatives markets; and

- a report published in March 1996 on *Cooperation Between Market Authorities* which recommends that market authorities evaluate carefully the risk of a market member defaulting when a large derivatives position reaches identified trigger levels, so that the necessary steps may be taken to address the risk posed, and which promotes mechanisms to facilitate the sharing of information to assist in such evaluation;

- a further report, also published in March 1996 on *Default Procedures* which among other things sets out a list of information items which should be available to market participants as to procedures that apply when a firm defaults, and identifies best practices on the treatment of proprietary and customer positions, funds and assets to permit the prompt isolation of the problem at the defaulting firm;

- the issuance in March 1996 of a *Recommendation on the Recognition of Bilateral Netting Agreements in the Calculation of Capital Requirements for Securities Firms,* which is intended to encourage the use of legally enforceable bilateral netting agreements by authorised securities firms;

consider a mechanism for improved transparency about the arrangements for customer asset protection in different jurisdictions;

- the preparation of a report on the implications of the use of the Internet and other electronic networks for the regulation of secondary markets.

A number of these issues were identified as of particular importance at a meeting of the regulators of the world's 16 largest futures and options markets in May 1995 which considered the implications for market regulators of the collapse of Barings. At the end of that meeting they issued the *Windsor Declaration* which outlined the main areas where further action was required. This work programme was subsequently adopted by IOSCO at its Annual Conference in July 1995, and IOSCO intends to publish a report in June which will review progress in the first year after publication of the Declaration.

Many of the issues listed above are also of interest to the *BIS Committee on Payments and Settlement Systems (CPSS)*, which is concerned with the integrity of settlement and payment systems from the perspective of the Central Banks. As noted in Section III above, IOSCO has recently established a co-ordinating procedure with the CPSS to identify projects of mutual interest where joint work between the two bodies may be appropriate. IOSCO is currently liaising with the CPSS in the preparation of the report on client asset protection referred to above as well as on a *Report on Margin Requirements for Equities and Derivatives Based on Equities* which will be published shortly.

VII. Responding to New Regulatory Challenges and Fighting Financial Fraud

IOSCO recognises that the increasing innovation and internationalisation of financial markets give rise to new challenges. Regulators need to ensure that their approach to these new challenges facilitates the beneficial effects of such developments whilst protecting against the risk of misuse or abuse. In particular this requires close co-operation between regulators in

different jurisdictions for the purpose of supervision and surveillance of financial markets, to assist in enforcement and to maintain the fight against financial fraud.

Notable aspects of this work include:

- *Report on Money Laundering (1992)* which provided guidance on methods that securities regulators could employ to protect against the use of securities and futures markets in money laundering schemes;

- a review which is currently under way of the capacity of jurisdictions to assist in the repatriation of illegally obtained assets. This project is intended to provide regulators with the knowledge necessary to address issues concerning the recovery of assets where illegally obtained funds are held outside the jurisdiction where the fraud is prosecuted; and

- a recently initiated study of the enforcement challenges associated with the increased use of public electronic networks such as the Internet, which are a growing means of transmitting information as well as for the solicitation and trading of securities and futures on a cross-border basis, regulators will need to be in a position to address situations where these networks are used for illegal purposes. IOSCO will build on current experience to suggest appropriate unilateral and multilateral responses to these developments.

VIII. Other Observations on Regulatory Cooperation

jurisdictions and different sectoral disciplines the extent of progress in recent years has been encouraging. Regulators cannot provide any absolute assurance against future problems and market disruptions, although IOSCO believes that the work currently in train as outlined in this document constitutes a sensible and practical programme to identify and address the risks that may arise in today's complex marketplace.

In this context, however, it should be noted that initiatives taken within the competence of the regulatory and supervisory authorities are inevitably constrained by the existing provisions of national law. In certain cases, these constraints can seriously impede the achievement of desirable supervisory objectives. Particular examples of such constraints already identified include:

- the secrecy provisions of national legislation which restricts the ability of regulators to assist their colleagues in other jurisdictions where there are restrictions on the exchange of banking information, particularly with respect to client information;

- the provisions of national insolvency legislation where there is no provision in national law to give recognition to the efficacy of bilateral netting agreements.

Where such problems are identified, national regulators will work with Ministers to identify appropriate ways in which these concerns could be addressed. IOSCO would welcome the support of Ministers in addressing these matters as and when they are identified.

IX. Conclusion

IOSCO welcomes the opportunity to provide the G-7 Finance Ministers with this account of its current work programme and its plans to strengthen the arrangements for international regulatory

cooperation. This work is kept under regular review and will continue to evolve in order to keep pace with developments in the international financial markets.

IOSCO is confident that the steps outlined in this document and the accompanying Joint Statement with the Basle Committee represents a sensible and cost effective programme to address areas of potential systemic risk, and seeks the support of the Ministers for its ongoing work.

Part 2

Section 2.1

Basle Committee on Banking Supervision

Preliminary Response
to the
Request of the G-7 Heads of Government
at the
June 1995 Halifax Summit

1. The Halifax Summit documents express the G-7 countries' interest in fostering close international cooperation among financial institution regulators and supervisory agencies, with the aim of enhancing the monitoring and containment of risk. This is a principle which the Basle Committee on Banking Supervision strongly supports and it welcomes the importance being placed on it by the G-7. At the request of the G-7 Finance Ministers, the Committee is now presenting its preliminary views on past, present and future collaboration between banking and securities regulators. This paper consists of an initial overview, a résumé of past initiatives which have resulted from collaboration between the Basle Committee and securities regulators and an outline of current or planned joint work. A more thorough review will be prepared for the Ministers in the New Year.

I. Overview

2. First, perhaps, it would be useful to recall what the Basle Committee is and how it operates. Established by the G-10 central bank Governors, the Committee has worked in its twenty years of existence to strengthen banking supervisory standards and encourage sound industry practices worldwide. The Committee's members are all full-time supervisors in central banks or other supervisory agencies, supported by a relatively small Secretariat provided by the Bank of International Settlements in Basle. A brief résumé of the Committee's history and its modus operandi is attached to this note. In particular, the résumé demonstrates the efforts which have been made to strengthen supervisory standards not only in G-10 countries but also worldwide. It should also be

noted that a number of initiatives to address payment and settlement risks have been undertaken by other Committees working under the aegis of the BIS.

3. As Ministers are aware, three major developments of financial systems over the past years have been the degree to which financial activity is now international in scope, the growing complexity of financial products (including derivatives), and the blurring of distinctions between banking institutions and securities firms. Individual national banking and securities supervisors have responded to these developments by improving their systems and abilities to monitor and contain the risks inherent in modern financial markets. However, the Basle Committee has long recognized that effective supervision can no longer be accomplished at national level alone. Virtually all of the Committee's work over twenty years has been directed towards convergence towards agreed common principles and common standards internationally. Some seven years ago the Committee concluded that supervision could not be fully effective in the absence of coordination between banking and securities regulators and took steps to develop contacts between the two disciplines. Shortly afterwards, similar overtures were made to G-10 insurance regulators.

4. Since the Halifax Summit, the Basle Committee has taken two initiatives in this area:

- first, it has attempted to intensify existing contacts (described in more detail below) with members of the Technical Committee of the International Organization of Securities Commissions (IOSCO) both at Chairman and at Working Group levels. A Coordination Group consisting of the Chairmen and Secretaries General of each Committee, assisted by one or two senior members, is being set up for this purpose and will shortly hold its first meeting;

II. Previous Initiatives which Have Resulted from Collaboration Between Bank and Securities Regulators

5. In 1988 the Basle Committee held the first of a series of meetings which certain G-10 securities supervisors were invited to attend in a personal capacity. Three of these meetings took place at annual intervals. The topics discussed included the need to improve arrangements for the exchange of information between bank and securities regulators, capital requirements for position risk and the supervision of the securities operations of banks. In 1991, with the establishment of the IOSCO Technical Committee, the possibility for cooperation and cooperation between the two families of supervisors improved considerably. A full meeting between the Basle Committee and the Technical Committee took place in January 1992. More frequent contacts have continued at Chairman level and at Working Group level, first on common capital requirements for market risk and more recently on financial conglomerates, risk management guidelines and derivatives reporting standards.

6. The Basle Committee has prepared and issued several papers jointly with securities regulators, particularly in the last two years. These include:

a) ***exchanges of information*** between banking and securities supervisors (April 1990);

b) two separate papers on ***risk management guidelines for derivatives*** which were developed simultaneously and released under a joint cover note (July 1994);

c) a ***derivatives reporting framework***, consisting of a "catalogue" and a minimum reporting framework representing a subset of the catalogue (May 1995);

d) a paper on the ***supervision of financial conglomerates*** prepared by an informal Tripartite Group of bank, securities and insurance regulators established at the initiative of the Basle Committee (July 1995).

7. During the course of 1991 and 1992 the Basle Committee and IOSCO held intensive discussions concerning the possibility of establishing common capital requirements for the market risks of banks and securities firms. Since these discussions did not produce a consensus, the Basle Committee issued formal proposals for banks alone in April 1993. These proposals were close to those adopted by the European Union in its Capital Adequacy Directive, which applies both to banks and securities firms. The Basle Committee has recently (April 1995) issued revised proposals, envisaging the possible use of internal models in measuring banks' market risks.

III. Ongoing and Future Collaboration Between Bank and Securities Regulators

8. There are several projects under way which are designed to reinforce prudential standards and encourage sound industry practices. These are, however, complex issues and progress will inevitably take time. They include:

- on ***capital adequacy***, IOSCO is currently studying the use of internal models for measuring market risks and some of its experts are in close contact with the relevant Basle Committee Working Group;

- on ***derivatives***, work is in train at technical level in order to expand the ***reporting*** framework (see 6 (c) above) from two aspects. The first is to cover market risks in more detail, and the second to develop guidelines for banks'

establishing a central register for derivatives contracts, a suggestion put forward by the German delegation in Halifax;

- on ***financial conglomerates***, the Basle Committee, IOSCO and the International Association of Insurance Supervisors have agreed to reconstitute the Tripartite Group (see 6 (d) above) as a forum which formally represents the three parent Committees. The Group has been given a mandate which includes the review of practical means to facilitate the exchange of information between the competent supervisors, examination of the possibility of establishing criteria to identify a lead supervisor and the development of a set of principles to govern the future supervision of financial conglomerates.

9. A more detailed response to the Halifax Communiqué will be prepared by the Basle Committee to provide a longer-term perspective on its activities, including a review of the Committee's past actions to strengthen prudential standards. It will also describe past relations with securities regulators and IOSCO. Following meetings with representatives of IOSCO planned over the next few months, the Committee will hopefully be in a position to present ideas for strengthening those relations, including the identification of potential areas of work for future collaboration between banking and securities regulators.

September 1995

Annex I

Basle Committee on Banking Supervision

1. The Basle Committee was established by the central bank Governors of the Group of Ten countries at the end of 1974 in the aftermath of serious disturbances in international currency and banking markets. The Committee's members come from Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Sweden, Switzerland, the United Kingdom and the United States. Countries are represented by the heads of supervision or senior executives of the central bank and other authorities with formal responsibility for the prudential supervision of banking business (see Annex II). The present Chairman of the Committee is Dr. T. Padoa-Schioppa, Deputy Director General of the Bank of Italy.

2. The Committee provides a forum for ongoing cooperation between member countries on banking supervisory matters. It does not possess any formal supranational supervisory authority; its conclusions do not have, and were never intended to have, legal force. Rather, it formulates broad supervisory standards, practices, and guidelines which individual authorities use to implement detailed arrangements - statutory or otherwise - which are best suited to their own national systems. In this way, the Committee encourages convergence towards common approaches and common standards without attempting detailed harmonization of member countries' supervisory techniques.

3. The key objectives of the Committee are to strengthen international cooperation, improve the overall quality of banking supervision worldwide, and ensure that no foreign banking establishment escapes supervision. In 1975, shortly after its foundation, the Committee addressed the supervision of foreign banking establishments in a document often referred to as the *"Concordat"*. The Concordat was revised and expanded in May 1983 (supplemented in April 1990) with the publication of *"Principles for the Supervision of Banks' Foreign Establishments"*. These principles establish, as a matter of best practice, how supervisory responsibility for banks' foreign branches, subsidiaries and joint ventures should be shared between host and parent (or home)

supervisory authorities. In June 1992, a number of these principles were reformulated as minimum standards. The Committee is working closely with banking supervisory authorities around the globe on the implementation of these standards.

4. Capital adequacy is another major focus of the Committee. In the early 1980s, capital ratios of the main international banks were deteriorating at a time when international risks, notably those vis-à-vis heavily-indebted countries, were growing. Backed by the G-10 Governors, the Committee resolved to halt that deterioration. In July 1988, it published the *Basle Capital Accord* which established minimum capital standards and a common framework for measuring capital adequacy. These minimum standards and the measurement framework are being followed not only in member countries, but in virtually all other countries having internationally-active banks as well.

5. The 1988 capital framework is not static, but is intended to evolve over time. A November 1991 amendment to the Accord provides more precision regarding the inclusion of general provisions or general loan-loss reserves as part of bank capital. An April 1995 amendment, effective at end-1995, recognizes the effects of bilateral netting of banks' credit exposures in derivative products and expands the matrix of add-on factors. The 1988 capital framework is also being expanded to address risks other than credit risk, its original focus. In April 1995, the Committee issued revised proposals to incorporate within the Capital Accord the market risks arising from banks' open positions in foreign exchange, traded debt securities, equities, commodities and options. The main change from an initial proposal in April 1993 is that banks be permitted, subject to strict qualitative and quantitative standards, to use their own internal models to measure market risk.

6. The Committee addresses a wide range of other supervisory issues and has published papers, for example, on the supervision of banks' foreign exchange positions, the management of

7. The Committee actively encourages cooperation between its members and other banking supervisory authorities around the world, and maintains close relations with regional banking supervisory associations. Contacts are further strengthened by biennial international conferences of banking supervisors, held since 1979. The next conference will take place in June 1996 in Sweden. The development of close personal contacts between supervisors in different countries has greatly helped in the handling and resolution of problems affecting individual banks as they have arisen. This is an important, though necessarily unpublicized, element in the Committee's regular work.

8. In response to the blurring of distinctions between banking and securities activities, the Committee works closely with the International Organization of Securities Commissions. The most recent result has been a joint report, in May 1995, setting out a framework for supervisory information about the derivative activities of banks and securities firms. Members of the Basle Committee are also working with securities and insurance regulators on the supervision of financial conglomerates. A discussion paper on this matter was issued in July 1995 and further work is in train. In addition, the Committee has worked with other international bodies such as accounting organizations which has resulted in the publication of occasional papers.

9. The Committee's Secretariat is provided by the Bank for International Settlements in Basle, where the Committee's meetings normally take place every three months. The Secretariat, currently seven strong, is mainly staffed by professional supervisors on temporary secondment from member institutions. In addition to undertaking the secretarial work for the Basle Committee and its sub-committees, it stands ready to give advice to supervisory authorities in all countries and conducts several annual training programmes for bank supervisors.

Basle, September 1995

Annex II

Institutions Represented on the Basle Committee on Banking Supervision

Belgium:	National Bank of Belgium
	Banking and Finance Commission
Canada:	Bank of Canada
	Office of the Superintendent of Financial Institutions
France:	Bank of France
	Banking Commission
Germany:	Deutsche Bundesbank
	Federal Banking Supervisory Office
Italy:	Bank of Italy
Japan:	Bank of Japan
	Ministry of Finance
Luxembourg:	Luxembourg Monetary Institute
Netherlands:	The Netherlands Bank
Sweden:	Sveriges Riksbank
	The Swedish Financial Supervisory Authority
Switzerland:	Swiss National Bank
	Swiss Federal Banking Commission
United Kingdom:	Bank of England
United States:	Federal Reserve Board
	Federal Reserve Bank of New York
	Office of the Comptroller of the Currency
	Federal Deposit Insurance Corporation
Secretariat:	Bank for International Settlements

Section 2.2

Organisation internationale des commissions de valeurs
International Organization of Securities Commissions
Organización internacional de comisiones de valores
Organização internacional das comissões de valores

OICV / IOSCO

October 3, 1995

The Honourable Paul Martin, P.C., M.P.
Minister of Finance
Ottawa (Ontario) K1A 0G8

Dear Minister,

It is my pleasure to submit the following preliminary response on behalf of the International Organization of Securities Commissions (IOSCO) to the G-7 Finance Ministers' request of June 1995. This letter outlines IOSCO's ongoing work on the topic of the monitoring and containment of risk. Annexed to this letter is Background which provides more descriptive information about IOSCO, the work it has completed in the past few years and its current agenda. I also enclose a copy of the Organization's most recent Annual Report.

The G-7 Ministers noted in their June 1995 Halifax Summit Report that closer international cooperation in the regulation and supervision of financial institutions and markets is essential to safeguard the financial system and prevent an erosion of prudential standards. The Ministers have urged a deepening of cooperation among regulators and supervisory agencies to ensure an effective and integrated approach, on a global basis, to developing and enhancing the safeguards, standards, transparency and systems necessary to monitor and contain risks.

The mandate of IOSCO is wholly consistent with such aims. IOSCO serves as the main vehicle through which securities regulators communicate and cooperate with each other on an international basis. As elaborated upon in the annexed Background, the members of IOSCO have publicly resolved to cooperate together in order to maintain fair and efficient securities markets, to exchange information to promote the development of markets, to establish common standards and effective

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surveillance of international securities transactions and to provide mutual assistance to ensure the integrity of the markets by a rigorous application of the standards and by effective enforcement against offenses. IOSCO also facilitates discussions and arrangements amongst its members, bilaterally or otherwise which advance its mission.

IOSCO considers close international cooperation with other regulators necessary to achieve its mandate. International cooperation has been actively pursued by IOSCO with others who regulate areas such as accounting and auditing standards, banking institutions, and insurance companies. Particularly important is our significant involvement with the Basle Committee of the Bank for International Settlements. This relationship with the Basle Committee has evolved over time and, of late, resulted in an ambitious joint workplan and output. As I remarked at our recent Annual Conference, market participants are increasingly seizing the opportunity to draw upon the relative strengths of the two regulatory cultures, (i.e., those applicable to banking and securities firms), rather than compromising either or both in the effort to achieve a better coordinated framework.

As with any effort to bring two cultures closer together, the differences in underlying regulatory objectives and instruments employed must be understood from the outset, in order to optimize the chances of drawing on the best each has to offer. Notwithstanding these differences, IOSCO strongly believes there are significant areas of commonality where continued cooperation with the financial institutions regulator will amplify collective interests and abilities. This is evidenced by the extensive work that IOSCO has undertaken jointly with the Basle Committee over the past two years.

As will be clear from this letter and its attachment, IOSCO is intensifying its efforts on international regulatory issues and cooperation in order to respond to the increasing globalization of financial

The specific work undertaken by IOSCO is primarily carried out through the five Working Groups of the Technical Committee. IOSCO's projects that focus on the monitoring and containment of risk are briefly summarized below. Further detail regarding the work performed is provided in the Background.

IOSCO's **Working Group on the Regulation of Market Intermediaries** has undertaken significant work on the topic of monitoring and containment of risk. Much of its focus in the past year has been devoted to joint work with the Basle Committee. A number of reports have been produced by the Working Group, both independently and in conjunction with the Basle Committee.

IOSCO and the Basle Committee have been participating, along with the International Association of Insurance Supervisors, in a Tripartite Group, which was formed to examine issues related to the supervision of financial conglomerates. A joint report regarding theses issues was released in July 1995. The report addresses structural concerns posed by financial conglomerates and their cross-border activities and the difficulties for different regulators from the insurance, banking and securities sectors in dealing with them. Work will be carried out in this area under a newly constituted Tripartite Group.

An IOSCO report, *"Operational and Financial Risk Management Control Mechanisms for Over-the-Counter (OTC) Derivatives Activities of Regulated Securities Firms"* was released in July 1994 concurrently with a Basle Committee report, *"Risk Management Guidelines for Derivatives"*. This joint release was followed up by a joint report with the Basle Committee issued in May 1995 entitled, *"Framework for Supervisory Information About the Derivatives Activities of Banks and Securities Firms"*.

The Technical Committee of IOSCO in response to the Basle Committee's invitation to comment on its most recent market risk capital proposals, adopted in July 1995 a report entitled, *"The Implications for Securities Regulators of the Increased Use of Value at Risk Models by Securities Firms"*. The report proposes that common work with the Basle Committee be pursued on model

testing and recommends that further consideration be given to the development of standards of best practice to be adopted by firms using value at risk models for regulatory purposes. Discussions concerning these initiatives are ongoing with a view to resolving several important issues so that IOSCO could support the use of proprietary models for regulatory purposes.

Other current collaborative efforts with the Basle Committee include initiatives relating to the treatment of netting for regulatory capital purposes and to disclosure practices regarding off-balance sheet instruments.

The **Working Group on the Regulation of Secondary Markets** has prepared a number of papers which focus on risk. The Working Group issued a report in 1993 entitled *"Mechanisms to Enhance Open and Timely Communication Between Market Authorities of Related Cash and Derivative Markets During Periods of Market Disruption"*. Other related work in areas such as cross-border proprietary screen-based trading systems, OTC derivatives transactions, transparency principles in relation to secondary equity markets, and margin requirements is ongoing.

The **Working Group on Enforcement and the Exchange of Information** issued a report adopted by IOSCO in June 1994 entitled, *"Issues Raised for Securities and Futures Regulators by Under-Regulated and Uncooperative Jurisdictions"* along with the related *"Resolution on the Commitment to Basic IOSCO Principles of High Regulatory Standards of Mutual Cooperation and Assistance"*. This report identifies the needs of regulators with respect to under-regulated and uncooperative jurisdictions. Work is also continuing on measures available on a cross-border basis to protect the interests and assets of defrauded investors. Additionally, the Working Group has raised awareness among IOSCO members of the need to collectively fight money laundering. The Working Group has also prepared a set of *Principles for Memoranda of Understanding (MOUs)* on

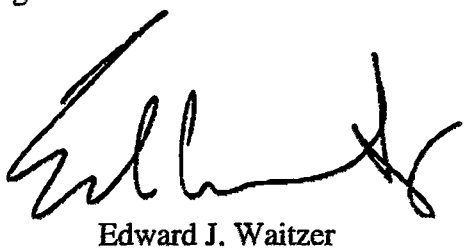
worldwide in multinational offerings. IOSCO has been working with the International Accounting Standards Committee and the International Auditing Practices Committee in this area. As well a set of commonly agreed non-financial disclosure standards acceptable to securities regulators is in the process of being developed.

The **Working Group on Investment Management** recently published a *Report on Investment Management* which outlined basic principles for the regulation of collective investment schemes (CIS) and an international comparative analysis that reviewed the regulatory framework applicable in several IOSCO jurisdictions. It is now focussing on cooperation issues of specific relevance to CIS. Three new projects which address custodial arrangements, emergency procedures and investor education and communication have recently been approved by the Technical Committee.

Many of the reports mentioned above were referred to during the discussions at Windsor in the United Kingdom in May 1995 by representatives of regulatory bodies from 16 countries responsible for supervising the world's largest futures and options markets. Follow-up work arising from that meeting, relating to cooperation between market authorities, protection of customer assets, default procedures and regulatory cooperation in emergencies, is being dovetailed into the work programmes of the various Working Groups.

All of the foregoing initiatives promote closer international cooperation among regulators and more effective monitoring and, in appropriate circumstances, containment of certain risks. The linkages forged, both within IOSCO and with other organizations, have become instrumental to a wide range of efforts, bilateral and multilateral, to enhance regulatory coordination and effectiveness and the harmonization of standards. We welcome the recognition that the First Ministers accorded in Halifax to the importance of such efforts.

Yours truly,



Edward J. Waitzer
Chairman of the Technical Committee

ANNEX

BACKGROUND TO G-7 FINANCE MINISTERS ON INTERNATIONAL COOPERATION IN THE REGULATION AND SUPERVISION OF FINANCIAL INSTITUTIONS AND MARKETS: THE WORK OF THE INTERNATIONAL ORGANIZATION OF SECURITIES COMMISSIONS (IOSCO)

Background

1. IOSCO began as the Inter-American Association of Securities Commissions in 1974. In 1983, it was transformed into an international body with 24 charter members and in 1986 its General Secretariat and head office were established in Montreal (Quebec). By the end of the XXth IOSCO Annual Conference which took place in Paris in July 1995, it had 121 regular, associate and affiliate members. The regular membership includes the statutory or governmental regulatory authorities responsible for the oversight of securities, futures and options markets in over 70 countries. The member regulators of IOSCO regulate more than 90% of the world's capital markets. Among the July 1995 additions to the membership of IOSCO are the China Securities Regulatory Commission, and the Russian Federation Commission on Securities and the Capital Market.

2. The associate membership is a small category comprising mainly additional statutory authorities from particular jurisdictions. The affiliate membership is composed of self-regulating organizations, (SROs), as well as international bodies with an interest in securities markets regulation.

Committee Structure

3. With a broad-based membership of this kind, IOSCO provides those entrusted with the responsibility for regulating securities markets the main vehicle through which to communicate and cooperate with each other on an international basis. IOSCO also views as important discussions and arrangements amongst its members, bilaterally or otherwise that facilitate the execution of its mission. The structure of IOSCO is designed to facilitate this process. A chart depicting it is included in IOSCO's most recent Annual Report, a copy of which is annexed. This shows the following key Committees:

- The Presidents Committee, which meets once a year during the Annual Conference, and is composed of the Presidents of the regular and associate member agencies of IOSCO; it has all powers necessary to achieve the objectives of the Organization (see paragraph 5).

- The Executive Committee, which has 18 members, 12 of whom are elected by the Presidents Committee; the remaining 6 represent the four IOSCO regions, and the Technical and Emerging Markets Committees; the Executive Committee meets periodically during the year and, in taking the decisions necessary to achieve IOSCO's objectives, is in effect its management and strategic planning committee.

- The 4 Regional Standing Committees meet to discuss specific regional problems of their memberships; the rate of meeting varies for each of these.

- The Technical Committee and the Emerging Markets Committee are the two

16 agencies that regulate the larger and more developed securities markets in the world; the Emerging Markets Committee, for its part, comprises agencies from 44 jurisdictions;

- The Technical Committee has as its objective the requirement to review major regulatory issues related to international securities transactions, to promote the adoption of common (or equivalent) rules worldwide, and to coordinate practical responses to these concerns; a more detailed analysis of its operations is given in paragraph 6;

- The Emerging Markets Committee has as its mission the development and improvement of efficiency of the emerging securities markets by establishing principles and minimum standards, preparing training programmes for the personnel of Committee members, and facilitating the exchange of information and transfer of technology and expertise; further information is given in paragraph 8;

- The Consultative Committee comprises the affiliate members of IOSCO, and aims to facilitate close dialogue between statutory regulatory authorities and SROs and international bodies; the objective of this is to provide for the injection of practitioner and other expertise into the deliberations of IOSCO, particularly the Technical and Emerging Markets Committees' Working Groups.

Annual Conference

4. IOSCO holds an Annual Conference for the full membership, which is normally divided into 2 main sections:

- the Committee, or non-public, sessions which, in effect, constitute the Annual General Meeting of the members, or stakeholders, in the organization; these last for about 2 full days;

- the Panel, or public, sessions, which observers of the international financial community and media can and do attend and at which major topical regulatory, market, and other issues relevant to world securities and futures markets are discussed; panellists include representatives of regulatory authorities, exchanges, firms, SROs, academic establishments, the financial media, government departments, and other organizations.

The Objectives of IOSCO

5. The IOSCO members have resolved:

- to cooperate with the aim of ensuring better regulation, on the domestic and international level, in order to maintain just and efficient securities markets;

- to exchange information on their respective experiences in order to promote the development of domestic markets;

- to unite their efforts to establish standards and the effective surveillance of international securities transactions;

- to provide mutual assistance to ensure the integrity of markets by rigorous application

Technical Committee: Recent Work

6. The Technical Committee's work has since 1990 been divided into 5 major subject areas:

- Multinational Disclosure and Accounting;
- Regulation of Secondary Markets:
- Regulation of Market Intermediaries;
- Enforcement and the Exchange of Information;
- Investment Management.

Specialized Working Groups have been set up to address each of these subject areas. The members of the Working Groups meet several times annually in order to carry forward their work, which is set on a continuing basis by the Technical Committee in the form of mandates.

7. Synopses of current developments in Working Groups are published at the Annual Conference in the form of reports by the Chairs of the Working Groups, and summarized in the Final Conference Communiqué. A copy of the Communiqué issued after the July 1995 Annual Conference in Paris is attached. A note on some of the most important work accomplished in recent times by each Working Group (WG) is set out below:

a. **WG1: Multinational Disclosure and Accounting**

The mandate of WG1 is to agree on the endorsement of a set of accounting, auditing and non-financial disclosure standards for use worldwide in multinational offerings. For this purpose, WG1 has been in discussions with the International Accounting Standards Committee (IASC) about a set of relevant standards, and the International Auditing Practices Committee (IAPC) with a view to endorsing international auditing standards. It has also worked on preparing commonly agreed non-financial disclosure standards acceptable to securities regulators.

At the July 1995 Conference the Technical Committee and the Board of the IASC issued a Joint Press Release announcing that they had agreed upon a work plan that, when successfully completed, would result in a comprehensive core set of international accounting standards (IAS). Provided the Technical Committee is satisfied with this core set, it will then be in a position to recommend endorsement of the IAS for cross-border capital raising and listing purposes. IOSCO has already endorsed IAS 7, *"Cash Flow Statements"* and has indicated to the IASC that a further 14 of the existing IAS will not require additional improvement, providing that the other core standards are successfully completed.

The goal of both bodies is that financial statements prepared in accordance with IAS can be used worldwide in cross-border offerings and listings as an alternative to the use of national accounting standards.

As regards the International Auditing Guidelines (IAG), IOSCO had provisionally endorsed a set of these in October 1992. However, these were in plain text without emphasis, or black-lining, of certain sections. In the period following this endorsement, the IAPC introduced black-lined IAG which superseded the previous set and, in some parts, changed their meaning. WG1 is currently focussing its efforts on accounting and non-financial disclosure issues, but expects to address the issue of possible IAG endorsement again in due course. The aim of both IOSCO and IAPC in this work would be the same as with international accounting standards, that international standards on auditing could be used as an alternative to national standards in relation to worldwide cross-border listings and offerings.

develop and propose for endorsement by the Technical Committee a set of non-financial minimum disclosure standards in due course.

b. **WG2: Regulation of Secondary Markets**

WG2 has completed work in the past year on regulatory issues associated with the *Regulation of Cross-Border Proprietary Screen-Based Trading Systems*, a report on which was publicly released during the October 1994 Annual Conference in Tokyo. The report is intended to contribute to the evolving debate concerning regulatory issues in this relatively new area.

WG2 also is currently considering topics relating to OTC derivatives markets. The first area of consideration is the enforceability of netting arrangements for such products. Other topics expected to follow are: clearing houses for OTC derivatives transactions; market information regarding OTC activity; and intermediary / customer relationships in OTC derivatives transactions. Market transparency issues also are expected to be addressed, as a follow-up to the set of *Initial Transparency Principles* previously produced by WG2.

Most recently, at the July 1995 Conference, WG2 submitted to the Technical Committee a Report entitled *"Summary and Chart of Margin Survey Responses"*. This survey had as its primary objective the compilation of a "comprehensive document describing margin provisions in member jurisdictions in order to recognize regulatory objectives and concerns about margin requirements". The Report, deriving from an analysis of the survey outcome, focused on margin requirements for equities and derivatives based on equities, and covers margin levels (both for initial and maintenance margin), procedures for margin calculation and collection, mechanisms set up to deal with extraordinary market conditions, and provisions concerning cross-margining. Additional work on some of the substantive issues is expected to be addressed by WG2 before the report is published.

Earlier reports prepared by WG2 include that of October 1993 entitled *"Mechanisms to Enhance Open and Timely Communication Between Market Authorities of Related Cash and Derivative Markets During Periods of Market Disruption"*. Particular note was taken of this report during the discussions at Windsor in the United Kingdom on May 16 and 17, 1995 by representatives of regulatory bodies from 16 countries responsible for supervising the activities of the world's major futures and options markets. This meeting resulted in the *Windsor Declaration*, which is referred to in more detail in paragraph 11.

c. **WG3: Regulation of Market Intermediaries**

WG3 has undertaken a substantial programme of work in recent years, particularly in the areas of prudential supervision and client protection. It has had the lead responsibility under the auspices of the Technical Committee for ensuring good coordination and consultation with the work of the Basle Committee on Banking Supervision. Much of its work in the past year has focussed on joint efforts with the Basle Committee. A number of significant reports have been produced by WG3, both independently and in conjunction with the Basle Committee. Among these are:

- *Principles for the Supervision of Financial Conglomerates* (October 1992), which addresses concerns relating to the structure of modern financial conglomerates and their cross-border activities, and the difficulty for different regulators from the insurance, banking, and securities sectors in dealing with them;

- *Operational and Financial Risk Management Control Mechanisms for*

- the above paper was publicly released simultaneously with the Basle Committee Report on *"Risk Management Guidelines for Derivatives"*; the occasion was marked by the fact that, for the first time, a Joint Press Statement relating to both reports was issued by the Basle Committee and the Technical Committee.

More recently, continued cooperation with the Basle Committee resulted in the publication, in May 1995, of a joint report with the Technical Committee on a *"Framework for Supervisory Information About the Derivative Activities of Banks and Securities Firms"*. It comprises a catalogue of information identified as important for an evaluation of derivatives risks and a common minimum framework of data elements that should be provided to regulators. The release of this report represents an important step in the ongoing cooperation between securities and banking regulators to ensure prudent oversight of the securities activities carried on by securities firms and by banks.

At the July 1995 Conference, the Technical Committee adopted a WG3 report entitled *"The Implications for Securities Regulators of the Increased Use of Value at Risk Models by Securities Firms"*. The report discusses the nature of these models and how they are developed, and considers the implications for securities regulators of recognizing their output for the purpose of calculating capital requirements for market risk. It was sent to the Basle Committee in response to that Committee's invitation to comment on its April 1995 proposals on capital requirements for market risk. The report proposes that common work with the Basle Committee be pursued on model testing and recommends that further consideration be given to the development of standards of best practice to be adopted by firms using value at risk models for regulatory purposes. Discussions concerning such initiatives are ongoing. In connection with the issuance of the report, the Chairman of the Technical Committee has written to the Chairman of the Basle Committee on Banking

Supervision summarizing the issues that need to be resolved before the Technical Committee could support the use of firm proprietary models for regulatory purposes. These issues include the ability of a model to accommodate a statistically improbable event, such as a market break or currency crisis; the ability to assess and set standards for a model's parameters, including the extent of the market movements applied to the underlying products, the correlations or netting factors used within the model and the observation period used; and, the need for consistent standards among dealers.

An informal Tripartite Group (comprising members of the Technical Committee, the Basle Committee and the International Association of Insurance Supervisors) has been examining issues relating to the supervision of financial conglomerates, a matter addressed by IOSCO in papers published in 1992. During the July 1995 Conference, the Technical Committee approved the publication of the Tripartite Group's final report with a jointly agreed Preface. All three groups of supervisors have subsequently agreed to participate in a reconstituted Tripartite Forum, which will pursue work on practical issues in this area.

In addition WG3 is continuing to consider the issue of the appropriate treatment of netting for capital purposes in close liaison with the Basle Committee. WG3 has reviewed the recent proposals of the Basle Committee with respect to the treatment of bilateral netting and is in the process of developing recommendations for consideration by the Technical Committee on bilateral and multilateral netting.

WG3 is also continuing its discussions with the Nouy sub-group of the Basle Committee on off-balance sheet instruments. The Nouy sub-group is participating

d. **WG4: Enforcement and the Exchange of Information**

In June 1994 the Technical Committee adopted a WG4 report entitled *"Issues Raised for Securities and Futures Regulators by Under-Regulated and Uncooperative Jurisdictions"* along with the related *"Resolution on the Commitment to Basic IOSCO Principles of High Regulatory Standards of Mutual Cooperation and Assistance"*. This report was published during the October 1994 Conference, and identifies the needs of regulators with respect to under-regulated and uncooperative jurisdictions. In particular, it describes the obstacles which may hamper the flow of information needed from such jurisdictions for the conduct of supervisory activities, as well as the prosecution of enforcement casework. It also describes methods used by Technical Committee members to obtain such information, and suggests possible courses of action to improve the situation.

The Resolution requests all IOSCO members to state their commitment to the Principles described, and to prepare a written self-assessment of their ability to provide mutual assistance and cooperation to foreign securities and futures regulators. It authorizes the General Secretariat of IOSCO to establish and maintain a file of the self-evaluations and to make them available to all members of the Organization. Finally, the Resolution indicates IOSCO's intention to monitor closely the ability of its members to obtain information, and to take such steps as may be necessary and appropriate to address the situation in the future.

At the July 1995 Conference, the Technical Committee, after consulting with the Emerging Markets Committee, adopted *Guidance Notes* designed to assist members of IOSCO in implementing the Resolution.

Meanwhile, work is continuing in WG4 on measures available on a cross-border basis to protect the interests and assets of defrauded investors. Focus is on measures available to freeze and repatriate assets, and to enforce foreign freeze and repatriation

orders. Consideration will be given to ways in which securities and futures authorities can work together, and with other authorities, to use and expand the available measures.

Other useful work by WG4 in recent years has included activity to raise the awareness among IOSCO members to implement measures to fight money laundering, in which there has been substantial contact with the Financial Action Task Force (FATF). It has also prepared a set of *Principles for Memoranda of Understanding (MOUs)* on the exchange of information and mutual assistance, to help regulators which undertake to negotiate and sign these administrative agreements.

e. **WG5: Investment Management**

WG5 is the most recently established of those under the Technical Committee's auspices. Its initial mandate was set in two parts in 1993:

- to identify equivalence in the regulatory framework for collective investment schemes for the purposes of eliminating barriers to cross-border distribution;

- to consider and recommend on the enhancement of cross-border regulatory cooperation in relation to collective investment schemes and their operators.

The first part of this mandate was completed in 1994 with the publication at the October 1994 Conference of the *"Principles for the Regulation of Collective Investment Schemes"*, together with an *Explanatory Memorandum.* At the July 1995

The Principles are intended to provide guidance for industry participants on the standards to be applied by collective investment schemes seeking access to international markets, and for IOSCO member agencies in their regulation of such schemes. Implementation of the principles should enhance cooperation among regulators in the supervision and oversight of the increasingly international investment management industry.

WG5 is currently focussing on the second part of its mandate, and has prepared a draft discussion paper concerning cooperation issues of specific relevance to collective investment schemes (CIS). These consider two main aspects:

- the extent of internationalization of CIS, including some impediments to cross-border activity and cooperation in this context; and

- how possible cooperation relating to CIS activities could be promoted; this is being proposed in the form of two non-exclusive models dealing with: (1) the accreditation of schemes for marketing in a foreign jurisdiction; and (2) the requirements for information exchange and surveillance inspections by domestic or foreign regulators in connection with the ongoing monitoring of foreign investment management activity.

It is hoped that work on these issues will be completed before the end of 1995.

WG5 recently was given the mandate to initiate work on three additional discussion papers. One paper will examine issues relating to CIS custodial arrangements and will include a "code of best practice" for CIS to ensure that their assets are separately identified and held safe. Another paper will address regulatory cooperation in emergencies and, in particular, the policies to be applied in determining whether suspension of dealing in and redemptions of CIS units is appropriate. The third paper

will examine issues relating to marketing, advertising, investor education, and disclosure, with particular focus on communicating information concerning risk. The first two papers in particular are consistent with the recommendations for future work set out in the *Windsor Declaration*, discussed in paragraph 11.

Emerging Markets Committee

8. The significant growth of the emerging securities markets in recent years is an increasingly important factor in the world economy, and has been reflected in the evolving structure of IOSCO. During 1994 work was undertaken to transform the previously existing Development Committee into the Emerging Markets Committee (EMC) by defining a new mission for it as follows:

- the development and improvement of efficiency of emerging markets;
- establishing principles and minimum standards;
- preparing training programs for the personnel of members; and
- facilitating the exchange of information, transfer of technology and expertise.

To accomplish these goals the EMC created a Working Group structure similar to that of the Technical Committee, and established new project agendas to facilitate the transfer of expertise from that Committee and to adapt it to the specific needs of emerging markets regulators.

9. The EMC structure facilitates coordination and information sharing at the Working Group level between IOSCO's two major Committees. The Technical Committee and the EMC

10. Although the EMC has in the last year been concerned with its reorganization, its predecessor, the Development Committee, produced a good deal of effective substantive output:

a. **Working Group on Disclosure**

- publication in 1994 of a model prospectus for emerging markets setting out the minimum disclosure standards to be used in public offerings; and

- surveying the level of implementation of the standards.

b. **Working Group on Institutional Investors**

This Group reported at the October 1994 Conference on the following:

- the impact of institutional investors in the development process of capital markets;

- evaluating the role of the regulatory agency;

- determining the appropriate degree of regulation of mutual funds and pension funds;

- evaluating the need to establish investment guidelines for institutional investors;

- comparative analysis of systems in developed and developing markets used to encourage institutional investors.

c. **Working Group on Derivatives**

This Group assembled and analyzed case studies of derivative markets at different stages of development, and concluded with a report published at the October 1994 Conference. This offered conclusions on the conditions for the development and regulation of derivative markets where there was broad and sufficient demand for the products traded, cost effectiveness in doing so, and the presence of an adequate financial infrastructure.

d. **Working Group on Clearing and Settlement**

Production since 1992 of a clearing and settlement blueprint to help emerging markets regulators supervise and participate in the establishment of clearing and settlement facilities in accordance with the Group of Thirty standards.

e. **Working Group on Market Incentives**

Publication in 1992 of a *Report on Stimulation Policies for Market Development* which includes an inventory of market development measures used in 24 emerging markets and a number of studies.

The formation of the new five Working Groups of the EMC, and the definition of their goals and working programmes to mirror those of the Technical Committee, has led and will continue to lead to greater coordination and cooperation. The respective Chairs of the EMC Working Groups act as observers at the Working Groups of the Technical Committee in order to obtain updated information that can be conveyed to all the members of this Committee. This allows for an effective channel of communication between the more experienced countries and those with less experience. The new structure serves to enhance transfers of technology and expertise to face issues arising from the

Windsor Declaration Follow-up

11. The Technical Committee Working Groups have substantial ongoing mandates to pursue. An injection of a considerable body of new work occurred, however, as a result of the Windsor Meeting and Declaration referred to above. The Technical Committee has authorized the Working Groups to consider the four main areas of work identified at Windsor and to decide what aspects could usefully be taken into their programmes. This process is now under way, with the aim of agreeing to action plans and embarking on them in time to report preliminary conclusions and recommendations to the next Technical Committee meeting in early November. The work entailed is covered by the broad range of issues examined at Windsor under the following headings:

- Cooperation between market authorities;
- Protection of customer positions, funds and assets;
- Default procedures;
- Regulatory cooperation in emergencies.

The detail of the specific items of work to be assessed for examination by the Working Groups is given in Part III of the *Windsor Declaration*, annexed hereto.

12. At the July 1995 Technical Committee meeting the Co-Chairmen of the Windsor meeting reported on interim progress in carrying forward agreements reached at Windsor, both nationally and through international bodies. They recommended means for IOSCO to coordinate its future work programme in this area with other bodies, notably the Basle Committee and the Futures Industry Association, which has issued its own report on the integrity of the futures markets. Their report and recommendations were accepted by the Technical Committee, and should provide an effective stimulus to ensuring that the future work of IOSCO remains focused on issues of practical concern, as well as being properly

dovetailed with the interests of other regulators, the industry, and investors. A copy of their report is attached.

Part 3

Section 3.1

Excerpt from the Halifax Summit (June 15-17, 1995) Communiqué

" **PREAMBLE**

1. We, the Heads of State and Government of seven major industrialized nations and the President of the European Commission, have met in Halifax for our 21st annual Summit. We have gathered at a time of change and opportunity, and have reaffirmed our commitment to working together and with our partners throughout the world." (Page 1)

" **MEETING THE CHALLENGES OF THE 21st CENTURY**

...

Strengthening the Global Economy

...

22. Closer international cooperation in the regulation and supervision of financial institutions and markets is essential to safeguard the financial system and prevent an erosion of prudential standards. We urge:

- a deepening of cooperation among regulators and supervisory agencies to ensure an effective and integrated approach, on a global basis, to developing and enhancing the safeguards, standards, transparency and systems necessary to monitor and contain risks;
- continued encouragement to countries to remove capital market restrictions, coupled with strengthened policy advice from international financial institutions on the appropriate supervisory structures;
- Finance Ministers to commission studies and analysis from the international organizations responsible for banking and securities regulations and to report on the adequacy of current arrangements, together with proposals for improvement where necessary, at the next Summit." (Page 4)

Section 3.2

Excerpt from the Halifax Summit Background Document Entitled "Review of International Financial Institutions"

" **6. Strengthening Financial Market Supervision and Regulation**

The growth of financial markets, the development of new instruments, and a desire for diversification of investment have spurred global integration of national markets and increased liquidity. These developments have led to a more efficient allocation of capital and thus greater growth of economic activity. At the same time, with today's highly integrated financial markets, there is a greater potential for the rapid transmission of financial disturbances. Close international cooperation in the regulation and supervision of financial institutions and markets is essential to the continued safeguarding of the financial system and to prevent erosion of necessary prudential standards.

Continued strengthening of these efforts has the full support of G-7 Finance Ministers and Central Bank Governors. We look forward to the development and further enhancement of concrete international understandings, where necessary and appropriate, on the safeguards, standards, transparency, and systems necessary to reduce potential risks. In this context, we recognize the important initiatives being undertaken separately and jointly by various committees under the aegis of the BIS and the International Organization of Securities Commissions as well as by national authorities.

- **The G-10 should be encouraged to intensify their review of work in this area and there should be a call for the Basle Committee on Banking Supervision and the International Organization of Securities Commissions to work closely together in addressing the major issues in this area and the desirable steps to address identified problems and to report back. These reports should help Ministers to reach conclusions regarding the extent of systemic risks and their implications for the world economy, and the need for any measures deemed essential to an integrated approach to potential systemic risks."** (Pages 9 and 10)