FEDERAL RESERVE BANK
OF NEW YORK

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BASLE COMMITTEE ON BANKING SUPERVISION

Supervisory Proposals for Internationally Active Banks

Comments Invited Through Year-End 1993

*To All State Member Banks, Bank Holding Companies,
and Branches and Agencies of Foreign Banks in the
Second Federal Reserve District, and Others Concerned:*

Following is the text of a statement by the Board of Governors of the Federal Reserve System:

The Federal Reserve Board has made available for public comment several documents on market risk and bank capital developed by the Basle Committee on Banking Supervision under the auspices of the Bank for International Settlements.

These consultative papers, which deal with supervisory treatment of netting arrangements, market risk, and interest rate risk, provide an overview of the work to date of the Basle Committee. While the matters addressed are in their preliminary stages and describe the current status of efforts that are of an ongoing nature, these efforts have potential implications for the evaluation of the capital adequacy of internationally active banks.

The attached Overview, prepared by the Basle Committee, summarizes each paper. The public comment period extends through year-end 1993. Copies of the Committee's papers can be obtained from the Board's Publications Services, Board of Governors of the Federal Reserve System, Washington, D.C. 20551.

Comment should be sent to Mr. William Wiles, Secretary, at the same address.

Any concrete proposals for modifying the U.S. risk-based capital guidelines that eventually grow out of these preliminary consultative papers would be issued for comment before they are adopted for U.S. banking organizations.

Printed on the following pages is a copy of the Basle Committee's press statement and overview. Comments should be sent to the Board, as indicated above, or to our Banking Studies Department. Copies of the full text of the Committee's papers can be obtained from the Board at the address indicated above or from this Bank's Public Information Department.

Questions on the papers may be directed to Christopher J. McCurdy, Vice President, Payments System Studies (Tel. No. 212-720-5446) or to Arturo Estrella, Assistant Vice President, Banking Studies and Analysis (Tel. No. 212-720-5874).

E. Gerald Corrigan,
President.

Basle Committee on Banking Supervision

PRESS STATEMENT

The Basle Committee on Banking Supervision, with the agreement of the central-bank Governors of the Group of Ten countries, has issued for public comment a three-part package of supervisory proposals for internationally active banks. Reflecting the scope of these proposals, the public comment period will extend to year-end 1993. The package contains consultative papers on netting, market risk and interest rate risk, each of which has been the object of work by the Committee for several years.

The first of these proposals, if enacted, would - under very carefully defined conditions - liberalise the terms of the 1988 Basle Capital Accord as they apply to the use of bilateral netting in the measurement of credit risk associated with certain classes of financial instruments. At the same time, the Committee is also soliciting the views of market participants on a number of issues relating to multilateral netting. However, the issues raised regarding multilateral netting are of a general nature and, pending further study, will not entail modifications to the Capital Accord.

The second proposal sets forth a framework which, if implemented, would modify the Capital Accord by providing explicit capital charges for the risks associated with price changes in open positions (including derivative positions) in debt and equity securities on banks' trading books and in foreign exchange. Until now, the Accord provided for explicit capital charges only for credit risk. This limitation was recognised when the Accord was adopted and efforts to remedy this limitation have been under way for some time. In the Committee's view, these efforts have taken on a greater sense of urgency owing to the rapid growth in the trading activities of many banks.

The proposals for assigning explicit capital charges to market risk are seen by the Committee as another step in promoting the 1988 Accord's dual objectives of strengthening the soundness and stability of the international banking system and achieving a greater degree of competitive equality among internationally active banks. The Committee also sees these proposals as a further step in the direction of greater convergence in supervisory policies across national boundaries and across various classes of financial instruments.

The Committee is mindful that these proposals are broadly similar to the Capital Adequacy Directive recently adopted by the European Community. The Committee is committed to continue to work with its associates in Brussels - and with the securities regulators - in order to achieve a still higher level of supervisory convergence and is hopeful that these proposals will help to facilitate that goal. These efforts reflect the Committee's ongoing commitment to soundness, competitive equality and efficiency in money and financial markets within and among nations.

The third proposal sets forth a common approach to the measurement of interest rate risk. Specifically, it proposes a methodology for estimating the extent to which the financial strength of a bank will be impaired by adverse movements of interest rates. The Committee views this methodology as a vehicle to assist national supervisors in identifying those relatively few institutions that may be especially vulnerable to changes in interest rates and in initiating appropriate supervisory responses on a case-by-case basis at the national level. Accordingly, the proposal does not contemplate a system of explicit capital charges for interest rate risk and thus would not entail changes in the Capital Accord.

While it is aware of the burden on banking institutions associated with seeking comment on all three of these proposals simultaneously, the Committee has chosen this approach because of the obvious and substantial overlap among the proposals. The Committee is also mindful that each of the proposals - reflecting the nature of the underlying activities - is highly complex, even though great effort was made to achieve simplicity. In these circumstances, the Committee believes that seeking public comment at this time on all three proposals will not only assist in evaluating their merits, but also assist in framing approaches for the orderly implementation of the proposals.

The full documentation associated with these proposals will be made available to banks and other interested parties through established channels at the national level within the respective G-10 countries. In addition, the proposals are being made available to supervisory authorities in a wide range of non-G-10 countries and their comments, and the comments of their internationally active banks, are welcome.

OVERVIEW

1. The Basle Committee on Banking Supervision[1] under the Chairmanship of Mr. E. Gerald Corrigan, President of the Federal Reserve Bank of New York, is today issuing for comment a package of supervisory proposals dealing with netting and market risks, together with an approach for the measurement of interest rate risk. Although each of these papers represents a discrete proposal, there are linkages in the implications they would have for banks' adherence to supervisory standards and requirements. The Committee has therefore decided to issue all three papers simultaneously.

2. The issue of the papers has been undertaken with the agreement of the central-bank Governors of the G-10 countries. Comments on the proposals are invited by end-December 1993.

3. The principal objective of the consultative process is to solicit the insights and judgement of private sector institutions and practitioners on the substance of the proposals, particularly in so far as they apply to the dual objectives of meaningful prudential standards and further movement towards regulatory convergence and competitive equality.

4. The package contains proposals for certain modifications to the Basle Capital Accord[2] of the July 1988 which will affect institutions' capital requirements. The market risk proposals could result in a higher or lower aggregate capital requirement, depending on the risk profile of the individual institution. This is because some of the requirements will substitute for existing credit risk requirements. Moreover, banks may have reduced overall

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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 Group of Ten countries in 1975. It consists of senior representatives of bank supervisory authorities and central banks from Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, Netherlands, Sweden, Switzerland, United Kingdom, and the United States. It usually meets at the Bank for International Settlements in Basle.

[2] In July 1988 the Basle Committee established a common measurement system and a minimum standard for the capital adequacy of international banks in the Group of Ten countries. These arrangements, commonly referred to as the Basle Accord, came into full force at the end of 1992 and have been adopted by numerous other countries.

capital charges under the netting proposal to the extent that they have legally valid netting arrangements governing their trading in certain financial instruments. The proposals for interest rate risk do not involve capital charges because they address only the measurement of interest rate risk.

I. Netting

5. The proposal on netting defines the precise conditions under which banks would be permitted to net the credit risks arising from trading in certain financial instruments under the Basle Capital Accord. The conditions laid down extend and define more clearly the present netting arrangements in the Accord (these conditions are consistent with the principles laid down in the Lamfalussy report by the Committee on Interbank Netting Schemes published by the BIS in November 1990). The paper contains a proposed text to amend the Accord in order to recognise certain bilateral netting arrangements. The paper also indicates the Committee's preliminary thinking as to the conditions under which multilateral netting might be recognised for capital measurement purposes at some future date.

6. The Committee is hopeful that the proposals for bilateral netting would be implemented shortly following the close of the consultation period (i.e. sometime in 1994).

II. Market risks

7. The work by the Basle Committee on market risks has been in progress for several years, having started when the Basle Capital Accord was finalised in July 1988. It was clear at that time that banks' trading activities were expanding rapidly, particularly in the derivative markets, and that the Accord's focus on credit risk would need to be widened, in due course, to encompass market risks. The Committee is now proposing that specific capital charges should be applied to open positions (including derivative positions) in debt and equity securities on banks' trading books and in foreign exchange. Securities held in banks' investment accounts would continue to be covered by the counterparty credit risk requirements of the present Accord and would also become subject to the measurement of interest rate risk described in the third paper in the package.

8. While the specific methodologies proposed for calculating the capital charges for each of the classes of instrument differ, the Committee has gone to great lengths to try to satisfy itself that the different methodologies produce roughly equivalent economic results. The Committee is also seeking comment on a proposal to expand the definition of capital to include a new class of short-term subordinated debt, which could be used for the sole purpose of meeting some of the capital charges for the market risk associated with debt securities and equities.

9. Parallel work in two other fora have interacted with and influenced the development of capital requirements for banks' market risks. One has been the European Community's attempts to establish a single market in banking and finance. Because of the need perceived in Europe to create a level playing-field between banks and non-banks operating in the same securities markets, the Community has enacted a Capital Adequacy Directive which applies to both banks and securities firms. In general, the methodology and much of the detail in the Capital Adequacy Directive is similar to the approach favoured by the Basle Committee since the outset of its work. Where there are significant differences, notably in the treatment of foreign exchange risk and position risk in equities, the Committee favours a stricter prudential standard for banks. Banks are invited to comment on any problems that may arise from the need to comply with two regimes. The Committee is resolved to collaborate with its colleagues in Brussels with a view to achieving closer convergence.

10. The second forum in which parallel work has been in progress is the Technical Committee of the International Organisation of Securities Commissions, which began to discuss the possibility of common minimum standards for securities firms at that Committee's first meeting in July 1987. The Basle Committee was naturally interested in this project and joint work was undertaken with a view to developing common minimum charges for banks' and securities firms' positions in traded debt securities and equities and related derivative instruments. Unfortunately, these discussions have not led to a successful result because IOSCO has been unable to reach agreement within its own group.

11. While regretting the inability of IOSCO to associate itself with these specific proposals, the Basle Committee has decided to proceed with publication of the proposals

because of the urgency of obtaining systematic input from banking institutions and practitioners. The banking industry is the focus of the consultation process. However, in anticipation of broader-based convergence, the overall approach has been designed with a view to its ultimate application to a wider spectrum of institutions.

III. Interest rate risk

12. The market risk proposals to apply capital requirements to debt securities on banks' trading books do not address the overall interest rate risks run by banks, i.e. the risk that a change in interest rates might adversely affect a bank's financial condition through its effect on all interest-related assets, liabilities and off-balance-sheet items, including the securities which are not held in the trading account. Interest rate risk for a bank is a much wider issue and raises many difficult measurement problems. At the same time, it is a significant risk which banks and their supervisors need to monitor carefully. Analytical work has been going on for a number of years to measure interest rate risk and the progress of this work is described in the third paper in the package.

13. This paper clearly indicates that it is the intention of the Basle Committee to develop a measurement system rather than an explicit capital charge for interest rate risk. Recognising that a certain degree of interest rate mismatching is a normal feature of the business of banking, the Committee holds the view that the existing capital requirements can be regarded as providing adequate protection against interest rate risk exposure in most situations. The measurement system is designed to identify institutions that may be incurring extraordinarily large amounts of interest rate risk. Within that context, it would be left to national authorities to determine what if anything might be done. The range of responses by national authorities might include an explicit capital charge on a case-by-case basis, but the situation could also be dealt with by a number of other supervisory remedies.

14. Following consultation on this paper, it is the intention of the Committee to seek to establish a common reporting framework for interest rate risk as a basis for developing, over time, a common approach to the measurement of the risk.