

NATIONAL SETTLEMENTS

Basel Committee on Banking Supervision announces steps to strengthen the resilience of the banking system

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The Basel Committee today is announcing a series of steps to help make the banking system more resilient to financial shocks. These include:

- | Enhancing various aspects of the Basel II Framework, including the capital treatment of complex structured credit products, liquidity facilities to support asset-backed commercial paper (ABCP) conduits, and credit exposures held in the trading book. At the same time, the Committee notes the importance of prompt implementation of the Basel II framework, as this will help address a number of the shortcomings identified by the financial market crisis.
- | Strengthening global sound practice standards for liquidity risk management and supervision, which the Committee will issue for public consultation in the coming months.
- | Initiating efforts to strengthen banks' risk management practices and supervision related to stress testing, off-balance sheet management, and valuation practices, among others.
- | Enhancing market discipline through better disclosure and valuation practices.

These measures will be introduced in a manner that promotes long-term bank resiliency and strong supervision, while seeking to avoid potentially adverse near-term impacts as the re-pricing of risk and deleveraging process continues in financial markets. The Committee's actions also are in support of the Financial Stability Forum's Working Group on Market and Institutional Resilience, which recently released its report to the G7 Finance Ministers and Central Bank Governors.

"A resilient banking system is central to sound financial markets and growth," stated Nout Wellink, Chairman of the Basel Committee on Banking Supervision and President of the Netherlands Bank. "Supervisors cannot predict the next crisis but they can carry forward the lessons from recent events to promote a more resilient banking system that can weather shocks, whatever the source. The key building blocks to core bank resiliency are strong capital cushions, robust liquidity buffers, strong risk management and supervision, and better market discipline through transparency."

The Basel II Capital Framework

The Committee reiterates the importance of implementing the Basel II Framework as it better reflects the types of risks banks face in an increasingly market-based credit intermediation process. Basel II is just now being implemented in most Basel Committee-member countries and many jurisdictions around the globe.

The market turmoil has already provided important lessons that will help guide the Committee in further strengthening certain aspects of the Framework. The Committee is introducing a number of measures to help ensure sufficient capital, to capture off-balance sheet exposures more effectively and to improve regulatory capital incentives.

In particular, the Committee will revise the Framework to establish higher capital requirements for certain complex structured credit products, such as so-called "resecuritisations" or CDOs of ABS, which have produced the majority of losses during the recent market turbulence. It will strengthen the capital treatment of liquidity facilities extended to support off-balance sheet vehicles such as ABCP conduits. More detailed proposals will be published later this year.

The Committee will strengthen the capital requirements in the trading book. Global banks' trading assets have

grown at double digit rates in recent years, and in some cases represent the majority of a bank's assets. The proportion of complex, less liquid credit products held in the trading book has likewise increased rapidly. The current value-at-risk based treatment for assessing capital for trading book risk does not capture extraordinary events that can affect many such exposures. The Committee, in cooperation with the International Organization of Securities Commissions (IOSCO), therefore is extending the scope of its existing proposed guidelines for "incremental default risk" to include other potential event risks in the trading book. Until this event risk charge is in place (planned for 2010), an interim treatment will be applied for complex securitisations held in the trading book. The Committee expects to issue its event risk proposal for public consultation later this year, and it also will conduct a quantitative impact assessment.

The Committee will monitor Basel II minimum requirements and capital buffers over the credit cycle. To the extent that this analysis reveals any shortcomings in capital cushions, the Committee will take appropriate measures to help ensure Basel II provides a sound capital framework for addressing banks' evolving and complex risk profiles.

Risk management practices

The market turmoil has revealed significant risk management weaknesses at banking institutions. Pillar 2 (the supervisory review process) provides supervisors with additional tools to assess banks' risk management and internal capital management processes. The Committee will issue Pillar 2 guidance in a number of areas to help strengthen risk management and supervisory practices. These relate to the management of firm-wide risks; banks' stress testing practices and capital planning processes; the management of off-balance sheet exposures and associated reputational risks; risk management practices relating to securitisation activities; and supervisory assessment of banks' valuation practices.

Strengthening banks' management of liquidity

Banks need to have strong liquidity cushions to weather prolonged periods of financial market stress and illiquidity. In July, the Committee will publish for consultation global sound practice standards for the management and supervision of liquidity risks. These will address many of the shortcomings witnessed in the banking sector. Among other weaknesses, these relate to stress testing practices, contingency funding plans, and management of on- and off-balance sheet activity as well as contingent commitments. The Committee will coordinate rigorous follow up by supervisors to ensure banks adhere to these fundamental principles.

The Committee also has launched an initiative to review the need for more consistency in global liquidity regulation and supervision of cross border banks as a way to enhance their resiliency to financial market stress.

Better disclosure and valuation practices

Weaknesses in bank transparency and valuation practices for complex products have contributed to the build-up of concentrations in illiquid structured credit products and the undermining of confidence in the banking sector. The Committee is taking concrete action to promote stronger industry practices in this area.

Disclosures

The Committee will promote enhanced disclosures relating to complex securitisation exposures, ABCP conduits and the sponsorship of off-balance sheet vehicles. Disclosure is a critical element of the Basel II Framework and Pillar 3 (market discipline) provides the Committee with the necessary leverage to achieve these enhancements, as such disclosures are a prerequisite for banks' being able to use the advanced approaches under Basel II. The Committee will issue further guidance in this area by 2009.

Valuation practices

Weaknesses in banks' valuation practices and related disclosures contributed to amplifying the market dislocation. Some of these shortcomings came to light during the course of the Committee's review of valuation practices that it conducted in 2007. In addition, the Committee will develop guidance that supervisors can use to assess the rigour of banks' valuation processes and thereby promote improvements in risk management in this area. This will draw on the Committee's existing trading book and fair value option guidance and industry best

practice.

About the Basel Committee

The **Basel Committee on Banking Supervision** provides a forum for regular cooperation on banking supervisory matters. It seeks to promote and strengthen supervisory and risk management practices globally. The Committee's members come from Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Spain, Sweden, Switzerland, United Kingdom and United States.