



# Changes to Basel Planned on Holdings, Liquidity Risk

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WASHINGTON — International regulators were poised to offer sweeping changes to the Basel II capital rule in the coming months to address some of the most troubling weaknesses in banking regulation exposed by the credit crunch and restore confidence in the financial system.

In a presentation to G7 finance ministers and central bankers here on Friday, the Financial Stability Forum said the Basel Committee on Banking Supervision will develop rules that could raise capital requirements for a wide range of assets, including off-balance sheet holdings. The Basel Committee's most immediate concern appears to be managing liquidity risk, which will be the subject of "sound practice guidance" by July.

"The turmoil demonstrated the central importance that effective liquidity risk management practices and high liquidity buffers play in maintaining institutional and systemic resilience in the face of shocks," according to a summary of the forum's recommendations to the G7 group.

A full copy of the forum's G7 report was not available at press time. But the summary said part of the Basel Committee guidance on liquidity risk management would broaden stress testing to include market-wide events.

The credit crunch has revealed that stress tests at many financial institutions do not sufficiently take larger market events that could damage the bank into account. American regulators have appeared open to expanding the tests but have grappled over exactly how that should be done.

The Basel Committee's liquidity risk management guidance will also seek to address intraday funding challenges and measure the "full range" of liquidity risk, including that associated with off-balance sheet holdings.

Those assets have proven particularly tricky since the fall, when banks, including Citigroup Inc., realized their off-balance sheet holdings carried greater exposures than they thought. Since then, several banks have decided to take losses by bringing those assets onto their balance sheets to avoid their reputations taking a hit on Wall Street for letting the assets fail.

The forum said the Basel Committee would issue a proposal this year separate from the liquidity risk guidance that would "strengthen the capital treatment for banks' liquidity facilities to off-balance sheet asset-backed commercial paper conduits."

The Basel Committee is also expected to "raise capital requirements for certain complex structured credit products, such as collateralized debt obligations of asset-backed securities."

As each day seems to bring more unsettling news about the industry and broader financial markets, transparency at financial institutions has surfaced as another key concern in recent months. To help ensure that markets are fully aware of bank exposures in future crises, the forum said the Basel Committee would issue guidance next year that would boost disclosures under Pillar 3 of Basel II for securitization exposures, sponsorship of off-balance sheet vehicles, liquidity commitments to asset-backed commercial paper conduits and valuations.

"This period of market turmoil and illiquidity has highlighted the importance to market confidence of reliable valuations and useful disclosures of the risks associated with structured credit products and off-balance sheet entities," according to the summary. "Enhanced disclosures by financial firms of more meaningful and consistent quantitative and qualitative information about risk exposures, valuations, off-balance sheet entities and related policies are important to restore market confidence."

American regulators have deviated from aspects of the international rule developed from the Basel Committee so some of the proposals expected in the coming months might not ultimately be implemented here. But regulators have stressed they will use the lessons of the credit crunch to inform their supervision of banks, particularly under Pillar 2 of Basel II, which gives examiners wide discretion to adjust capital levels at an individual bank.

Basel II went live in the United States on April 1 though none of the 12 banks that are required to adopt the framework have started the "parallel run" period, during which banks follow Basel I and the new rule at the same time.

The forum made recommendations to the G7 ministers that went beyond Basel II to urge greater transparency in the securitization process.

"Originators, arrangers, distributors, managers and credit rating agencies should strengthen transparency at each stage of the securitization chain, including by enhancing and

standardizing information on an initial and ongoing basis about the pools of assets underlying structured credit products."

The forum also called on credit rating agencies to strengthen their scrutiny of complex products diligence conducted on assets by requiring underwriters to explain the due diligence performed on an asset.

Investors have cried foul in recent months after highly-rated assets still created losses but the forum said the over reliance on ratings should be addressed.

"Investors should consider how they use credit ratings in their investment guidelines and mandates for risk management and valuation," according to the summary. "Ratings should not replace appropriate risk analysis and management on the part of investors."

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