in which they are engaged. It has been suggested that the latter approach would entail no regulatory distinctions by legal classes of financial institutions. Supervisory authorities would monitor firms based on industry-developed codes of conduct. In essence, it would be a move towards self-regulation with supervisors focusing on select firms, for example, those with weaker capital positions or less developed risk management systems.[18]

Systemic Risk and Counterparty Credit Risk

Since there are such close linkages between firms dealing in derivatives, systemic difficulties could arise if, for example, one large firm becomes financially troubled and eventually defaults on its commitments as an OTC counterparty. This is known as counterparty credit risk, and is similar to credit risks faced by banks when making loans. The ability of derivatives dealers to evaluate, monitor and react effectively to counterparty credit risk is essential for the efficient functioning of OTC derivatives markets. Reducing counterparty credit risk by only dealing with credit worthy counterparties can help to reduce systemic risk.

The market itself is already facilitating the evaluation of counterparty credit risk in the form of counterparty credit ratings issued by the major credit rating agencies (Standard and Poor's and Moody's).[19] However, there remain several problems that make counterparty credit risk difficult to assess, some of which can best be addressed by an improved, internationally coordinated approach to supervision.

- First, specific accounting rules have not been established for most derivative instruments, resulting in often inconsistent and unreliable financial reporting.[20] It is essential that principles be established for the consistent accounting and disclosure of derivatives, and that a mechanism be established for national accounting authorities to work towards adopting uniform practices internationally for banks and nonbanks alike.

- Second, there is considerable uncertainty concerning the legal status of "netting" agreements within countries and across international borders, and the legal treatment of derivatives contracts in different jurisdictions with different

[18] See M. Goldstein and D. Folkerts-Landau, *op. cit.*, p. 16.

[19] See Bank for International Settlements, *International Banking and Financial Market Developments*, Basle Switzerland, February 1995, p. 24.

[20] See General Accounting Office, *op. cit.*, pp. 92-3.