G20 Working Group on Enhancing Sound Regulation and Strengthening Transparency

Final Report

GROUP 1

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1. Executive Summary

G20 leaders tasked this working group with reviewing work underway and making recommendations that will strengthen international regulatory standards, enhance transparency in global financial markets and ensure all financial markets, products and participants are appropriately regulated or subject to oversight, depending on their circumstances.

The recommendations contained in this report are a response to the causes of the current crisis, and are intended to prevent future ones from occurring. They are based on a recognition that robust regulation in each country, based on effective global standards, is vital to future financial stability. The first line of defence is sound regulation - institution by institution and product by product - and recent events have clearly demonstrated that regulatory failures in some jurisdictions fuelled the current crisis. It is clear that the regulatory framework needs strengthening, and it is essential to get micro-prudential regulation right in order to promote financial institutions that are sound and that manage risks appropriately.

What has become clear most recently is that this is a systemic crisis which has at its root the build-up of imbalances across the financial system. History shows that, while each financial crisis is different, a shared feature is that they are preceded by a period of excess risk-taking, strong credit growth and asset price increases that show up in various markets. The current crisis highlights the extraordinary financial and social costs of failures in the financial system.

As directed by the Leaders Declaration and G20 Troika, an important focus of Working Group 1 has been to strengthen microprudential policy while supplementing it with a greater emphasis on a system-wide approach to regulation in order to better mitigate the build-up of systemic financial imbalances more effectively. In most jurisdictions, this will require improved coordination mechanisms between various financial authorities, mandates for policymakers and regulatory authorities that include consideration of financial system stability, and effective tools to address systemic problems. It will also require re-assessment of the appropriate scope of regulation and oversight. Further consideration should also be given to the role of risk management with respect to the incentives created by compensation practices and to enhancing the resilience of market infrastructure.

To achieve these objectives, this report contains recommendations in the following areas

- A System-wide Approach to Financial Regulation
- Scope of Regulation
- Oversight of Credit Rating Agencies
- Transparent Assessment of Regulatory Regimes
- Procyclicality

- Capital
- Liquidity
- Infrastructure for OTC Credit Derivatives
- Compensation Schemes and Risk Management
- Transparency
- Effective Enforcement
- Technical Assistance and Capacity Building in Emerging Market Economies

<u>Underlying Causes of the Market Turmoil:</u>

The turmoil which began to unfold during the Summer of 2007 was, in part, a consequence of an extended period of low real interest rates around the world, supported by an expansionary monetary policy, large current account imbalances, robust global growth and limited volatility in economic conditions. This benign environment caused investors to extend their search for yield further out the credit quality curve, leading to overly optimistic assessments and lack of due diligence in assessing credit risk.

In response to the demand for both increased credit and higher yield, the financial system developed new structures and created new instruments that supported higher leverage and appeared to offer higher risk-adjusted yields. Many of these instruments were opaque and masked the extent of leverage and interconnectedness of risk, which appeared to be globally dispersed across a wide range of institutions and markets, and much of the due diligence in examining these innovations was outsourced to credit rating agencies.

The trading of innovative over-the-counter financial products, particularly those aimed at transferring credit risk, particularly credit default swaps and collateralized debt obligations, expanded very rapidly. Financial institutions failed to properly manage and monitor risks to liquidity in the event that these markets froze.

At the same time, regulated banks and financial institutions supported the acceleration of financial innovation and the push towards more unregulated pools of capital by establishing off-balance sheet and structured investment vehicles. These unregulated investment vehicles, created in response to features of the regulatory and accounting framework, often financed their operations without minimum capital buffers or adequate liquidity plans, were exposed to maturity mismatches and held asset compositions whose risks were often misunderstood.

Risk management within institutions and oversight expertise by regulators did not keep pace with these innovations. Financial sector compensation schemes based on short-term returns, without consideration of the attendant risks, reinforced the momentum for risk taking.

Eventually the increase in asset prices could not be sustained. Delinquencies translated into price decreases on U.S. sub-prime mortgage-backed securities, which in turn produced losses for investors and led to margin calls for leveraged sub-prime asset holders. As the market uncertainty about the quality of assets spread, increased risk aversion, reduced liquidity, and concerns about the soundness of major financial institutions fed on each other. Many institutions experienced significant balance sheet pressures, which led to a tightening of lending standards with adverse effects on real economic growth.

In hindsight, policymakers, regulators and supervisors in some advanced countries did not act to stem excessive risk-taking or take into account the interconnectedness of the activities of regulated and non-regulated institutions and markets. This was due in part to fragmented regulatory structures and legal constraints on information sharing. Further, uncertainties concerning the implementation and valuation of structured products and the valuation of positions in illiquid market conditions, and some qualities of the international bank capital framework, may have exacerbated the turmoil.

Identified Weaknesses:

Some of the more salient weaknesses identified as drivers of the current turmoil include:

Weaknesses in Underwriting Standards: The credit quality of loans granted with the intention of transferring them to other entities through the securitization process was not adequately assessed.

Lack of Oversight of Systemic Risks: While the build-up of leverage and the underpricing of credit risk were recognized in advance of the turmoil, their extent was underappreciated and there was no coordinated approach to assess the implications of these systemic risks and policy options to address them. There was also insufficient recognition of the interconnectedness of risks within both regulated and unregulated markets.

Lack of Oversight of Unregulated Pools of Capital: Unregulated and lightly regulated pools of capital, such as investment banks, hedge funds, private equity funds, and a number of the banks' off-balance sheet securitization vehicles, grew disproportionately in importance during the period preceding the crisis. Regulatory arbitrage pushed risks outside of the regulatory framework and oversight of these markets and entities was left to indirect regulation through oversight of related regulated counterparties and to market discipline.

Weak performance by Credit Rating Agencies: There was an over-reliance on credit rating agencies and shortcomings in rating models and methodologies, as well as insufficient attention to conflicts of interest in the rating process.

Procyclical Tendencies Fed by Regulatory and Accounting Frameworks: The crisis has highlighted the role of certain aspects of accounting frameworks and capital regulation to increase the natural tendency of the financial system to amplify business cycles, affecting both the degree of credit expansion in benign conditions and degree of credit contraction in the downturn.

Shortcomings in Risk Management Practices: A number of the standard risk management tools used by financial firms relied on samples of historical data from short periods and were not suited to estimating the scale of potential losses in the adverse tail of risk distributions for structured credit products. Moreover, compensation arrangements often created incentives for excessive risk-taking through insufficient regard to longer-term risks.

Financial Innovation Outpacing Risk Management: There was a significant acceleration of financial innovation in years leading up the crisis that far outpaced the ability of firms to manage risks and of regulators to effectively monitor them.

Weaknesses in Disclosure: Weaknesses in public disclosures by financial institutions damaged market confidence during the turmoil. Public disclosures that were required of financial institutions did not always make clear the type and magnitude of risks associated with their on- and off-balance sheet exposures.

Weaknesses in Resolution Procedures: Existing procedures for resolving troubled nonbank institutions have been shown to be inadequate when an institution imposes substantial systemic risks. In addition, national resolution mechanisms have not been effective in some cross-border resolutions.

Lack of Transparency in Various OTC Markets: In many cases, investors and other market observers could obtain only minimal, if any, information about pricing, trading volume, and aggregate open interest in various products that trade in the OTC markets.

A vision for the future financial system

In providing its recommendations, the Working Group envisages a financial system which will maintain many of the key features of the current system while continuing to evolve in response to ongoing global trends.

The future financial system will continue to be global, interconnected, and reliant on open global trade in services, as well as free capital flows across jurisdictions. Linkages and inter-related risks across institutions and markets will continue.

There will be a combination of global banks operating across borders and national banks which will focus on market niches.

Financial institutions will continue to rely on a combination of deposits and capital markets for funding. Funding markets will continue to be interconnected across jurisdictions. Also, liquid and well-regulated markets will continue to be critical for raising capital and for efficiently managing financial risks.

Financial innovation will continue to play an important role. Policymakers and regulatory authorities will need to become better equipped to manage the effects of innovation on the prudential safety net.

While some products may need to be simplified in order to increase acceptance in the financial sector in the near term, innovation will inevitably mean that products and risk management techniques will continue to evolve in complexity. The regulatory framework will need to respond to associated risks accordingly.

A massive deleveraging is being forced by large losses coupled with sharp reductions in counterparty risk exposures, and the post-crisis period will likely be characterized by a financial system with lower levels of leverage, reduced funding mismatches (both in terms of maturity and currency), less exposure to counterparty risk, and greater transparency regarding financial instruments. Nevertheless, as the credit cycle recovers and matures, there will be inevitable pressure to expand profits through increased leverage.

The type, size, and cross-border exposures of institutions and markets that will survive the crisis will likely be considerably different than before. As banks and financial institutions consolidate, policy makers will have to adapt prudential regulation to varying degrees of size and concentration. Similarly, competition policy will play an important role in ensuring healthy competition.

The future financial system will require greater consistency in the regulation of similar instruments and of institutions performing similar activities, both within and across borders.

Large complex financial institutions will continue to operate in multiple jurisdictions in order to meet the needs of their large global clients, with supervision that is better coordinated internationally and a robust international resolution framework.

Capital markets will require greater emphasis on reducing counterparty risk and on ensuring that market infrastructure can continue to offer a source of funding during periods of stress.

The complexity of contemporary finance will continue to pose a challenge for financial institutions, for example for their valuation and risk management practices, and for the capacity of the international community of supervisors and regulators to discharge their responsibilities.

Transition to a new regulatory regime:

It will be necessary to consider appropriate timing and a reasoned response to changes in the regulatory framework going forward. Recommendations should avoid regulatory over-reaction which can lead to perverse and inefficient market responses. For example, while ultimately capital buffers for the system should be strengthened in order that they can be drawn as needed in downturns, changes in the current environment may have negative consequences on the real economy. A considered review of the consequences of reforms and harmonization, coordinated across jurisdictions, is necessary to increase the effective transition to a more stable financial system.

Review of Progress of G20 Action Plan

This Report presents a high level overview of measures taken in response to each item of the Washington Action Plan. A very substantial amount of work is underway to take forward the policy development necessary to implement these measures and, overall, this work is proceeding well and in a coordinated fashion.

Based on progress so far, certain measures could be highlighted by Leaders as milestones of particular importance at the London Summit as evidence of the exceptional amount of implementation work by national authorities and international bodies.

A. Measures to address the current crisis

On Transparency:

- Several accounting standard setting bodies published guidance to clarify expectations for the valuation of financial instruments, including complex securities.
- Prudential supervisors in many jurisdictions strongly encouraged their internationally active financial institutions to enhance disclosure by adopting leading risk disclosure practices addressed in a report by the Senior Supervisors Group to the FSF, and larger financial institutions have responded well. This has resulted in disclosure of more meaningful qualitative and quantitative information about risk exposures involving complex instruments.
- BCBS has published proposals for enhanced disclosures related to securitizations.

B. Measures for the medium/longer term

On Regulatory Regimes:

- IOSCO, the IAIS and the BCBS have undertaken initiatives to assess differences in regulation across sectors, identify regulatory gaps, and examine issues related to expanding the scope of regulation.
- IOSCO assessed the compliance of credit rating agencies with its code of conduct, and is currently developing a framework for the global monitoring of compliance.

On Procyclicality:

- Working groups formed by the FSF have prepared recommendations to mitigate procyclicality with respect to bank capital, provisioning practices, and valuation and leverage.

On Prudential Oversight:

- The Basel Committee issued, for consultation, proposals to strengthen the risk capture of the Basel II framework, including enhancements to the capital treatment of securitizations, off-balance sheet exposures, and trading book activities. These measures form part of a comprehensive strategy to strengthen the regulation, supervision and risk management of internationally active banks in order to address weaknesses revealed by the crisis. This strategy also includes work in progress to enhance the consistency and quality of the Tier 1 capital base and to mitigate procyclicality.

- A group of global prudential supervisors is working with the industry to strengthen the infrastructure for over-the-counter (OTC) credit derivatives, with the top priorities being the implementation of central counterparties for credit default swaps (CDS). Central counterparties have been launched in late 2008, one in the European Union and one in the U.S., and more are expected to begin operating during 2009. Furthermore, major European securities dealers and banks have committed to using at least one of these solutions to clear all eligible European name-referenced CDS. ***[Is this statement also applicable for the US?]***

On Compensation Schemes and Risk Management:

- A Working Group of the FSF has developed sound practice principles for compensation schemes.
- The BCBS and national prudential supervisors issued guidance to enhance practices in a number of risk management areas, including stress testing, risk concentrations, off-balance sheet exposures, valuation and liquidity risk.

On Transparency:

- The IASB and the U.S. FASB have established an advisory group comprised of senior leaders with broad international experience in financial markets to advise the Boards in considering accounting issues emerging from the global crisis. Furthermore, the Trustees of the International Accounting Standards Committee Foundation (IASCF) approved in mid-January the establishment of a formal link to a newly created external Monitoring Board composed of public authorities. They also approved the expansion of the IASB membership to 16 members and provided guidelines regarding geographic diversity.
- The two initiatives above (*i.e.*, enhanced guidance on fair value accounting and enhanced risk disclosure) will also have a longer-term effect.

Recommendations to Leaders by the Working Group

The objective of the recommendations for further reform made by the Working Group is to build a financial system that will support growth and rising living standards across the globe, while reducing the risk of financial instability. Financial crises have very large social costs. At the same time, there are large social benefits to all from a dynamic and efficient financial system that transforms savings into productive investments, and helps households and businesses manage risk. The regulatory framework needs to maximize stability and efficiency while ensuring an appropriate balance where there are trade-offs.

The following is a summary of the recommendations for further action of the Working Group. The Report identifies bodies that could be tasked with implementing and monitoring progress against these recommendations as well as implementation timelines. By charting a clear direction and a timeline, the package of recommendations has the potential to provide the sense of clarity and increased confidence the financial system requires in the short run, and increased efficiency and stability going forward.

Summary of Recommendations:

System-wide Approach to Financial Regulation

Recommendation 1: As a supplement to their core mandate, the mandates of all national financial regulators, central banks, and oversight authorities, and of all international financial bodies and standard setters **(tbc)**, should take account of financial system stability.

Recommendation 2: Within each country there should be an effective mechanism for appropriate domestic financial sector authorities to jointly assess the systemic risks across the financial system and to co-ordinate the domestic policy response to limit the build-up in systemic risk. The structure of this coordinating mechanism should be transparent, with clear assignments of roles, responsibilities and accountability for each authority

Recommendation 3: Financial sector authorities should have suitable macroprudential tools to address systemic vulnerabilities. Measures that are simple to understand and to implement are preferable to more complex ones, and tools that rely on pre-specified limits or rules are attractive. However, rules need to be complemented with the informed judgement of regulators based on their joint assessment of the risks across the financial system.

Such policy tools will be developed by IOSCO, the IAIS, the BCBS, the expanded FSF and other relevant international bodies and standard setters (*e.g.*, IASB, CGFS). Potential macroprudential tools that should be explored further might include:

a. Supplementing risk-based capital measures with simple measures to contain the build-up of leverage, with enhanced sensitivity to off-balance sheet exposures;
b. Capital requirements that adjust over the financial cycle;
c. Loan-loss provisioning standards that are more forward looking;
d. The use of longer historical samples to assess risk (for example with estimates of Value-at-Risk) and margin requirements; and
e. Greater focus on loan-to-value ratios for mortgages.

Recommendation 4: The expanded FSF, together with the IMF, should create an effective mechanism for key financial authorities in each country to periodically come together around an international table to jointly assess the systemic risks across the global financial system and to coordinate policy responses.

Scope of Regulation

Recommendation 5: All systemically important financial institutions, markets and instruments should be subject to an appropriate degree of prudential regulation or oversight, consistently applied and proportionate to their local and global systemic importance.

In order to determine the appropriate degree of regulation or oversight, national authorities should determine appropriate mechanisms to allow them to gather relevant information on all financial institutions, markets and instruments in order to assess the potential for the failure or severe stress of these institutions, markets and instruments to contribute to systemic risk, either on their own or through linkages with other segments of the financial system. Information on systemic risk should be monitored though a globally coordinated mechanism.

National authorities should have the authority to expand the perimeter of regulation in a timely way, recognizing that it may vary across countries and through time.

Recommendation 6: Large complex financial institutions require particularly robust oversight at a national and international level given their systemic importance at a national and international level, which arises in part from their size and interconnectedness (or correlation) with other institutions, and from their influence on markets.

Recommendation 7: The boundaries of the regulatory framework should be reviewed periodically within national jurisdictions, in light of financial innovation and broader trends in the financial system, and these should be subject to international coordination and review.

Recommendation 8: The systemic importance of financial institutions, markets and instruments depends on a wide range of factors, including their size, leverage, and interconnectedness, as well as funding mismatches. The IMF, in consultation with the expanded FSF and other bodies, should jointly develop a common international framework to help national authorities assess whether a financial institution, market or an instrument is systemically important.

This framework should strive to treat similar activities more consistently for regulatory or oversight purposes regardless of the legal form of the institution, so as to avoid regulatory arbitrage.

Oversight of Credit Rating Agencies

Recommendation 9: All credit rating agencies should be subject to an oversight regime that includes mandatory registration and that requires compliance with the IOSCO Code of Conduct Fundamentals. National authorities should obtain the authority to enforce compliance and require changes to a rating agency's practices and procedures for managing conflicts of interest and assuring the quality of their ratings. Given the global scope of some credit rating agencies, the oversight framework should be consistent across jurisdictions with appropriate sharing of information between national authorities responsible for the oversight of credit rating agencies.

Transparent Assessment of Regulatory Regimes

Recommendation 10: All G20 members should commit to undertake a Financial Sector Assessment Program (FSAP) report and to publish its conclusions. Depending on the frequency of FSAPs, national authorities may wish to supplement the FSAP process by periodically undertaking a self-assessment of their regulatory frameworks based on internationally agreed methodologies and tools. The results of these self-assessments should be subject to international coordination and validation, and should become public.

To improve the FSAP process, the basis upon which countries are assessed should be expanded to encompass macroprudential oversight, the scope of regulation, and the supervisory approach to assessing the risk impacts of the structure of compensation schemes at financial institutions.

Procyclicality

Recommendation 11: The FSF and its member bodies, particularly the BCBS, should develop supervisory and regulatory approaches to mitigate procyclicality in the financial system by promoting the build-up of capital buffers during the economic expansion, through earlier recognition of loan losses and by dampening the adverse interaction between fair valuation, leverage and maturity mismatching in times of stress.

Recommendation 12: Accounting rules and valuation practices should reflect the evolution of risks through the cycle, thus facilitating greater consistency with good risk management and sound prudential regulation, while maintaining transparency in the presentation of financial statements. Accounting standard setters and prudential authorities should collaborate to achieve those objectives, with particular emphasis on providing enhanced guidance on examining ways to enable more through-the-cycle loan-loss provisioning practices and to dampen the role of fair value accounting in amplifying business cycles. Particular emphasis should be given to providing enhanced guidance on the application of fair value accounting and the treatment of provisions.

Prudential Oversight:

Capital

Recommendation 13: Capital should serve as an effective buffer to absorb losses over the cycle, so as to protect both the solvency of financial institutions in the event of losses, and their ability to lend.

Once conditions in the financial system allow it, the international standard for the minimum level of capital for banks should be increased and the quality and global consistency of capital should be enhanced. In addition, capital buffers above minima and loan-loss provisions should be built up in good times in order to enhance the ability of regulated financial institutions to withstand large shocks.

In this context, the BCBS should develop standards to promote the build-up of capital and liquidity buffers in good times that can be drawn down in periods of stress. The BCBS should also develop a simple, transparent leverage indicator.

In the meantime, the international standard for the minimum level of capital should remain unchanged, and capital buffers above minima should be allowed to decline in response to deteriorating economic conditions and credit quality, and urgent consideration should be given to measures that would facilitate access to additional private sector capital in the downturn.

Recommendation 14: G20 Leaders should support the progressive adoption of the Basel II capital framework across the G20.

Liquidity

Recommendation 15: Prudential supervisors should deliver a global framework for promoting stronger liquidity buffers at financial institutions, including cross-border institutions, to ensure that they can withstand prolonged periods of market and funding liquidity stress.

Infrastructure for OTC Credit Derivatives

Recommendation 16: Financial institutions should take the necessary actions, including by way of standardizing credit derivatives contracts, to clear OTC transactions on credit derivatives through central counterparties. If needed, national authorities may enhance incentives for the use of central counterparties to clear OTC credit derivatives.

Recommendation 17: Central counterparties should be subject to transparent and effective oversight by prudential supervisors, and meet high standards in terms of risk management, operational arrangements, default procedures and transparency. The CPSS and IOSCO should review their recommendations for central counterparties to ensure they take into account the unique characteristics of credit derivatives.

Compensation Schemes and Risk Management

Recommendation 18: Large financial institutions should ensure that their compensation frameworks are consistent with their long-term goals and with prudent risk-taking. As such, the Board of Directors of each financial institution should set clear lines of responsibility and accountability throughout the organization to ensure that the design and operation of its remuneration system supports the firm's goals, including overall risk tolerance. Boards should also ensure there are appropriate mechanisms for monitoring remuneration schemes.

Recommendation 19: In order to promote incentives for prudent risk taking, each financial institution must review its compensation framework to ensure it follows sound practice principles such as those developed by the FSF. These include the need for remuneration systems to provide incentives consistent with the firm's long-term goals, to be adjusted for the risk taken by employees, and for the variable components of compensation to vary symmetrically according to performance.

Recommendation 20: Prudential supervisors should enhance their oversight of compensation schemes by taking the design of remuneration systems into account when assessing risk management practices. The BCBS should more explicitly integrate this dimension in its guidance for the assessment of risk management practices by national prudential supervisors.

Transparency

Recommendation 21: Accounting standard setters should accelerate efforts to reduce the complexity of accounting standards for financial instruments, to improve accounting standards for foreign currency translation, and to enhance presentation standards in order to allow the users of financial statements to better assess the uncertainty surrounding the valuation of financial instruments and to better reflect the economic substance of financial assets and liabilities denominated in foreign currency.

Recommendation 22: The IASB should enhance its efforts to facilitate the global convergence towards a single set of high-quality accounting standards by sharing the experience of countries that have completed this process, by providing technical assistance and by increasing representation from EMEs within its governance structure.

Effective Enforcement

Recommendation 23: The effective enforcement of regulation should be a priority of all financial regulators. As such, national financial regulators and oversight authorities should review the effectiveness of their enforcement activities and ensure that appropriate resources are available for monitoring the application of regulation and for prosecuting offenders and that the enforcement function is independent from other activities or from external influences.

Technical Assistance and Capacity Building in Emerging Market Economies

Recommendation 24: Recognizing that the degree of development of financial systems varies considerably across the G20, national authorities commit to assist each other in enhancing their capacity to strengthen regulatory frameworks. In addition, IOSCO, the IAIS and the BCBS should have the appropriate capacity to provide technical assistance. The needs of emerging market economies deserve particular consideration.

In developing these recommendations, the Working Group has sought to avoid exacerbating the current strains on markets and institutions, and to identify appropriate timelines and clear responsibilities for implementing and monitoring progress. The Working Group offers these recommendations for consideration by Leaders so that further clarity will be provided on improvements to the current microprudential regulatory framework, and so that authorities can move forward in a globally coordinated effort to limit systemic risk and mitigate future crises.

2. Introduction

The Working Group was tasked with reviewing work underway in member countries and in international bodies and making recommendations that will enhance transparency in global financial markets, strengthen international regulatory standards, and ensure that all financial markets, products and participants are regulated or subject to oversight, as appropriate to their circumstances.

The mandate of the Working Group was not to make detailed technical recommendations, but to provide direction for policy measures to be pursued further by appropriate authorities and to provide some guiding principles for timely, coordinated policy action.

Given the breadth of its mandate, the Working Group has identified some priorities to focus on, which are reflected in the recommendations for further reform presented throughout this report. Members were surveyed to obtain their views on these priority areas and to gather information on measures taken to implement the Washington Action Plan. The Working Group worked through regular conference calls, combined with one face-to-face meeting.

As mandated in the Leaders' Declaration, the Working Group relies to a large extent on existing work streams underway. International bodies conducting this work – the FSF, IOSCO, BCBS, IAIS, IASB, IMF and WB – all participated on the Working Group in order to share progress and enhance discussion of collaborative approaches for further work. Their participation has been of tremendous value to the Working Group.

This report is structured around the areas for reform identified in the Washington G20 Leaders' Action Plan. It provides some assessment of the need for reform in these areas, identifies the Leaders' Action Items, summarizes progress to date made against these items, and proposes rationale and recommendations for further action and ideas for further reform.

For symmetry with other working groups, this report follows a common approach which outlines the Washington Action Plan items, identifies the process for taking forward the Action Plan, assesses progress, and makes recommendations for further work to be done. The Working Group also makes some recommendations that go beyond the Washington Action Plan. An analysis of the specific action items pointed to an overarching observation, in that the interaction of specific regulatory and policy features, and of the actions taken by market participants, can have an impact on the risk of the system which may not be fully recognizable in a framework which focuses on the actions of individual market participants. These interconnected actions need to be monitored and addressed within each jurisdiction and in a globally coordinated fashion. The report begins with an overview of this overarching theme, and addresses each of the Action Items and related recommendations, and finally offers some ideas for going beyond the Washington plan.

3. System-wide Approach to Financial Sector Regulation

It is fundamental that regulators and standard setters strive to achieve a prudential regulatory framework that protects the stability of financial institutions. Regulatory and supervisory weaknesses, such as regards underwriting standards in the U.S. mortgage market, helped exacerbate the current crisis. It is essential that prudential regulation at the firm level be strengthened and that competent national regulators provide a first line of defence in preventing instability in the financial system.

However, a fundamental lesson from the current crisis is that effective supervision at the individual firm level, while necessary, is not sufficient to safeguard the soundness of the financial system as a whole. Regulators, supervisors, and central bankers need to supplement strong microprudential regulation with a macroprudential overlay to more effectively monitor and address the build-up of imbalances that have the potential to cause financial instability.

The objective of enhancing the macroprudential orientation for the regulatory framework will guide considerations throughout this Report. This objective is consistent with the Leaders' principle of making regulatory regimes more effective over the economic cycle.

Complementing a strong microprudential regulatory system must be a mechanism that can also ensure consideration of the number of related issues which Leaders have raised, and which can affect the build up of risk in the system, that are not explicitly captured in a supervisory approach to stability that focuses on regulated institutions only. Such an approach, for example, does not explicitly address risks that were transferred to other unregulated entities or that existed in less-regulated segments of the financial system. This illustrates the need to complement microprudential regulation with a macroprudential oversight framework whose objective is to limit the build-up in system-wide risk.

Since the risk of distress to the financial system as a whole is not simply the sum of the risk to its individual components, the impact of the collective behaviour of economic agents on aggregate risk needs to be taken into account explicitly. To illustrate, take the example of a bank's leverage during an economic expansion. It may be individually appropriate for banks to take more risk during benign economic times, for example by increasing lending. However, when this behaviour is widespread, the overall leverage of the banking sector may create the potential for financial instability. Macroprudential and macroprudential authorities may view this situation differently. The increased leverage may not be viewed as a concern from a microprudential perspective if it is supported by appropriate safeguards at the institution level, for example by sufficient capital buffers. However, even if these safeguards are considered appropriate for an individual institution, a macroprudential regulator may nonetheless be concerned by the potential for a systemic imbalance arising from a widespread increase in the overall leverage of the banking sector. As another example, the behaviour of individual institutions in markets as conditioned by capital requirements for their trading book, internal risk management practices, and rules and practices regarding margin requirements can lead to procyclicality in financial market prices.

A challenge for policymakers is to achieve the appropriate balance between the complementary microprudential and macroprudential approaches to financial sector oversight. Traditional microprudential objectives still need to be vigorously pursued in order to preserve financial stability, since incidents of financial stress are likely to be less frequent - and the associated costs reduced – if individual institutions are well managed, if markets function efficiently, and if the infrastructure supporting the financial system is strong.

The ability of authorities to address systemic risk needs to be considerably enhanced. A number of policy institutions, for example central banks, have enhanced their analysis of systemic risks in recent years - many of the systemic vulnerabilities that caused or enhanced the current turmoil had in fact been identified – but policy mechanisms to effectively translate these analyses into policy action are lacking.

Several issues being addressed in this report involve considerations related to this need for enhanced macroprudential oversight. For example, the forces through which the financial system contributes to amplify business fluctuations and risk taking, possibly causing or exacerbating financial instability, need to be examined and mitigated. These include certain aspects of compensation schemes at financial institutions, of margin requirements and risk management practices focused on Value-at-Risk calculations based on short historical samples, of the capital adequacy framework, and of valuation and loan-loss provisioning practices. In addition, there is a need to redefine the scope of the regulatory framework in order to establish appropriate oversight for the institutions and markets that may be the source of systemic risk. Risk management also needs to be enhanced to better evaluate vulnerabilities arising from low-frequency, system-wide risks, and to better mitigate these risks.

The Working Group views a commitment towards improving financial sector policy so that it can effectively mitigate the build-up of systemic risk to be of the highest priority. Resources must be committed to develop an overarching framework for addressing these issues. Building such a framework will involve reviewing the mandates of authorities, establishing national and international coordination mechanisms, and enhancing their tools to effectively address systemic concerns. There will be differing judgments as we move through this process, but it is essential that we move forward even if we do not yet have all the answers. Thirty years ago, when monetary policy began to focus on price stability, there were many differing assessments of the relevance of this approach, and many aspects are still not fully understood. Yet, the focus of monetary policy on this goal has resulted in significant success in keeping inflation low, which has been widely regarded as a beneficial development.

The Working Group recommends that the mandate of all national financial regulators and oversight authorities and of all international financial bodies should include promotion of financial system stability, as a complement to their core mandates, and that there should be a lead authority responsible for macroprudential oversight in each jurisdiction. Financial sector authorities need to address systemic risks, and they need to consider the implications of their policies and standards for the stability of the financial system.

Policymakers will need to address issues of coordination and cooperation, both at the domestic and international level. In addition, the relevant authorities must ensure they have instruments at their disposal to limit the buildup of imbalances with the potential to contribute to financial instability. Such policy tools will be developed with assistance of the financial standard setters, such as IOSCO, the IAIS and the BCBS. Global standards should be minimum best practices and national authorities would have the right to impose higher standards appropriate to their own circumstances.

The analysis of these instruments prior to their implementation should be conducted in a comprehensive fashion, taking into account the interaction between the various instruments considered. There may also be need for a review of governance of each authority, given the potential pressure for discretion in application of these tools at various points over the business cycle. The recommendations of WG2, for example with respect to early warning exercises, and WG3, should support these expanded roles for the international bodies..

There is disagreement within the Working Group on whether this should apply to accounting standard setting bodies. Some believe that promoting financial stability might conflict with the primary objective of accounting standard setting bodies to provide information on the economic situation of an entity. They argue that, if promoting financial stability leads to reduced transparency or to information distortions, this could lead to an overall outcome that is undesirable. However, others consider it is crucial for accounting standard setters to take the implications of their standards for the stability of the financial system into consideration, recognizing that financial stability is not their primary objective.

As an overarching framework to approach the Washington Action Plan, the Working Group recommends the following:

***Recommendation 1*: As a supplement to their core mandate, the mandates of all national financial regulators, central banks, and oversight authorities, and of all international financial bodies and standard setters (tbc) should take account of financial <u>system</u> stability.**

- **Responsibility:** Finance Ministries, national financial regulators and oversight authorities, central banks, IOSCO, IAIS, BCBS, [IASB and other accounting standards setters], expanded FSF, IMF
- **Timeline**: To be completed within 2 years
- **Monitoring:** Compliance by national authorities to be monitored by IMF-WB (through FSAP and Article IV), compliance by international bodies to

be monitored by expanded FSF

Recommendation 2: **Within each country there should be an effective mechanism for appropriate domestic financial sector authorities to jointly assess the systemic risks across the financial system and to co-ordinate the domestic policy response to limit the build-up in systemic risk. The structure of this coordinating mechanism should be transparent, with clear assignments of roles, responsibilities and accountability for each authority.**

- **Responsibility**: Finance Ministries, financial regulators and supervisors and central banks, in cooperation with other relevant bodies, including policy authorities for housing finance and accounting standard setters, as appropriate
- **Timeline**: To be completed within 2 years
- **Monitoring**: IMF-WB (through FSAP and Article IV)

Recommendation 3: **Financial sector authorities should have suitable macroprudential tools to address systemic vulnerabilities. Measures that are simple to understand and to implement would be preferable to more complex ones, and tools that rely on pre-specified limits or rules are attractive. However, rules need to be complemented with the informed judgement of regulators based on their joint assessment of the risks across the financial system.**

Such policy tools will be developed by IOSCO, the IAIS, the BCBS, the expanded FSF and other relevant international bodies and standard setters (*e.g.*, IASB, CGFS). Potential macroprudential tools that should be explored further might include:

f. Supplementing risk-based capital measures with simple measures to contain the build-up of leverage, with enhanced sensitivity to off-balance sheet exposures;
g. Capital requirements that adjust over the financial cycle;
h. Loan-loss provisioning standards that are more forward looking;
i. The use of longer historical samples to assess risk (for example with estimates of Value-at-Risk) and margin requirements; and
j. Greater focus on loan-to-value ratios for mortgages.

- **Responsibility**: National authorities, IOSCO, IAIS, BCBS, expanded FSF, CGFS
- **Timeline for tool development**: Expanded FSF to provide an annual report on the suite of tools under development by its members, with an Interim Report in Fall 2009
- **Timeline for tool implementation**: On an ongoing basis
- **Monitoring**: Development of tools to be monitored by G20 countries, as well as expanded FSF, and their implementation by the IMF-WB

(through FSAP and Article IV)

Recommendation 4: **The expanded FSF, together with the IMF, should create an effective mechanism for key financial authorities in each country to periodically come together around an international table to jointly assess the systemic risks across the global financial system and to coordinate policy responses.**

- **Responsibility**: Expanded FSF, IMF, Finance Ministries, national financial regulators, central banks, and oversight authorities
- **Timeline**: Fully implemented within 2 years, with initial system in place by the Fall 2009 FSF meetings
- **Monitoring**: G20

4. Washington Action Plan

The structure of the financial system has changed over time, with new types of institutions emerging and with distinctions between different types of players becoming more blurred as their activities converged. New types of complex financial instruments - sometimes with embedded leverage and a lack of transparency about their structure and the drivers of their performance - have also emerged. Although these developments may have come about as a result of innovations aimed at improving the efficiency of the financial system, they have also created opportunities for increasing leverage and for shifting risks among players in highly opaque ways.

In order to support innovation, and because the link to depositor protection was limited, policymakers have traditionally relied on market discipline to promote integrity in this segment of the financial system. These institutions and markets were thus often lightly regulated or unregulated. One of the lessons of the current crisis is that market discipline did not adequately fulfill its intended role during the last economic cycle as risk exposures of regulated financial institutions and the shadow banking system, the complexity of the financial system and its opaqueness to both regulators and market participants, ultimately proved destabilizing.

4.1.1 The Scope of Regulation

The role of certain financial institutions, markets and innovative instruments that were either unregulated or lightly regulated in contributing to the current crisis has highlighted the need for financial sector policymakers to redefine the perimeter of the regulatory framework. Examples of institutions and instruments currently unregulated or lightly regulated include mortgage brokers/originators, investment banks, securitization vehicles, credit rating agencies, as well as hedge funds and other private asset pools.

The need for enhancing prudential oversight stems in part from the realization that products and vehicles removed from a bank's balance sheet may still pose risk to financial institutions. Further, systemic failures, once largely confined to large institutions, can result from the interconnectedness between institutions whose individual condition may not pose a systemic risk but whose correlated fluctuations with others do. While regulation to protect market integrity in support of efficient capital markets will continue to play a critical role in the functioning of the financial system, this section will explore the need to supplement this regulation when systemic risks may not be fully captured in the current regulatory framework. But top-notch business conduct rules and effective consumer protection and financial education policies are critical to the efficiency and integrity of financial markets.

Action Item: The appropriate bodies should review the differentiated nature of regulation in the banking, securities, and insurance sectors and provide a report outlining the issue and making recommendations on needed improvements. A review of the scope of financial regulation, with a special emphasis on institutions, instruments, and markets that are currently unregulated, along with ensuring that all systemically-important institutions are appropriately regulated, should also be undertaken. (For action in the medium term)

Process for Taking Forward the Leaders' Action Item

Since the Washington Summit, international bodies have undertaken a number of initiatives to assess differences in regulation across sectors, identify regulatory gaps and examine issues related to expanding the scope of regulation in response to this action item.

1. The Joint Forum, a Working Group of the BCBS, IOSCO and the IAIS, is undertaking a project to identify gaps in the oversight of systemically important institutions and to evaluate differences in regulatory approach across the banking, securities and insurance sectors.
2. An IOSCO Task Force is exploring whether and how to extend key regulatory principles applying to regulated products and markets, in the areas of transparency, market conduct, and market infrastructure, to securitized products and CDS. An interim report will be published in mid-March.
3. An IOSCO Task Force is examining issues surrounding unregulated entities such as hedge funds, including the development of recommendations for mitigating risks associated with their trading and opacity through oversight. An interim report setting forth a range of options will be published in early March.
4. The IAIS is elaborating its medium-to long-term strategic focus through examining issues related to the supervision of internationally active

insurance groups, macro elements of prudential supervision including contagion effects and the issue of non-regulated entities and regulatory consistency across financial sectors. A report is expected in June 2009.

The FSF will draw from the above work to review regulatory objectives, the instruments of regulation, and to what entities and activities these instruments should apply. This will be discussed at the March 12-13 FSF Meeting.

Working Group Assessment

Work underway in response to this action item is only a first step towards achieving the Leaders' vision of a financial system in which all systemically important institutions are appropriately overseen.

As a starting point for determining how to assign appropriate oversight, more work is urgently needed to define systemic importance. The IMF and the FSF would be well placed to conduct this work jointly. The recent Geneva Report and the G30 report "Financial Reform: A Framework for Financial Stability" are useful starting points. They note that assessments of systemic significance should take into account a wide range of factors, including size, interconnectedness, leverage and funding mismatches.

The increased integration of markets globally should be taken into account when assessing the systemic importance of any given financial institution, market or instrument given the potential for contagion across borders. Achieving a robust framework for regulating cross-border institutions is therefore important. This issue is treated by Working Group 2.

In order to assess appropriate regulatory capture, a framework to gather information and assess risk that is pervasive in both its geographical and institutional coverage is necessary. Authorities need the ability to acquire sufficient relevant information on the activities and exposures of all financial institutions, participants - including hedge funds - and issuers, in order to periodically assess their contribution to systemic risk, either on their own or through linkages with other segments of the financial system.

Three key areas for additional data collection by regulators should be considered in order to analyze the potential risks posed and decide whether regulatory action is needed. First, data on the nature of an institution's activities - including, for example, its size, investment style, and linkages to systemically important markets – should be collected. Second, regulators should develop and monitor common metrics to assess the significant exposures of counterparties on a group-wide basis, including prime brokers for hedge funds, to identify systemic effects. Third, data on the condition of markets such as measures on the volatility, liquidity and size of markets which are deemed to be systemically important and/or vulnerable, should also be collected. It is envisaged that regulators would use a combination of existing information sources, including data collected from key institutions and vehicles. Consideration of what regulatory, registration or oversight framework would best enable this information collection and subsequent action would be determined by financial regulators at the home and host country level.

After identifying financial institutions, markets or instruments presenting risks that regulators wish to address, this could then be achieved over time as appropriate, whether by direct or indirect regulation, depending on the nature of the risk and/or the intensity of oversight that is desired. Attention should be given to limiting negative spill-overs to other parts of the financial system in the event of severe stress or failure, for example by enhancing counterparty risk management and by developing effective resolution regimes. In order to cope with the changes in the structure of the financial system over time, and recognizing that the determinants of systemic risk may vary over time and across countries, regulators need to have the ability to assign regulatory requirements within their jurisdictions, and they need to periodically review the perimeter of regulation to ensure that all parts of the system that could pose systemic risk have appropriate prudential requirements and resolution regimes.

Particular consideration should be given to the potential for the shadow banking system and for highly-leveraged institutions such as hedge funds to contribute to systemic risk. We note that leverage may arise both directly through formal debt (*e.g.*, bonds, credit lines, IOUs) and indirectly through implicit borrowing due to certain derivatives transactions. Anecdotal evidence suggests that this indirect leverage is particularly important for hedge funds, and it should be taken into account when assessing their systemic importance. Oversight for hedge funds is discussed further in section 3.1.3.

In addition to traditional prudential tools such as capital buffers or risk management guidelines, prudential oversight for systemically important financial institutions could be enhanced either by restricting some of their activities that may present particularly high risks or conflicts of interest, or by assigning appropriate capital charges to reflect non-core activities. Examples of measures restricting activities for banking institutions are given in the G30 Report. They include disallowing the sponsorship or the management of private pools of capital in which the bank's own funds are commingled with that of clients, imposing strict capital and liquidity requirements for large proprietary trading, and retaining a meaningful part of credit risk when packaging and selling structured products. Another option includes increasing the costs of dealing in certain non-standard activities, perhaps through appropriate capital charges, so that financial institutions will be able to determine whether the cost of accommodating innovation merits the change.

Because of practical implementation issues, legal structures and jurisdictional limits will necessarily play an important role in the development of any supervisory model. However, given the convergence in the activities conducted by different types of financial institutions, achieving greater consistency in the regulatory principles that would apply to similar markets and institutions performing similar activities, both within and across borders, would be desirable in order to reduce the scope for regulatory arbitrage. The Working Group recommends that the expanded FSF conduct an analysis of the regulatory perimeter to examine practical issues related to putting greater emphasis on functions and activities and less emphasis on legal status.

The minimum degree of oversight applicable to the entire financial system has been an area of disagreement within the Working Group. The majority of Working Group members consider that some form of disclosure requirements for material entities or markets are a sufficient minimum standard, with authorities in each jurisdiction assessing risks posed by financial institutions, markets and instruments and increasing the degree of oversight according to their risk. However, some Working Group members would prefer that a minimum degree of regulation be applicable to all systemically important financial institutions, markets and instruments.

Recommendation 5: All systemically important financial institutions, markets and instruments should be subject to an appropriate degree of prudential regulation or oversight, consistently applied and proportionate to their local and global systemic importance.

In order to determine the appropriate degree of regulation or oversight, national authorities should determine appropriate mechanisms to allow them to gather relevant information on all financial institutions, markets and instruments in order to assess the potential for the failure or severe stress of these institutions, markets and instruments to contribute to systemic risk, either on their own or through linkages with other segments of the financial system. Information on systemic risk should be monitored though a globally coordinated mechanism.

National authorities should have the authority to expand the perimeter of regulation in a timely way, recognizing that it may vary across countries and through time.

- Responsibility: Financial authorities, central banks, IOSCO, IAIS and BCBS, with guidance from the expanded FSF and the IMF
- Timeline: Two stages: process to obtain information underway in Fall 2009, with system in place within 2 years
- Monitoring: Expanded FSF to ensure a consistent approach to the perimeter of regulation, and the information collection framework to be monitored by IMF-WB (through FSAP and Article IV)

Recommendation 6: Large complex financial institutions require particularly robust oversight at a national and international level given their systemic importance at a national and international level, which arises in part from their size and interconnectedness (or correlation) with other institutions, and from their influence on markets.

- Responsibility: Prudential supervisors, with guidance from the expanded FSF

- **Timeline: Ongoing**
- **Monitoring: Expanded FSF**

Recommendation 7: The boundaries of the regulatory framework should be reviewed periodically within national jurisdictions, in light of financial innovation and broader trends in the financial system, and these should be subject to international coordination and review.

- **Responsibility: Prudential supervisors, central banks, and securities regulators, with guidance from the expanded FSF and the IMF**
- **Timeline: Ongoing**
- **Monitoring: Expanded FSF**

Recommendation 8: The systemic importance of financial institutions, markets and instruments depends on a wide range of factors, including their size, leverage, interconnectedness, as well as funding mismatches. The IMF, in consultation with the expanded FSF and other bodies, should jointly develop a common international framework to help national authorities assess whether a financial institution, market or an instrument is systemically important.

This framework should strive to treat similar activities more similarly for regulatory or oversight purposes regardless of the legal form of the institution, so as to avoid regulatory arbitrage.

- **Responsibility: IMF, expanded FSF**
- **Timeline: Fall 2009**
- **Monitoring: G20**

Two areas of particular concern have been raised by members of the Working Group, which are given attention below: the oversight of credit rating agencies and of hedge funds.

4.1.2 Oversight of Credit Rating Agencies

Investors in fixed income markets failed to probe deeply enough into the nature of the assets they bought, and instead relied too much on credit ratings.

In addition, several issues related to credit rating agencies (CRAs) and their ratings have been cited as contributing factors to the current crisis, including:

- Concerns that they relied on flawed rating methodologies in determining ratings for structured products;
- Insufficient transparency concerning their assumptions, criteria and methodologies used for rating structured products; and
- Potential conflicts of interest.

In response to these concerns, IOSCO updated its Code of Conduct Fundamentals for CRAs in May 2008. The revised Code of Conduct incorporates changes designed to directly address conflicts of interest and transparency issues associated with ratings of structured financial instruments. The Code of Conduct requires CRAs to disclose their own codes of conduct and explain how these individual codes are consistent with the IOSCO standards.

As originally envisioned, enforcement of the Code was left to market participants (*e.g.*, investors, issuers) by virtue of their ability to assess for themselves the degree of compliance of any given CRA with the Code and to adjust their views of this particular CRA's rating opinions accordingly. While this approach offered the benefit of flexibility, the difficulty of confirming compliance remained a weakness which IOSCO and securities regulators in many jurisdictions have been working towards addressing.

Action Item: Regulators should take steps to ensure that credit rating agencies meet the highest standards of IOSCO and that they avoid conflicts of interest, provide greater disclosure to investors and to issuers, and differentiate ratings for complex products. This will help ensure that credit rating agencies have the right incentives and appropriate oversight to enable them to perform their important role in providing unbiased information and assessments to markets. (For immediate action by March 31, 2009)

Action Item: IOSCO should review credit rating agencies' adoption of the standards and mechanisms for monitoring compliance. (For immediate action by March 31, 2009)

Action Item: Credit Ratings Agencies that provide public ratings should be registered. (For action in the medium term)

Process for Taking Forward the Leaders' Action Item

Following publication of the revised IOSCO *Code of Conduct Fundamentals for Credit Rating Agencies*, all of the major rating agencies adopted codes of conduct based on this enhanced set of guidelines. IOSCO is currently reviewing the extent to which these agencies' own codes satisfy its guidelines, and a report will be published in early March. The report indicates that the large global CRAs have largely adopted the changes to the Code or, in certain instances, such as in relation to considering a separate rating scale or subscript for structured products, have clearly explained why they have not adopted that part of the Code. Some smaller national agencies have not adopted the changes but appear likely to do so soon, and a few small agencies have yet to adopt codes based on the IOSCO Code.

Since the Code lacks legal authority, any enforcement of the Code rests with national regulators. Credit rating agencies are registered in the U.S., and proposals to require registration are at various stages of the regulatory process in other jurisdictions, including the European Union and Japan. The FSF is following these national and regional initiatives and is working to promote a globally consistent approach to oversight of credit rating agencies.

The IOSCO Task Force on Credit Rating Agencies has developed a common inspection module for regulators undertaking inspections of CRAs in their jurisdictions. The module provides a baseline for developing inspections based on the IOSCO Code. The Task Force is also in the process of drafting a paper outlining an approach that securities regulators can use to oversee globally active CRAs. This approach will include a permanent IOSCO committee for dialogue with the CRA industry and for information sharing among IOSCO members regarding the regulation of CRAs. This paper will also discuss a college of regulators approach, buttressed by bilateral arrangements regarding ongoing supervision of globally active CRAs. The intention is for this paper to be available by mid March.

Working Group Assessment

The two action items for immediate action – taking steps towards ensuring compliance with the IOSCO code and developing mechanisms for monitoring compliance – are on track to be met by the April Leaders Summit, and the medium term action of national registration is already underway in many jurisdictions.

The Working Group is of the opinion that the IOSCO Code of Conduct is a helpful common frame of reference and that it establishes appropriate standards with respect to incentives alignment, due diligence and transparency. However, a self-regulatory framework does not appear sufficient to ensure compliance with the IOSCO Code. A sound regulatory framework with robust supervision of CRAs by public authorities is necessary to ensure that professional standards are applied, that procedures and policies agreed upon by CRAs are adequately followed, that the integrity of the rating process is upheld, and that conflicts of interest are eliminated or adequately managed. Effective supervision requires surveillance of CRAs' activities and, where necessary, enforcement of rules applying to CRAs. Therefore, rigorous but proportionate rules should be enacted, consistent with international standards, concerning:

- The prevention of conflicts of interest, and the adequate management of those conflicts that arise;
- Safeguards, both about the quality of ratings and of the ratings methodology; and
- Transparency regarding the rating process, both in general and with respect to a specific issuer or financial instrument, to the credit rating agencies' historical performance and to how credit rating agencies operate internally. Moreover, a dual rating scale distinguishing between corporate and sovereign debt, on the one hand, and structured financial products, on the other, would be desirable.

The Working Group has focused on strengthening enforcement mechanisms in order to foster discipline in the credit rating industry. Specifically, the Working Group recommends that Leaders complement their commitment on the registration of credit rating agencies with one to enhance enforcement, by requiring that regulators obtain the authority to require changes to a CRA's practices and procedures for managing conflicts of interest and assuring the quality of their ratings.

Given the global scope of some credit rating agencies, it is desirable for the oversight framework to be consistent across jurisdictions in order to avoid regulatory arbitrage, and to avoid unnecessary compliance costs for those CRAs conducting international activities. Conflicting national-based regulation could have unintended consequences for users of credit ratings if it forces CRAs to separate their operations by jurisdiction and diminishes their analytical abilities. Their resources would be better employed towards improving their performance and, as such, the common monitoring module developed by IOSCO and the role of the IOSCO Task Force on Credit Rating Agencies in promoting cross-border cooperation are important.

There are a small number of rating agencies which have global operations, and others that specialize within a national market. In order to avoid duplication, some regulator should be assigned the responsibility for coordinating the monitoring and enforcement of the IOSCO Code of Conduct for each credit rating agency. This process could be conducted through IOSCO.

***Recommendation 9*: All credit rating agencies should be subject to an oversight regime that includes mandatory registration and that requires compliance with the IOSCO Code of Conduct Fundamentals. National authorities should obtain the authority to enforce compliance and require changes to a rating agency's practices and procedures for managing conflicts of interest and assuring the quality of their ratings. Given the global scope of some credit rating agencies, the oversight framework should be consistent across jurisdictions with appropriate sharing of information between national authorities responsible for the oversight of credit rating agencies.**

- **Responsibility:** National authorities
- **Timeline:** To be completed within 2 years
- **Monitoring:** by IOSCO and IMF-WB (through FSAP and Article IV)

4.1.3 Best Practices for Private Pools of Capital

While the benefits of hedge fund activity to the functioning of financial markets have been recognized, questions have been raised about the comparatively limited extent to which hedge fund managers and funds are subject to direct oversight. Concerns expressed relate, in particular, to the risks that their leverage and short-term funding represent for the stability of the financial system; and to a perceived lack of transparency of hedge funds *vis-à-vis* regulators and other financial market actors. Recently, there have also been concerns about the abusive use of short selling by hedge funds as well as some internal processes, in particular the manner in which hedge funds manage their risks, value their asset portfolios and avoid potential conflicts of interest.

> *<u>Action Item</u>: Private sector bodies that have already developed best practices for private pools of capital and/or hedge funds should bring forward proposals for a set of unified best practices. Finance Ministers should assess the adequacy of these proposals, drawing upon the analysis of regulators, the expanded FSF, and other relevant bodies. (For immediate action by March 31, 2009)*

<u>Process for Taking Forward the Leaders' Action Item</u>

In 2007, the FSF called on the hedge fund industry to develop a code of best practices in the context of an update to its report on highly leveraged institutions. In response, two hedge fund associations, the Hedge Fund Standards Board in the U.K. and the Asset Managers' Committee in the U.S., have prepared separate codes of good practice for the industry. Additional standards have been developed by the Alternative Investment Management Association. Work is now underway amongst these private bodies to produce a single summary standards document. When this becomes available, the FSF and IOSCO will assess and comment on the adequacy of these proposals.

<u>Working Group Assessment</u>

While concerns that hedge funds – or groups of hedge funds – may generate systemic risk and impose externalities on the financial system are supported by the LTCM experience in 1998, there is little evidence that hedge funds have played a significant role in the current financial crisis. There is already some form of oversight over hedge funds in most jurisdictions, primarily through their relationships with prime brokers, which are subject to prudential supervision. A debate is ongoing on whether these current arrangements need to be complemented by deepening of direct regulatory oversight of hedge funds, accompanied by some global or international capacity to aggregate information on financial system exposures to hedge funds.

Some WG members have proposed that the Working Group recommend more formal and consistent oversight for hedge funds, while others argue that the limited role of hedge funds in contributing to the current crisis and the effectiveness of the existing indirect approach for overseeing hedge fund activity to mitigate systemic risks arising from private pools of capita suggest they do not merit priority action. The need for more formal oversight for hedge funds is an area of disagreement within the Working Group which reflects in part differences in the development of the hedge funds industry – and, correspondingly its systemic importance - across the G20. Some Working Group members wish to avoid jurisdictions in which hedge funds do not represent a significant risk from having to commit to regulating them.

The general framework proposed by the Working Group in section 4.1.1 for redefining the scope of regulation will help increasing oversight of the hedge funds industry. This framework will require hedge funds to register with authorities and to provide them with certain data to enable regulators to assess their relative systemic importance and to determine when further regulatory action is required.

In the case of hedge funds, the data collected would likely include the size, investment style, borrowing and performance of the fund along with its participation in certain systemically important markets. In addition, since one mechanism through which the failure of a systemically important hedge fund or cluster of hedge funds would be transmitted to the broader financial system – and potentially the real economy - is through its counterparties, it would be appropriate for regulators to develop and monitor common metrics to assess the significant exposures of counterparties, including prime brokers for hedge funds.

In the interim, the Working Group recommends expanded capture of information on activities, risks and interconnectedness with systemically important institutions. This would include improved access of authorities to macro-prudential information from hedge funds in order to better assess vulnerabilities in the broader financial system

4.1.4 Transparent Assessment of Regulatory Regimes

The Financial Sector Assessment Program aims to promote the soundness of financial systems through evaluations supported by experts from a range of national agencies and standard-setting bodies with the objectives of identifying the strengths and vulnerabilities of a country's financial system; determining how key sources of risk are being managed; ascertaining the sector's developmental and technical assistance needs; and helping prioritize policy responses. As such, this program represents a useful tool for enhancing the regulatory framework.

> *<u>Action Item</u>: To the extent countries or regions have not already done so, each country or region pledges to review and report on the structure and principles of its regulatory system to ensure it is compatible with a modern and increasingly globalized financial system. To this end, all G-20 members commit to undertake a Financial Sector Assessment Program (FSAP) report and support the transparent assessments of countries' national regulatory systems. (For action in the medium term)*

<u>Process for Taking Forward the Leaders' Action Item</u>

Thirteen member countries of the G20 have undertaken a FSAP assessment.

Working Group Assessment

[Could the IMF and the WB please confirm the number above and provide information on plans for FSAPs in the near- to medium-term? Have any actions been taken since the November Summit? For example, are there some commitments from G20 countries that have yet to undertake a FSAP?]

The IMF and the World Bank are continuing to enhance the analytical framework for financial sector assessments. For instance, they are focusing more on systemic linkages and dynamics, and are taking a more systematic approach to stability and developmental assessments to enhance their comparability across countries.

- Recent assessments for advanced economies have focused mainly on evaluating the risks of exposure to US subprime-related products. More broadly, they focused on the risk of external contagion, as well as cross-border crisis management.
- Assessments in emerging market countries have focused on evaluating resilience to a range of possible shocks that could be triggered as a consequence of the unfolding crisis; for example, stress-testing scenarios where external sources of liquidity suddenly dry up. In addition, the assessment examines crisis management frameworks and, in countries where foreign banks predominate, cross-border cooperation arrangements among host and home country supervisors.

Outside the FSAP process, it is possible for jurisdictions to undertake self-assessments or assisted assessments to diagnose weaknesses in their systems and identify remedial actions. For example, India has recently undertaken such a self-assessment. IOSCO and the IAIS have developed self-assessment frameworks that can be used to identify areas for enhancement in preparing for the FSAP. To ensure objective and appropriate assessments, the appropriate self-assessment tools and sufficient methodology for assessments should be developed in cooperation with the IMF and the World Bank by international financial standard-setting bodies (IOSCO, IAIS and BCBS).

IOSCO and the IAIS encourage countries conducting self-assessments to obtain assistance from independent experts to develop action plans for addressing gaps in the implementation of global standards. They also facilitate this process. For instance, IOSCO recently conducted a workshop to train assessors to be able to undertake peer reviews of these self-assessments.

The Working Group recommends that Leaders reiterate their commitment made in Washington to undertake an FSAP and request that the IMF and the WB prepare a plan and timetable of completed and upcoming assessments by the Fall of 2009. Depending on the frequency of FSAPs, the process could be supplemented by periodic self-assessments of regulatory frameworks based on internationally agreed methodologies and tools. The results of these self-assessments should be subject to international coordination and validation, and should become public. These actions would allow for a monitoring of progress on improvements to transparency and to compliance with international standards and regulations.

FSAPs should also be used to monitor consistency in regulatory frameworks and the perimeter of regulation. The basis upon which countries are assessed should be expanded to include macroprudential oversight and the regulatory oversight of the structure of compensation schemes at financial institutions

Given the increasing globalization of the financial system, G20 Leaders should also encourage non-G20 countries to take similar steps to assess the strength of their national financial systems.

***Recommendation 10*: All G20 members should commit to undertake a Financial Sector Assessment Program (FSAP) report and to publish its conclusions. Depending on the frequency of FSAPs, national authorities may wish to supplement the FSAP process by periodically undertaking a self-assessment of their regulatory frameworks based on internationally agreed methodologies and tools. The results of these self-assessments should be subject to international coordination and validation, and should become public.**

To improve the FSAP process, the basis upon which countries are assessed should be expanded to encompass macroprudential oversight, the scope of regulation, and the supervisory approach to assessing the risk impacts of the structure of compensation schemes at financial institutions.

- **Responsibility**: Finance Ministries, IMF/WB
- **Timeline**: G20 countries that have not undertaken an FSAP should immediately commit to do so, in consultation with the IMF/WB; Countries with systemically important financial systems should be subject to a self-assessment every 5 years, and FSAP Updates in consultation with IMF/WB
- **Monitoring:** IMF/WB

4.2 Procyclicality

The crisis has raised questions whether certain aspects of accounting frameworks and capital regulation increase the natural tendency of the financial system to amplify business cycles. This tendency is particularly disruptive and apparent during an economic downturn or when the financial system is facing strains. There is a lack of incentives for the financial system to lean against rapid growth of credit and asset values during benign economic conditions. This would not only mitigate the build-up of imbalances that give rise to systemic risk but, by building up prudential buffers during the benign phase of an economic cycle, when it is easier and cheaper to do so, institutions would enter more challenging times from a stronger position.

> *<u>Action Item</u>: The IMF, expanded FSF, and other regulators and bodies should develop recommendations to mitigate pro-cyclicality, including the review of how valuation and leverage, bank capital, executive compensation, and provisioning practices may exacerbate cyclical trends. (For immediate action by March 31, 2009)*

<u>Process for Taking Forward the Leaders' Action Item</u>

The FSF has formed three workstreams to study the forces that contribute to procyclicality in the financial system and examine possible options for mitigating them. These workstreams have focused on (i) bank capital, (ii) loan loss provisioning, and (iii) the interaction of valuation and leverage practices. The FSF has also formed a workstream to develop sound practice principles for ensuring that compensation schemes do not provide incentives for excessive risk taking. This work is discussed in section 3.4.1.

- *<u>Bank capital</u>*: This Joint FSF-BCBS workstream is examining the impact of Basel II on the cyclicality of capital requirements and developing ways to mitigate the risk of regulatory capital amplifying shocks to the financial sector and the real economy going forward. The workstream is developing recommendations on changes to the regulatory capital framework so that it raises the quality and level of capital in the banking system during strong economic conditions that can be drawn down during periods of economic and financial stress; revision to the market risk framework of Basel II to reduce the reliance on cyclical VaR-based capital estimates; supplementing the risk-based capital framework with a simple, transparent measure to help contain the build up of leverage in the banking system; and recommending that supervisors use stress tests as part of the Pillar 2 supervisory review process to validate the adequacy of banks' capital buffers above the regulatory minimum during periods of rapid growth. .

- *<u>Loan loss provisioning</u>*: This workstream is analyzing the potential contribution of loan loss provisioning to procyclicality with a view to recommending enhancements to loan loss provisioning practices and standards. Recommendations under consideration include that accounting standards setters issue a statement that reiterates the required use of sound management judgement as part of existing loan loss provisioning standards; and that they reconsider their current loan loss provisioning requirements and related disclosures on an expedited basis to reflect a broader range of available credit information, including by analysing expected loss and dynamic provisioning approaches. Other recommendations under consideration include reviewing and eliminating constraints in Basel II that may limit banks from maintaining robust loan loss provisions; and reviewing and enhancing the Pillar 3 disclosures about loan loss provisioning practices and related credit risk and credit losses in loan portfolios.

- <u>*Valuation and Leverage*</u>: This joint FSF-CGFS workstream is analyzing the significance of the link between valuation and leverage as a source of procyclicality. It is considering the use of quantitative indicators and/or constraints on leverage and margins; a research program to measure funding and liquidity risk attached to maturity transformation and based on its findings, which information should be made available to supervisors on leverage and on maturity mismatches on a system-wide basis; the use of valuation reserves or adjustments be considered for fair valued financial instruments when data or modelling needed to support their valuation is weak; and an examination of possible changes to relevant standards to dampen adverse dynamics potentially associated with fair value accounting.

The FSF will discuss reports from these work streams at its meeting in mid-March.

<u>*Working Group Assessment*</u>

This action item has been achieved. The Working Group now proposes that recommendations from the FSF Working Groups be assessed by the BCBS and accounting standard setters, taking into consideration practical issues related to their use and implementation, and that regulation and standards be enhanced over time to mitigate procyclicality. The Working Group proposes that a roadmap be prepared for the Fall of 2009, and that annual updates be provided to the expanded FSF.

The assessment of these recommendations should include an analysis of the interaction between measures to mitigate procyclicality and the objective should be to attain a comprehensive strategy that achieves the best overall outcome. In the near term, consideration could be given to options that do not require a major reworking of accounting standards for provisions/impairment. This could come through the use of prudential rather than accounting mechanisms.The roadmap to address pro-cyclicality should also take into account the need for training and for technical assistance at institutions and regulators, with particular attention to those in emerging market economies.

Measures that are simple to understand and to implement would be preferable to more complex ones, and policy tools that are based on rules are attractive. However, as the recent crisis made plain, rules-based tools can be arbitraged, so the informed judgment of regulators will also be an important part of efforts to dampen procyclicality.

There is some disagreement within the Working Group with respect to the implementation of provisioning techniques that are more forward-looking or counter-cyclical. Accounting standards for provisioning of loan losses through the income statement require evidence that there is a deterioration in the loan portfolio. "Through-the-cycle" or counter-cyclical provisioning where provisions are increased in good times for the possibility that the environment may deteriorate in the future is not consistent with accounting standards. While accounting standards setters agree in principle that such provisioning practices would be desirable from a financial stability perspective, this would reduce the integrity of financial statements, whose function is to present an objective and accurate representation of the financial situation of an entity. Mitigating the procyclicality arising from provisioning practices requires that the BCBS and accounting standards setters collaborate to identify solutions that are compatible with their complementary objectives of enhancing the stability of the financial sector and promoting transparency of economic results in financial reports, respectively.

Recommendation 11: The FSF and its member bodies, particularly the BCBS, should develop supervisory and regulatory approaches to mitigate procyclicality in the financial system by promoting the build-up of capital buffers during the economic expansion, through earlier recognition of loan losses and by dampening the adverse interaction between fair valuation, leverage and maturity mismatching in times of stress.

- **Responsibility**: FSF and member bodies, BCBS, CGFS
- **Timeline for development**: Strategic plan Fall 2009, with further progress reported by year end
- **Timeline for implementation**: As appropriate, with discussion with sector and coordination by the expanded FSF
- **Monitoring**: Expanded FSF

Recommendation 12: Accounting rules and valuation practices should reflect the evolution of risks through the cycle, thus facilitating greater consistency with good risk management and sound prudential regulation, while maintaining transparency in the presentation of financial statements. Accounting standard setters and prudential authorities should collaborate to achieve those objectives, with particular emphasis on providing enhanced guidance on examining ways to enable more through-the-cycle loan-loss provisioning practices and to dampen the role of fair value accounting in amplifying business cycles. Particular emphasis should be given to providing enhanced guidance on the application of fair value accounting and the treatment of provisions.

- **Responsibility**: Accounting standards setters, BCBS
- **Timeline for development**: Strategic plan Fall 2009
- **Timeline for implementation**: As appropriate, with discussion with sector and coordination by the expanded FSF
- **Monitoring:** Expanded FSF

4.3 Prudential Oversight

This section addresses actions to enhance prudential oversight with respect to capital and liquidity, in addition to the need for a sound infrastructure for OTC credit derivatives that would reduce their potential systemic risk.

4.3.1 Capital

The crisis has shown that a strong capital base is critical to bank resilience, and broader financial stability, by underscoring a number of weaknesses in capital adequacy, primarily with respect to banking institutions. First, the Basel II framework did not properly capture the risk associated with certain assets, in particular, complex credit products in the *trading book*. These products, to date, have produced the majority of the losses at banks, as well as complex securitisations and contingent exposures to off-balance sheet vehicles. Second, the minimum level of capital, as well as its quality, failed to support the banks' risk exposures going into the crisis. Third, the cyclicality of capital buffers has amplified the economic downturn (see section 3.2). Fourth, discrepancies across financial institutions in measures of capital make solvency ratios difficult to compare.

Action Item: Authorities should ensure that financial institutions maintain adequate capital in amounts necessary to sustain confidence. International standard setters should set out strengthened capital requirements for banks' structured credit and securitization activities. (For immediate action by March 31, 2009)

Action Item: Definitions of capital should be harmonized in order to achieve consistent measures of capital and capital adequacy. (For action in the medium term)

Process for Taking Forward the Leaders' Action Item

The Basel Committee on Banking Supervision has announced a package of measures to strengthen the Basel II capital framework in order to address weaknesses revealed by the crisis in the banking sector, and additional measures are being developed. These measures form part of a comprehensive strategy to strengthen the regulation, supervision and risk management of internationally active banks.

In addition to mitigating the influence of the capital framework on risk-taking and the economic cycle (see section 3.2), two key building blocks of this strategy are:

- *Strengthening the risk capture of the Basel II framework*: In January 2009, the BCBS issued for consultation proposals to strengthen the risk capture of Basel II framework. These include enhancements to the capital treatment of securitizations, off-balance sheet exposures, and trading book activities.

- *Enhancing the consistency and quality of the Tier 1 capital base*: The BCBS is considering various measures to promote the highest forms of capital, in particular, ordinary shares and reserves in the Tier 1 capital base and enhancing the global consistency of minimum capital requirements. The definition of capital is being reviewed as part of this work in order to achieve global consistency. It will be a medium term project, however, as many jurisdictions are currently using new types of capital instruments to inject public money and strengthen the capital base of their banking system. The BCBS will review recommendations to achieve this at its March 2009 meeting.

These two building blocks are being considered in conjunction with a third strategic priority, mitigating procyclicality, which is addressed in section 3.2. The BCBS will consider preliminary recommendations to mitigate procyclicality at its March 2009 meeting, along with recommendations for enhancing the consistency and quality of the Tier 1 capital base.

Further initiatives of the BCBS to enhance the capital framework that are less advanced include:

- Reviewing the treatment of external ratings under the framework and whether there are any adverse incentives that should be mitigated (at the July 2009 BCBS meeting);
- Strengthening the treatment of counterparty credit risk under the three pillars of Basel II (at the December 2009 BCBS meeting); and
- Evaluating concrete ways to supplement the Basel II risk-based capital framework with a simple, transparent measure to help contain the build up of leverage over the cycle.

The BCBS plans to develop recommendations in these areas by the end of 2009.

In the insurance sector,_the IAIS is developing a comprehensive and cohesive set of supervisory papers to address issues that have emerged from the financial crisis with respect to the assesment of the solvency of insurance companies. For example, standards and guidance on the structure of regulatory capital requirements and on the use of internal models and enterprise risk management for solvency purposes have been completed or are undergoing review. Other solvency supervisory papers taking into account recent events are under development or review, including standards and guidance on capital resources, valuation for solvency purposes and investment and asset-liability management. The IAIS will continue to work with its members to facilitate proper implementation of these standards to enhance resilience of the solvency position of insurers.

Working Group Assessment

The capital adequacy framework for the banking sector has been enhanced in response to the action items above: enhancements to the risk capture of the Basel II framework have established stronger capital requirements for banks' structured credit and securitization activities, and the medium term action item of harmonizing definitions of capital is being addressed in conjunction with work to improve the quality of capital. Further, the strategic plan of the BCBS includes enhancements to the capital adequacy framework not part of the Washington Action Plan.

Going forward, the Working Group believes that actions need to be taken to strengthen institutions' capital levels. While raising minimum prudential capital requirements from their current levels would provide additional capital strength during periods of stress, they would further encourage procyclical behaviour, at the aggregate level. Emphasis should be placed on encouraging institutions to operate at higher buffers above minimum prudential capital requirements, to allow for capital to be drawn down during adverse periods without triggering heightened supervisory action.

As such, the Working Group recommends that higher buffers above a minimum level of capital are needed for the system once the current crisis has abated. The international minimum capital requirements should also be increased. It is important, however, for G20 Leaders to send a clear message that supervisors will be extremely cautious about adding to the already severe procyclical behaviour in the marketplace, and therefore will not consider raising recommended buffers above minimum capital ratios during the crisis. Any enhancements will be introduced in a manner that promotes the near term resilience of the banking sector and its ability to provide credit to the economy. Timelines for implementation may vary across the G20 depending on the technical capabilities of each country's institutions and regulators.

A strong, high quality capital base (*e.g.*, common shares) is critical for banks to be able to absorb losses and maintain lending during periods of severe economic and financial stress. Based on lessons drawn from recent developments, a strong capital base should achieve an appropriate balance between ensuring that both prudential and competitive equity objectives are maintained in the future.

Recognizing the need to also mitigate procyclicality (see section 3.2), this high quality capital should serve as a buffer which would be built up during periods of rapid earnings growth and be drawn down in a downturn.

The Working Group also recommends that G20 Leaders support the progressive adoption of the Basel II capital framework across the G20 once strains in markets have abated. The move to the Basel II framework improves risk capture and better handles periods of rapid innovation and the new products that such periods produce. Moreover, Basel II captures off-balance-sheet vehicles, ensuring they are subject to regulatory capital requirements. Timelines for implementation may vary across the G20 depending on the level of technical capabilities of each country's regulators and institutions (see section 4.3 for more on technical assistance).

Nonetheless, in the context of rapid financial innovation and risk-based regulatory capital requirements, a well constructed non-risk-based capital measure can at least partially address the problem of modelling deficiencies and ensure a minimum level of capital is retained in the banking system. The case for a complementary, non-risk-based capital measure as a regulatory "back-stop" to the Basel II risk-based capital requirement should be examined by the BCBS.

<u>*Recommendation 13*</u>: Capital should serve as an effective buffer to absorb losses over the cycle, so as to protect both the solvency of financial institutions in the event of losses, and their ability to lend.

Once conditions in the financial system allow it, the international standard for the minimum level of capital for banks should be increased and the quality and global consistency of capital should be enhanced. In addition, capital buffers above minima and loan-loss provisions should be built up in good times in order to enhance the ability of regulated financial institutions to withstand large shocks.

In this context, the BCBS should develop standards to promote the build-up of capital and liquidity buffers in good times that can be drawn down in periods of stress. The BCBS should also develop a simple, transparent leverage indicator.

In the meantime, the international standard for the minimum level of capital should remain unchanged, capital buffers above minima should be allowed to decline in response to deteriorating economic conditions and credit quality, and urgent consideration should be given to measures that would facilitate access to additional private sector capital in the downturn.

- **Responsibility**: BCBS
- **Timeline**: Two stages: The need to begin the transition to the medium-term phase will be discussed at periodic BCBS meetings. Once it has begun, the transition is to be completed as appropriate, in consultation with the industry and with coordination by the expanded FSF
- **Monitoring**: Expanded FSF

<u>*Recommendation 14*</u>: G20 Leaders should support the progressive adoption of the Basel II capital framework across the G20.

- **Responsibility**: Prudential supervisors
- **Timeline**: Two stages: The need to begin the transition to the medium-term phase to be discussed periodically at FSF meetings. Once it has begun, the transition is to be completed as appropriate, in consultation with the industry and with coordination by the expanded FSF
- **Monitoring**: IMF-WB (through FSAP and Article IV), BCBS

4.3.2 Liquidity

Recent events have highlighted a number of limitations in the lines of defence of financial institutions during a period of severe liquidity strain. Many of the actions by which financial institutions can address liquidity pressures, for example by selling illiquid assets for cash or by competing more aggressively for retail deposits, suffer when liquidity pressures are widespread and many institutions attempt to use the same funding strategies.

The increasing complexity of financial instruments also creates challenges for managing liquidity. The inclusion of options in financial instruments (*e.g.*, credit rating downgrade clauses) and the fact that some instruments have short track records or do not trade actively, increases the difficulty in assessing the behaviour of these instruments during periods of stress and consequently, for managing liquidity.

Another weakness revealed by the crisis is that liquidity, which some large global financial institutions are increasingly managing in a centralised manner across borders, may not be fully transferable across borders in times of stress, as national supervisors and domestic crisis management policies may require that sufficient liquidity be held for local operations.

Action Item: Regulators should develop and implement procedures to ensure that financial firms implement policies to better manage liquidity risk, including by creating strong liquidity cushions. (For immediate action by March 31, 2009)

Action Item: Supervisors and central banks should develop robust and internationally consistent approaches for liquidity supervision of, and central bank liquidity operations for, cross-border banks. (For action in the medium term)

Process for Taking Forward the Leaders' Action Item

Standards for liquidity management in the banking sector will be materially raised by the BCBS' *Principles for Sound Liquidity Risk Management and Supervision*, published in September 2008. The foundation for this guidance is the fundamental principle that banks should establish a robust framework for managing liquidity risk, and that they maintain sufficient liquidity, including a cushion of unencumbered, high quality liquid assets, to withstand a range of stress events, including those involving the loss or impairment of both unsecured and secured funding sources. This guidance also clarifies expectations that supervisors should assess the adequacy of both a bank's liquidity risk management framework and its liquidity position, and should take prompt action if a bank is deficient in either area in order to protect depositors and limit potential damage to the financial system.

These guidelines include a principle calling for cooperation and information sharing among supervisors and other stakeholders, such as central banks, for the liquidity supervision of cross-border banks. This principle provides examples of firm-specific stress situations that should require closer and more frequent communication among stakeholders.

The BCBS Working Group on Liquidity has initiated work to promote greater consistency of liquidity regulation and supervision for cross-border banking groups. This includes an evaluation of tools, metrics and benchmarks that supervisors can use to assess the resilience of banks' liquidity cushions and constrain any weakening in liquidity maturity profiles, diversity of funding sources, and stress testing practices. This will be discussed at the July 2009 BCBS meeting.

In addition, the Committee on the Global Financial System (CGFS) released a report in July 2008 to enhance the operational frameworks for the provision of liquidity by central banks, including cross-border banks. This report recommends that central banks enhance their capacity to address problems in the international distribution of liquidity by establishing or maintaining standing swap lines among themselves, and by accepting assets denominated in a foreign currency or obligations booked abroad as collateral. Moreover, the CPSS prepared a report on operational arrangements that central banks could make, on an individual or coordinated basis, to strengthen their operational readiness to cope with a wide range of scenarios under which they might seek to provide cross-border liquidity. Many central banks across the G20 have begun implementing these recommendations.

Although recent events did not reveal weaknesses with respect to the liquidity management in the insurance sector, the IAIS has expanded its planned review of solvency supervisory papers to take into account this issue.

Working Group Assessment

The BCBS guidance establishes guidelines for the management of liquidity risk, including the use of cushions of unencumbered, high quality assets to withstand a range of stress events. This adequately addresses the Washington action item to this effect, as weaknesses in this area that were revealed by the crisis pertained mainly to the banking sector. The BCBS will conduct a comprehensive review of whether its standards for liquidity have been effectively implemented in the second half of 2009.

The Working Group proposes that Leaders support the implementation of these principles and extend them to other financial institutions. In order to improve liquidity resilience against future crises, financial institutions will need to hold increased levels of stable core funding that is more likely to be stable across the economic cycle.

An effective global liquidity framework for managing liquidity in large, cross-border financial institutions should include internationally agreed levels of liquidity buffers, and should encourage an increase in the quality of their composition. Such a framework needs to be comprehensive and take into account liquidity needs for the overall institution.

<u>Recommendation 15</u>: **Prudential supervisors should deliver a global framework for promoting stronger liquidity buffers at financial institutions, including cross-border institutions, to ensure that they can withstand prolonged periods of market and funding liquidity stress.**

- **Responsibility**: Prudential supervisors, BCBS, IAIS
- **Timeline**: To be completed within 2 years
- **Monitoring:** Expanded FSF

4.3.3 Infrastructure for OTC Credit Derivatives

The market for credit default swaps (CDS) operates on a bilateral, over-the-counter (OTC) basis and has grown to many times the size of the market for the underlying credit instruments. In light of problems involving some large players in this market, attention has focused on the systemic risks posed by CDS. For instance, the inability of certain protection sellers to meet their CDS obligations has raised questions about the potentially destabilizing effects of the CDS market on other markets. Also, the deterioration of credit markets generally has increased the likelihood of CDS payouts, thus prompting protection buyers to seek additional margin from protection sellers. These margin calls have strained the balance sheets of protection sellers, and may have forced asset sales that contributed to put downward pressure on the cash securities markets.

<u>Action Item</u>: Supervisors and regulators, building on the imminent launch of central counterparty services for credit default swaps (CDS) in some countries, should: speed efforts to reduce the systemic risks of CDS and over-the-counter (OTC) derivatives transactions; insist that market participants support exchange traded or electronic trading platforms for CDS contracts; expand OTC derivatives market transparency; and ensure that the infrastructure for OTC derivatives can support growing volumes. (For immediate action by March 31, 2009)

<u>Process for Taking Forward the Leaders' Action Item</u>

A group of global prudential supervisors is working with the industry to strengthen the infrastructure for OTC credit derivatives. The top near-term priority is to oversee the implementation of central counterparties for CDS.

Representatives from regulatory agencies with direct authority over one or more of the existing or proposed CDS central counterparties (including those in the U.S., U.K., Germany and the European Union) have begun discussing possible information sharing arrangements and other methods of cooperation within the regulatory community. The primary objectives of this effort include the application of consistent standards and the promotion of consistent public policy objectives and oversight approaches for all CDS central counterparties, as well as logistical support in carrying out oversight responsibilities.

In the U.S., the President's Working Group announced in November 2008 a broader set of policy objectives to guide efforts aimed at addressing the full range of challenges associated with OTC derivatives, with a primary focus on CDS. Policy objectives include:

- Public reporting of prices, trading volumes and aggregate open interest;
- The development by supervisors of consistent policy standards and risk management expectations;
- The registration of all transactions in credit default swaps not cleared through a CCP in central contract repositories;
- Support for trading on exchanges or other centralized trading platforms for standardized CDS contracts; and
- A review by regulatory agencies to determine if they have adequate enforcement authority to police against fraud and market manipulation (with proposals for changes in authority where warranted).

The creation of a central counterparty for OTC credit derivatives is also a priority in Europe, where the European Commission has established a Working Group composed of market participants, national regulators and the European Central Bank to deliver progress in this area. As a result of discussions within this EC Working Group, the International Swaps and Derivatives Association and the European Banking Federation have committed to the use of at least one EU central counterparty to clear CCP-eligible CDS on European reference entities and indices based on these entities. These associations have also committed to work closely with infrastructure providers, regulators and the European authorities including the European Central Bank in resolving outstanding technical, regulatory, legal and practical issues. These efforts mirror the engagement the industry has made in other jurisdictions.

At the same time, following a request from EU Member States, the Committee of European Securities Regulators and the European System of Central Banks are in the process of revising their recommendations for CCPs in order to ensure that they cater for the specificities of derivatives markets in general and the CDS market in particular. Furthermore, the European Commission is also examining whether additional regulatory requirements might be necessary in this area.

In terms of transparency, IOSCO is working with the financial service industry to examine the viability of a secondary market reporting system for different types of structured finance products. In particular, it is focusing on whether the nature of structured finance products lends itself to such reporting and the cost and benefits such a system might entail. IOSCO has conducted a survey of industry participants and is planning to hold a roundtable with industry participants to discuss whether a secondary reporting system for structured finance products would be viable.

Working Group Assessment

The launch of central counterparties (CCPs) for OTC credit derivatives is an important step towards reducing systemic risk. Clearing and settling CDS contracts through a central counterparty means that the two counterparties to a CDS are no longer exposed to each other's credit risk. Hence, well-managed, and properly regulated CCP could vastly simplify the containment of the failure of a major market participant. Central counterparties also contribute to enhancing market efficiency by helping ensure that eligible trades are cleared and settled in a timely manner, thereby reducing the operational risks associated with significant volumes of unconfirmed and failed trades. And the development of a CCP facilitates greater market transparency, including the reporting of prices for CDS, trading volumes, and aggregate open interest. The availability of pricing information can improve the fairness, efficiency, and competitiveness of markets — all of which enhance investor protection and facilitate capital formation. The degree of transparency, of course, depends on the extent of participation in the CCP, which is not mandatory. The industry's commitment to clear CCP-eligible CDS through central counterparties should ensure a substantial increase in the transparency of the market for these contracts.

Prudential supervisors have been collaborating with market participants to increase market transparency. One major step in this initiative is the publication of weekly aggregate market data from a central repository. Regulators are working to identify a consistent set of data that central counterparties should make available to the public on a regular basis, including market prices, market depth and open interest.

The Working Group recommends that the financial industry take the necessary steps to clear OTC transactions on credit derivatives through central counterparties in order to reduce systemic risk. If needed, some incentives may be provided by national authorities, for example, by taking a higher capital charge for transactions not cleared through central counterparties.

In order to foster transparency and to promote the use of CCP and of exchange trading for credit derivatives, public authorities should also encourage the financial industry to standardize contracts and to use data repository for the remaining non-standardized contracts and promote fair and open access to central counterparty services.

In addition, in order to ensure that the infrastructure for centralized clearing and settlements meets high prudential standards, the Working Group recommends that a review of the CPSS-IOSCO Recommendations for Central Counterparties and the accompanying guidance be undertaken, and that prudential supervisors apply these (possibly enhanced) standards.

In order to mitigate systemic risk resulting from counterparty credit risk, in the short run, it would be beneficial for there to be a competitive environment for central counterparties without imposing regulatory requirements that unduly fragment the market.

In the future, it may be appropriate to consider the need for central counterparties for other types of derivatives trading over-the-counter.

***Recommendation 16*: Financial institutions should take the necessary actions, including by way of standardizing credit derivatives contracts, to clear OTC transactions on credit derivatives through central counterparties. If needed, national authorities may enhance incentives for the use of central counterparties to clear OTC credit derivatives.**

- **Responsibility**: Financial institutions, prudential supervisors and other authorities, central banks
- **Timeline**: To be completed within two years; Industry to prepare an action plan on standardization in the Fall 2009
- **Monitoring**: Prudential supervisors and expanded FSF

***Recommendation 17*: Central counterparties should be subject to transparent and effective oversight by prudential supervisors, and meet high standards in terms of risk management, operational arrangements, default procedures and transparency. The CPSS and IOSCO should review their recommendations for central counterparties to ensure they take into account the unique characteristics of credit derivatives.**

- **Responsibility**: Prudential supervisors, CPSS, IOSCO
- **Timeline**: To be completed within 2 years
- **Monitoring**: Expanded FSF

4.4 Compensation Schemes and Risk Management

4.4.1 Compensation Schemes

General consensus has emerged that compensation practices at financial institutions are one factor, among many, that contributed to the financial crisis. For instance, bonus payments were tied to short-term profits without adequate regard to the longer-term risks they imposed on their firms, and this incentives misalignment amplified the risk-taking that severely threatened the global financial system.

<u>Action Item</u>: Financial institutions should have clear internal incentives to promote stability, and action needs to be taken, through voluntary effort or regulatory action, to avoid compensation schemes which reward excessive short-term returns or risk taking. (For immediate action by March 31, 2009)

<u>Process for Taking Forward the Leaders' Action Item</u>

To better understand the forces at play, an FSF Working Group reviewed relevant reports and analyses by other bodies and experts, engaged in discussions with experts from the financial industry, the public sector and academia, and investigated industry practice by conducting a global survey of practice at major financial firms. It also reviewed the results of a number of surveys commissioned by others.

In its assessment of compensation practices, the FSF has observed that too little attention was given to links between compensation and risks. In particular, the FSF observed that:

- Most financial institutions viewed compensation systems as being unrelated to risk management and risk governance; and
- Financial supervisory and regulatory authorities did not focus on the implications for risk of compensation systems.

In this context, it is clear that changes to existing practices are necessary on several fronts to ensure that perverse compensation incentives do not induce excessive risk-taking in financial institutions in the future. As such, the FSF developed Principles for Sound Compensation Practices for financial institutions to prevent incentives towards excessive risk taking that may arise from compensation schemes. This Working Group formulated nine principles to achieve more effective governance in setting and monitoring compensation within financial institutions, to better align compensation practices with prudent risk taking, and to ensure effective supervisory oversight and improve disclosure practices.

Additional initiatives undertaken to guide the adoption of improved compensation practices in the financial sector include the consultation guidance on Basel II Pillar 2 to enhance sound corporate governance and risk management, which will help reinforce adherence to sound compensation practices.

In addition, the OECD will explore, in the context of the OECD Principles of Corporate Governance, how compensation practices at both the management and operating levels should be amended to achieve sounder long-term strategies that better address the interests of the institution, its shareholders and other stakeholders.

Working Group Assessment

In order to build on the analysis of remuneration practices that was conducted and on the sound practice principles that were developed, the Working Group recommends that Boards of Directors and the management of financial institutions take appropriate actions to structure compensation in a manner consistent with sound practice principles such as those developed by the FSF.

A number of financial institutions have announced changes to their compensation structures. However, it is important that reforms in this regard be done on an industry-wide basis, so that improved risk management and compensation practices by some systemically important firms are not undermined by the unsound practices of others.

Since competitive pressures, a perceived first-mover disadvantage or other factors could hinder the ability of financial institutions to effectively address deficiencies in compensation schemes, the Working Group views national authorities' supervisory and regulatory infrastructure as the appropriate vehicle for promoting compliance with sound compensation practices. It is not intended, however, that national authorities or prudential supervisors would prescribe particular designs or levels of compensation. In addition, since financial firms differ in goals, activities and culture, as do jobs within a firm, any compensation system must work in concert with other management tools in pursuit of prudent risk taking.

***Recommendation 18*: Large financial institutions should ensure that their compensation frameworks are consistent with their long-term goals and with prudent risk-taking. As such, the Boards of Directors of financial institutions should set clear lines of responsibility and accountability throughout their organizations to ensure that the design and operation of its remuneration system supports the firm's goals, including its overall risk tolerance. Boards should also ensure there are appropriate mechanisms for monitoring remuneration schemes.**

- **Responsibility:** Boards of Directors of financial institutions
- **Timeline:** Fall 2009
- **Monitoring:** Prudential supervisors

***Recommendation 19*: In order to promote incentives for prudent risk taking, each financial institution must review its compensation framework to ensure it follows sound practice principles such as those developed by the FSF. These include the need for remuneration systems to provide incentives consistent with the firm's long-term goals, to be adjusted for the risk taken by employees, and for the variable components of compensation to vary symmetrically according to performance.**

- **Responsibility:** Financial institutions
- **Timeline:** Fall 2009
- **Monitoring:** Prudential supervisors

***Recommendation 20*: Prudential supervisors should enhance their oversight of compensation schemes by taking the design of remuneration systems into account when assessing risk management practices. The BCBS should more explicitly integrate this dimension in its guidance for the assessment of risk management practices by national prudential supervisors.**

- **Responsibility:** Prudential supervisors, BCBS
- **Timeline:** Fall 2009
- **Monitoring:** Expanded FSF

4.4.2 Risk Management Practices

Shortcomings in risk management practices revealed by the current crisis reflect a failure to implement effective firm-wide risk management systems as well as a number of more technical limitations associated with risk management tools, including their inability to model severe financial shocks and the fact that most quantitative tools are backward looking. The many weaknesses in risk management practices that were revealed include the inability of financial institutions to adequately monitor risk concentrations across products and geographical areas, shortcomings in stress testing and inappropriate practices for managing risks arising from structured products.

> *<u>Action Item</u>: Regulators should develop enhanced guidance to strengthen banks' risk management practices, in line with international best practices, and should encourage financial firms to re-examine their internal controls and implement strengthened policies for sound risk management. (For immediate action by March 31, 2009)*

<u>Process for Taking Forward the Leaders' Action Item</u>

In the banking sector, the BCBS is enhancing guidance for supervisory oversight in a number of important risk management areas, using Pillar 2 of Basel II as a foundation. The focus of this guidance is on:

- Enhancing firm-wide risk oversight, risk management and internal controls;
- Managing more effectively specific risk areas such as firm-wide risk concentrations, off-balance sheet exposures and associated reputational risks, securitization exposures, valuations and liquidity risk; and
- Improving banks' stress testing practices.

These enhancements were included as part of the Basel II consultative document issued in January 2009.

In addition to the BCBS guidance, supervisors from most G20 countries have published, or are in the process of publishing, supplementary guidance on a wide variety of areas in response to the crisis, including securitization, risk concentrations, contingency planning and stress testing.

The Senior Supervisors Group (SSG), a group of prudential supervisors, is undertaking an assessment of major institutions' strengths, weaknesses and gaps in relation to the recommendations for strengthened risk management practices that have been made in public and private sector reports during 2008 (*e.g.*, Financial Stability Forum, Senior Supervisors Group, U.S. President's Working Group, International Institute of Finance, Counterparty Risk Management Group III). A summary of the findings is expected in the spring of 2009.

In the insurance sector, the IAIS is reviewing all existing and new supervisory papers to incorporate lessons drawn from the financial crisis. More specifically, the standards and guidance on asset-liability management and investment risk management are being updated to reinforce coverage on issues such as the use of stress testing in identifying risks, including concentration and liquidity risk. An issues paper on corporate governance is also being developed as foundation for future supervisory papers on corporate governance which will cover topics such as risk management and control functions, function and qualification of board members and the use of third party assessments such as credit ratings. The appropriateness of the reinsurance plan of direct insurers is also addressed in an IAIS standard on reinsurance.

Working Group Assessment

The Working Group welcomes the BCBS consultative document to address a wide range of weaknesses in risk management practices that played a significant role in causing and accelerating the crisis.

In addition to shortcomings with risk management tools and with the supervision of risk management practices, the global financial crisis has highlighted the failure of the Boards of Directors of many of financial institutions in fostering an effective risk management culture in their organizations. It should be recognized that, first and foremost, it remains the responsibility of the private sector to take the lead in strengthening firm-wide risk management frameworks. Both management and the Board of Directors are responsible for putting in place adequate risk management and control systems.

> *Action Item: Supervisors should ensure that financial firms develop processes that provide for timely and comprehensive measurement of risk concentrations and large counterparty risk positions across products and geographies. (For immediate action by March 31, 2009)*

Process for Taking Forward the Leaders' Action Item

The BCBS's Basel II consultative document issued in January 2009 includes enhanced Pillar 2 guidance on the assessment by management and supervisors of risk concentrations. The Committee's enhanced guidance sets clear expectations for Boards of Directors and senior management to set incentives across the firm to control risk exposures and concentrations in accordance with the firm's stated risk appetite. The guidance also sets supervisory expectations for capturing firm-wide risk concentrations arising from both on- and off-balance sheet exposures and securitization activities. Generally, banks are expected to have in place effective internal policies, systems and controls to identify, measure, monitor, manage, control and mitigate their risk concentrations in a timely manner, and under various conditions, including stressed market situations.

Working Group Assessment

The BCBS guidance establishes processes that provide comprehensive measurement of concentration risk, ensure that banks have credit risk mitigation strategies and internal limits to risk concentrations and ensure that these risks should be assessed under a supervisory review process. This addresses the Washington action item in holding supervisors responsible for the due diligence of risk concentrations held by their financial institutions. The BCBS will begin a review of its existing guidance on sound practices for managing risk concentrations and large exposures later in 2009.

Action Item: The Basel Committee should study the need for and help develop firms' new stress testing models, as appropriate. (For immediate action by March 31, 2009)

Action Item: Firms should reassess their risk management models to guard against stress and report to supervisors on their efforts. (For immediate action by March 31, 2009)

Process for Taking Forward the Leaders' Action Item

The BCBS issued a consultative paper on principles for sound stress-testing practices and supervision in January 2009. This paper presents sound principles for the governance, design and implementation of stress testing programmes at banks and addresses weaknesses in stress testing exposed by the financial crisis.

Many Working Group members have indicated that the guidance from the BCBS will be used to help refine stress-testing practices in their countries. A number of Working Group members have also indicated plans to extend stress-testing activities as part of their supervisory framework and will issue recommendations, following consultations, in the near-term.

In addition, the October 2008 follow-up report of the FSF urged private sector organisations that have recommended improvements to industry risk management practices to establish frameworks for rigorously monitoring and reporting on the timely implementation of these improvements. Implementation will be monitored by prudential supervisors and, in the case of banks, reinforced through Pillar 2 reviews under the Basel II framework. The Institute of International Finance has prepared and distributed an assessment framework for financial institutions to use.

Working Group Assessment

Stress testing is an ongoing process and the Working Group urges financial institutions to continuously improve their practices. Sound stress testing also involves selecting appropriate scenarios, and the Working Group encourages financial institutions to pay particular attention to this, including in reflecting the important system-wide interactions between the various institutions, markets and instruments in the financial system. This would facilitate the development of risk mitigation or contingency plans across a range of stressed conditions

Stress testing is an important tool to alert management to adverse unexpected outcomes related to a variety of risks, and it should be used as such. It is especially important after long periods of benign economic and financial conditions, when fading memory of negative conditions can lead to complacency and the underpricing of risk.

> <u>Action Item</u>: Banks should exercise effective risk management and due diligence over structured products and securitization. *(For immediate action by March 31, 2009)*

<u>Process for Taking Forward the Leaders' Action Item</u>

The Basel II consultative document issued in January 2009 includes enhanced Pillar 2 guidance in this area. Standards for the risk management and due diligence of structured products and securitization are being enhanced in most G20 countries where markets for these instruments are developed. Securitization practices are being clarified, and some countries are setting stronger due diligence standards over structured products and securitization.

<u>Working Group Assessment</u>

The Working Group welcomes the steps taken by the BCBS to address the risks of securitization. The BCBS' guidance to include a bank's on- and off-balance sheet securitization activities in risk management, including product approval, risk concentration limits and estimates of market, credit and operational risk largely addresses the previous deficiencies in risk-management of securitized products.

4.5 Transparency

In hindsight, weaknesses in public disclosures have played a significant role in the crisis. For instance, the public disclosures of financial institutions did not always make clear the type and magnitude of their risk exposures, including those associated with off-balance sheet exposures. In addition, recent events in financial markets revealed some weaknesses and inconsistencies in the application of fair value accounting at financial institutions.

The type of information disclosed heading into the turmoil was often not sufficiently timely and useful to many investors and other market participants. Public disclosures that were required of financial institutions did not always make clear the type and magnitude of risks associated with their on- and off-balance sheet exposures. There were also shortcomings in the other information firms provided about market and credit risk exposures, particularly as these related to structured products. Where information was disclosed, it was often not done in an easily accessible or usable way.

> <u>Action Item</u>: *The key global accounting standards bodies should work to enhance guidance for valuation of securities, also taking into account the valuation of complex, illiquid products, especially during times of stress. (For immediate action by March 31, 2009)*

Process for Taking Forward the Leaders' Action Item

Several accounting standard setting bodies published guidance to clarify expectations for the valuation of complex securities and other financial instruments during the Fall of 2008. These notices were broadly consistent with one another. They emphasized the need for greater management judgment in estimating fair values when markets are inactive and provided advice for evaluating the reliability of valuation inputs.

In addition, at the end of November 2008, the BCBS released a consultation paper that provides guidance to banks and banking supervisors to strengthen valuation processes for financial instruments. This guidance reinforces the guidance published by accounting standard setters.

The IASB is in the process of enhancing guidance for fair value measurement more generally, for both financial and non-financial assets and liabilities. This broad review of fair value measurement was initiated in November 2006 to simplify, clarify and harmonize the overall body of guidance that has been added piecemeal to a number of standards over the years. The objective of this project is to create a single source of guidance for fair value measurement and disclosure. An exposure draft is expected in the first half of 2009.

In February 2009, FASB indicated it would re-examine its guidance for fair value accounting and disclosures in 2009.

Working Group Assessment

Considerable work has been undertaken to enhance guidance for the valuation of financial instruments, including complex and illiquid instruments, and more work is underway. We consider that the action plan with respect to fair value guidance has been achieved.

In order to support transparency and allow the users of financial statements to assess the financial health of a company, fair value valuation needs to be complemented with sufficient disclosure standards on valuation techniques. When valuation models are used, notes to financial statements must include a description of assumptions taken and a discussion of the incidence of alternative inputs on valuation. The Working Group recommends that efforts to enhance disclosure standards in order to allow users of financial statement to evaluate the uncertainty surrounding valuation be accelerated.

***Recommendation 21*: Accounting standard setters should accelerate efforts to reduce the complexity of accounting standards for financial instruments, to improve accounting standards for foreign currency translation, to enhance presentation standards in order to allow the users of financial statements to better assess the uncertainty surrounding the valuation of financial instruments, and to better reflect economic substance of financial assets and liabilities denominated in foreign**

currency.

- **Responsibility**: Accounting standard setters
- **Timeline**: Fall 2009
- **Monitoring:** Expanded FSF

Action Item: Accounting standard setters should significantly advance their work to address weaknesses in accounting and disclosure standards for off-balance sheet vehicles. *(For immediate action by March 31, 2009)*

Process for Taking Forward the Leaders' Action Item

The FASB issued, for public comment, proposed accounting changes for de-recognition of financial assets and consolidation of off-balance sheet entities. These revised standards are expected to be finalized in 2009 and effective in 2010. The FASB also issued enhanced disclosure standards for off-balance sheet entities that were effective beginning with 2008 year end reporting.

The IASB issued, for public comment, proposed accounting changes for consolidation of off-balance sheet entities. This revised standard is expected to be effective in 2011. The IASB also accelerated its de-recognition project and expects to publish an exposure draft in the first half of 2009, to be effective no earlier than 2011.

Given the complexity of the issues involved, the effective dates could change.

Working Group Assessment

This Action Item has been largely met. While initiatives by accounting standards setters to enhance consolidation requirements, including disclosure standards for off-balance sheet entities have been underway since before the crisis began, the standards have been further strengthened and revisions accelerated, and the two major accounting bodies plan to converge their standards.

Action Item: Regulators and accounting standard setters should enhance the required disclosure of complex financial instruments by firms to market participants. (For immediate action by March 31, 2009)

Action Item: Financial institutions should provide enhanced risk disclosures in their reporting and disclose all losses on an ongoing basis, consistent with international best practice, as appropriate. Regulators should work to ensure that a financial institution's financial statements include a complete, accurate, and timely picture of the firm's activities (including off-balance sheet activities) and are reported on a consistent and regular basis. (For action in the medium term)

Process for Taking Forward the Leaders' Action Item

To enhance transparency and market confidence, the FSF recommended in its April 2008 report that financial institutions draw from leading practices to ensure that they provide robust meaningful disclosures about risk exposures, including those associated with complex financial instruments, in mid-year 2008 statements. Prudential supervisors of countries that are part of the FSF strongly encouraged their internationally active financial institutions to use these recommended practices in their mid-year reporting. The FSF also asked IOSCO to assess the adequacy of initiatives that private sector groups are taking forward to enhance issuer transparency for securitized products. This assessment was undertaken as part of IOSCO's work on securitized products, on which it will produce an interim report in March.

In January 2009 the BCBS issued for comment proposals to strengthen Pillar 3 disclosure standards for banks' securitisation activities, building on the recommended sound practice disclosures of the FSF.

In addition, the IASB has released several proposals in recent months to improve disclosure of financial instruments. These include enhancements to the disclosure of exposure to risk from off-balance sheet items, and an amendment to the standard for the presentation of financial statement (IFRS 7) to clarify and enhance disclosures about fair value measurements and the liquidity risk of financial instruments, including for complex financial instruments.

Working Group Assessment

Following the leading practice disclosure framework advanced by the FSF, large financial institutions have substantially expanded their disclosures about risk exposures, including those associated with complex financial instruments and other related policies.

Action Item: Regulators, supervisors, and accounting standard setters, as appropriate, should work with each other and the private sector on an ongoing basis to ensure consistent application and enforcement of high-quality accounting standards. (For action in the medium term)

Process for Taking Forward the Leaders' Action Item

The IASB has established an external monitoring body composed of representatives of public authorities and of international organizations that have requirements for accountability to public authorities. This monitoring body includes IOSCO, the European Commission, the US SEC, the Japan FSA, the IMF, and the World Bank. The BCBS will also be a participating as an observer.

In addition the IASB and the U.S. FASB have established an advisory group comprised of senior leaders with broad international experience in financial markets to advise the Boards in considering accounting issues emerging from the global crisis. The primary function of the Financial Crisis Advisory Group (FCAG) is to advise the Boards about standard-setting implications of (1) the global financial crisis and (2) potential changes to the global regulatory environment. The group will conclude its activities within approximately six months, and will conduct advisory meetings during that time.

The FCAG will consider how improvements in financial reporting could help enhance investor confidence in financial markets. The advisory group also will help identify significant accounting issues that require the urgent and immediate attention of the Boards, as well as issues for long-term consideration. In providing that advice, the advisory group will draw upon work already underway in a number of jurisdictions on accounting and the credit crisis, as well as information gathered from the public roundtables—one each in Asia, Europe, and North America—that the Boards hosted in November and December 2008.

Working Group Assessment

In many countries, high level committees were established to ensure coordination between regulators of various sectors, accounting standard setters and industry representatives. Mechanisms have been put in place for coordination between accounting firms, listed companies, accounting standard setters and regulators to foster consistent application of prescribed standards.

Action Item: The key global accounting standards bodies should work intensively toward the objective of creating a single high-quality global standard. (For action in the medium term)

Process for Taking Forward the Leaders' Action Item

IFRS are in use in over 100 countries, and about 40 more are in the process of either adopting or converging with them. While some countries have adopted the

IFRS without modifications, others have tailored the IFRS to their country specific conditions during the process of convergence.

Working Group Assessment

The long-term benefits likely to result from the use of a harmonized set of international accounting standards are considerable, in particular from a market transparency and cost perspective. While adapting IFRS according to national circumstances rather than fully complying with them may be appropriate in some cases to take into account country-specific characteristics of markets, it also voids some of the benefits of a global set of accounting standards. Enhanced representation of EMEs within the IASB governance structure would allow for standards that reflect the unique circumstances of these countries.

***Recommendation 22*: The IASB should enhance its efforts to facilitate the global convergence towards a single set of high-quality accounting standards by sharing the experience of countries that have completed this process, by providing technical assistance and by increasing representation from EMEs within its governance structure.**

- **Responsibility**: IASB
- **Timeline**: Fall 2009
- **Monitoring**: Expanded FSF

5. Going beyond the Action Plan

In this section, we propose recommendations for addressing concerns not covered by the Washington Action Plan. They relate to governance issues for enhancing the macroprudential orientation of the regulatory framework, to ensuring that appropriate resources are available for effective enforcement, and to providing assistance to countries that require it for enhancing their regulatory frameworks.

5.1 Effective Enforcement

Achieving the objectives of the regulatory framework requires not only sound regulation but also effective enforcement. No matter how sound the rules are for regulating the conduct of market participants, if the system of enforcement is ineffective – or is perceived to be ineffective – the ability of the system to achieve the desired outcome is undermined.

It is thus essential that participants are appropriately monitored, that offenders are vigorously prosecuted and that adequate penalties are imposed when rules are broken. A regulatory framework with strong monitoring, prosecution, and application of penalties provides the incentives for firms to follow the rules. This, in the end, adds to the framework's credibility and enhances investor confidence in the financial system. Thus, a coordinated approach by securities regulators and self-regulatory organizations, law enforcement agencies and other actors in the legal system to monitor, investigate, and punish improper behaviour is necessary at a national and, in the context of globalization of the financial system, at the international level.

In terms of international cooperation, IOSCO has developed a multilateral memorandum of understanding (MMOU) on cooperation and information sharing for securities regulation and enforcement purposes. The MMOU is specific about the information, including banking and broking information, which must be made available on request of signatories for the specific purpose set out in the MMOU. It has raised the standard of international information sharing by requiring that banking secrecy laws do not prevent the exchange of information for securities enforcement purposes. Applicants to become a signatory are required to undergo an independent verification process. Over two thirds of IOSCO's eligible members have become signatories or undergone the verification process and committed to addressing the gaps identified by the process, including seeking legislative change if necessary.

Supervisory colleges are within the remit of the G20 Working Group on Reinforcing International Cooperation and Promoting Integrity in Financial Markets (*i.e.*, Working Group 2).

We recommend that authorities review the effectiveness of their enforcement activities and ensure that appropriate resources, including both human and financial resources, are available to achieve this.

<u>Recommendation 23</u>: The effective enforcement of regulation should be a priority of all financial regulators. As such, national financial regulators and oversight authorities should review the effectiveness of their enforcement activities and ensure that appropriate resources are available for monitoring the application of regulation and for prosecuting offenders and that the enforcement function is independent from other activities or from external influences.

- **Responsibility**: Prudential supervisors and securities regulators
- **Timeline**: To be completed within 2 years
- **Monitoring**: IMF-WB (through FSAP and Article IV)

5.2 Technical Assistance and Capacity Building in Emerging Market Economies

For some countries, for example those with less-developed financial systems, transition towards the implementation of enhanced standards and regulations may present a greater challenge. The Working Group recommends that national authorities commit to assist each other in order to enhance the capacity of the G20 as a whole to strengthen the regulatory framework. Appropriate technical assistance should also be provided to these countries by international standard setting bodies in order to allow for the effective implementation of more challenging new regulations that are consistent with international standards and codes. Examples include those for mitigating procyclicality, for adopting the Basel II capital framework and for converging towards a global set of high-quality accounting standards.

Recommendation 24: Recognizing that the degree of development of financial systems varies considerably across the G20, national authorities commit to assist each other in enhancing their capacity to strengthen regulatory frameworks. In addition, IOSCO, the IAIS and the BCBS should have the appropriate capacity to provide technical assistance. The needs of emerging market economies deserve particular consideration.

- **Responsibility**: Finance Ministries, prudential supervisors, securities regulators, IOSCO, IAIS, BCBS
- **Timeline**: Ongoing
- **Monitoring**: IMF-WB (through FSAP and Article IV)

6. Conclusions and Recommendations

Given the analysis of the Working Group, we have concluded the following list of medium-term recommendations.

[The list will be updated once recommendations are finalized.]

There are ___ areas of disagreement within the Working Group:

1. Whether the mandate of accounting standard setters should include taking into account the stability of the financial system as a complement to their core mandate. A manifestation of this disagreement is in how to achieve more forward-looking provisioning practices.
2. The minimum level of oversight applicable to the entire financial system (*i.e.*, disclosure vs. regulation)

3. Some WG members proposed that the Working Group recommend more formal and consistent oversight for hedge funds, while others argue the limited role of hedge funds in contributing to the current crisis does not merit priority action.

4.

Draft