FINANCIAL STABILITY FORUM

Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience

Update on Implementation

2 April 2009

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Introduction

In its April 2008 *Report on Enhancing Market and Institutional Resilience* ("the FSF Report"), the Financial Stability Forum (FSF) and its member bodies issued a comprehensive set of recommendations reflecting a consensus, both internationally and cross-sectorally, on the actions needed to address the fundamental weaknesses that have been at the root of the present turmoil and to build a more resilient financial system. The FSF Report sets out concrete actions in five areas: (i) strengthening capital, liquidity and risk management in the financial system; (ii) enhancing transparency and valuation; (iii) changing the role and uses of credit ratings; (iv) strengthening the authorities' responsiveness to risks; and (v) putting in place robust arrangements for dealing with stress in the financial system. A well-defined process was created for follow-up, with institutional responsibilities and timetables for implementation, and a rigorous framework for monitoring and reporting.

In October 2008, the FSF published a follow-up report ("the Follow-up Report") reviewing progress in implementation of the recommendations, and described the work underway by national authorities and international bodies as well as parallel initiatives in the private sector complementing official action. The Follow-up Report reiterated the FSF's commitment to monitor and coordinate implementation so as to preserve the advantages of integrated global financial markets and a level playing field across countries.

This report provides an update of implementation progress since October 2008. Since October, extensive progress has been made in the implementation of the FSF Report's recommendations:

- Banking supervisors have published proposals for improving risk coverage under Basel II, especially with regard to credit-related risks in the trading book. They have also published revised capital charges for liquidity commitments to off-balance sheet entities and for the re-securitised instruments.
- The Basel Committee on Banking Supervision (BCBS) published in January 2009 the standards for firm-wide risk management that supervisors will assess under Pillar 2 of the capital framework. The standards cover governance, risk concentrations, capital planning, off-balance-sheet exposures, underwriting, securitization activities and reputational risk.
- Central counterparty clearing for over-the-counter (OTC) credit derivatives have been launched in the US and in Europe.
- Consistent guidance has been issued by the International Accounting Standards Board (IASB) and the US Financial Accounting Standards Board (FASB) for fair valuation when markets are illiquid, and for the transfer of assets between valuation categories in rare circumstances. The IASB has also proposed revised standards for the consolidation and disclosure of off-balance sheet entities and

related exposures. The IASB finalised in March 2009 an amendment to International Financial Reporting Standards (IFRS) 7 setting forth enhancements to required risk and valuation disclosures for financial activities, including for complex financial instruments.

- The 2008 revisions of the International Organization of Securities Commissions (IOSCO) *Code of Conduct Fundamentals for Credit Rating Agencies* (CRAs) have been substantially implemented by several CRAs including the three largest agencies. IOSCO has also developed a model examination module to be used by authorities that regulate and inspect CRAs.
- Supervisory colleges have been established for most of the financial institutions identified by the FSF Working Group on Market and Institutional Resilience (FSF WG), and many of them held face-to-face meetings by end-2008. `
- The International Association of Deposit Insurers (IADI) and BCBS issued in March 2009 *Core Principles for Effective Deposit Insurance Systems*.
- The FSF has adopted *Principles for Cross-border Cooperation on Crisis Management*, published in April 2009.

Since issuing its April 2008 report, the FSF and its member bodies have examined the forces that contribute to procyclicality in the financial system and developed recommendations covering the bank capital framework, loan loss provisioning practices, and ways of dampening the adverse interaction between leverage and valuation. The recommendations and outputs of the workstreams related to procyclicality are presented in the *Report of the FSF on Addressing Procyclicality in the Financial System*, published in April 2009. In addition, the FSF has developed *Principles for Sound Compensation Practices*, also published in April 2009.

The efforts underway following the FSF Report also helped support key aspects of the Action Plan adopted by the G20 Leaders at their November 2008 Summit and have resulted in an extensive exchange of information with the G20 in the preparation of the London Summit.

The following pages summarise the progress since October 2008 in implementing the five areas of recommendations set forth in the FSF report.

I. Strengthened prudential oversight of capital, liquidity and risk management

1. Capital requirements

The BCBS published in January 2009 a consultative package that includes proposals on changes to capital requirements related to trading book exposures, including complex and illiquid credit products. The Committee proposes to supplement the current Value-at-Risk (VaR)-based trading book framework with an incremental risk capital charge, which includes default risk as well as migration risk, for unsecuritised credit products. It also proposes that, for securitised products, the capital charges for the banking book would apply. Once implemented, the incremental risk capital charge will reduce the incentive for regulatory arbitrage between the banking and trading books. An additional proposed response is to require banks to calculate a stressed VaR taking into account a one-year observation period relating to significant losses, which would be in addition to the VaR based on the most recent one-year observation period. The proposed trading book changes are expected to be implemented by 31 December 2010.

The BCBS's January consultative document also includes a proposal on higher capital charges for collateralized debt obligations (CDOs) that involve re-securitisations (i.e., CDOs of asset-backed securities). The Committee has also proposed to increase capital requirements for liquidity lines extended to support asset-backed commercial paper conduits by eliminating the distinction between short-term and long-term liquidity facilities. In addition, the Committee has proposed the requirement that banks obtain comprehensive information about the underlying exposure characteristics of their externally-rated securitisation positions, both within and across structures. Failure to obtain such information would result in higher capital requirements. The BCBS has proposed an implementation date of end-2009 for these Pillar 1 enhancements.

As part of the FSF work on procyclicality, the FSF in cooperation with the BCBS has set out recommendations to address the potential procyclicality of the Basel II framework. Some of these recommendations are focused on mitigating the cyclicality of the minimum capital requirement, while maintaining an appropriate degree of risk sensitivity. Other measures are intended to introduce countercyclical elements into the framework. These recommendations are described in detail in the FSF report on *Addressing Procyclicality in the Financial System*. The BCBS will develop the details of these recommendations over the course of 2009, with a preliminary package of integrated proposals to be reviewed in the Fall and a final package to be presented in December 2009.

The BCBS has launched its monitoring exercise to track the impact of the Basel II framework and its cyclicality through regular data collection by its Capital Monitoring Group (i.e., reporting to the BCBS every six months). The first results of the data monitoring effort were reviewed at the Committee's March 2009 meeting. Over time this will enable the Committee to monitor the extent to which the capital regime reveals unacceptably high levels of capital cyclicality and to take additional measures as appropriate.

In the insurance sector, the International Association of Insurance Supervisors (IAIS) is developing a comprehensive and cohesive set of solvency standards. Although issues such as procyclicality, liquidity risk, concentration risk, contagion risk and stress testing were not mainly directed at insurance supervisors, the planned review of the existing suite of solvency supervisory papers has been expanded to consider the extent to which these papers address the identified risks. For instance, standards and guidance on the structure of regulatory capital requirements and on the use of internal models and enterprise risk management for solvency purposes are undergoing review to address issues which have emerged from the financial crisis. Other solvency supervisory papers are also under development or review taking into account recent events, including standards and guidance on capital resources and valuation for solvency purposes. The work plan also includes the development of group-wide supervisory assessments that take into account all the components of internationally active insurance groups.

2. Liquidity management

The BCBS's Working Group on Liquidity is monitoring in a coordinated way the implementation by banks and supervisors of the standards for liquidity risk management and measurement set out in the *Principles for Sound Liquidity Risk Management and Supervision*, published by the BCBS in September 2008. The Working Group will complete a systematic review of the implementation of the Principles by BCBS members in the second half of 2009 and will report its findings to the BCBS by year-end. The Principles underscore the importance of establishing a robust liquidity risk management framework that is well integrated into the bank-wide risk management process. Among other things, they require banks to (i) maintain a cushion of unencumbered, high quality liquid assets as insurance against stress; (ii) actively manage their intraday liquidity positions and risks; (iii) identify and measure the full range of liquidity risks, including contingent liquidity risks; and (iv) conduct regular stress tests for a variety of short-term and protracted institution-specific and market-wide stress scenarios. The Principles highlight the key role of supervisors, including the responsibility to intervene to require effective and timely remedial action by a bank to address liquidity risk management deficiencies.

The Working Group on Liquidity has also initiated efforts to promote greater consistency of liquidity regulation and supervision for cross-border banking groups. This includes a review of tools, metrics and benchmarks that supervisors can use to assess in a more consistent manner the resilience of banks' liquidity cushions and constrain any weakening in liquidity maturity profiles, diversity of funding sources, and stress testing practices, among other things. The Working Group will present concrete proposals for such metrics and benchmarks for review by the BCBS in July 2009.

3. Supervisory oversight of risk management

The BCBS's January 2009 consultative package proposes enhanced 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 (i) enhancing firm-wide risk oversight, risk management and internal controls; (ii) managing more effectively specific risk areas such as firm-wide risk concentrations, off-balance sheet exposures and associated reputational risks, securitisation exposures, valuations and liquidity risk; and (iii) improving banks' stress testing practices. The enhanced Pillar 2 guidance will help promote better risk management and identification as well as assessments by banks of their capital adequacy, subject to review by supervisors.

In the insurance sector, the IAIS is reviewing all existing and new supervisory papers to incorporate lessons drawn from the financial crisis, notably in respect of risk management. Specifically, the standards and guidance on asset-liability management and investment risk management are being updated to reinforce coverage of issues such as the use of stress testing in identifying risks, including concentration and liquidity risk. The IAIS is also developing an issues paper on corporate governance as a foundation for future supervisory papers on corporate governance over such areas as risk management and compensation. An IAIS standard on reinsurance and other forms of risk transfer is addressing the assessment of the appropriateness of the reinsurance cover, the risk management strategy of direct insurers, as well as the appropriate supervision of reinsurance companies.

The Senior Supervisors Group (SSG) is undertaking an assessment of major financial institutions' strengths, weaknesses and gaps against the recommendations for strengthened risk management practices that were set out by public and private sector fora during 2008 (e.g., the SSG's March Report to the FSF, the U.S. President's Working Group (PWG)'s March Report, the FSF Report, the Institute of International Finance's July Report, the Counterparty Risk Management Policy Group's August Report). The SSG expects to release a summary of its findings in the spring of 2009 in a report to the FSF.

With the aim to reduce incentives towards excessive risk taking that may arise from compensation schemes, the FSF has developed *Principles for Sound Compensation Practices*. The Principles are intended to apply to significant financial institutions, and are especially critical for large, systemically important firms. It is expected that the Principles will be reinforced through supervisory examination and intervention at the national level, as well as through standard setting bodies like the BCBS. Authorities, working through the FSF, are expected to ensure coordination and consistency of approaches across jurisdictions.

As a complement to FSF work on sound compensation practices, the Organisation for Economic Co-operation and Development (OECD) is exploring, in the context of the OECD Principles of Corporate Governance, how compensation issues at both the senior and operating levels can be better aligned with the interests of shareholders. The role of tax incentives is also an important element that will be explored.

4. Operational infrastructure for over-the-counter derivatives

The Follow-up Report of October 2008 urged market participants to put in place central counterparty clearing for OTC credit derivatives and to achieve more robust operational processes in OTC derivatives markets. At end-October, market participants released a letter outlining their further commitment and concrete plans for building a stronger integrated infrastructure capable of supporting the OTC derivatives markets. Supervisors are working together to monitor progress and encourage further efforts to improve the operational infrastructure for OTC derivatives. Central counterparties for OTC credit derivatives were launched in the U.S. and in Europe.

In November 2008, the U.S. PWG announced a series of initiatives to strengthen oversight and the infrastructure of the OTC derivatives markets. The initiatives include the development of credit default swaps (CDS) central counterparties and the establishment of a Memorandum of Understanding regarding CDS central counterparties among the Federal Reserve, the US Securities and Exchange Commission (SEC) and Commodity Futures Trading Commission. The PWG also announced a broad set of policy objectives to guide efforts to address the full range of challenges associated with OTC derivatives. The policy objectives are: (i) improving the transparency and integrity of the CDS market; (ii) enhancing risk management of OTC derivatives; (iii) further strengthening the OTC derivatives market infrastructure; and (iv) strengthening cooperation among regulatory authorities.

The SSG issued in March 2009 a report to the FSF entitled *Observations on Management of Recent Credit Default Swap Credit Events*. The report assesses how firms manage their CDS activities related to the settlement of credit derivatives transactions terminated by the occurrence of a credit event. Overall, surveyed market participants confirmed the effectiveness of the existing auction-based settlement mechanism and supported the effort to permanently incorporate the mechanism into standard credit derivatives documentation. The supervisors that have been involved in these initiatives will continue to monitor and assess the ongoing progress. In March 2009, the International Swaps and Derivatives Association published the final documentation to hardwire the auction-based settlement mechanism into standard CDS documentation with an adherence period open until 7 April 2009.

Work on counterparty credit risk at banks arising from OTC derivatives is one of the priorities of the BCBS's forward agenda. The BCBS will conduct a review of the treatment of counterparty credit risk under the three pillars of Basel II, focusing on the adequacy of the required capital, the quality of risk management and the adequacy of internal and external transparency. Specifically, it will review the Pillar 1 treatment for counterparty credit risk arising from OTC derivatives, credit derivatives, repos and securities financing activities; the counterparty risk management requirements under Pillar 2; and the adequacy of information available to senior management about firm-wide counterparty exposures as well as the disclosure requirements under Pillar 3.

IOSCO launched in November 2008 a Task Force on Unregulated Financial Markets and Products. The Task Force is working on an interim report on regulatory measures to improve confidence and transparency in the OTC markets, with a focus on securitised products and CDS. The interim report will be published in April 2009. The Task Force is exploring whether and how extending key regulatory principles that apply to regulated products and markets in the areas of transparency, market conduct and market infrastructure should apply to securitised products and CDS.

II. Enhancing transparency and valuation

1. Risk disclosures by market participants

The IASB finalised in March 2009 an amendment to IFRS 7 setting forth enhancements to required risk and valuation disclosures for financial activities, including for complex financial instruments.

As part of its Basel II consultative package released in January 2009, the BCBS has proposed enhancements to disclosures for securitisations, off-balance-sheet exposures and underwriting activities. The aim is to advocate, through Pillar 3 of the Basel II capital framework, enhancements to banks' disclosures of their risk profiles, particularly in relation to complex capital market and securitisation activities, building on the sound practice disclosures recommended by the FSF Report.

The IAIS recently conducted a high-level survey on the implementation of its three key disclosure standards (concerning Technical and Investment Performance and Risks for Non-Life and Life Insurers and Reinsurers). Based on the survey findings, the IAIS will raise the focus and priority of public disclosure requirements, notably by further reviewing its disclosure standards and considering enhancements or development of new standards where necessary.

2. Accounting and disclosure standards for off-balance sheet vehicles

The IASB proposed in December 2008 revised standards for the consolidation of off-balance sheet entities and disclosure of related risk exposures. The proposals, which were open for public comment until 20 March 2009, form part of the IASB's comprehensive review of off-balance sheet activities, and seek to strengthen the requirements for identifying which entities a company controls. The proposals present a new, principle-based, definition of *control of an entity* that would apply to a wide range of situations, including those involving special purpose vehicles. The proposals also include enhanced disclosure requirements that are intended to enable an investor to assess the extent to which a reporting entity has been involved in setting up special structures and the risks to which these special structures expose the entity. The FASB has also proposed revised standards in this area and both sets of standards are expected to be finalised in 2009.

The IASB staff has also been developing proposals to improve derecognition requirements (including securitisations) which are expected to be published in the first half of 2009. The IASB and FASB met together in March 2009 to discuss strategies to converge their consolidation and derecognition requirements. At the conclusion of their joint meeting and building on work underway, the IASB and FASB announced their plan to work jointly and expeditiously towards common standards that deal with off-balance sheet activity and the accounting for financial instruments.

3. Valuation

The IASB finalised in October 2008 *Educational Guidance on the Application of Fair Value Measurement of Financial Instruments when Markets Become Inactive.* The guidance will promote sound practices for valuation of complex securities and other financial instruments and related disclosures, emphasising the need for greater management judgment in estimating fair values when markets are inactive. This guidance converged with similar guidance issued by the SEC, FASB and the Accounting Standards Board of Japan in September and October 2008. In March 2009, the FASB issued two proposed FASB Staff Positions on (i) fair value and distressed sales and on (ii) impairment of available-for-sale and held-to-maturity assets. The IASB requested that interested parties provide their views to the IASB on these FASB proposals by 20 April 2009.

In March 2009, the IASB also finalised an amendment to IFRS 7, which was proposed in October 2008, to amend its fair value disclosure requirements based on a three-level fair value hierarchy (similar to that used in Statement of Financial Accounting Standards No. 157, *Fair Value Measurements*, issued by the US FASB). The amendments require disclosures about the level of the fair value hierarchy for assets and liabilities, the fair value measurements resulting from the use of significant unobservable inputs to valuation techniques and the movements between different levels of the fair value hierarchy. The amendments also clarify and enhance the existing requirements for the disclosure of liquidity risk.

The IASB and FASB conducted three joint public roundtables in November and December to identify further financial reporting issues highlighted by the global financial crisis, including those related to complex securities and their valuation. Roundtable participants saw an urgent need for a broader examination by the IASB and the FASB of the role of fair value measurement for financial instruments, including the issues of improving the impairment requirements, classification issues, the fair value option and transfers between the categories. Given the urgency of the matter, the Boards have agreed to fast track this project with the intention to finish the project in the next few months.

At end-November 2008, the BCBS released its consultative paper *Supervisory Guidance for Assessing Banks' Financial Instrument Fair Value Practices*, which provides guidance to banks and supervisors to strengthen valuation processes for financial instruments. Certain portions of this guidance relating to banks' valuation processes for complex, illiquid securities and other financial instruments are re-emphasised in the BCBS's proposed supplemental Pillar 2 guidance. This supplemental guidance is part of the proposed enhancements to Basel II, which was issued for comment in January 2009. The Pillar 2 guidance will also reinforce sound corporate governance, control and risk management over valuations of financial instruments.

Responding to calls from the FSF and other bodies, the International Auditing and Assurance Board has issued two staff alerts to address issues relevant in the current crisis. The purpose of the alerts is to highlight areas within the International Standards on Auditing that are particularly relevant in the audit of fair value accounting estimates and going concern assumptions in times of market uncertainty. The first alert issued in October 2008 is entitled *Challenges in Auditing Fair Value Accounting Estimates in the Current Market Environment*. The second alert issued in January 2009 is entitled *Audit Considerations in respect of Going Concern in the Current Economic Environment*.

4. Transparency in securitisation processes and markets

The Securities Industry and Financial Markets Association (SIFMA), the American Securitization Forum (ASF), the European Securitisation Forum (ESF) and the Australian Securitisation Forum (AuSF) issued in December 2008 a joint report that identifies priorities for immediate action by the industry which is likely to have the greatest near-term impact, as well as recommendations to enhance industry practices in securitisation and structured credit markets. The near-term priorities identified in the report include improvement of disclosure of information on underlying assets for residential mortgage-backed securities (RMBS) and enhancing transparency with regard to underwriting and origination practices. Recommendations were made to increase and enhance initial and ongoing information on RMBS and to strengthen and standardise core representations and warranties for RMBS, among other issues. The Japan Securities Dealers Association published in March 2009 rules for distributors and standardised formats of disclosure to enhance transparency of securitised products.

The FSF has asked IOSCO to assess the adequacy of the private sector initiatives, including for enhancement of issuer transparency and disclosure principles in relation to securitisation products. IOSCO's Task Force on Unregulated Financial Markets and Products, whose main task is to consider the boundaries of current securities regulation, will also carry out this work. An interim report of the Task Force will be published in April 2009.

In order to address the opacity of the secondary trading of structured products, IOSCO is working with the financial services industry to examine the viability of a secondary market reporting system for different types of structured products. In particular, the work is focusing on whether the nature of structured products lends itself to such reporting and the cost and benefits such a system might entail. A report is expected to be presented to the IOSCO Technical Committee in June 2009.

III. Changes in the role and uses of credit ratings

1. Quality of the rating process

IOSCO has been reviewing adoption by CRAs of the *Code of Conduct Fundamentals for Credit Rating Agencies*. The Code was revised in May 2008 to set out materially enhanced requirements to protect the quality and integrity of the rating process, including CRAs' independence and avoidance of conflicts of interest and their responsibilities to the investing public and issuers. IOSCO published in March 2009 a report analysing the extent to which CRAs around the world have incorporated the IOSCO Code of Conduct provisions into their codes of conduct. The report has found that a larger proportion of the CRAs reviewed were aware of the IOSCO Code of Conduct, and have taken steps to incorporate its provisions into their codes of conduct, than when they were previously surveyed in 2007. The 2008 revisions of the IOSCO Code have been substantially implemented by several CRAs including the three largest agencies.

IOSCO has also developed a model examination module to be used, as appropriate, by those IOSCO members that regulate and inspect CRAs. This model will help create a common understanding of the types of information that regulators around the world might find useful when inspecting a CRA against regulatory requirements based on the IOSCO Code of Conduct. The model covers areas such as the quality and integrity of the rating process; CRAs' procedures for monitoring and updating ratings; prohibited acts and practices; compliance; procedures for internal audit; analyst and employee independence and the treatment of confidential information.

Alongside work at IOSCO, various national and regional initiatives are ongoing to strengthen oversight of CRAs. In this respect, the SEC approved in December 2008 a series of measures to increase transparency and accountability at CRAs and ensure provision of more meaningful ratings and greater disclosure to investors. The measures cover a wide range of credit rating processes from conflicts of interest to publication of rating methodologies and disclosure of ratings history information. The European Commission (EC) adopted in November 2008 a proposal for regulation on CRAs, which introduces a registration procedure for CRAs to enable European supervisors to control the activities of CRAs whose ratings are used within the European Union (EU). The proposal, which will be considered by the European Parliament and the Council, requires CRAs to make sure that ratings are not affected by conflicts of interest; to remain vigilant on the quality of the rating methodology and the ratings; and to act in a transparent manner. In March 2009, the government of Japan presented a bill which introduces a new regulatory framework for CRAs including a registration procedure. In November 2008, Australia announced the outcomes of its review of CRAs, setting out new oversight regimes of CRAs including a licensing system. Canada is also in the process of establishing CRA regulation.

The FSF is following these national and regional initiatives and working to promote a globally consistent approach to oversight and regulation of CRAs. The IOSCO Code of Conduct can serve as a template for regulation, thereby facilitating a convergence of approaches to CRA regulation by individual jurisdictions.

In view of recent events, there is a need for greater interaction between CRAs and regulators, and greater coordination among securities regulators overseeing globally active CRAs. IOSCO discussed at its February 2009 meeting, and will continue to explore, the options presented regarding supervisory colleges and/or bilateral cooperation arrangements and their possible use in the oversight of CRAs. These arrangements would be particularly useful for oversight of the largest CRAs, which provide ratings around the world and whose operations cross numerous borders. IOSCO has also decided to launch a permanent standing committee on CRAs, which will review and update the international regulatory consensus regarding CRA oversight and serve as a forum for regular interaction between regulators and CRAs. The permanent committee will allow IOSCO to keep abreast of the developments in the CRA industry, as well as facilitate convergence of regulatory approaches to CRAs.

2. Differentiated ratings and expanded information on structured products

The revised IOSCO Code asks CRAs to differentiate ratings of structured products from other ratings. The EC proposal for regulation on CRAs seeks to enable investors to distinguish between ratings for structured products and for traditional products (corporate, sovereign) by requiring the use of a different rating category for structured finance instruments or the provision of additional information on their risk characteristics.

So far, the largest CRAs have not adopted a different symbology for ratings of structured products, though they indicate in their ratings releases that the security being rated is a structured product. One largest CRA states that it will differentiate its ratings of structured products through additional commentary.

In the Follow-up Report of October 2008, the FSF called on CRAs to enhance their efforts to comply with the FSF recommendations, including by making industry-wide proposals for providing differentiated information or ratings for structured products. We reiterate this call and request CRAs to move forward as a matter of urgency.

3. Use of ratings by investors and regulators

In its joint report of December 2008, the SIFMA, the ASF, the ESF and the AuSF made various recommendations to enhance industry practices in the securitisation and structured credit markets. The recommendations included establishment of core industry-wide market standards of due diligence disclosure and quality assurance practices for RMBS. In response to the FSF's request, IOSCO is assessing the adequacy of these recommendations.

IOSCO is reviewing investment managers' due diligence relating to structured finance products, including a study on the type of due diligence typically conducted by investment managers who offer collective investment schemes to retail investors when making investment in structured products. A report on investment managers' due diligence practices is expected to be presented to the IOSCO Technical Committee in June 2009. IOSCO is also reviewing financial firms' internal control systems that are in place to understand and address the risks arising from investment in structured products.

The Joint Forum finalised in December 2008 its stocktaking of the uses of ratings in legislation, regulations and supervisory guidance by its member authorities in the banking, securities and insurance sectors. This stocktaking will facilitate the ability of authorities and policymakers to better assess the extent to which the use and reliance on credit ratings for supervisory and regulatory purposes is appropriate.

The BCBS has agreed to initiate work to review the role of external ratings under Basel II (which are limited to the standardized approach and the securitization framework) and determine whether there are any adverse incentives that need to be addressed.

Based on the results of the Joint Forum stocktaking exercise on the use of ratings, future IAIS supervisory papers will consider the use of credit ratings in investment and risk management.

IV. Strengthening the authorities' responsiveness to risks

1. Improving information exchange and cooperation among authorities

Good progress has been made in establishing supervisory colleges. Protocols for establishing the colleges as well as a list of the major global financial institutions to which the colleges should apply have been developed by the FSF WG. Supervisory colleges now exist for most of the financial institutions identified by the FSF WG, and many of them held face-to-face meetings by end-2008. The FSF will review the college arrangements in 2009, once experience with the colleges has been garnered, while the FSF WG will continue to follow up on the functioning of supervisory colleges on an ongoing basis. The FSF WG will ask home supervisors whether their colleges matched the FSF protocols, and as needed, work to ensure consistency in approaches. It will also be considering processes for pulling together across college examinations non-institution specific information of wider interest and that will enable this information to flow to relevant parties including non-supervisory authorities and standard setters.

The IAIS is developing a *Guidance paper on the use of supervisory colleges in group-wide supervision* of insurance groups and is liaising with the BCBS and FSF on supervisory colleges for cross-sectoral consistency. The paper, to be completed in October 2009, will provide guidance to insurance supervisors worldwide on the role of supervisory colleges and the practical issues to consider in the establishment and operation of the colleges. The IAIS is undertaking a survey on supervisory colleges for insurance groups which will inform the development of the aforementioned Guidance paper and serve as a basis for input to the FSF's review of the college arrangements.

The BCBS is reinforcing the implementation of the protocols for colleges as they relate to the banking sector through its newly formed Standards Implementation Group. The BCBS will be providing periodic updates to the FSF on its college related work, which will ensure that these protocols are carried forward in the banking sector over the longer term.

2. Enhancing international bodies' policy work

The FSF and its members are taking steps to encourage greater supervisory and regulatory responsiveness at national and international levels to risk assessments, including those arising from rapid evolution and innovation in products and markets. At the international level, the BCBS has been conducting regular discussions on emerging issues and risks and their implication for supervisory priorities. The IAIS is assessing its existing and new workstreams against a list of identified pressure points to ensure that all the issues are adequately dealt with. It is also working at facilitating group supervision and charting a focus of the IAIS on the supervision of internationally active insurance groups and systemically important entities, contagion effects and unregulated entities in view of consistency among financial sectors. The FSF is enhancing its work on the identification of vulnerabilities in the financial system.

In order to strengthen the cooperation between the FSF and the International Monetary Fund (IMF), the FSF Chairman and the IMF Managing Director sent a joint letter in November 2008 to the G20 Ministers and Governors that clarifies how they see their organizations' respective tasks and responsibilities. This covered four points:

1. Surveillance of the global financial system is the responsibility of the IMF.
2. Elaboration of international financial sector supervisory and regulatory policies and standards, and coordination across the various standard setting bodies, is the principal task of the FSF. The IMF participates in this work and provides relevant inputs as a member of the FSF.
3. Implementation of policies in the financial sector is the responsibility of national authorities, who are accountable to national legislatures and governments. The IMF assesses authorities' implementation of such policies through Financial Sector Assessment Programs, Reports on the Observance of Standards and Codes and Article IVs.
4. The IMF and the FSF will cooperate in conducting early warning exercises. The IMF assesses macro-financial risks and systemic vulnerabilities. The FSF assesses financial system vulnerabilities, drawing on the analyses of its member bodies, including the IMF. Where appropriate, the IMF and FSF may provide joint risk assessments and mitigation reports.

In line with the November joint letter and drawing on their complementary areas of focus, the FSF and the IMF have recently stepped up their collaboration on developing a framework on early warnings. The FSF is working to enhance the actionable outputs from, and systematic follow up of, its extensive international vulnerabilities exercise. The IMF is undertaking a vulnerability exercise for advanced economies and an early warning exercise focusing on macro-financial risks and systemic vulnerabilities. The two organisations are sharing inputs on risks and vulnerabilities at an early stage of their respective processes. The aim is to strengthen the early identification of key vulnerabilities and macro-financial linkages and the timely formulation of mitigating actions.

V. Robust arrangements for dealing with stress in the financial system

The BCBS's Cross-border Bank Resolution Group (CBRG) has examined existing resolution policies, allocation of responsibilities and legal frameworks, in order to better understand the potential impediments and possible improvements to cooperation in the resolution of cross-border banks. The findings have been collected in an interim report, which was approved by the BCBS in December 2008. The interim report recommends that further examination and a detailed consideration of individual bank failures and rescues be conducted in order to draw out the lessons of the current crisis for bank resolution mechanisms and their application across borders. The BCBS has directed the CBRG to conduct its recommended further work. The CBRG is now drawing lessons from recent individual bank failures and rescues. It will also work on possible responses to improve bank resolution mechanisms and their application across borders. The CBRG is scheduled to report to the BCBS in September 2009.

The BCBS and the IADI issued in March 2009 the *Core Principles for Effective Deposit Insurance Systems* for public consultation. The Core Principles address a range of issues including deposit insurance coverage, funding and prompt reimbursement, as well as issues related to public awareness, resolution of failed institutions and cooperation with other safety net participants including central banks and supervisors.

The FSF adopted and issued in April 2009 a set of high-level *Principles for Cross-border Cooperation on Crisis Management* developed by a working group of the FSF. The principles include a high-level commitment to cooperation between relevant authorities, including supervisory agencies, central banks and finance ministries, both in making advanced preparations for dealing with financial crises and in managing them. The next steps of the working group will be to develop a systemic impact assessment framework, analogous to the heatmaps approach employed in the EU, to ensure that authorities have a common in-crisis vocabulary with which to discuss the impact of a crisis. The working group will also produce a practically-focused addendum to the 2001 report on *Winding Down Large and Complex Financial Institutions* (LCFIs), drawing on practical examples of the difficulties associated with dealing with a failing LCFI underscored recently. Finally, the working group will provide a document, on which authorities can draw, which will include a slimmed down list of key data to identify ex-ante, drawing on the previous FSF fact book initiative.

In the insurance sector, a crisis management framework, that includes the catastrophe related function of the IAIS Global Reinsurance Market Report, is under consideration.