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

Follow-up on Implementation

10 October 2008

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Executive Summary

In April 2008, the Financial Stability Forum (FSF) submitted to G7 Finance Ministers and Central Bank Governors a comprehensive set of recommendations for addressing the weaknesses that have produced the present crisis and for strengthening the financial system going forward. The *Report on Enhancing Market and Institutional Resilience* drew on an extensive body of work by national authorities and the main international supervisory, regulatory, and central bank bodies.

The guiding principles of this work is to recreate a financial system that operates with less leverage, is immune to the set of misaligned incentives at the root of this crisis, where prudential and regulatory oversight is strengthened, and where transparency allows better identification and management of risks.

Since late March, strains in the financial system have deepened to unprecedented levels, necessitating extraordinary official sector emergency measures. In the immediate term, stabilizing financial systems remains the priority of all concerned.

Despite these pressures, a substantial amount of work has been underway to take forward the policy development necessary to implement the FSF Report's recommendations.

This work is proceeding well and in a coordinated fashion. The actions endorsed by the G7 for implementation by end-2008 will see concrete results by then. These include, as detailed in this report, further measures to strengthen standards and oversight of bank capital and liquidity, risk management standards in financial institutions, valuation practices and accounting standards.

We will continue to oversee and coordinate implementation of the recommendations in a manner that preserves the advantages of integrated global financial markets and a level playing field across countries. We will assess, accelerate and, where needed, adjust our work in the light of recent events. We will also deepen the interaction on the recommendations with financial authorities in other major economies.

Alongside this, the FSF will address additional issues, building on the work of its member authorities and international bodies:

- In the weeks and months ahead, we will monitor and address the international interaction and consistency of emergency arrangements and responses being put in place to address the current financial crisis.
- We will be taking forward work to mitigate sources of pro-cyclicality in the financial system. Work has been set in train on the scope for improvements to the capital regime, loan-loss provisioning practices, compensation arrangements, and the management of interactions between valuation and leverage.
- We will also reassess the scope of financial regulation, with a special emphasis on institutions, instruments and markets that are currently unregulated.
- And we will work to better integrate macroeconomic oversight and prudential supervision, to help translate more effectively systemic concerns into concrete supervisory and regulatory responses.

In view of market developments, implementation of certain of our recommendations needs to accelerate:

- Market participants need to move ahead urgently to put in place central counterparty clearing for over-the-counter (OTC) credit derivatives and achieve more robust operational processes in OTC derivatives markets.
- Accounting standards setters must conclude their work promptly to enhance and converge guidance on valuation of instruments in inactive markets, and accounting and disclosure standards for off-balance sheet activities and related risks.

In addition, we call on:

- Credit rating agencies (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.
- Private sector organisations that have recommended improvements to industry practices to establish frameworks for rigorously monitoring and reporting on their timely implementation.

I. Assessment of implementation progress

In its April 2008 *Report on Enhancing Market and Institutional Resilience* ("the FSF Report"), the FSF set out a comprehensive set of recommendations reflecting a consensus, both internationally and cross-sectorally, on the actions needed to address the fundamental weaknesses in the financial system that are at the root of the present turmoil and to build a more resilient financial system. These recommendations were directed at a wide range of actors in the official and private sectors, including banks, securities firms, insurance companies, CRAs, accountants, supervisors, central banks and international organisations. The FSF Report called for 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.

An exceptional amount of implementation work by national authorities and international bodies is underway, as well as several parallel initiatives in the private sector that can complement official action.

In endorsing the FSF Report, the G7 communiqué in April identified a number of priority actions to be implemented or initiated within 100 days. These recommendations were all addressed on time. The actions endorsed by the G7 for implementation by end-2008 are expected to see concrete results by then. Work is also on track to implement many other recommendations, as summarised below and described in detail in Section III of this report.

Strengthened prudential oversight of capital, liquidity and risk management

Basel II capital requirements

- Regulatory capital requirements for banks' trading book exposures will be raised as set out in the *Guidelines for Computing Capital for Incremental Risk in the Trading Book*, proposed in July by the Basel Committee on Banking Supervision (BCBS) and the International Organization of Securities Commissions (IOSCO).
- Later this year, the BCBS will set out proposals for raising capital requirements for re-securitisations and short-term liquidity facilities extended to asset-backed commercial paper (ABCP) conduits.

Liquidity Management

- Standards will be materially raised by the BCBS *Principles for Sound Liquidity Risk Management and Supervision*, published in September, which also requires banks to maintain robust liquidity cushions as a safeguard against protracted periods of liquidity stress. The BCBS has also initiated work to promote greater convergence in the implementation of liquidity supervision for cross-border banking groups.

Supervisory oversight of risk management

- The BCBS is enhancing guidance for supervisory oversight of firm-wide risks and management of specific risks areas such as concentrations, off-balance sheet exposures and securitisations, reputational risk and implicit support, valuations and liquidity risk. The BCBS is also developing principles for sound stress testing practices by the end of this year, which it will reinforce through the Pillar 2 review process.

Operational infrastructure for OTC derivatives

- Market participants have pledged to develop robust central clearing facilities for OTC credit derivatives, in some cases as early as in 2008, and complete other commitments to achieve greater certainty and operational improvements in OTC derivatives markets.

Enhancing transparency and valuation

- Using the disclosure framework recommended by the FSF, large financial institutions have substantially expanded their disclosures about risk exposures, valuations, off-balance sheet entities and related policies. A proposed standard of the International Accounting Standards Board (IASB) expected by year-end will set forth enhancements to required risk disclosures about financial activities.
- The IASB will finalise in October guidance that will promote sound practices for valuation of financial instruments and related disclosures, emphasising the need for greater judgment in valuations when markets are inactive. This guidance will converge with similar guidance issued by the US Securities and Exchange Commission (SEC) and the US Financial Accounting Standards Board (FASB) in September and October. Also, by year-end, the BCBS will issue for comment guidance to enhance the Pillar 2 supervisory assessment of banks' valuation processes and to reinforce sound corporate governance, control and risk management over valuations of financial instruments.
- By year-end, the IASB will propose revised standards for the consolidation of off-balance sheet entities and related risk exposures. The FASB has also proposed revised standards in this area and the two bodies plan to converge their standards.
- The BCBS will issue for comment by the end of this year proposals to strengthen Pillar 3 disclosure standards for banks' securitisation activities, building on the recommended sound practice disclosures of the FSF.

Changes in the role and uses of credit ratings

- CRAs' adoption of IOSCO's revised *Code of Conduct Fundamentals for Credit Rating Agencies* will be reviewed by IOSCO and findings will be published in January 2009. IOSCO will also develop mechanisms by which national regulators can coordinate their ongoing monitoring of CRAs' compliance with the IOSCO Code, and is examining the options for promoting closer coordination between regulators to oversee CRAs.

Strengthening the authorities' responsiveness to risks

- Protocols for establishing by year-end supervisory colleges for each of the major global financial institutions are being developed by the FSF. The colleges will improve information exchange and cooperation in addressing cross-border issues. A review of these arrangements will be undertaken in 2009 once enough experience has been garnered.

Robust arrangements for dealing with stress in the financial system

- Central banks have taken extraordinary steps to supply liquidity effectively to the markets and institutions under stress. Under the auspices of the Committee on the Global Financial System (CGFS), central banks are continuing to actively investigate the lessons drawn from the recent experiences for their operational frameworks.
- National authorities are reviewing and in cases have proposed material changes to domestic frameworks for dealing with failing banks.
- Internationally, the BCBS is analysing existing resolution policies, allocation of responsibilities and legal frameworks to better understand the potential impediments and possible improvements to co-operation in the resolution of cross-border banks and will discuss its findings in December. The FSF has launched a project to develop high-level principles for cross-border financial crisis management, the results of which will be discussed by the FSF in March 2009.

Progress in the areas described above has been significant, in some cases ahead of schedule, and will strengthen the foundations of the financial system going forward.

In the light of market developments, there are certain areas where implementation should be accelerated:

- Market participants need to move ahead urgently to put in place central counterparty clearing for OTC credit derivatives and achieve more robust operational processes in OTC derivatives markets.
- Accounting standards-setters must conclude their work promptly to enhance and converge guidance on valuation of instruments in inactive markets, and progress and converge new accounting and disclosure standards for off-balance sheet activities.

In addition, we call 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.

To preserve a level playing field and maintain open and integrated financial markets, it is important that authorities avoid a fragmented approach in implementing the recommendations, including on oversight of CRAs, accounting and valuation standards, supervisory and regulatory standards, and supervisory oversight of banks' risk management practices.

Authorities remain committed to maintaining momentum in developing and implementing the recommended actions effectively and in full. Some measures will be phased in over

time to avoid adding to the adjustment challenges the system faces now. Continued monitoring of conditions will inform authorities' decisions on the timing for introducing certain reforms, including higher capital requirements. However, there should be no uncertainty about the authorities' determination to implement this internationally agreed program of actions.

The FSF welcomes the initiatives by private sector bodies – such as the Counterparty Risk Management Policy Group (CRMPG III), the Institute of International Finance (IIF), the member bodies of the Securities Industry and Financial Markets Association (SIFMA) and ISDA – that identify lessons from recent events and recommend best industry practices. These proposals are consistent with and complementary to the FSF efforts. Collective action of market participants is now needed to ensure rigorous implementation.

- Private sector organisations that have recommended improvements to industry practices should establish frameworks for rigorously monitoring and reporting on their timely implementation. Implementation will be monitored by the official sector and, in the case of banks, reinforced through Pillar 2 reviews under the Basel II framework.

Relevant international bodies should also review more broadly the recommendations made by the private sector and see if additional public workstreams are needed in response to these recommendations.

II. Work of the FSF going forward

Going forward, FSF members are committed to ensuring that all FSF recommendations are implemented promptly. Near-term priorities include:

- Assessing aspects of the international interaction and consistency of emergency arrangements and responses being put in place to address the current financial crisis.
- Completion of the work programs set out by accounting standards-setters, including enhanced guidance on valuation of instruments in inactive markets and accounting and disclosure standards for off-balance sheet activities, in ways that improve the international convergence of standards.
- Timely finalisation of enhancements to the Basel II capital framework.

In addition, as noted in the FSF Report, the FSF has set in train an examination of the forces that contribute to procyclicality in the financial system and possible mitigating options. This work, which draws on previous and ongoing work in a number of national and international bodies, centres on four areas:

- The *capital* regime: The project will examine the impact of Basel II on the cyclicality of capital requirements, and will explore measures that can be taken to strengthen capital buffers in good times and enhance banks' ability to dip into them during adverse conditions.
- Sound loan-loss *provisioning*: The FSF will examine how judgment is used in existing accounting standards to build sound, robust provisioning levels consistent with the credit losses inherent in their loan portfolios; and whether, in a longer term perspective, changes in accounting standards and the capital regime can promote more effective through-the-cycle provisioning consistent with providing transparency with respect to changes in credit trends.
- *Compensation* arrangements in financial institutions: The interests of authorities and shareholders broadly align in this area but firms face a collective action problem. The FSF will examine the appropriate role for regulators and supervisors in reinforcing sound compensation practices or mitigating associated risks, including through the use of supervisory reviews under Pillar II of Basel II.
- *Valuation and leverage*: Financial innovation has made these two phenomena more closely intertwined. The FSF will analyse the significance of the interplay between valuation and leverage as a source of procyclicality, and examine the need for policy responses to address adverse consequences of this interaction.

While the output of this work will emerge over time, the FSF will present a progress report on its procyclicality agenda to the G7 in April 2009.

Finally, there are a number of fundamental issues that warrant further review and action by the FSF in the medium term, building on the work of its member authorities and international bodies:

- Strengthening cross-border crisis management, bank resolution frameworks and bankruptcy regimes for cross-border financial institutions.
- Reassessing the scope of financial regulation, with a special emphasis on institutions, instruments and markets that are currently unregulated.
- Better integrating macroeconomic oversight and prudential supervision, to help translate more effectively systemic concerns into concrete supervisory and regulatory responses.

The resulting program of action, drawing on the lessons of the crisis, should strengthen the resilience of the global system while preserving a level playing field and maintaining open and integrated financial markets.

III. Implementation of the FSF recommendations

This Section describes in detail the measures that have been taken, are underway or are being planned in response to the FSF Report's recommendations.

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

1.1. Capital requirements

The Basel II capital framework needs timely implementation. Supervisors will assess the impact of the implementation.

The FSF Report noted that a starting point for improving major banks' capital adequacy is the timely implementation of Basel II. The Basel II framework is a significant improvement over the Basel I rules in the incentives it provides for sound risk management practices, its alignment of minimum capital requirements with risks banks face, and its flexibility to be adapted to and address evolving risks from financial innovation.

As countries are moving forward with Basel II implementation, supervisors are closely monitoring its impact on overall bank capital levels. A capital monitoring exercise is in place to track minimum capital requirements, actual capital buffers above the minimum and how the minimum requirements compare to Basel II floors. Analysis of the first data submissions will be available to the BCBS in the first quarter of 2009, and data will continue to be collected on an ongoing semi-annual basis.

The FSF Report noted that supervisors should assess the need for additional capital buffers or supplementary measures of capital strength as a complement to risk-based measures. Several countries have proposed or are considering such supplementary measures, including in the form of a balance-sheet leverage ratio, to better contain leverage in the system, guard against risk measurement errors and strengthen banks' overall shock absorption capacity.

The BCBS has launched a joint undertaking with the FSF to examine the impact of Basel II on the cyclicality of capital requirements and possible measures to promote stronger cushions over the cycle. The FSF will report to the G7 on the progress of its wider pro-cyclicality project in April 2009.

Supervisors will strengthen the Basel II capital treatment of structured credit and securitisation activities.

The BCBS and IOSCO issued in July proposals for additional capital requirements for credit exposures held in banks' and securities firms' trading books and the BCBS will issue later this year proposals to raise capital requirements for complex structured credit products

and strengthen the capital treatment of liquidity facilities extended to off-balance sheet vehicles.

The BCBS and IOSCO proposal on *Guidelines for Computing Capital for Incremental Risk in the Trading Book* will strengthen the capital regime for trading book positions with a new charge for risks that are incremental to value at risk (VaR).[1] The proposal expands the scope of the capital charge to capture not only price changes due to defaults but also other sources of price risk, such as those reflecting credit migrations and significant moves of credit spreads and equity prices that are not captured under Basel II's existing trading book regime. For example, the new incremental risk charge (IRC) will ensure that Basel II capital charges will much better capture the recent losses experienced in collateralized debt obligations (CDOs) of asset-backed securities (ABS) and other re-securitisations held in the trading book. It also seeks to address the concern that much of the build-up of risk and leverage as well as a majority of losses at banks occurred in trading book. In addition, the proposal addresses how supervisors should evaluate banks' IRC models. The comment period ends on 15 October and final guidelines will be issued later this year. The new rules will be phased in during 2010–11.

The BCBS will issue by year-end a consultative document setting out higher capital requirements for re-securitisations, including risk weights for highly-rated CDOs of ABS. The consultative document will also include a proposal to increase capital charges for short-term liquidity facilities extended to ABCP conduits, thereby reducing incentives to structure such facilities for regulatory capital arbitrage purposes. The intention is to introduce these higher capital requirements over time to avoid exacerbating near-term strains.

Supervisors will continue to update the risk parameters and other provisions of the Basel II framework as needed.

National supervisors are assessing banks' compliance with the Basel II framework in their supervisory process. As part of its capital monitoring exercise, the BCBS will track on an ongoing basis the impact of Basel II on bank capital levels. This will shed light on the effects of the proposed amendments to Basel II and help determine whether additional efforts are needed to strengthen capital in the banking system. In addition, BCBS members regularly exchange information on how supervisors are implementing the various aspects of Basel II and conducting model approvals in practice.

The BCBS has also launched a joint undertaking with the FSF to examine the impact of Basel II on the cyclicality of capital requirements and possible measures for mitigating it. The FSF will report to the G7 on progress with this work in April 2009.

[1] See the consultative documents on "Computing Capital for Incremental Risk in the Trading Book" and "Revisions to the Basel II market risk framework", http://www.bis.org/press/p080722.htm

Authorities should ensure that the capital buffers for monoline insurers and financial guarantors are commensurate with their role in the financial system.

The International Association of Insurance Supervisors (IAIS) carried out a survey of existing rules and planned changes to the regulatory framework for monolines and financial guarantors in relevant jurisdictions. Monoline insurers are typically subject to the same regulatory requirements as other more conventional insurers, but survey results indicate that a strengthening of the regulatory framework for these institutions, including capital requirements, is being considered in key countries.

In the US, a major monoline insurer jurisdiction, several important legislative initiatives have been undertaken at the federal and state levels. For example, the New York State Insurance Department is preparing a legislative bill and revised regulations to enhance New York State's controls over bond insurers. Among the items included is a curtailing of bond insurers' ability to guarantee certain complex structured products, an increase in required capital and reserves and a tightening of risk limits.

1.2. Liquidity management

Supervisors will issue for consultation sound practice guidance on the management and supervision of liquidity by July 2008.

After issuing a public consultation document in June, the BCBS released in September *Principles for Sound Liquidity Risk Management and Supervision*. The Principles materially raise standards for sound liquidity risk management and measurement – including the capture of off-balance sheet exposures, securitisation activities and other contingent liquidity risks that were not well managed during the turmoil. The Principles underscore the importance of establishing a robust liquidity risk management framework that is well integrated into the bank-wide risk management process. Key elements of a bank's governance of its liquidity risk management are also emphasised. Moreover, the document sets out principles to strengthen the measurement and management of their liquidity risk. Among other things, a bank should:

- Maintain a cushion of unencumbered, high quality liquid assets as insurance against a range of stress scenarios;
- Actively manage its intraday liquidity positions and risks to meet payment and settlement obligations on a timely basis under both normal and stressed conditions, and thus contribute to the smooth functioning of payment and settlement systems;
- Conduct regular stress tests for a variety of short-term and protracted institution-specific and market-wide stress scenarios and use the outcomes to develop robust and operational contingency funding plans; and
- Ensure the alignment of risk-taking incentives of individual business lines with the liquidity risk exposures the activities create.

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 Principles also stress the need for regular communication with other supervisors and public authorities, both within and across national borders. They also recommend regular public disclosure that enables market participants to make an informed judgement about the soundness of a bank's liquidity risk management framework and liquidity position.

The guidance focuses on liquidity risk management at medium and large complex banks, but the sound principles have broad applicability to all types of bank. The document notes that implementation of the sound principles by both banks and supervisors should be tailored to the size, nature of business and complexity of a bank's activities. Other factors that a bank and its supervisors should consider include the bank's role and systemic importance in the financial sectors of the jurisdictions in which it operates.

The BCBS expects banks and supervisors to implement the Principles thoroughly and quickly, and will assess progress in this area. It will also start to examine possible steps to promote more robust and internationally consistent liquidity approaches for cross-border banks. This will include assessing the scope for further convergence of liquidity supervision.

1.3. Supervisory oversight of risk management, including of off-balance sheet entities

Supervisors will use Pillar 2 to strengthen banks' risk management practices, to sharpen banks' control of tail risks and mitigate the build-up of excessive exposures and risk concentrations.

Over the recent year, supervisors have committed considerable resources to strengthen risk monitoring and management practices at firms where weaknesses have come to light.

In addition, supervisors are developing guidance for use under Pillar 2 of Basel II to strengthen risk management practices in areas where important weaknesses contributed to the recent crisis. 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 including concentrations, off-balance sheet exposures and securitisations, reputational risk and implicit support, 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. The draft guidance will be issued for comment by year-end.

National authorities have also developed or are developing guidelines and regulations for the supervision of banks' risk management practices, requiring banks to conduct firm-wide risk management and improve their risk management tools and practices.

Relevant regulators should strengthen the requirements for institutional investors' processes for investment in structured products.

IOSCO has set in train a workstream to review investment managers' due diligence in the case of investments in structured products on behalf of collective investment schemes offered to retail investors. IOSCO has developed an initial draft paper on issues that it plans to address as part of this review effort. It will finalise the review by the end of 2009.

IOSCO will coordinate with the Senior Supervisors Group (SSG) in a study of the internal control systems of financial firms in different jurisdictions, to draw conclusions on their adequacy with respect to the management of risks associated with structured products and to develop principles to address any concerns identified. The target date of this work is 2009.

At the national level, authorities have taken or are planning various initiatives, including revising supervisory guidelines for deposit-taking institutions to promote rigorous valuation processes and better understanding of risk profiles with regard to structured products, as well as reviewing pension fund supervisory practices.

The financial industry should align compensation models with long-term, firm-wide profitability. Regulators and supervisors should work with market participants to mitigate the risks arising from inappropriate incentive structures.

Two industry groups have addressed compensation issues. The IIF issued in July Principles of Conduct on compensation policies,[2] which recommended that compensation incentives be based on performance and be aligned with shareholder interests and long-term, firm-wide profitability, taking into account overall risk and the cost of capital. The IIF intends to carry out a survey of remuneration practices going forward. In its August report the CRMPG III identified compensation schemes as one of five primary driving forces of the turmoil.[3] The Group concluded that compensation practices should be based on the performance of the bank as a whole and be heavily stock-based, with the stock vesting over an extended period of time.

The FSF has identified compensation issues as one of the procyclicality-related topics meriting further analysis and will report back to the G7 on its discussions in April 2009. The Central Bank Governors and Finance Ministers of the Group of Ten (G10) will also discuss the implications of compensation and other incentives for financial stability at its upcoming meeting in October.

National initiatives are also underway. For example, the Bank of Italy issued a regulation on banks' organisation and corporate governance, requiring that remuneration schemes be consistent with risk management policies and long-term strategies. Other authorities are reviewing remuneration policies and practices in their financial sector and expect results by year-end.

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2 "Final Report of the IIF Committee on Market Best Practices: Principles of Conduct and Best Practice Recommendations", http://www.iif.com/

3 "Containing Systemic Risk: The Road to Reform". http://www.crmpolicygroup.org/docs/CRMPG-III.pdf

1.4. Operational infrastructure for over-the-counter derivatives

Market participants should act promptly to ensure that the settlement, legal and operational infrastructure underlying OTC derivatives markets is sound.

Since regulatory efforts to reduce operational risk in OTC derivatives began in late 2005, the industry has made improvements to both the credit and equity derivatives markets. In June 2008, the Federal Reserve Bank of New York convened major market participants and their primary supervisors to agree on an agenda to strengthen the legal, operational and settlement infrastructure for all OTC derivatives.

Major industry participants provided regulators in July with a letter outlining an expanded plan to address additional asset classes, including OTC interest rate, commodities and foreign exchange derivatives. In the near-term, they increased the standards for accuracy and timeliness of trade data submissions and the timeliness of resolving errors for credit default swaps, and outlined their approach for performance enhancements across all asset classes including: reducing confirmation backlogs, automating key processes such as novations and continuing to standardize and automate new products. The industry committed to provide by October 2008 longer-term strategic plans to improve the infrastructure, with the ultimate goal of confirming transactions on trade date and eliminating material processing backlogs.

In addition to these operational improvements, market participants are undertaking other steps to improve risk management in OTC derivatives processing, including: (i) developing a robust and prudently managed central clearing facility for credit derivatives with the objective to launch index products in 2008; (ii) implementing best practices for collateral management, including performing weekly portfolio reconciliations by the end of 2008; (iii) maximizing the use of multilateral trade termination services; and (iv) executing an implementation plan aimed at educating buy-side firms about efforts to improve the OTC derivatives infrastructure.

The International Swaps and Derivatives Association has committed to achieving greater certainty in credit event management. It will publish by year-end standardized documentation establishing an auction-based mechanism for the settlement of obligations in credit default swaps following a credit event. The documentation will initially cover defaults and failure-to-pay events and will be expanded to cover restructuring events, as well as defaults of monoline insurers, at a later date.

In Europe, a further initiative was announced in July 2008 aiming at creating a central counterparty solution which might be seen as an additional and complementary step to improve the resilience of the post-trade infrastructure for OTC derivatives.

The August report of the CRMPG III also included a series of recommendations aimed at enhancing the resilience of credit markets, with particular attention to strengthening the OTC derivatives markets.

In view of market developments, it is important that market participants press ahead with their commitments to improve the OTC credit derivatives markets, including putting in place central counterparty clearing arrangement in the near future.

2. Enhancing transparency and valuation

2.1. Risk disclosures by market participants

Financial institutions should strengthen their risk disclosures and supervisors should improve risk disclosure requirements under Pillar 3 of Basel II.

To enhance transparency and market confidence, the FSF recommended that financial institutions draw from leading practices to ensure that they provide robust meaningful disclosures in mid-year 2008 reports, for significant exposures. Supervisors and national authorities strongly encouraged their internationally active financial institutions to use these recommended leading risk disclosure practices in their mid-year reporting, and larger financial institutions have responded well. This has resulted in disclosure of more meaningful qualitative and quantitative information about risk exposures involving (i) structured investment vehicles, ABCP conduits and other special purpose entities (SPEs); (ii) CDOs; (iii) other subprime and Alt-A exposures, including whole loans, residential mortgage-backed securities, derivatives and other exposures; (iv) commercial mortgage-backed securities; and (v) leveraged finance. As part of this initiative, larger financial institutions also expanded their disclosures about valuations, corporate governance and controls over valuations, valuation methodologies and the uncertainty associated with valuations. The IASB is considering these enhanced disclosure practices as it develops a proposed revised standard by end-2008 on new risk and valuation disclosures (discussed below).

The BCBS is developing for consultation by end-2008 proposed guidance to further strengthen Pillar 3 disclosure requirements under Basel II for securitisation and resecuritisation exposures, sponsorship of off-balance sheet vehicles, liquidity commitments to ABCP conduits, valuations with regard to securitization exposures and pipeline and warehousing risks. This effort is well underway and is also drawing from leading practice risk disclosures that banks are providing in response to the FSF recommendations. The BCBS plans to issue final guidance in 2009.

2.2. Accounting and disclosure standards for off-balance sheet entities

The IASB should improve the accounting and disclosure standards for off-balance sheet vehicles on an accelerated basis and work with other standard setters toward international convergence.

The IASB has been working on an accelerated basis to enhance International Financial Reporting Standards (IFRS) for off-balance sheet entities and related disclosures, which is particularly important in the light of market developments. The IASB is developing a proposed standard that will clarify the principle that companies must consolidate those entities that they control and will provide greater emphasis on consolidation when companies have significant involvement with SPEs' risks and rewards. The IASB will also

propose enhanced disclosures for both consolidated and non-consolidated entities, including SPEs, in order to provide a better understanding about:

- the judgements made by management when reaching decisions to consolidate or not;
- the nature and financial effect of restrictions on assets and liabilities resulting from legal entity boundaries that exist within the reporting group; and
- the nature of, and risks associated with, the company's significant involvement with legal entities that it does not consolidate (including SPEs).

To address the FSF recommendation in a timely manner, the IASB held a public roundtable of experts in September about its draft proposed standard instead of issuing its usual initial discussion paper for consultation. The IASB plans to issue for consultation the proposed standard on consolidation (including SPEs) and related risk disclosures by end-2008. The final IASB consolidation standard is likely to be issued in the second half of 2009 and is expected to be effective 12 to 18 months afterwards. The IASB will encourage early adoption and jurisdictions could make this standard effective well before the mandatory required effective date.

Also, in September, the FASB issued three proposals for public comment that would significantly change accounting for securitisations of financial assets, the criteria for determining whether to consolidate certain SPEs,[4] and related disclosures. The proposed amendments would eliminate the criteria for a "qualifying special-purpose entity" or "QSPE" and cause banks and other companies to evaluate former QSPEs for consolidation.[5] In addition, the approach to determining the "primary beneficiary" who consolidates certain SPEs would be modified by inclusion of new qualitative criteria to assess control, and companies would be required to more frequently reassess whether consolidation is required. Moreover, additional year-end and interim period disclosures by transferors, primary beneficiaries and sponsors of certain SPEs, and other companies holding significant interests in certain SPEs would be expected prior to the effective date of the final amendments to the FASB standards.

The new FASB rules are expected to become effective in the 2010 fiscal year and the effective date for the proposed disclosures would be as of end-2008.

2.3. Valuation

International standard setters should enhance accounting, disclosure and audit guidance for valuations. Firms' valuation processes and related supervisory guidance should be enhanced.

[4] These are referred to as variable interest entities or "VIEs", which are a form of SPE specified in US generally accepted accounting principles (US GAAP).

[5] QSPEs have been used extensively for securitisations. Under US GAAP, financial assets and related liabilities that are transferred to a QSPE are not recorded on the balance sheet of the transferor or another beneficial interest holder, being exempt from consolidation. By eliminating the QSPE references in US GAAP, the proposed standard would abolish this treatment.

The IASB has established an expert advisory panel to assist it in reviewing best practices in the area of valuation techniques and formulating any necessary additional guidance on valuation methods for financial instruments and related disclosures when markets are no longer active. In September, the IASB published a draft paper about valuation and disclosure practices when markets are no longer active, based on discussions with its expert advisory panel, which includes key banks, insurance companies, audit firms, regulators and analysts.[6] The IASB plans to issue the paper in final form in October.

Based on the paper's summary of the panel's discussions and illustrations, users and preparers should gain better insights into:

- how to review key information and apply reasonable expert management judgment to determine sound fair value measurements for various instruments when markets are not active, consistent with existing IFRS standards; and
- how to provide better disclosures about valuation controls and governance, valuation techniques, and the uncertainty associated with valuations.

In summary, the IASB draft paper indicates that when faced with inactive markets, firms estimate the fair value for financial instruments based on a thorough understanding of these instruments and consideration of all available relevant information. Such information includes values in recent trades, broker bids, information from pricing services, relevant indices and other inputs to model-based valuation techniques. Recent trades (that are not distressed sales) for the same or similar instruments cannot be ignored when considering the relevance and reliability of the available information during the determination of management's best estimate. Judgment is needed in assessing all available information when estimating fair value in inactive markets.

Firms might arrive at a range of possible values for an instrument because of the different sources of information available and the different reasonable alternative assumptions that an entity could use. A firm's management determines its best estimate of fair value within that range by making judgements about the available information, consistent with the IFRS definition of fair value.[7] In exercising judgement, different firms might arrive at different estimates of fair value for the same instrument and both firms might still meet the IASB objective of fair value measurement.

The models used to develop fair value estimates need to be periodically calibrated to the market and the draft paper discusses valuation adjustments that may be appropriate for model-based estimates. Sound documentation would need to be maintained to support key aspects of the valuation process, including inputs, assumptions, and methodologies. Also, institutions can enhance transparency by providing disclosures about the valuations (including about the "level 1, 2 and 3" hierarchy of fair values), valuation techniques and

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[6] Organisations represented on the IASB's expert advisory panel are presented on the IASB's website (http://www.iasb.org/Current+Projects/IASB+Projects/Fair+Value+Measurement/Expert+Advisory+Panel.htm). The expert advisory panel has been meeting with IASB Board members and staff during June, July and August. The draft paper does not establish new IASB standards or new requirements for entities applying IFRS or other GAAP. However, entities should find the information about the processes used and the judgments made when measuring and disclosing fair value useful in meeting the objectives and requirements of IFRS.

[7] An instrument's "fundamental value" based solely on management's cash flow estimates is not the same as its fair value.

uncertainties, controls and governance and other important related matters. The IASB plans to draw from the disclosure practices identified by the expert advisory panel in proposing amendments to its financial instrument risk and valuation disclosure requirements in IFRS 7 in October 2008.

In September, the SEC staff issued a letter on additional disclosures about fair values that management should consider providing as part of their upcoming public reports. The additional issues are the result of the SEC's reviews and its public roundtables that took place over the summer. Also in September, the SEC Office of the Chief Accountant and the FASB staff provided clarifications on fair value accounting under US standards that intend to help preparers, auditors, and investors address fair value measurement questions that have been cited as most urgent in the current environment. The FASB also issued in October for comment additional interpretative guidance on fair value measurement under US standards that is to be finalised later in October. In a press release in early October, the IASB found the guidance by the SEC and FASB staffs to be consistent with IFRS. The IASB committed to ensure that any IFRS guidance is consistent with the clarification issued by the US SEC staff and the FASB staff. This will help ensure comparability across borders.

The FSF acknowledges the significant efforts of accounting standards setters, and urges them to accelerate their work to enhance and converge their guidance on the valuation of instruments in inactive markets.

The BCBS is developing guidance to enhance the supervisory assessment of corporate governance and controls over banks' valuation processes and related risk management and capital adequacy issues. The guidance will reinforce sound bank valuation practices and address approaches supervisors should take when deficiencies are identified. The drafting effort is well underway and further dialogue is planned with securities markets regulators as part of the development process. The BCBS plans to issue the guidance for consultation by end-2008. Furthermore, the BCBS plans to address improved valuation disclosures as part of proposed amendments to the disclosure requirements of Pillar 3 of Basel II that will be issued for public comment around year-end 2008.

The International Auditing and Assurance Standards Board (IAASB) established in early-2008 a task force to consider how best to approach the development of possible further fair value auditing guidance and this task force was later charged with developing a response to the FSF recommendation. As recommended by the FSF, the six largest audit firms shared with the IAASB task force the audit approaches that they brought to bear in addressing the auditing and financial reporting issues that arose during the turmoil. A number of IAASB auditor interviews were conducted jointly with the US audit regulator. The IAASB issued in October a Staff Audit Practice Alert addressing challenges in auditing fair value accounting estimates in the current market environment and that points to enhanced auditing approaches for valuations that are set forth in the new International Standard on Auditing 540 issued in 2008. Also, the IAASB will hold an education session for multinational audit firms on valuation auditing challenges during October and it plans further work to improve the information available about valuation practices and from pricing services in 2008 and 2009.

2.4. Transparency in securitisation processes and markets

Securities market regulators should work with market participants to expand information on securitised products and their underlying assets.

A large body of work is underway in the market community, including within the European Securitisation Forum (ESF), the American Securitization Forum and the Japan Securities Dealers Association, to strengthen initial and ongoing disclosures and transparency relating to structured products. Securities markets regulators and IOSCO are continuing to closely monitor the adequacy of these improvements. Some of these efforts are summarised in 3.3 below.

3. Changes in the role and uses of credit ratings

3.1. Quality of the rating process

CRAs should improve the quality of the rating process and manage conflicts of interest in rating structured products.

IOSCO issued in May a revised *Code of Conduct Fundamentals for CRAs* that sets out materially enhanced requirements for processes and procedures that should be in place to protect the quality and integrity of the rating process.[8] This covers CRAs' independence and avoidance of conflicts of interest and CRAs' responsibilities to the investing public and issuers.

IOSCO and its member authorities expect CRAs to give full effect to the revised Code of Conduct and to demonstrate to regulators and market participants how they adopt the Code in their own codes of conduct. To this end, the IOSCO Task Force on CRAs will (i) conduct a review of CRAs' adoption of codes of conduct based on the revised IOSCO Code of Conduct and publish its findings in January 2009; (ii) work toward developing by January 2009 mechanisms by which national regulators can coordinate their monitoring of CRAs with the substance of the IOSCO Code; and (iii) examine options for promoting closer coordination between regulators to oversee CRAs.

In June and July, the SEC proposed a three-fold set of reforms to regulate the conflicts of interest, disclosures, internal policies and business practices of CRAs registered with the SEC as nationally recognized statistical rating organisations (NRSROs). It is anticipated that the proposed rulemakings will be finalised this fall. The first set of proposed rulemakings would address conflicts of interest in the credit rating industry and require new disclosures designed to increase CRAs' transparency and accountability.

In the European Union (EU), the Committee of European Securities Regulators (CESR) publishes a yearly report that includes a review of the implementation of the IOSCO Code of Conduct. The CESR proposed in May to strengthen oversight of CRAs, including through the establishment of an international body to develop standards in line with the

[8] http://www.iosco.org/library/pubdocs/pdf/IOSCOPD271.pdf

IOSCO Code of Conduct and monitor their observance. The Economic and Financial Affairs Council (ECOFIN) agreed in July that a strengthened oversight regime for CRAs was required. ECOFIN supported an enhanced European approach to oversight but highlighted the need to strengthen international cooperation to ensure implementation of internationally approved principles. The European Commission issued for comment in July a document on conditions for authorisation, operation and supervision of CRAs in the EU, including a proposal on the CRA registration regime. The document sets forth a number of requirements for CRAs, such as avoidance of conflicts of interest, sound rating methodologies and transparency of rating activities.

A possible new regulatory framework for CRAs is also under discussion in other jurisdictions, including Canada and Japan.

The FSF is working to follow these national and regional initiatives and facilitate coordination as necessary to ensure a globally consistent approach to oversight and regulation of CRAs and avoid a fragmentation of CRAs' role across financial markets.

3.2. Differentiated ratings and expanded information on structured products

CRAs should differentiate ratings on structured finance from those on bonds, and expand the initial and ongoing information provided on the risk characteristics of structured products.

The revised IOSCO Code of Conduct asks CRAs to differentiate ratings of structured products from other ratings. Similarly, the SEC's proposed new rules would require CRAs to differentiate the ratings they use on structured products through either different symbology or a report disclosing the differences. In the private sector, the IIF July report stated that "rating agencies should develop a different or additional ratings scale or indicator for structured products (compared to corporate bonds)."

The revised IOSCO Code of Conduct requires expanded information on the risk characteristics of structured products. It asks CRAs to make clear, in a prominent place, the limitations of ratings of financial products with limited historical data upon which to base the rating. It also requires CRAs to provide investors and subscribers with sufficient information about their loss and cash-flow analysis, and to disclose the degree to which they assess the sensitivity of a structured product's rating to changes in the underlying rating assumptions.

In July, the CGFS Study Group on ratings in structured finance met with CRAs to follow-up on the recommendations in the CGFS report published at the beginning of July.[9] The CGFS recommended that CRAs further strengthen their efforts to capture and highlight the greater tail risk element in structured finance ratings, and that they draw investor attention to the specific risks of structured finance through forward-looking economic scenarios.

[9] "Ratings in structured finance: what went wrong and what can be done to address shortcomings?" www.bis.org/publ/cgfs32.pdf

The major CRAs are planning various initiatives to expand information on structured products, including potential rating volatility scores; loss sensitivities; publication of rating outlooks; disclosure of rating assumptions; and supplementary information on loss-given-default. These steps are welcome but enhanced efforts by CRAs are needed to fulfil the FSF recommendations, including industry-wide proposals for providing differentiated information or ratings for structured products.

3.3. CRA assessment of underlying data quality

CRAs should enhance their review of the quality of the data input and of the due diligence performed on underlying assets by originators, arrangers and issuers involved in structured products.

The revised IOSCO Code of Conduct requires CRAs to (i) adopt reasonable measures so that the information they use in assigning a rating is of sufficient quality to support a credible rating; (ii) establish product review functions to examine the feasibility of rating new products that are materially different from those rated; and (iii) refrain from rating where the complexity or structure of a new structured products or the lack of robust data on underlying assets raise serious questions as to whether CRAs can determine a credible rating.

The SEC's first set of proposed rulemakings would prohibit CRAs from issuing a rating on a structured product unless information on assets underlying the product was made available to other CRAs and would require CRAs to disclose whether and how they rely on third-party due diligence to verify the assets underlying structured products.

On the issuer side, the SIFMA, the ESF and the Commercial Mortgage Securities Association (CMSA) are taking forward various initiatives to develop issuer transparency and disclosure principles in relation to structured products. IOSCO plans to ask originators and sponsors of securitisation programs to develop best practices on due diligence and risk management. The objective is to ensure that the assets originated for transfer off their balance sheets are of the same quality and subject to the same valuations as those kept on balance sheets.

3.4. Uses of ratings by investors and regulators

Investors should address their over-reliance on ratings. Investor associations should consider developing standards of due diligence and credit analysis for investing in structured products.

The SIFMA, the ESF and the CMSA are developing securitisation investor credit assessment principles to support investors in developing well articulated investment processes and independently assessing the risks associated with a transaction. The associations are also discussing securitisation investor valuation principles, in particular for investors in structured credits subject to mark-to-market rules. This set of principles, which

will foster appropriate use of ratings in risk assessment, is to be implemented by year-end or shortly thereafter.

Due diligence issues will also be covered by IOSCO's projects to review the adequacy of investment managers' due diligence and to study the internal control systems of financial firms (see 1.3).

Authorities will review their use of ratings in the regulatory and supervisory framework.

The Joint Forum has launched a stocktaking of the uses of ratings in legislation, regulations and supervisory guidance by its member authorities in the banking, securities and insurance sectors. The stocktaking will be finalised by end-2008.

The third set of the SEC's recent proposed rulemakings would clarify to investors the limits and purposes of credit ratings and ensure that the role assigned to ratings in SEC rules and forms is consistent with the objectives of having investors make an independent judgment of credit risks. The proposed rules would remove, with limited exceptions, all references to NRSRO credit ratings from the SEC's rules and forms.

The European Commission's consultation document published in July considers options to address the excessive reliance of investors on credit ratings. The document identifies references made to ratings in EU legislation and looks at possible approaches to reduce excessive reliance on ratings. The final proposal is expected to be issued in the coming weeks.

4. Strengthening the authorities' responsiveness to risks

4.1. Translating risk analysis into action

Supervisors, regulators and central banks – individually and collectively – will take additional steps to more effectively translate their risk analysis into actions that mitigate those risks.

Supervisors and central banks are well aware of the need to align their resources and expertise to the greater complexity of financial products and markets. This requires shifting resources out of traditional areas and recalibrating the skill mix to make sure it keeps pace with financial innovation. Authorities are taking steps in this direction – for instance by hiring market and risk experts, intensifying internal training, and promoting staff exchanges and secondments to foreign regulators and banks. It is to be recognized, however, that progress in this area can only be gradual.

There is a growing consensus among authorities and the industry that for oversight to be effective there should be direct communication between the supervisors and the firm's board and senior management. Many national authorities have in place direct channels of communication with senior management and, as needed, bank boards. The CRMPG III also called for arrangements whereby high-level officials from primary supervisory bodies meet

at least annually with the boards of directors of large financial intermediaries to share their views on the underlying stability of the firm and its capacity to absorb periods of adversity. It is the high level of the exchange between supervisors and the boards that should help each better discharge their respective duties.

At the international level the FSF, both directly and through the action of its members, is taking steps to ensure that its risk analysis and recommendations can draw market participants' attention and responsive action. This means spelling out in greater clarity the nature of risks and vulnerabilities that have been identified and giving more visibility to the risk assessments and related action points, including by stepping up the interaction with private sector and FSF outreach. The financial industry recognizes that it has a role in this endeavour and has remained engaged with the FSF and its members to deepen the two-way dialogue on risks and policy responses. A round table with representatives of the private sector was held on the occasion of the FSF plenary meeting in September.

4.2. Improving information exchange and cooperation among authorities

Authorities' exchange of information and cooperation in the development of good practices will be improved at national and international levels.

Authorities have worked to expand the use of international supervisory colleges as a tool for enhanced cross-border communication among supervisors, building on existing examples of colleges, such as in the Basel II framework and in the EU. Colleges will be established by year-end for each of the major global financial institutions. Discussions are ongoing to ensure that the FSF arrangements and those proposed in the EU context are structured in a consistent and mutually reinforcing way. A review of the FSF arrangements will be undertaken in 2009, once experience with them has been garnered. In the EU, the Committee of European Banking Supervisors has undertaken a review of good practices for colleges that is expected to be completed in the first half of 2009.

The SSG has provided an example of the way supervisors can flexibly organise themselves to address in a timely way issues of common interest. The SSG meets on an ad hoc basis, and has provided key contributions in identifying leading practices in areas such as risk management and disclosure. This work is set to continue as needed going forward.

Supervisors and central banks are working together on improving the exchange of information and the assessment of financial stability risks, including through meetings of Central Bank Governors and Heads of Supervision at the Bank for International Settlements. A number of countries are also reviewing existing arrangements for communication and co-operation among supervisors and central banks.

4.3. Enhancing international bodies' policy work

International bodies will enhance the speed, prioritisation and coordination of their policy development work.

As part of their efforts to respond to the turmoil, international regulatory, supervisory, and central bank committees have adjusted priorities and accelerated their work timetables in line with FSF recommendations, as described in detail in the other parts of this report. Standard setters have also worked jointly in areas of common interest, for instance in the case of joint BCBS-IOSCO work on strengthening capital requirements for trading books exposures. The work on procyclicality undertaken by the FSF provides another opportunity for joint review of issues where interdependencies across standard-setting areas are significant.

Cooperation between the FSF and the IMF on financial stability issues is being intensified. Since March 2008, the IMF regularly shares through the Financial Stability Note it contributes to FSF meetings its assessment of global financial vulnerabilities, drawing from its surveillance and analytical work, in the direction of early identification of key vulnerabilities and assessment of macro-financial linkages. The IMF will identify and raise in the FSF recurring areas of structural weakness across countries and financial systems, drawing from its experience in assessing standards and financial stability across countries. In turn, the IMF will draw from the FSF discussions of vulnerabilities and mitigating actions issues that it may follow up in its bilateral and multilateral surveillance, and monitor implementation of relevant FSF recommendations in its well-established role as an impartial and systematic assessor. The FSF and the IMF will also continue to co-organise meetings on topics of interest to the FSF and IMF membership – such as the high-level meeting of FSF and G20 deputy governors, deputy finance ministers and heads of supervision on 9 October.

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

5.1. Central bank operations

Central bank operational frameworks should be sufficiently flexible in terms of potential frequency and maturity of operations, available instruments, and the range of counterparties and collateral, to deal with extraordinary situations.

Central banks have continued to adjust their operational frameworks and expanded operations to address persistent tensions in money markets. Where needed, they have widened the range of eligible collateral and counterparties, developed new instruments to provide term funds, increased the size and average maturity of their longer-term operations and established term securities lending facilities. Central banks have retained and, in some cases, exercised the option to scale back their enhanced operations when market conditions improve.

In July 2008 the CGFS published a report on central bank operations in response to the turmoil.[10] This report reviews central bank actions through end-April and sets out several recommendations with regard to the desirable features of central bank operational

[10] "Central bank operations in response to the financial turmoil", CGFS Papers, No. 31 (2008), available at http://www.bis.org/publ/cgfs31.pdf?noframes=1.

frameworks. The recommendations in the CGFS report mirror those made by the FSF, while adding detail on how such recommendations may be implemented. The CGFS report also highlights the need for authorities to clearly communicate with market participants and the media. Furthermore, it emphasises the need to weigh expected benefits of central bank actions to address market dislocation against their potential costs and introduce safeguards against distortions of incentives where necessary.

The CGFS has since followed up on its recommendation on the international distribution of liquidity, focusing on two policy options: (i) inter-central bank swap lines; and (ii) the use of cross-border collateral. Building on the experience of how swap lines among central banks have facilitated liquidity provision across borders since December 2007, the CGFS recommended that central banks proceed with further discussions on the use of swap lines bilaterally. Central bank cooperation via swap arrangements expanded in mid-September in response to resurgent money market tensions. The CGFS is further investigating policy issues arising from the acceptance of cross-border collateral in coordination with the Committee on Payment and Settlement Systems (CPSS). The CPSS is studying the details of the definition and acceptability of cross-border collateral, and is actively seeking feedback from the industry on this point.

5.2. Arrangements for dealing with weak banks

Authorities will clarify and strengthen national and cross-border arrangements for dealing with weak banks.

A number of national governments have committed to introduce legislation that strengthens the authorities' powers to deal with distressed banks and other financial institutions.

The BCBS is analysing existing resolution policies, allocation of responsibilities and legal frameworks to better understand the potential impediments and possible improvements to co-operation in the resolution of cross-border banks and will discuss its findings in December. In addition, central banks of the G10 countries have launched an exercise to identify desirable features in resolution frameworks from central banks' perspective.

Separately, the Task Force on Crisis Management of the European System of Central Banks (ESCB) Banking Supervision Committee has assisted EU central banks in the implementation of the Memorandum of Understanding (MoU) on cross-border financial crisis. Authorities in countries that lacked explicit early intervention frameworks or MoUs for cross-border cooperation and information exchange have engaged in the preparation of such MoUs.

Authorities will review and, where necessary, strengthen deposit insurance arrangements.

In recent months, a number of countries have made fundamental changes to strengthen their deposit insurance arrangements. These have included expanding coverage level and in cases changes to banks resolution frameworks. In the EU, the European Commission issued

a report in September to revise the EC Directive on Deposit Guarantee Schemes, especially in relation to the speed of payout and coverage levels.

In early-2008, the International Association of Deposit Insurers (IADI) drafted a set of *Core Principles for Deposit Insurance* to enhance the effectiveness of deposit insurance systems, drawing on the experience of its members, with a view to finalising the Principles by the spring of 2009. The Principles are reflective of, and designed to be adaptable to, a broad range of country circumstances, settings and structures. The Principles call for compulsory membership for all banks and require that the coverage level be made explicit. Sound ex-ante funding arrangements are critical to the effectiveness of a deposit insurance system. Building public awareness of the features of the deposit insurance system, and clarity in the information on reimbursement of depositors, are essential elements of effective deposit insurance scheme.

The BCBS jointly with IADI will establish by year-end whether the IADI Principles can supplement the *Basel Core Principles for Effective Banking Supervision* in the area of effective deposit insurance systems.

Authorities will strengthen cross-border cooperation in crisis management.

A project of the FSF aims at filling a number of gaps in the existing crisis management frameworks, notably in the area of international contingency plans; common internationally established high level principles for crisis management; and coordinated international testing of financial crisis management arrangements.

The project composes of two parts: (i) drafting a checklist of issues and actions that would need to be considered to manage a distressed large complex financial institution (LCFI); and (ii) defining a set of high level principles for international financial crisis management. Such principles would cover, for instance, overall objectives of financial crisis management, moral hazard issues and cross-border communication. The project will be well-advanced by the end of the year, and complements parallel work on central bank cooperation, including the acceptance of foreign collateral and on resolution of cross-border banking crises.

The European Commission envisages finalising a white paper on early intervention schemes across border among member states by end-2009. Separately, insurance supervisors have adopted the IAIS Multilateral MoU (MMoU) on cooperation and information exchange in 2007, and members are expected to become signatories shortly. The MMoU regime will be reviewed in 2009 in terms of its methodology and criteria for impact assessment on coordination during a crisis.

Annex A

List of recommendations[11]

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

Capital requirements		
The Basel II capital framework needs timely implementation. Supervisors will assess the impact of the implementation.		
II.1 The Basel II capital framework needs timely implementation.	National supervisors	2008 -
II.2 Supervisors will assess the impact of Basel II implementation on banks' capital levels and will decide whether additional capital buffers are needed.	National supervisors, BCBS	2008 -
Supervisors will strengthen the Basel II capital treatment of structured credit and securitisation activities.		
II.3 The BCBS will issue proposals in 2008 to raise capital requirements for certain complex structured credit products such as CDOs of asset-backed securities (ABSs).	BCBS	2008
II.4 The BCBS and IOSCO will issue proposals in 2008 to introduce additional capital requirements for credit exposures in the banks' and securities firms' trading books.	BCBS, IOSCO	2008
II.5 The BCBS will issue proposals in 2008 to strengthen the capital treatment for banks' liquidity facilities to off-balance sheet ABCP conduits.	BCBS	2008
Supervisors will continue to update the risk parameters and other provisions of the Basel II framework as needed.		
II.6 Supervisors will continue to update the risk parameters and other provisions of the Basel II framework to ensure that its incentives remain adequate, and will rigorously assess banks' compliance with the framework.	BCBS, national supervisors	2008 -
II.7 Supervisors will assess the cyclicality of the Basel II framework and take additional measures as appropriate.	BCBS	2009 -
Authorities should ensure that the capital buffers for monoline insurers and financial guarantors are commensurate with their role in the financial system.		
II.8 Insurance supervisors should strengthen the regulatory and capital framework for monoline insurers in relation to structured credit.	National supervisors, IAIS	2008 -

[11] In the third column, the timeline for those recommendations for which work is expected to be continued over time is represented by adding a dash (-) after the date when the implementation is expected to start.

Liquidity management		
Supervisors will issue for consultation sound practice guidance on the management and supervision of liquidity by July 2008.		
II.9 The BCBS will issue for consultation sound practice guidance on the management and supervision of liquidity by July 2008.	BCBS	July 2008
II.10 National supervisors should closely check banks' implementation of the updated guidance as part of their regular supervision. If banks' implementation of the guidance is inadequate, supervisors will take more prescriptive action to improve practices.	National supervisors	2008 -
II.11 Supervisors and central banks will examine the scope for additional steps to promote more robust and internationally consistent liquidity approaches for cross-border banks. This will include the scope for more convergence around liquidity supervision as well as central bank liquidity operations.	BCBS, national supervisors, central banks	2008-09
Supervisory oversight of risk management, including of off-balance sheet entities		
Supervisors will use Pillar 2 to strengthen banks' risk management practices, to sharpen banks' control of tail risks and mitigate the build-up of excessive exposures and risk concentrations.		
II.12 National supervisors will use the flexibility within Basel II to ensure that risk management, capital buffers and estimates of potential credit losses are appropriately forward-looking and take account of uncertainties associated with models, valuations and concentration risks and expected variations through the cycle. National supervisors will report to the BCBS with a view to ensuring a level playing field and the BCBS will share its findings and actions with the FSF.	National supervisors, BCBS	2008-09
II.13 Supervisors will strengthen guidance relating to the management of firm-wide risks, including concentration risks.	BCBS, national supervisors	2008-09
II.14 Supervisors will strengthen stress testing guidance for risk management and capital planning purposes.	BCBS, national supervisors	2008-09
II.15 Supervisory guidance will require banks to manage off-balance sheet exposures appropriately.	BCBS, national supervisors	2008-09
II.16 Supervisors will issue guidance to strengthen risk management relating to the securitisation business.	BCBS, national supervisors	2008-09
II.17 Supervisors will strengthen their existing guidance on the management of exposures to leveraged counterparties.	National supervisors	2008-09
Relevant regulators should strengthen the requirements for institutional investors' processes for investment in structured products.		
II.18 Regulators of institutional investors should strengthen the requirements or best practices for firms' processes for investment in structured products.	National regulators	2009

The financial industry should align compensation models with long-term, firm-wide profitability. Regulators and supervisors should work with market participants to mitigate the risks arising from inappropriate incentive structures.		
II.19 Regulators and supervisors should work with market participants to mitigate the risks arising from remuneration policies.	National regulators, supervisors	2008 -
Operational infrastructure for OTC derivatives		
Market participants should act promptly to ensure that the settlement, legal and operational infrastructure underlying OTC derivatives markets is sound.		
II.20 Market participants should amend standard credit derivative trade documentation to provide for cash settlement of obligations stemming from a credit event, in accordance with the terms of the cash settlement protocol that has been developed, but not yet incorporated into standard documentation.	Market participants	2008
II.21 Market participants should automate trade novations and set rigorous standards for the accuracy and timeliness of trade data submissions and the timeliness of resolutions of trade matching errors for OTC derivatives.	Market participants	2008
II.22 The financial industry should develop a longer-term plan for a reliable operational infrastructure supporting OTC derivatives.	Financial industry	2008 -

III. Enhancing transparency and valuation

Risk disclosures by market participants		
Financial institutions should strengthen their risk disclosures and supervisors should improve risk disclosure requirements under Pillar 3 of Basel II.		
III.1 The FSF strongly encourages financial institutions to make robust risk disclosures using the leading disclosure practices summarised in this report, at the time of their upcoming mid-year 2008 reports.	Financial institutions	Mid-2008
III.2 Going forward, investors, financial industry representatives and auditors should work together to provide risk disclosures that are most relevant to the market conditions at the time of the disclosure.	Financial industry representati-ves, auditors	2008 -
III.3 The BCBS will issue by 2009 further guidance to strengthen disclosure requirements under Pillar 3 of Basel II.	BCBS	2009
Accounting and disclosure standards for off-balance sheet entities		
III.4 The IASB should improve the accounting and disclosure standards for off-balance sheet vehicles on an accelerated basis and work with other standard setters toward international convergence.	IASB	2008-09

Valuation		
International standard setters should enhance accounting, disclosure and audit guidance for valuations. Firms' valuation processes and related supervisory guidance should be enhanced.		
III.5 The IASB will strengthen its standards to achieve better disclosures about valuations, methodologies and the uncertainty associated with valuations.	IASB	2008-09
III.6 The IASB will enhance its guidance on valuing financial instruments when markets are no longer active. To this end, it will set up an expert advisory panel in 2008.	IASB	2008-09
III.7 Financial institutions should establish rigorous valuation processes and make robust valuation disclosures.	Financial institutions	2008
III.8 The BCBS will issue for consultation guidance to enhance the supervisory assessment of banks' valuation processes and reinforce sound practices in 2008.	BCBS	2008
III.9 The International Auditing and Assurance Standards Board (IAASB), major national audit standard setters and relevant regulators should consider the lessons learned during the market turmoil and, where necessary, enhance the guidance for audits of valuations of complex or illiquid financial products and related disclosures.	IAASB, major national audit standard setters, relevant regulators	2008-09
Transparency in securitisation processes and markets		
Securities market regulators should work with market participants to expand information on securitised products and their underlying assets.		
III.10 Originators, arrangers, distributors, managers and CRAs should strengthen transparency at each stage of the securitisation chain, including by enhancing and standardising information on an initial and ongoing basis about the pools of assets underlying structured credit products.	Originators, arrangers, distributors, managers and CRAs	2008
III.11 Originators and issuers of securitised products should be transparent about the underwriting standards for the underlying assets. They should also make available to investors and CRAs the results of their own due diligence.	Originators, issuers	2008
III.12 Investors, and their asset managers, should obtain from sponsors and underwriters of structured credit products access to better information about the risk characteristics of the credits, including information about the underlying asset pools, on an initial and ongoing basis.	Investors and their asset managers	2008
III.13 Securities market regulators will work with market participants to study the scope to set up a comprehensive system for post-trade transparency of the prices and volumes traded in secondary markets for credit instruments.	Securities market regulators, market participants	2008-09

IV. Changes in the role and uses of credit ratings

Quality of the rating process		
CRAs should improve the quality of the rating process and manage conflicts of interest in rating structured products.		
IV.1 IOSCO will revise its Code of Conduct Fundamentals for Credit Rating Agencies by mid-2008.	IOSCO	Mid-2008
IV.2 CRAs should quickly revise their codes of conduct to implement the revised IOSCO CRA Code of Conduct Fundamentals. Authorities will monitor, individually or collectively, the implementation of the revised IOSCO Code of Conduct by CRAs, in order to ensure that CRAs quickly translate it into action.	CRAs, authorities	2008 -
IV.3 CRAs should demonstrate that they have the ability to maintain the quality of their service in the face of rapid expansion of their activities, and allocate adequate resources to both the initial rating and to the rating's regular review.	CRAs	2008 -
Differentiated ratings and expanded information on structured products		
CRAs should differentiate ratings on structured finance from those on bonds, and expand the initial and ongoing information provided on the risk characteristics of structured products.		
IV.4 CRAs should clearly differentiate, either with a different rating scale or with additional symbols, the ratings used for structured products from those for corporate bonds, subject to appropriate notification and comment.	CRAs	2008 -
IV.5 CRAs should expand the initial and ongoing information that they provide on the risk characteristics of structured products.	CRAs	2008 -
CRA assessment of underlying data quality		
CRAs should enhance their review of the quality of the data input and of the due diligence performed on underlying assets by originators, arrangers and issuers involved in structured products.		
IV.6 CRAs should review the quality of the data input and the due diligence performed by originators, arrangers and issuers.	CRAs	2008 -
Uses of ratings by investors and regulators		
Investors should address their over-reliance on ratings. Investor associations should consider developing standards of due diligence and credit analysis for investing in structured products.		
IV.7 Investors should reconsider how they use credit ratings in their investment guidelines and mandates and for risk management and valuation. Ratings should not replace appropriate risk analysis and management on the part of investors. Investors should conduct risk analysis commensurate with the complexity of the structured product and the materiality of their holding, or refrain from such investments.	Investors	2008 -

Authorities will review their use of ratings in the regulatory and supervisory framework.		
IV.8 Authorities should check that the roles that they have assigned to ratings in regulations and supervisory rules are consistent with the objectives of having investors make independent judgment of risks and perform their own due diligence, and that they do not induce uncritical reliance on credit ratings as a substitute for that independent evaluation.	International committees, national authorities	2008 -

V. Strengthening the authorities' responsiveness to risks

Translating risk analysis into action		
Supervisors, regulators and central banks – individually and collectively – will take additional steps to more effectively translate their risk analysis into actions that mitigate those risks.		
V.1 Supervisors should see that they have the requisite resources and expertise to oversee the risks associated with financial innovation and to ensure that firms they supervise have the capacity to understand and manage the risks.	National supervisors	2008 -
V.2 Supervisors and regulators should formally communicate to firms' boards and senior management at an early stage their concerns about risk exposures and the quality of risk management and the need for firms to take responsive action. Those supervisors who do not already do so should adopt this practice.	National supervisors and regulators	2008 -
V.3 At the international level, the FSF will give more force to its own risk analysis and recommendations, both directly and through the actions of its members, by initiating and following up action to investigate and mitigate risk.	FSF	2008 -
V.4 The FSF will establish a mechanism for regular interaction at senior level with private sector participants, including investors and CRAs, for prompting mitigating actions to identified risks and weaknesses.	FSF	2008
Improving information exchange and cooperation among authorities		
Authorities' exchange of information and cooperation in the development of good practices will be improved at national and international levels.		
V.5 The use of international colleges of supervisors should be expanded so that, by end-2008, a college exists for each of the largest global financial institutions.	National supervisors	2008
V.6 Supervisors involved in these colleges should conduct an exercise, by 2009, to draw lessons about good practices.	National supervisors	2009
V.7 To quicken supervisory responsiveness to developments that have a common effect across a number of institutions, supervisory exchange of information and coordination in the development of best practice benchmarks should be improved at both national and international levels.	National supervisors	2008 -

V.8 Supervisors and central banks should improve cooperation and the exchange of information including in the assessment of financial stability risks. The exchange of information should be rapid during periods of market strain.	National supervisors, central banks	2008 -
V.9 To facilitate central bank mitigation of market liquidity strains, large banks will be required to share their liquidity contingency plans with relevant central banks.	National supervisors, central banks, large banks	2008
Enhancing international bodies' policy work		
International bodies will enhance the speed, prioritisation and coordination of their policy development work.		
V.10 International regulatory, supervisory and central bank committees will strengthen their prioritisation of issues and, for difficult to resolve issues, establish mechanisms for escalating them to a senior decision-making level. As part of this effort, they will establish timetables for required action and action plans for addressing delayed or difficult issues.	International committees	2008 -
V.11 National supervisors will, as part of their regular supervision, take additional steps to check the implementation of guidance issued by international committees.	National supervisors	2008 -
V.12 The FSF will encourage joint strategic reviews by standard-setting committees to better ensure policy development is coordinated and focused on priorities.	FSF	2008 -
V.13 The FSF and IMF will intensify their cooperation on financial stability, with each complementing the other's role. As part of this, the IMF will report the findings from its monitoring of financial stability risks to FSF meetings, and in turn will seek to incorporate relevant FSF's conclusions into its own bilateral and multilateral surveillance work.	FSF/IMF	2008 -

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

Central bank operations		
Central bank operational frameworks should be sufficiently flexible in terms of potential frequency and maturity of operations, available instruments, and the range of counterparties and collateral, to deal with extraordinary situations.		
VI.1 To meet an increased but uncertain demand for reserves, monetary policy operational frameworks should be capable of quickly and flexibly injecting substantial quantities of reserves without running the risk of driving overnight rates substantially below policy targets for significant periods of time.	Central banks	2008
VI.2 Policy frameworks should include the capability to conduct frequent operations against a wide range of collateral, over a wide range of maturities and with a wide range of counterparties, which should prove especially useful in dealing with extraordinary situations.	Central banks	2008

VI.3 To deal with stressed situations, central banks should consider establishing mechanisms designed for meeting frictional funding needs that are less subject to stigma.	Central banks	2008
VI.4 Central banks should have the capacity to use a variety of instruments when illiquidity of institutions or markets threatens financial stability or the efficacy of monetary policy.	Central banks	2008
VI.5 To deal with problems of liquidity in foreign currency, central banks should consider establishing standing swap lines among themselves. In addition, central banks should consider allowing in their own liquidity operations the use of collateral across borders and currencies.	Central banks	2008-09
Arrangements for dealing with weak banks		
Authorities will clarify and strengthen national and cross-border arrangements for dealing with weak banks.		
VI.6 Domestically, authorities need to review and, where needed, strengthen legal powers and clarify the division of responsibilities of different national authorities for dealing with weak and failing banks.	National supervisors, central banks, governments	2008-09
VI.7 Internationally, authorities should accelerate work to share information on national arrangements for dealing with problem banks and catalogue cross-border issues, and then decide how to address the identified challenges.	National authorities, BCBS	2008
Authorities will review and, where necessary, strengthen deposit insurance arrangements.		
VI.8 Authorities should agree a set of international principles for deposit insurance systems.	National authorities	2008-09
VI.9 National deposit insurance arrangements should be reviewed against these agreed international principles, and authorities should strengthen arrangements where needed.	National authorities	2008-09
Authorities will strengthen cross-border cooperation in crisis management.		
VI.10 For the largest cross-border financial firms, the most directly involved supervisors and central banks should establish a small group to address specific cross-border crisis management planning issues. It should hold its first meeting before end-2008.	Relevant central banks and national supervisors	2008
VI.11 Authorities should share international experiences and lessons about crisis management. These experiences should be used as the basis to extract some good practices of crisis management that are of wide international relevance.	National supervisors, central banks	2008-09

Annex B

List of Documents

I Strengthened prudential oversight of capital, liquidity and risk management

BCBS: Principles for Sound Liquidity Risk Management and Supervision, http://www.bis.org/publ/bcbs144.htm

BCBS: Proposed revisions to the Basel II market risk framework, http://www.bis.org/publ/bcbs140.htm

BCBS: Guidelines for Computing Capital for Incremental Risk in the Trading Book, http://www.bis.org/publ/bcbs141.htm

BCBS: Range of practices and issues in economic capital modelling, http://www.bis.org/publ/bcbs143.htm

BCBS: Basel Committee on Banking Supervision announces steps to strengthen the resilience of the banking system, http://www.bis.org/press/p080416.htm

Joint Forum: Credit Risk Transfer – Developments from 2005 to 2007, http://www.bis.org/publ/joint21.htm

Joint Forum: Cross-sectoral review of group-wide identification and management of risk concentrations, http://www.bis.org/publ/joint19.htm

SSG: Observation on risk management practices during the recent market turbulence, http://www.newyorkfed.org/newsevents/news/banking/2008/SSG_Risk_Mgt_doc_final.pdf

New York Federal Reserve Bank: Summary of OTC Derivatives Commitments,

http://www.newyorkfed.org/newsevents/news/markets/2008/CommitmentSummaryTable.pdf

The President's Working Group on Financial Market: Report, http://www.ustreas.gov/press/releases/reports/pwgpolicystatemktturmoil_03122008.pdf

Enhancing transparency and valuation

BCBS: Fair value measurement and modelling: An assessment of challenges and lessons learned from the market stress, http://www.bis.org/publ/bcbs137.htm

IOSCO: Report on the Subprime Crisis - Final Report, Report of the Technical Committee of IOSCO,

http://www.iosco.org/library/pubdocs/pdf/IOSCOPD273.pdf

IOSCO: IOSCO addresses current market turmoil,

http://www.iosco.org/news/pdf/IOSCONEWS127.pdf

IOSCO: Proposed Elements of International Regulatory Standards on Funds of Hedge Funds Related Issues Based on Best Market Practices,

http://www.iosco.org/library/pubdocs/pdf/IOSCOPD281.pdf

SSG: Leading-Practice Disclosures for Selected Exposures,

http://www.newyorkfed.org/newsevents/news/banking/2008/SSG_Leading_Practice_Disclosures.pdf

CEBS: CEBS Report on banks' transparency on activities and products affected by the recent market turmoil, http://www.c-ebs.org/formupload/41/41f5a47b-7989-47bd-a80e-0f2b0c15b116.pdf

IASB: IASB update on response to the credit crisis, http://www.iasb.org/NR/rdonlyres/38FE5674-7BFF-4656-9F81-7A28CE560B00/0/Update_on_IASB_response_to_creditcrisis.pdf

http://www.iasb.org/NR/rdonlyres/C852569A-8BA6-4636-8C0D-DB7EEB088A26/0/IASBannouncesnextstepsinresponsetothecreditcrisis.pdf

IASB: IASB Expert Advisory Panel Draft guidance: Measuring and disclosing the fair value of financial instruments in markets that are no longer active,

http://www.iasb.org/NR/rdonlyres/F309C029-84B4-4F1F-BFB6-886EE9922A42/0/Expert_Advisory_Panel_draft_160908.pdf

IASB and FASB update to 2006 Memorandum of Understanding,

http://www.iasb.org/NR/rdonlyres/D10C94A3-7EE1-4EAF-A030-8530C32E70EB/0/Update_2006_MoU_press_release1.pdf

ASBJ and IASB review progress in achieving convergence in accounting standards, http://www.iasb.org/NR/rdonlyres/EF9EB40A-5C22-49B6-9BB0-50D5A1587052/0/ASBJIASBmeetinglast11September.pdf

SEC: SEC Office of the Chief Accountant and FASB Staff Clarifications on Fair Value Accounting, including proposed FASB Staff Position illustration,

http://www.sec.gov/news/press/2008/2008-234.htm

a) FASB Staff Position (proposed illustration) on fair value accounting, http://www.fasb.org/fasb_staff_positions/prop_fsp_fas157-d.pdf

b) IAASB Challenges in Auditing Fair Value Accounting Estimates in the Current Market Environment, http://web.ifac.org/download/Staff_Audit_Practice_Alert.pdf

Changes in the role and uses of credit ratings

IOSCO: The Role of Credit Rating Agencies in Structured Finance Markets - Final Report, Report of the Technical Committee of IOSCO,

http://www.iosco.org/library/pubdocs/pdf/IOSCOPD270.pdf

IOSCO: Code of Conduct Fundamentals for Credit Rating Agencies, Report of the Technical Committee of IOSCO,

http://www.iosco.org/library/pubdocs/pdf/IOSCOPD271.pdf

IOSCO: IOSCO urges greater international coordination in the oversight of credit rating agencies, http://www.iosco.org/news/pdf/IOSCONEWS126.pdf

CGFS: Ratings in structured finance: what went wrong and what can be done to address shortcomings?, http://www.bis.org/publ/cgfs32.htm

Strengthening authorities' responsiveness to risks

UK authorities: Financial stability and depositor protection: further consultation,

http://www.hm-treasury.gov.uk/media/E/1/consult_depositorprotection010708.pdf

UK authorities: Financial stability and depositor protection: special resolution regime, http://www.hm-treasury.gov.uk/media/1/1/consult_finstab_specialresolution220708.pdf

US Treasury: The Department of the Treasury Blueprint for a modernized financial regulatory structure, http://www.treas.gov/press/releases/reports/Blueprint.pdf

European G8 Members: Summit of European G8 members - Statement,

http://www.elysee.fr/documents/index.php?mode=view&lang=fr&cat_id=1&press_id=1881

IMF: The Recent Financial Turmoil—Initial Assessment, Policy Lessons, and Implications for Fund Surveillance,

http://www.imf.org/external/np/pp/eng/2008/040908.pdf

Robust arrangements for dealing with stress in the financial system

CGFS: Central bank operations in response to the financial turmoil,

http://www.bis.org/publ/cgfs31.htm

BIS: MC Compendium - Monetary policy frameworks and central bank market operations, http://www.bis.org/publ/mktc02.htm

IADI: Core Principles for Effective Deposit Insurance Systems - International Association of Deposit Insurers,

http://www.iadi.org/IADI%20Core%20Principles/FSF%20-%20IADI%20Core%20Principles%20final%2029%20Feb2008.pdf

VI Publications by the Private Sector

Counterparty Risk Management Policy Group (CRMPG III), “Containing Systemic Risk: The Road to Reform”,

http://www.crmpolicygroup.org/docs/CRMPG-III.pdf

The Institute of International Finance (IIF), “Final Report of the IIF Committee on Market Best Practices: Principles of Conduct and Best Practice Recommendations”, http://www.iif.com/

European and Global Trade Associations: Industry Take Further Steps Toward Improving Transparency,

http://www.europeansecuritisation.com/dynamic.aspx?id=1518