5 February 2008

FSF Working Group on Market and Institutional Resilience

Interim Report to the G7 Finance Ministers and Central Bank Governors

Since the Working Group's preliminary report in October, we have continued to sharpen our analysis of the causes of recent events and the appropriate responses to them. This interim report discusses the Working Group's views to date on adjustments and near term challenges in the financial system; the causes of and weaknesses revealed by market turbulence; and broad policy directions for strengthening the resilience of key elements of the financial system.

The work programmes of the international supervisory, regulatory and central bank committees and national authorities to diagnose the causes of the turmoil and to address weaknesses are playing an important role in the Group's work.[1] The Group will continue to consolidate these diagnoses and develop specific recommendations for its report in April.

I. Current conditions and adjustments in the financial system

Since last autumn, we have seen some easing of conditions in money markets but growing worries about the impact of asset price declines and anticipated credit impairment on financial institutions' capital and lending capacity. As institutions adjust to these conditions, the potential exists that risk shedding could tighten credit constraints on a widening set of borrowers and thereby slow economic growth, which could further impair credit. Uncertainty about how much these forces will affect growth in turn affects asset pricing and earnings prospects at financial institutions. There remains a risk that further shocks may lead to a recurrence of the acute liquidity pressures experienced last year. It is likely that we face a prolonged adjustment, which could be difficult.

Although the environment has weakened since October, a number of adjustments have taken place that should help to mitigate the ongoing impact of the turmoil on financial markets. Considerable de-leveraging has taken place since the start of the turmoil, including a substantial shrinkage of the weakest components of the conduit and SIV sector. While this has contributed to market strains and difficult liquidity conditions in the period to date, it has diminished a potential source of downward market amplification going forward. Coordinated central bank liquidity operations since December have led to a substantial easing of strains in money and interbank markets.

---

[1] The Working Group comprises national authorities, the chairs of international supervisory, regulatory and central bank bodies and the relevant international institutions as members. The Basel Committee on Banking Supervision (BCBS), the International Organization of Securities Commissions (IOSCO), the Committee on the Global Financial System (CGFS), the Committee on Payment and Settlement Systems (CPSS), the Joint Forum, the International Accounting Standards Board (IASB), the BIS, the ECB and the IMF are the international organisations that are members of the Working Group in addition to national authorities.

Significant steps have also been taken by financial institutions to reduce the information problems associated with the characteristics and valuations of structured finance products, off-balance sheet vehicles, and banks' exposures that amplified the turmoil last autumn. Although uncertainty remains about the ultimate scale of losses and value of some asset holdings, iterative adjustments in valuation assumptions have provided a firmer foundation for judgments about the condition of key institutions. Importantly, some larger financial firms have taken actions and are planning to take further steps to raise capital.

Amidst difficult conditions, some aspects of the financial system have continued to function well. The trading and settlement infrastructure has handled very large market swings and increased trading volumes well. Credit markets for corporations and consumers have proven largely resilient. On balance, capital buffers at large institutions have remained well above regulatory minima.

Nevertheless, given the continued uncertainty about the scale and distribution of further losses and about the macroeconomic outlook, risk aversion has expanded to a broader set of markets and products. The wider ramifications for credit markets and financial counterparties of the difficulties facing the monoline insurance sector are illustrative of the complex network of interdependencies in the financial system and of the need for co-operation amongst authorities and market participants to respond to current challenges.

Short-term actions

The most immediate task for market participants is to rebuild confidence in the creditworthiness and robustness of financial institutions. This is a necessary condition for the re-establishment of adequate market liquidity and credit intermediation. As just noted, such a confidence-building process is underway but can only be solidly achieved through appropriate valuation of assets and risk exposures and adequate capital and liquidity buffers. While authorities should avoid hasty prescriptive measures, official policy responses can buttress these market efforts. Market participants and policymakers should give priority to near-term confidence-building actions, including the following:

- Realistic asset pricing is critical to restore asset market liquidity and market-based credit intermediation. *Firms* need to recognise the realistic market value of their assets and the uncertainties that exist around those values. The sooner this happens, the sooner buyers will return and the overhang in markets will clear.
- *Financial institutions and auditors* have worked together to improve valuation approaches and risk disclosures for structured products in end-year financial accounts. But further work is needed in the near-term to provide confidence to markets that valuation practices and related loss estimates are adequate and allow for more meaningful comparisons. Firms should provide clear disclosure of their risk exposures and the methodology used in determining these exposures. *Securities regulators and supervisors* are taking steps to encourage appropriate disclosure, and should develop and enhance existing arrangements to share information with each other and with central banks on key firms.
- *Supervisors* will continue to work closely with individual financial institutions to ensure that their capital and liquidity levels can adequately buffer them against the rapidly evolving risks and that, where needed, those buffers are replenished.

- *Central banks* will continue to respond flexibly and rapidly to developments, working in concert when necessary. But central banks are conscious that liquidity operations cannot substitute for the more fundamental need for the market to recover confidence that the current risks to the financial system are manageable.

The Working Group recognises that an important source of uncertainty about the strength of the financial system is the outlook for growth and its implications for asset values. The recovery of the financial sector will therefore depend, at least in part, on greater confidence that the downside risks to economic activity have been contained.

II. Underlying causes and weaknesses

With conditions still evolving and extensive work streams within the FSF membership underway, it is too early to draw final lessons.

The Working Group is distinguishing in its work between factors that contributed to the build-up of excessive credit exposures and those that triggered and amplified the turmoil. While some factors can plausibly be assigned to either category, the distinction is useful in terms of developing and evaluating potential policy responses.

The build-up of excessive exposures had a range of causes and drivers. Unusually benign global macroeconomic, monetary and financial conditions over recent years bred high risk appetites, a reach for yield and rising leverage among financial institutions, investors and borrowers. A wave of financial innovation created instruments and risk exposures so complex that risk management systems at a broad range of financial institutions, including many of the largest global banks, failed to control them effectively. Among the specific weaknesses that the Working Group has identified as having played a critical role in contributing to the build-up of exposures are the following:

- *Poor underwriting and some fraudulent practices in the US subprime mortgage sector*, in part reflecting gaps in the US regulatory structure, but also widespread expectations that house prices would continue to rise.
- *Shortcomings in firms' risk management practices*: poor assessment and/or management of market and funding liquidity, concentration and reputational risks, including from off-balance sheet exposures, and insufficient regard to tail risks and their interaction under stress.
- *Poor investor due diligence practices,* including excessive, too often mechanical, reliance on credit rating agencies (CRAs); limited understanding of the nature of the ratings and of the characteristics of the complex instruments; and inadequate use of information provided.
- *Poor performance by the CRAs* in evaluating the risks of subprime residential mortgage backed securities and CDOs of asset-backed securities.
- *Incentive distortions of various kinds:*
    - *The pre-Basel II capital framework* that encouraged banks to securitise low risk assets and, importantly, to support securitisation of high risk assets through instruments with lower capital charges (such as 364-day liquidity facilities).

- *Weak incentives for parties in the originate-to-distribute chain* to generate and provide initial and ongoing information on the quality and performance of underlying assets. Mechanisms to address these issues weakened in recent years as risk premia fell, securitisation markets grew and products became more complex.
- *Compensation schemes* in financial institutions that encouraged disproportionate risk-taking with insufficient regard to longer-term risks. These risks were not subject to adequate checks and balances in firms' risk management systems.

- *Public disclosures* that were required of financial institutions that did not always make clear the risks associated with their on- and off-balance sheet exposures.

The amplifiers relate to factors that shaped the responses of market participants and public authorities to market shocks, including the information available to them and their capacity to take stabilising actions. As in many previous episodes of financial turmoil, this one featured broad increases in risk aversion, falling market liquidity and de-leveraging that helped to amplify the initial shock. In addition, a number of specific amplifying factors played a prominent role in this episode. Amongst these were:

- *Bank-sponsored off-balance sheet vehicles* (conduits and SIVs) that issued shorter-term liabilities against these complex products and lacked adequate capital and liquidity resources to support the liquidity and maturity transformation in which they were engaged.
- *Actions by firms to build up liquidity* to fund contingent commitments and/or in anticipation of the increased likelihood they would be called on to fund such commitments.
- *Shortcomings in modelling and valuation of complex instruments*, which meant that firms and investors misjudged or were unable to rapidly assess their exposures once ratings deficiencies emerged and liquidity evaporated.

In considering areas for policy responses, we are giving priority to identifying corrective actions going forward that are most likely to achieve tangible gains, whether these be actions by individual firms, by private sector groupings, or by public authorities.

Considerations that should guide the policy response

Financial institutions, investors and CRAs have strong incentives to address many of the weaknesses that have come to light. However, authorities need to ensure that an appropriate incentive structure is in place and that tail risks are adequately controlled. And they must decide where a greater element of prescription about transparency will be necessary, given potential collective action problems and other market failures. Authorities should not pre-empt or hinder market-driven adjustments, but monitor them and add discipline where needed.

Authorities must do all they can to identify emerging problems so as to be able, if necessary, to take prompt appropriate action to mitigate them. But we must also recognise the difficulty in foreseeing and preventing financial crises. Efforts must therefore be focused at trying to ensure that the core of the system is resilient when markets come under stress. Authorities should closely monitor developments affecting core financial firms' resilience, and focus on incentives that promote institutional and market discipline, using tools under their control.

Specifically, supervisors need to sharpen incentives for regulated institutions to improve risk management and stress-testing practices and the adequacy of their capital and liquidity buffers. They must do so in a manner that encourages firms to exercise sound governance practices that result in disciplined risk-taking, without attempting to replace firms' judgment.

Supervisors and central banks should work to identify and address practices and mechanisms that have the effect of amplifying market turmoil once it occurs. A significant element in the present turmoil was the re-concentration of liquidity and credit risks onto banks' balance sheets from off-balance sheet entities they had constructed. The market shock was also amplified by uncertainty about the distribution of losses, the unforeseen linkages among certain types of risks, the uncertainty surrounding asset valuations, and the size of exposures to underlying credit problems relative to banks' capital base.

Supervisors and regulators need to make sure that the risk management and control framework within financial institutions keeps pace with the innovation and dynamic change in financial markets and business models. The challenge is to find a balance that fosters innovation, without leaving the system too vulnerable to the excesses and risks that tend to accompany large structural shifts. Events have shown that the quality of risk management varied significantly amongst the largest and apparently most sophisticated market participants. Though the problems first became visible in the US sub-prime sector, they reflect more generally excessive risk taking and leverage, and weak risk management and asset valuation practices, in many financial institutions across a number of countries.

Authorities must be vigilant to the stability risks that can emanate from the periphery of the financial system and seek effective ways to mitigate them. Where market discipline fails, expanding the scope of regulatory coverage must be considered. But not every market failure in financial systems has an appealing or effective regulatory solution. Additional regulations can also create new areas for regulatory arbitrage or promote moral hazard where they stretch the resources of supervisors and regulators too far. Authorities therefore need to be careful that their efforts to correct one market distortion do not create a new one.

III. Areas for policy consideration

Working Group members agree on the following policy directions to support and extend the large number of efforts by member bodies of the FSF and others in the private and public sectors. The Working Group will deliver specific recommendations in its final report in April.

1. Supervisory framework and oversight

- *Capital arrangements:* A resilient framework for capital requirements is central to creating appropriate capital buffers in the system and the right incentives for risk management. The implementation of Basel II, and the use of its three reinforcing pillars, is an important step to achieve this. The Basel Committee will take account of the lessons from recent events and assess whether refinements to the Basel II framework are needed, including with respect to the calibration of certain aspects of the securitisation framework. Supervisors will need to monitor and use the flexibility within Basel II, including its Pillar 2, to ensure that capital buffers are appropriately forward-looking and take account of uncertainty associated with valuations. Bearing in mind that some financial institutions

have had to raise additional capital as a result of the turmoil, supervisors should also consider the need for additional capital buffers or, as appropriate in national contexts, supplementary measures of capital strength as a complement to risk-based capital adequacy measures.

- *Liquidity buffers:* The turmoil has demonstrated the need for larger and more robust liquidity buffers and an internationally shared view among supervisors on sound liquidity risk management guidelines. Strengthening industry and supervisory sound practice standards for liquidity risk management, including stress testing, contingency funding plans, disclosure and control of intraday risks, should have the highest priority. The Basel Committee is developing recommendations on this subject. Supervisors and central banks should also examine the scope for the development of a more robust and internationally consistent approach to liquidity risk supervision for cross-border banks. Large banks' liquidity contingency plans should be shared with central banks.
- *Risk management practices:* Supervisors should focus on the capacity of a firm as a whole to manage risk. This involves not only assessing firms' risk management capacity but also the extent to which firms integrate their risk assessments into their overall decision-making processes and controls. Supervisors need to sharpen firms' focus on tail risks and enhance stress-testing regimes in order to identify and mitigate the build-up of excessive risk exposures and concentration risks. Firms' managements need to act proactively in response to stress test results. Pillar 2 of Basel II provides a useful framework for implementing these approaches. The ongoing multilateral supervisory review will also make recommendations in these areas.
- *Off-balance sheet activities*: Basel II strengthens incentives in the financial system to manage risks appropriately and will reduce the regulatory arbitrage that generated large off-balance-sheet risk exposures. Basel II provides a framework within which to adapt capital requirements and associated guidance to ensure that its incentives remain appropriate as financial markets and the complexity of financial products evolve. Supervisors will examine the incentives provided by Basel II and accounting treatments that might induce financial institutions to remove assets from the balance sheet.

2. Underpinnings of the originate-to-distribute model

- The underpinnings of the OTD model – including origination and underwriting standards, transparency at each stage of the securitisation process, the role and uses of credit ratings – need to be strengthened. Originators, underwriters, rating agencies and investors are working to this end. Authorities must ensure that an appropriate incentive structure comes into place. US regulatory authorities must continue to investigate the extent to which underwriting weaknesses or possibly fraudulent practices comprised part of the broader sub-prime problem.
    - Institutions arranging securitised products should be transparent about the underwriting standards for the underlying assets and the risk characteristics of structured financial products. They should also make available to investors and CRAs the results of their own due diligence. Market-based measures to address potential incentive problems in the securitisation chain are crucial to the viability of the OTD model.

- Authorities should encourage private sector initiatives to increase access to information on underlying assets.

3. The uses and role of credit ratings

- Investors, many of whom have relied inappropriately on ratings in making investment decisions, must obtain the information needed to exercise due diligence. Investment guidelines should recognise the uncertainty around ratings and differentiate products according to their risk characteristics.
- CRAs must clarify and augment the information they provide to investors on structured finance products. They should ensure that uncertainties surrounding their models and rating methodologies are made transparent. We welcome that CRAs are considering differentiating ratings of such products from corporate ratings.
- Issuers, underwriters and sponsors should take reasonable steps to ensure the accuracy and robustness of information provided to CRAs as well as to investors. CRA assessment of the credibility of this information is needed to improve rating accuracy.
- CRAs need to take adequate steps to address concerns about potential conflicts of interest, including concerns about their remuneration models. The IOSCO Code of Conduct will be modified to address these concerns.
- Authorities should examine whether the roles that they have assigned to ratings in regulation and supervisory rules are consistent with the objective of having investors make independent judgment of risks and perform their own due diligence, and do not induce uncritical reliance on credit ratings as a substitute for that independent evaluation.
- Authorities are aware that credit ratings play an important role in investment and risk management frameworks. The transitional implications of any changes to ratings frameworks or to regulation and supervisory rules should be carefully considered.

4. Market transparency

- Financial institutions need to improve the usability of disclosed information about risk exposures and valuations, including those related to structured products and off-balance sheet vehicles. Investors, industry representatives and auditors should work together to identify the types of relevant and useful disclosures, including those about valuation methodologies and the key valuation assumptions and drivers of changes in value.
- Further improvements are needed in firms' valuation methodologies and in the data that they use as inputs to their valuation processes, in particular when markets are illiquid. Firms that ordinarily look to prices established in liquid markets need to have in place methodologies for valuing assets when markets become illiquid. Industry associations, standard setters and auditors should work to this end.
- Authorities should encourage market-led improvements in market transparency and disclosure standards. But a more prescriptive approach by securities market regulators, bank supervisors and accounting standard setters may prove necessary if these are inadequate.
- The disclosure requirements under Pillar 3 of Basel II are an effective tool for enhancing transparency and risk management practices at banks in light of market developments.

The Basel Committee should encourage proper implementation of Pillar 3 disclosures (including risk information about exposures, securitisations, and structured products), and consider whether they need to be further enhanced.

5. Supervisory and regulatory responsiveness to risks

- Supervisors, central banks and financial authorities - individually and collectively - need to become more effective in translating risk analysis into action. Cooperation, including the exchange of information, needs to improve at both national and international levels.
    - *Supervisors and regulators* must ensure that the skills of supervisors and the scope of risk management systems keep pace with and take account of financial innovation.
    - *Supervisors and regulators* should communicate early their concerns about risk exposures and the quality of risk management practices to the boards and senior management of firms.
    - *International committees* should speed up their policy decision-making processes concerning areas of risk in financial institutions and markets.
- *Coordination* between the supervision of individual institutions and the broader view arising from central banks' financial stability analysis should be enhanced. The supervision of individual institutions should be informed by the results of central banks' assessments of the stability of the broader financial system, and the central bank assessments should be informed by supervisory assessment of individual institutions.

6. Authorities' ability to respond to crises

- *Central banks'* operational frameworks must be able to supply liquidity effectively when markets and institutions are under stress. Central banks are actively investigating what lessons they can draw from recent experiences for their operational frameworks, including the capacity to provide liquidity broadly and flexibly under stressed conditions, for their communication with markets, and for the steps that might be advisable across central banks to address liquidity needs in globalised financial markets. This includes an examination of the scope for greater consistency in eligible collateral policies.
- *Authorities* need to strengthen, where appropriate, arrangements (legal frameworks for resolution, deposit insurance, etc) for dealing with weak and failing banks, both nationally and cross-border.