FSB FINANCIAL STABILITY BOARD

Overview of Progress in the Implementation of the G20 Recommendations for Strengthening Financial Stability

Report of the Financial Stability Board to G20 Leaders

4 November 2011

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I. Introduction

Since the onset of the global financial crisis, the G20 has established core elements of a new global financial regulatory framework that will make the financial system more resilient and better able to serve the needs of the real economy. National authorities and international bodies, with the Financial Stability Board (FSB) as a central locus of coordination, have further advanced this financial reform programme, based on clear principles and timetables for implementation. This report details the additional progress made in developing and implementing global policy reforms since the G20 Seoul Summit in November 2010.

Major international policy reforms have now been agreed, to address risks and strengthen regulation across the financial sector. A key goal of the policy reforms has been to reduce the moral hazard and other risks associated with systemically important financial institutions (SIFIs) whose disorderly failure, because of their size, complexity and systemic interconnectedness, would cause significant disruption to the wider financial system and economic activity. A comprehensive standard for reform of resolution frameworks has now been established that, when fully implemented, will enable authorities to resolve failing financial institutions quickly without destabilising the financial system or exposing taxpayers to the risk of loss. At the same time, failures of SIFIs will be made less likely through greater loss absorbency capacity of global SIFIs (G-SIFIs), more intensive supervision and more robust core financial market infrastructure.

With the strengthening of banking regulations, there is a risk that incentives will increase for market participants to shift banking activities into the less regulated "shadow banking" system. Given the role the shadow banking system played in the crisis, these incentives must be counteracted. The FSB has developed a framework for strengthening the oversight and regulation of the shadow banking system, which includes an annual monitoring exercise and a workplan for developing detailed regulatory policy recommendations in 2012.

As the work to develop international regulatory policy nears completion, attention must increasingly turn to ensuring full and consistent implementation of the agreed policy reforms across jurisdictions, in order to deliver the more resilient global financial system that is needed and to avoid regulatory arbitrage. The implementation timelines that have been set are necessarily ambitious, but realistic. For example, a transition period up to 2019 has been built in for banks to fully implement the new Basel III capital and liquidity frameworks as well as the additional capital surcharges for global systemically important banks (G-SIBs), so as to minimise any burden on economies that are still in the process of recovery.

The FSB is responsible for coordinating and promoting the monitoring of the implementation of agreed G20 and FSB financial reforms and for reporting on it to the G20. Therefore the FSB is setting up a coordination framework, in collaboration with international standard-setting bodies (SSBs), to intensify its monitoring and public reporting of implementation, focusing in particular on priority reform areas. This framework will include rigorous monitoring of Basel II, II.5 and Basel III implementation through the Basel Committee on Banking Supervision (BCBS); a Peer Review Council for

monitoring consistent implementation of global SIFI (G-SIFI) policies; a coordination group on over-the-counter (OTC) derivatives reforms; and ongoing monitoring on the implementation of compensation principles and standards. In addition to detailed monitoring, the FSB Secretariat, in consultation with FSB members, will provide an annual scoreboard to the G20 Leaders tracking progress across the full range of reforms.

This new coordination framework builds on what has already been a wide-ranging process of FSB monitoring, designed to highlight for corrective action areas where there are risks that policy objectives will not be met, or where implementation is not meeting the agreed timelines. Some of these areas are highlighted below.

- Much work remains to establish legal frameworks for effective intervention in failing firms, including those that operate in multiple jurisdictions, and to remove impediments under existing national law to cross-border resolution. The standards set out in the FSB's newly agreed *Key Attributes of Effective Resolution Regimes* are designed to address this. Their implementation will require legislative changes in many jurisdictions.
- Many jurisdictions need to address weaknesses in their supervisors' mandates, to ensure sufficient independence to act, appropriate resources, and a full suite of powers to proactively identify and address risks. The Basel Core Principles for Effective Banking Supervision are being strengthened in this area, raising the international standards that are the subject of IMF-World Bank assessments.
- With only just over one year until the end-2012 deadline for implementing the G20 commitments on OTC derivatives reform, few FSB members have the necessary legislation or regulations in place. Jurisdictions should aggressively push forward to meet the G20 deadline in as many areas as possible, and the FSB will step up its coordination of international policies in this area, including appropriate sequencing.
- International accounting standards will not have converged by the end-2011 deadline previously set by the G20 and, while progress has been made in a number of areas, in some other areas the path to convergence has yet to be identified. The FSB will continue to encourage accounting standard-setters in their ongoing work to complete the convergence process.

New challenges and risks to the financial system will emerge even as we implement the agreed policy reforms. The FSB continuously monitors vulnerabilities in the financial system to identify new risks and, where warranted, recommend regulatory responses. One such example that the FSB has highlighted this year has been the potential systemic risks from developments in the Exchange-Traded Funds (ETF) market.

The following sections describe in greater detail the progress made by the FSB and its members to promote financial stability and strengthen the resilience of the global financial system, including through surveys conducted by the FSB's Implementation Monitoring Network.

II. Improving the soundness of the banking system

1. Basel III capital and liquidity reforms

The Basel III regulatory framework for capital and liquidity was endorsed by the G20 Leaders at their Seoul Summit and the detailed rules text was issued on 16 December 2010.[1] The framework seeks to strengthen the resilience of the banking system through prudential measures that will enhance the quality of capital; increase the level of capital; promote the build-up of capital buffers to mitigate pro-cyclicality; supplement the risk-based capital requirements with a leverage ratio; and introduce a set of global liquidity standards. Refinements to the capital requirements for counterparty credit risk in bilateral derivatives trades were completed in June 2011. Phased implementation of the framework will start on 1 January 2013 with full application by 1 January 2019.

For the newly introduced leverage ratio and liquidity requirements, the Basel III framework includes transition periods that provide for parallel runs and observation. During the transition, the BCBS will closely observe the impact of the new requirements and, if necessary, address any unintended consequences.

The transition period for the leverage ratio that began on 1 January 2011 includes a supervisory monitoring period and a parallel run period. The supervisory monitoring period, which has already begun, is focusing on developing templates for tracking the underlying components of the definition and resulting ratios. During the parallel run period from 1 January 2013 to 1 January 2017, the BCBS will assess whether the proposed design and calibration of the minimum Tier 1 leverage ratio of 3% is appropriate over a full credit cycle and for different types of business models. Bank-level disclosures of the leverage ratio and its components will start on 1 January 2015. Based on the results of the parallel run period, adjustments to the definition and calibration of the leverage ratio will be carried out in the first half of 2017, with a view to migrating to a Pillar 1 treatment on 1 January 2018.

Similarly, the observation period for the liquidity ratios began on 1 January 2011. While the observation period for the Liquidity Coverage Ratio (LCR) extends until mid-2013, the BCBS has agreed to accelerate its review to arrive at any adjustments in key areas well in advance of the mid-2013 deadline. The Net Stable Funding Ratio (NSFR) is expected to be finalised by mid-2016. With any revisions included, the LCR will be introduced on 1 January 2015 and the NSFR will become a minimum standard by 1 January 2018.

Further to the G20 request made in November 2010[2], the BCBS has also evaluated the impact of the regulatory treatment for trade finance, with an emphasis on low income countries. As a result, reductions to the capital requirements for some types of trade finance exposure were finalised at its recent meeting in September.

With the global regulatory framework in place, FSB members have embarked on the process of implementing Basel III in their jurisdictions. The European Commission has put forward a

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1 https://www.bis.org/publ/bcbs189.pdf, and http://www.bis.org/publ/bcbs188.pdf

2 *G20 Seoul Summit Document*, Para.41 and 44 (http://www.g20.org/Documents2010/11/seoulsummit_declaration.pdf)

legislative proposal that would implement the Basel III framework in the EU through a directive and a regulation, and Saudi Arabia has issued draft Basel III regulations. Other jurisdictions are currently in the process of developing their proposals for implementation: for example, China has adopted leverage ratio standards and aims to implement the Basel III capital and liquidity requirements from 2012. Mexico will implement the full capital standards from 2012. However, there are concerns that the implementation of Basel III may not be fully consistent with the global agreement and may not be achieved on time in some jurisdictions. The BCBS and FSB will closely monitor national implementation measures. The BCBS, for example, published in October 2011 a *Progress Report on Basel III Implementation*[3] which provides a high-level overview of its members' progress in adopting Basel II, Basel II.5 (enhancements to trading book exposures and securitisations) and Basel III as of end-September 2011. As a next step, the BCBS is planning to review the consistency of members' national rules or regulations with the Basel III minimum standard to identify differences that could raise prudential or level playing field concerns. This will feed into the FSB's monitoring framework that will provide the basis for reporting to G20 Leaders on implementation of priority reforms.

2. Basel II implementation

At the Pittsburgh Summit in September 2009, G20 Leaders reaffirmed their commitment that all major G20 financial centres adopt Basel II by 2011. Not all major G20 financial centres have yet adopted Basel II. Basel II.5, which the BCBS and FSB agreed should be implemented by end-2011, may also not be implemented in full by all major G20 financial centres by then. A number of emerging market jurisdictions have made progress in implementing Basel II. For example, Indonesia is expected to complete its implementation of Basel II in 2012, and Argentina plans to publish its national regulations for implementing Basel II in 2012. The BCBS will continue to monitor rigorously its members' domestic adoption and implementation timelines for Basel II as well as Basel II.5. The results of such monitoring will be published on a regular basis.

3. Risk Management

A number of supervisory initiatives aim at encouraging improvement in banks' risk management. In June 2011 the BCBS issued two documents to advance the management of operational risk. The *Principles for the Sound Management of Operational Risk*[4] set out 11 principles that are based on industry best practices and supervisory experience and cover three overarching themes: governance, risk management and disclosure. The BCBS expects all banks to establish sound operational risk management and continuously improve their approaches. The second document, *Operational Risk - Supervisory Guidelines for the Advanced Measurement Approaches (AMA),*[5] sets out supervisory guidelines relating to governance, data and modelling for banks adopting AMA under the Basel II framework.

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[3] http://www.bis.org/publ/bcbs203.pdf

[4] http://www.bis.org/publ/bcbs195.pdf

[5] http://www.bis.org/publ/bcbs196.pdf

In addition, in December 2010 the BCBS issued a report[6] that sets out sound practices and recommendations to strengthen the backtesting of internal assessments of counterparty credit risk exposures. Backtesting is an integral element of the model validation process for banks that use internal models to compute their regulatory capital and the financial crisis has revealed that additional guidance in this area is required.

The Senior Supervisors Group (SSG), which is made up of senior financial supervisors from ten jurisdictions, continues to encourage better risk management by banks through identifying key issues and best practices. The SSG issued a report[7] in December 2010 that sets out the progress of financial institutions in developing risk appetite frameworks and in building robust information technology (IT) infrastructures and firm-wide data aggregation capabilities. The SSG concluded that while firms have made progress in these areas, considerably more work must be done. In particular, major banks are challenged in their ability to aggregate risk data, despite its critical importance for strategic planning, decision making and risk management. The SSG will continue to monitor and review practices in these areas periodically.

Following up on the guidance and reports from the BCBS, SSG and other international bodies, national authorities have taken measures to improve risk management practices of banks in their jurisdictions, particularly in stress testing. In the US, the Dodd-Frank Act requires the Federal Reserve Board (FRB) to conduct annual stress tests for all systemically important companies and the companies themselves to conduct semi-annual internal stress tests. Summaries of the stress test results must be published. Germany meanwhile revised in December 2010 its circular on Minimum Requirements for Risk Management, requiring financial institutions to have sound stress testing practices in place. The China Banking Regulatory Commission (CBRC) has conducted stress tests addressing the local property market. The Hong Kong Monetary Authority (HKMA) conducted a benchmarking review to assess the effectiveness of risk management practices in stress testing and issued a circular in August 2011 to the industry on sound practices identified. The HKMA is also finalising a revised stress testing guideline to take account of international standards and best practices.

III. Addressing SIFIs

At the Seoul Summit, the G20 Leaders endorsed the recommendations set out in the October 2010 FSB report *Reducing the moral hazard posed by systemically important financial institutions*.[8] The report specified that the policy framework for SIFIs should combine:

- a resolution framework and other measures to ensure that all financial institutions can be resolved safely, quickly and without destabilising the financial system and exposing the taxpayer to the risk of loss;

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6 http://www.bis.org/publ/bcbs185.pdf

7 *Observations on Developments in Risk Appetite Frameworks and IT Infrastructures*, http://www.newyorkfed.org/newsevents/news/banking/2010/an101223.pdf

8 http://www.financialstabilityboard.org/publications/r_101111a.pdf

- a requirement that SIFIs and initially in particular global SIFIs (G-SIFIs) have higher loss absorbency capacity to reflect the greater risks that these institutions pose to the global financial system;
- more intensive supervisory oversight for financial institutions which may pose systemic risk;
- robust core financial market infrastructures to reduce contagion risk from the failure of individual institutions and
- other supplementary prudential and other requirements as determined by the national authorities.

The FSB has now completed policy development in a number of key areas, as described below. The FSB will establish a Peer Review Council (PRC) to review the full and consistent implementation of the G-SIFI measures. The FSB, working together with the SSBs, will begin this year to define the modalities to extend expeditiously the policy framework to all SIFIs.

1. G-SIFI determination and increasing the loss absorption capacity of G-SIFIs

After a careful review of responses to the July 2011 consultative document,[9] the BCBS has issued a finalised assessment methodology and additional loss absorbency requirements for G-SIBs.[10] The main features remain the same as in the consultative document, with the BCBS making some changes to certain indicators to improve the methodology for identifying G-SIBs, which will be subject to additional testing by March 2012 using updated bank data.

The assessment methodology is an indicator-based measurement approach designed to assess the likely impact of the failure of a bank on the global financial system and wider economy. The selected indicators reflect the *size* of banks, their *interconnectedness*, the lack of readily available *substitutes* for the services they provide, their *global cross-jurisdiction activity* and their *complexity*. This methodology has been used to identify an initial set of 29 institutions as G-SIBs. However, that set is expected to change over time, reflecting changes to institutions and the financial system, thus providing incentives to banks to reduce their systemic importance. The BCBS will continue to improve the quality and transparency of the data underlying the assessment methodology in time for implementation beginning 1 January 2016. The methodology will also be subject to periodic review and refinement to reflect individual bank and system-wide developments. Moreover, structural changes in regional arrangements will be reviewed as actual changes in those arrangements are made.

The additional loss absorbency requirement will need to be met with Common Equity Tier 1 (CET1) capital, which is the highest quality capital. G-SIBs will be allocated to "buckets" requiring levels of additional loss absorbency from 1.0% to 2.5% depending on the systemic importance of the G-SIB. To provide a disincentive for banks facing the 2.5% charge to increase materially their global systemic importance, there is an – initially empty – top bucket requiring 3.5% additional CET1. The requirement will be phased in between 1 January 2016

[9] http://www.bis.org/publ/bcbs201.pdf.

[10] http://www.bis.org/press/p111104.htm.

and 1 January 2019, in parallel with the Basel III capital conservation and countercyclical buffers.

The International Association of Insurance Supervisors (IAIS) is expected to complete its assessment methodology for identifying globally systemically important insurers in time for the G20 Summit in June 2012. In addition, the IAIS will develop a common framework for the supervision of internationally active insurance groups by 2013 in order to foster group-wide supervision and global convergence of regulatory and supervisory approaches.

2. Improving the capacity to resolve firms in crisis

The FSB has finalised the *Key Attributes of Effective Resolution Regimes for Financial Institutions*, [11] following a careful review of responses to the July 2011 consultative document. [12] The Key Attributes form an international standard, setting out the essential elements that all resolution regimes should have to minimise disruptions arising from the failure of a financial institution and ensure that national authorities can resolve institutions in an orderly manner that does not expose taxpayers to the risk of loss. The Key Attributes apply to any financial institution that could be systemically significant or critical if it fails, and, in a manner as appropriate, to financial market infrastructures (FMIs).

The Key Attributes call for jurisdictions to have a designated resolution authority that has a broad range of powers to intervene and resolve a financial institution that is no longer viable, including through transfers of business and creditor-financed recapitalisation ("bail-in" within resolution), in a way that preserves financial stability; ensures continuity of systemically important financial services and infrastructure functions; protects depositors and insurance policy holders; allocates losses to shareholders and unsecured creditors in their order of seniority; does not expose taxpayers to the risk of loss; and avoids unnecessary destruction of value.

For internationally active firms, the Key Attributes also set out a framework for coordination and cooperation that underlines the leading role of the home country authority and creates incentives for national authorities to cooperate in planning for and conducting the resolution of a cross-border firm, while providing adequate safeguards to protect the right of the host country to take independent measures if necessary to preserve financial stability. The framework for cooperation is underpinned by crisis management groups and institution-specific cross-border cooperation agreements for all G-SIFIs.

Because sound planning and preparation are essential, the Key Attributes also call for Recovery and Resolution Plans (RRPs) for G-SIFIs and any other firm that its home authority assesses could have a systemic impact in the event of failure. RRPs will detail credible options for reversing financial deterioration or, where that is not possible, for resolving the failed firm. The preparation and maintenance of RRPs will be supported by resolvability assessments that evaluate the feasibility of resolution strategies in light of the structure of the firm and systemic importance of its functions. Where authorities assess that a firm cannot be

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[11] http://www.financialstabilityboard.org/publications/r_111104cc.pdf.

[12] http://www.financialstabilityboard.org/publications/r_110719.pdf.

effectively resolved under the applicable resolution regime, they will have powers to require the adoption of measures to improve resolvability.

Effective implementation of the Key Attributes will require substantial follow-up work by national authorities, standard setting bodies (SSBs) and firms. Legislative changes will be required in many jurisdictions to ensure that the national resolution framework confers all the necessary powers on national authorities. Firms and authorities will also need to develop RRPs and put in place an ongoing process for planning and cooperation. Changes in the structure and operations of financial institutions may also be needed to ensure that they are resolvable.

Following the crisis, a number of jurisdictions have adopted, or are preparing, legislation to strengthen their resolution regimes. For example, in the US authorities continue to work on implementing the Dodd-Frank Act, which requires resolution plans to be developed and, establishes a framework for the resolution of failed or failing SIFIs. The European Commission is expected to propose an EU framework for the recovery and resolution of financial institutions before the end of 2011. Once adopted, that framework will apply in all 27 EU member states. Meanwhile post-crisis the UK and Germany have adopted legislation, and the Netherlands has consulted on a bank resolution regime. Outside the EU, Brazil is working on legislative proposals to enhance the resolution powers of the central bank and Switzerland has revised legislation. In China, the CBRC has drafted the regulations governing the resolution of banking institutions in collaboration with other authorities.

Authorities have also made progress in establishing crisis management groups and enhancing cross-border cooperation. For example, in a number of countries such as Canada, the Netherlands, Spain, Switzerland, the UK and US, crisis management groups are already operational for the major cross-border banking groups.

A number of authorities have also embarked on the preparation of RRPs:

- The US adopted rules to implement the requirements for resolution plans set out in the Dodd-Frank Act with the largest and most complex firms having to submit their plans by July 2012.
- In France, the largest banks are preparing RRPs, which are expected to be finalised in 2012.
- In Italy, the largest banks and their crisis management groups are preparing RRPs.
- The UK authorities have conducted a pilot project on RRPs involving the six largest UK banks and in August 2011 published a consultation paper setting out the proposed requirements for RRPs that will apply to all UK banks.
- In Canada, draft recovery plans have been developed for the largest banks and are expected to be finalised in 2012. Resolution plans are in the early stages of development and are expected to be finalised by end-2012.
- In Brazil, a regulation has been issued allowing the central bank to require financial institutions to prepare recovery plans.

Such initial steps are welcome, but significant work remains to implement the Key Attributes in a complete and consistent manner across jurisdictions. The FSB will carry out an iterative series of peer review assessments of implementation of the Key Attribute*s*, with a first

thematic peer review beginning by end-2012. The FSB will also regularly monitor progress in the preparation, for all G-SIFIs, of resolvability assessments, due to be completed by October 2012, and institution-specific cooperation agreements and RRPs, which should be finalised by end-2012. The FSB Peer Review Council will by 2013 undertake an initial review of whether the G-SIFI requirements, including relating to RRPs and institution-specific cooperation agreements, have been implemented in an effective manner.

More generally, the FSB, with the involvement of the International Monetary Fund (IMF), the World Bank and sectoral SSBs, will develop an assessment methodology that provides greater technical detail on the various elements of Key Attributes. CPSS and IOSCO are undertaking joint work on recovery and resolution issues for FMIs. If, based on their findings, the FSB concludes that special resolution arrangements for FMIs are required, it will, with the involvement of CPSS and IOSCO, review which *Key Attributes* specifically apply to FMIs and whether further specific powers need to be incorporated in the Key Attributes to address their resolution.

3. Improving the intensity and effectiveness of SIFI supervision

Increasing the intensity and effectiveness of supervision is a key component of the FSB's framework for SIFIs. In November 2010 the FSB released a report on the subject[13], prepared in consultation with the IMF, that drew lessons from the crisis and set out recommendations aimed at making SIFIs, and financial institutions more generally, less susceptible to failure.

Many countries are seeking to make headway in intensifying their supervision of SIFIs by improving their supervisory tools and methods to enable supervisors to focus on key areas of risk and to identify underlying weaknesses in firms' risk management practices. In some cases, supervisory expectations for risk management functions at SIFIs have been increased and some supervisors are clearly communicating that performance previously seen as *satisfactory* is no longer acceptable. At present, supervisors do not consider most SIFIs' risk management control functions to be strong.

To ensure that such changes to supervisory practices endure, the FSB called on supervisors to be held to higher standards. The BCBS is reviewing the Basel Core Principles for Effective Banking Supervision – the global standards against which supervisors are assessed under the IMF-World Bank Financial Sector Assessment Program (FSAP) – and plans to issue the revised Core Principles for public consultation around end-2011. The bar is being raised considerably, including with respect to supervisors' resources and independence. The IMF and World Bank will seek to increase the resources devoted to FSAPs, allowing them to drill down into more details and form more robust opinions on the effectiveness of supervision.

Despite progress made, efforts toward improving the intensity and effectiveness of supervision are not proceeding as quickly as they should and are being hampered by a number of factors. At the forefront are the generally weak state of firms' risk-data aggregation capabilities and a persisting need for improvement of supervisory agencies' resources. The FSB has published a progress report[14] on the implementation of the recommendations of the

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[13] *Intensity and Effectiveness of Supervision*, http://www.financialstabilityboard.org/publications/r_101101.pdf

[14] http://www.financialstabilityboard.org/publications/r_111104ee.pdf.

SIE report and set out five additional recommendations to support ongoing enhancement of supervision. In particular, it recommends that the FSB, in coordination with the BCBS, develop a set of supervisory expectations to improve firms' data aggregation capabilities so that risk exposures are adequately and accurately captured.

The crisis also highlighted the shortcomings in cross-border supervisory relationships, which are being addressed through the strengthening of supervisory college functioning and the establishment of crisis management groups. While colleges have helped to increase communication between supervisors, supervisors do not commonly undertake coordinated supervisory work such as joint supervisory plans and joint examinations. One of the key challenges arises from legal constraints to the ability of supervisors to share data, and this challenge becomes greater the more globally present the financial institution – and hence, the larger the college is.

Supervisory colleges are an important tool and the BCBS and IAIS continue to study and improve their effectiveness. Their work will feed into the next SIE progress report to be submitted to the FSB by end-2012. In this regard, the BCBS conducted a survey in March 2011 to benchmark current practices against its October 2010 *Good Practice Principles on Supervisory Colleges*[15] to gather early feedback on the challenges and inconsistencies in interpreting and implementing the principles and to identify additional tools that might be needed to facilitate implementation of the new principles. The IAIS conducted an impact assessment survey of its October 2009 *Guidance Paper on the Use of Supervisory Colleges in Group-wide Supervision*[16] and is collecting information to assess the need to review and update the supervisory guidance. The IAIS has also conducted a number of regional forums on the effectiveness of supervisory colleges and has developed the IAIS Repository on Supervisory Colleges for insurance supervisors to obtain information and serve as basis for input to other bodies such as the FSB.

4. Strengthening core financial market infrastructures

The robustness of the infrastructure underpinning financial transactions is central to containing contagion in the event of a SIFI failure. The Committee on Payment and Settlement Systems (CPSS) and IOSCO will finalise in early 2012 international standards for core financial market infrastructures. These contain a single, comprehensive set of 24 principles designed to apply to all systemically important payment systems, central securities depositories, securities settlement systems, central counterparties (CCPs) and trade repositories. The principles will form a new and more demanding standard, replacing the three existing sets of CPSS and CPSS-IOSCO standards, *the Core principles for systemically important payment systems* (2001); *the Recommendations for securities settlement systems* (2001); and *the Recommendations for central counterparties* (2004). A consultative paper on the new standards was issued in March 2011.[17]

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[15] http://www.bis.org/publ/bcbs177.htm

[16] http://www.iaisweb.org/__temp/Guidance_paper_No__3_8_on_the_use_of_supervisory_colleges_in_group-wide_supervision.pdf

[17] http://www.bis.org/publ/cpss94.htm

CPSS and IOSCO have also started work on resolution of financial market infrastructures and will work with the FSB to develop sector-specific guidance for the application of the FSB Key Attributes resolution framework to these infrastructures.

IV. Expanding and refining the regulatory perimeter

1. Shadow Banking

At the Seoul Summit, following the completion of the Basel III framework, G20 Leaders called for work to address the potential that strengthened banking regulation would widen regulatory gaps vis-à-vis the shadow banking system. They requested the FSB, in collaboration with SSBs, to develop recommendations to strengthen the regulation and oversight of the shadow banking system.

In response to the G20's request, the FSB formed a Task Force to clarify what is meant by the "shadow banking system" and its role in and risks to the wider financial system; to set out approaches for effective monitoring of the shadow banking system; and to prepare, where necessary, additional regulatory measures to address the systemic risk and concerns about regulatory arbitrage that it poses.

In April 2011 the FSB issued a background note[18] that set out the FSB's thinking on these issues. It defined the shadow banking system on the basis of a practical two-step approach by first casting the net wide to all non-bank credit intermediation for monitoring purposes and then narrowing the focus for policy purposes to a subset where systemic risks (maturity/liquidity transformation, imperfect credit risk transfer and/or leverage) and concerns about regulatory arbitrage are relevant.

The Task Force has since conducted a detailed monitoring exercise to review recent trends in the global shadow banking system and a regulatory mapping exercise to take stock of existing national and international regulatory initiatives relevant to shadow banking. Following its study, the FSB published in October 2011 recommendations for a framework to enhance the monitoring of trends and risks in the shadow banking system, and areas in which regulatory measures should be examined to address these risks.[19]

The recommendations for developing a stronger monitoring framework include high-level principles for authorities and a stylised monitoring process. The FSB will continue to conduct annual monitoring exercises to assess global trends and risks based on the proposed monitoring framework.

The recommendations for strengthening regulation identified five areas where workstreams have now been launched to assess the case for further regulatory action and to report proposed policy recommendations to the FSB:

(i) the regulation of banks' interactions with shadow banking entities (indirect regulation), in particular, examining: consolidation rules for prudential purposes;

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[18] http://www.financialstabilityboard.org/publications/r_110412a.pdf

[19] http://www.financialstabilityboard.org/publications/r_111027a.pdf

limits on the size and nature of a bank's exposures to shadow banking entities; risk-based capital requirements for banks' exposures to shadow banking entities; and treatment of implicit support;

(ii) the regulatory reform of money market funds (MMFs) to mitigate their susceptibility to runs and other systemic risks;

(iii) the regulation of other shadow banking entities, including assessing the scale and risks of these entities and whether enhanced prudential measures (e.g., capital and liquidity regulation) are called for;

(iv) the regulation of securitisation, in particular with regard to retention requirements and transparency; and

(v) the regulation of securities lending and repos (repurchase agreements), including possible measures on margins and haircuts.

For workstream (i), BCBS will develop proposed policy recommendations by July 2012. Similarly, the International Organisation of Securities Commissions (IOSCO) will develop proposed policy recommendations by July 2012 for (ii) and (iv). For (iii) and (v), new workstreams under the FSB Task Force will develop proposed policy recommendations by September 2012 and December 2012 respectively.

2. Hedge Funds

At the Seoul Summit, the G20 Leaders reiterated their commitment to work in an internationally consistent and non-discriminatory manner to strengthen regulation and supervision of hedge funds. Further steps have been taken by international bodies and national and regional authorities to advance this agenda.

- In the US, the Dodd-Frank Act generally requires all advisers to hedge funds (and other private pools of capital, including private equity funds) whose assets under management exceed $100 million to register with the Securities and Exchange Commission (SEC). The recordkeeping and reporting requirements are also designed to require private fund advisers to report information on the funds they manage that is sufficient to assess whether any fund poses a threat to financial stability.
- In November 2010 the European Parliament and Council approved legislation to ensure appropriate oversight and regulation of hedge funds, private equity funds and other important market participants. EU member states must implement the directive by 22 July 2013. As a result, all managers above a certain threshold will need to be authorised and will be subject to disclosure, organisational and operational requirements, including risk management.
- In late 2010, the Australian Securities and Investments Commission (ASIC) surveyed Australia's largest managers (controlling 50% of sector assets) to assess the potential systemic significance of local hedge funds. The data were analysed and a summary was provided to IOSCO. In addition, ASIC released a consultation paper on proposed regulatory guidance on retail hedge fund disclosure in February 2011.

- Singapore will implement changes in early 2012 aimed at enhancing supervisory oversight over fund managers (including hedge funds) and raising the quality of new entrants to the industry. This would include mandatory licensing of fund managers above a specified threshold. All fund managers will also be subject to business conduct and capital requirements. These enhancements are on top of current requirements on all fund managers to disclose appropriate information if requested, including information needed for assessment of systemic risks.

At the international level, IOSCO has carried out a review of the implementation of the six High Level Principles in its report on *Hedge Funds Oversight* of June 2009[20] and of Principle 28 of its *Objectives and Principles of Securities Regulation*[21] on hedge fund regulation, reporting the results to the FSB in October 2011. This review, which covers the steps taken by jurisdictions to meet these principles and the legislative developments, finds that some of the major financial centres have made changes regarding oversight of the hedge fund managers, but that, still, the hedge funds themselves (i.e. the pools of assets) usually enjoy the status of unregulated entities and are often located in tax haven jurisdictions.

IOSCO also carried out its first hedge fund survey, on a "best efforts" basis to collect comparable information as of end-September 2010 on hedge fund exposures and risks globally, and provided high-level summary results from the survey to the FSB in July 2011. While not all member jurisdictions were able to share data due to legal constraints, the survey has provided some useful insights into the estimated 30% of assets under management in the global hedge fund industry captured by the survey. These include: the areas of portfolio concentration; market footprint; levels of leverage; and portfolio liquidity levels. This global survey has also influenced discussions in the US and EU for achieving consistency in information collection and analysis.

Meanwhile, the FSB workstream on shadow banking entities will assess, among other things, whether some types of hedge funds fall within the shadow banking definition.

3. Securitisation

Re-establishing securitisation on a sound basis remains a priority in many jurisdictions in order to support provision of credit to the real economy and improve banks' access to funding. Numerous initiatives by regulators, central banks and the private sector to improve market practices have been undertaken with the aim of rebuilding investor confidence.

To further facilitate such initiatives and to reduce risks stemming from unsound securitisation practices, the FSB has launched a new workstream on securitisation within its work to strengthen regulation of the shadow banking system. The workstream will focus particularly on (i) retention requirements for suppliers of securitisation (e.g. originators, sponsors) and (ii) transparency and standardisation of securitisation products, so as to address misaligned incentives. IOSCO, in coordination with the BCBS, will take stock of implementation in these two areas and develop policy recommendations as necessary for FSB review by July 2012.

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[20] http://www.iosco.org/library/pubdocs/pdf/IOSCOPD293.pdf

[21] http://www.iosco.org/library/pubdocs/pdf/IOSCOPD154.pdf

The Joint Forum's[22] *Report on asset securitisation incentives*,[23] published in July 2011, analyses the incentives to engage in securitisation before the financial crisis, the distortions created by misalignments and conflicts of interest which emerged, and the interplay of incentives in the aftermath of the crisis. It underlines the importance of building an internationally and cross-sectorally consistent regulatory and supervisory framework to address these issues.

In addition to initiatives taken at the international level, some national authorities have made further progress during 2011 in improving securitisation market regulation.

- In the US, the Dodd-Frank Act requires that securitisers retain certain credit risk. In March 2011 the Federal agencies published their joint proposed rules relating to credit risk retention, which require securitisers to retain at least 5% of the credit risk of the assets underlying the securities. The rules will be effective for RMBS one year after the publication of the final rules, and two years after publication for all other ABS. Also as required by Dodd-Frank Act, the SEC adopted new regulations in January 2011 that would require issuers of ABS and the credit rating agencies (CRAs) that rate them to provide new disclosures about representations, warranties and enforcement mechanisms as well as rules that would require issuers of ABS to conduct a review of the underlying assets and make public any asset review reports produced by third parties.
- The EU has adopted legislation providing that banks must apply a 1250% regulatory capital risk weight to exposures to securitisation risk, unless the originator or sponsor (or original lender) has confirmed that it will retain at least 5% of the risk. This EU legislation has already been transposed into the laws of EU member states.
- In April 2011 the Canadian Securities Administrators proposed a framework for the regulation of securitised products that would improve investor protection through enhanced transparency and disclosure requirements.

4. Exchange-Traded Funds (ETFs)

In April 2011 the FSB published a note that discussed the potential risks to financial stability arising from the recent rapid growth and innovation in the ETF market.[24] Associated pieces by the BIS[25] and IMF[26] were published shortly thereafter. The FSB note aimed at improving understanding of the possible emerging issues for financial stability, and encouraging the financial industry, early in the product cycle, to adapt risk management practices, disclosure and transparency to the pace of innovation in the ETF market.

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[22] The Joint Forum comprises members of the BCBS, IOSCO and IAIS and deals with issues common to the banking, securities and insurance sectors, including the regulation of financial conglomerates.

[23] http://www.bis.org/publ/joint26.pdf

[24] http://www.financialstabilityboard.org/publications/r_110412b.pdf

[25] http://www.bis.org/publ/work343.pdf

[26] *Global Financial Stability Report*, April 2011, Annex 1.7, http://www.imf.org/external/pubs/ft/gfsr/2011/01

Among the developments that contributed to heightened complexity and opacity were the branching of ETFs into other asset classes (for example, emerging markets and commodities) where liquidity is typically thinner and transparency lower; and the increased popularity of synthetic ETFs which differ from physical ETFs through the use of derivatives in their structures. Closer surveillance of potential vulnerabilities by market, banking and macroprudential authorities is needed to ensure that the ETF market grows in a safe and sustainable manner.

Market authorities have initiated work to address some of the issues related to ETFs. For example, IOSCO has an ongoing workstream aimed at: (i) examining the experience and key regulatory aspects regarding ETFs across IOSCO members; (ii) identifying the common issues of concern; and (iii) developing, if appropriate, a set of principles or best practices on ETF regulation to address the identified issues for public consultation by early 2012. The European Securities and Markets Authority (ESMA) published in July 2011 a consultation paper on the potential shape of future regulation of ETFs and structured Undertakings for Collective Investments in Transferable Securities (UCITS).[27]

The FSB will continue to monitor developments in the ETF market closely and to engage with the industry, and will consider policy actions as necessary.

5. Differentiated Nature and Scope of Financial Regulation

Following its *Review of the Differentiated Nature and Scope of Financial Regulation* published in January 2010[28], the Joint Forum continues to assess implementation of the report's recommendations. The report focused on areas where differences in the nature and scope of sectoral regulation became sources of systemic risk in the current financial crisis. The Joint Forum is revising its 1999 *Principles on the Supervision of Financial Conglomerates* to address risks posed by unregulated entities. For the insurance sector, the IAIS published in April 2010 a guidance paper on the treatment of unregulated entities which takes into account related lessons learned from the crisis.[29] More generally, lessons learnt from the crisis were taken into account in the recent review and update of the IAIS Insurance Core Principles. IOSCO has also published a discussion paper[30] in February 2011 on the role of securities regulators in mitigating systemic risk. It has also revised its *Objectives and Principles of Securities Regulation* and associated assessment methodology[31] to require that securities regulators take into consideration systemic risk issues and the perimeter of regulation. As part of its review of the Basel Core Principles, the BCBS will strengthen the preconditions for effective banking supervision by setting out the institutional arrangements for identifying risks to the financial system holistically. One of the overarching considerations in updating the Basel Core Principles is to support greater consistency and harmonisation

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27 http://www.esma.europa.eu/index.php?page=home_details&id=586

28 http://www.bis.org/publ/joint24.pdf.

29 http://www.iaisweb.org/__temp/21__Guidance_paper_on_the_treatment_of_non-regulated_entities_in_group-wide_supervision.pdf

30 https://www.iosco.org/library/pubdocs/pdf/IOSCOPD347.pdf

31 http://www.iosco.org/library/pubdocs/pdf/IOSCOPD359.pdf

across financial sectors where appropriate to reduce opportunities for regulatory arbitrage. The BCBS has also started reviewing, within one of the FSB workstreams on shadow banking, whether non-bank entities that banks sponsor or provide implicit support to are adequately captured in the Basel III framework.

V. Improving OTC and commodity derivatives markets

1. Implementing OTC derivatives market reforms

In September 2009 in Pittsburgh, the G20 Leaders agreed that all standardised OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by end-2012 at the latest; OTC derivative contracts should be reported to trade repositories; and non-centrally cleared contracts should be subject to higher capital requirements. The FSB published a report *Implementing OTC Derivatives Markets Reforms* in October 2010 that set out 21 recommendations to address practical issues in implementing the G20 Leaders' commitments.[32]

The FSB's OTC Derivatives Working Group (ODWG) has been monitoring the implementation of the OTC derivatives markets reforms, with reports every six months. The FSB's first progress report was published in April 2011 and expressed concern regarding many jurisdictions' likelihood of meeting the end-2012 deadline.[33]

In October 2011, the FSB published its second progress report, which delivers a more detailed assessment of the implementation of reforms.[34] The report finds that few FSB members have the legislation or regulations in place yet to provide the framework for implementing the commitments to central clearing, organised platform trading and reporting to trading repositories. Consistency in implementation across jurisdictions is critical and, understandably, smaller markets want to see what frameworks the US and EU put in place when developing their own frameworks, particularly in the area of central clearing. Nevertheless, it is important that all jurisdictions advance as far as they are able before finalisation of the US and EU regimes, to be in a position to act expeditiously once rules are finalised in these two largest OTC derivatives markets. Jurisdictions should push forward aggressively to meet the end-2012 deadline in as many areas as possible. The following describes the progress in the key areas of OTC derivatives markets reforms.

- **Central clearing**: FSB members remain committed to changing legislative and regulatory frameworks, as needed, by end-2012 to achieve the G20 commitment to central clearing. Some practical progress continues to be made toward increasing the volumes and expanding the range of products that are centrally cleared. However, some smaller markets want to consider factors such as oversight arrangements, and the availability of infrastructure for indirect clearing, before deciding whether to rely on global infrastructure, or promote local clearing infrastructure. Taking into account

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32 http://www.financialstabilityboard.org/publications/r_101025.pdf

33 http://www.financialstabilityboard.org/publications/r_110415b.pdf

34 http://www.financialstabilityboard.org/publications/r_111011b.pdf

current progress and the pace at which jurisdictions are implementing central clearing mandates, the FSB believes that the target of central clearing for all standardised OTC derivatives contracts will not be fully met by end-2012 in all FSB member jurisdictions.

- **Organised platform trading**. Progress towards the establishment of legislative and regulatory frameworks in the area of exchange and electronic platform trading is markedly behind the progress in other areas. Only the US has enacted legislation and is in the process of implementing its regulations. The EU has established its policy direction and its legislative process is underway. Most other jurisdictions have not yet made basic decisions about regulatory measures, including whether any regulatory action will be taken. Efforts to set an international standard for what the organised platform trading commitment means culminated in the IOSCO *Report on Trading of OTC Derivatives* published in February 2011.[35] IOSCO will prepare an additional report by end-2011 that will consider the existing platforms used for the trading of derivatives and the characteristics of those platforms. No further international policy guidance on implementing this commitment is anticipated.
- **Reporting to trade repositories**. FSB members remain committed to putting in place by end-2012 the legislative and regulatory frameworks for achieving the G20 commitment regarding reporting to trade repositories. However, a number of legal and implementation issues need to be resolved to ensure that the data collected in trade repositories is suitable for meeting different regulatory mandates and that authorities have effective access to data stored in trade repositories relevant to their respective mandates. In this regard, CPSS and IOSCO are carrying forward work on access to trade repository data, including cross-border access by foreign authorities. Actual reporting of OTC derivatives contracts to trade repositories is showing progress in the interest rate, credit, and equity derivatives asset classes. Currently, trade repositories are not operational for the commodity and foreign exchange asset classes, although infrastructure is under development. Based on the current state of implementation, the FSB believes that the target of having all OTC derivatives contracts reported to trade repositories, will not be fully met by end-2012 in all FSB member jurisdictions.
- **Higher capital requirements**. The commitment to higher capital requirements for non-centrally cleared derivatives will be implemented, for banks, through the Basel III framework which strengthens the requirements for counterparty credit risk exposures arising from OTC derivatives transactions. Some aspects of that framework, in particular as it relates to banks' exposures to central counterparties, are still being finalised. The BCBS is consulting the CPSS and IOSCO and it will undertake an impact study to compare the capital charges of non-centrally cleared and centrally-cleared trades. Complementing the BCBS work, the FSB will gather information regarding capital requirements for non-bank regulated entities. Final BCBS rules are expected to be released around end-2011, to permit implementation by end-2012. Additionally, BCBS, CPSS, IOSCO, and the Committee on the Global

[35] http://www.iosco.org/library/pubdocs/pdf/IOSCOPD345.pdf

Financial System (CGFS) are participating in a working group to set margining standards for non-centrally cleared derivatives, with a consultative report expected in mid-2012.

- **Standardisation**. Standardisation is a core element for meeting the G20 commitments relating to central clearing, organised platform trading and reporting to trade repositories. To date, coordinated industry action led by the OTC Derivatives Supervisors Group, composed of the supervisors of the main derivatives dealers, has been the main driver of increased standardisation through a series of quantitative and qualitative commitments. As implementation of the G20 commitments progresses, authorities expect the industry to continue to increase standardisation of OTC derivatives products.

A number of potential overlaps, gaps, or conflicts in legal and regulatory frameworks have been identified and authorities are working on solutions. Further, work is needed to assess whether the issues that have been identified imply material problems for implementation at a global, systemic level. As a matter of priority, specific overlaps, gaps, and conflicts should continue to be discussed by authorities both bilaterally and multilaterally. A coordination group is being established to address some of these issues.

The ODWG will continue to actively monitor the consistency of implementation across jurisdictions. The ODWG will bring any overlaps, gaps, or conflicts that may prove detrimental to the G20 objectives to the attention of the FSB, particularly if there seems to be a risk that these will impede OTC derivatives reforms and will not be satisfactorily resolved through existing bilateral or multilateral channels.

2. Regulation and supervision of commodity derivatives markets

At the Seoul Summit, the G20 Leaders requested further work on regulation and supervision of commodity derivatives markets. The G20 Finance Ministers and Central Bank Governors in April 2011 asked IOSCO to finalise by September its recommendations on regulation and supervision in this area.

IOSCO published in September 2011 its *Principles for the Regulation and Supervision of Commodity Derivatives Markets*.[36] The report, which was endorsed by the FSB, highlights the key role that market authorities play in helping to ensure that the commodity derivatives markets serve their fundamental price discovery and hedging functions while operating free from manipulation and abusive trading schemes. Market authorities also play a critical role in responding to disorderly market conditions. IOSCO will conduct a survey of the implementation of the principles in 2012.

The Principles cover the following areas:

- *Contract design*: to avoid susceptibility to price manipulation or distortion.

[36] http://www.iosco.org/library/pubdocs/pdf/IOSCOPD358.pdf

- *Market Surveillance*: to detect manipulative or abusive trading practices, including powers needed to access information for on-exchange, OTC and cash market transactions, and the importance of monitoring large positions.
- *Addressing disorderly markets*: the intervention powers needed by market authorities, such as formal position management powers, including the authority to set *ex ante* position limits, as well as other discretionary powers.
- *Enforcement and information sharing*: the powers that are needed to prohibit, investigate and take enforcement actions against market abuse, as well as the need for information sharing among market authorities.
- *Enhancing price discovery*: through the publication of open interest according to certain categories of traders, the establishment of formalised systems to allow regulators to impose position limits; the reporting of OTC derivatives to trade repositories; and enhancing information regarding physical commodities that underlie a financial market contract.

IOSCO, the International Energy Agency, International Energy Forum and the Organization of the Petroleum Exporting Countries submitted to the G20 Finance Ministers and Central Bank Governors in October 2011 a report on how oil spot markets are assessed by price reporting agencies, and how this affects the transparency and functioning of oil markets, as requested by the G20 Leaders in November 2010.

VI. Developing macroprudential frameworks and tools

1. Macroprudential frameworks and tools

The FSB, IMF and BIS published a joint progress report in October 2011 on macroprudential policy frameworks and tools,[37] responding to a request at the November 2010 G20 Summit. The report traces progress in three broad areas: (i) advances in the identification and monitoring of systemic risk; (ii) the designation and calibration of instruments for macroprudential purposes; and (iii) building institutional and governance arrangements in the domestic and international context. The main message of the report is that effective macroprudential frameworks require institutional arrangements and governance structures, tailored to national circumstances, that can ensure an open and frank dialogue among policymakers on policy choices that have an impact on systemic risk, resolve conflicts between policy objectives and instruments, and mobilise the right tools to limit systemic risk.

Although the development and implementation of macroprudential frameworks is still at an early stage, important steps have been taken nationally and internationally. Monitoring efforts have focused on closing data gaps and on developing better indicators and models to assess systemic risk both within and outside the banking system. There has also been progress in developing new macroprudential tools, including Basel III's countercyclical capital buffer and the additional loss absorbency requirement for G-SIFIs, and in assessing the effectiveness of existing ones. A number of jurisdictions have been adjusting institutional arrangements to

[37] http://www.financialstabilityboard.org/publications/r_111027b.pdf

support macroprudential policy, and international workstreams have examined key characteristics of these arrangements.

There is scope for further progress in several areas. First, further fundamental and applied research is needed, not least to better inform the collection and analysis of data underway. Second, newly-introduced tools will need to have performance evaluated against expectations. Finally, many jurisdictions still lack specific institutional arrangements for the conduct of macroprudential policy and those that have recently introduced them will need to gather experience on their performance.

A number of jurisdictions have made further progress in developing macroprudential frameworks at both national and regional level. In some cases, this involves rethinking the appropriate institutional boundaries between central banks and financial regulatory agencies, or the setting up of dedicated policymaking committees. In others, efforts are underway to enhance cooperation within the existing institutional structure.

- In the US, the Financial Stability Oversight Council (FSOC) established by the Dodd-Frank Act creates collective accountability among the federal financial regulators, state regulators and the Treasury for identifying risks and responding to emerging threats to financial stability. The FSOC published in July 2011 its first annual report, highlighting emerging threats to financial stability. The FRB has also begun to incorporate macroprudential considerations in its regulation and supervision of banks.
- In the EU, the European Systemic Risk Board (ESRB), which is responsible for macroprudential oversight of the financial system, became operational in January 2011. The key tasks of the ESRB include identifying and prioritising systemic risks; issuing warnings on those systemic risks that are significant; and making recommendations for remedial action.
- The UK Government set up an interim Financial Policy Committee in February 2011 to identify, monitor and take action to remove or reduce systemic risks.
- Mexico established in 2010 a Financial System Stability Council to identify and address risks and vulnerabilities threatening the functioning of its financial system.
- In Turkey, the Financial Stability Committee (FSC) under the chairmanship of the Deputy Prime Minister for economic and financial affairs was established in June, 2011. The FSC monitors and identifies systemic risks and determines macro-prudential measures and policies as needed.
- In China, the CBRC is set to introduce the conservation buffer and countercyclical buffer requirements as part of its Basel III framework from 1 January 2012.

International cooperation and coordination on monitoring have been enhanced through the work of the FSB Standing Committee for the Assessment of Vulnerabilities, the IMF's regular bilateral and multilateral surveillance and the IMF-FSB Early Warning Exercise. These focus on the identification of common exposures, risk concentrations and interlinkages within and across financial systems, and on the build-up of financial imbalances, both domestically and globally.

2. Addressing data gaps revealed by the financial crisis

Data gaps are an inevitable consequence of the ongoing development of markets and institutions. The lack of timely, accurate information can hinder effective surveillance and policy responses both nationally and internationally. An IMF/FSB report[38] in November 2009 identified the main financial and economic information gaps and made recommendations for closing them.

Following up on some of the recommendations in that report, the FSB issued in October 2011 a consultation paper *Understanding Financial Linkages: A Common Data Template for Global Systemically Important Banks*[39] on a set of options and proposals to introduce a new common data template for G-SIBs, substantially strengthening information on linkages between G-SIBs, their exposures and funding dependencies.

The heart of the proposal is to collect harmonised data in two important dimensions:

- consistent data on the principal bilateral exposures of G-SIBs as well as on their main individual funding providers. Such data are crucial to identify the build-up of exposures to common counterparties and to analyse the potential for contagion and spillover through the financial network.
- granular information on the main exposures and sources of funding of G-SIBs by reference to key markets, sectors and instruments. Such data are essential to detect the build-up of potential risk concentrations and funding vulnerabilities, as well as to analyse the dispersion of exposures and risk positions.

The consultation feedback, along with ongoing work on the legal and policy issues associated with the sharing of commercially-sensitive data, will inform cost-benefit analysis that will guide decisions on the development and implementation of the proposed template. The new template would be introduced in a series of incremental steps to provide institutions with time to meet new requirements.

VII. Strengthening and converging accounting standards

At the Seoul Summit, the G20 Leaders re-emphasised the importance of achieving a single set of high quality, improved global accounting standards and called on the IASB and the FASB to complete their convergence project by end-2011.

Nearly all FSB member jurisdictions have either adopted IASB standards (International Financial Reporting Standards - IFRS) or have programmes underway to converge with, or consider adoption of, IFRS by end-2012. The US SEC continues to work toward making a determination by end-2011 whether to incorporate International Financial Reporting Standards (IFRS) into the financial reporting system for US issuers. Foreign private issuers in the US are already allowed to follow IFRS.

While progress has been made with convergence, the IASB and FASB have further revised their target completion dates for their remaining convergence projects so that they extend into

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[38] *The Financial Crisis and Information Gaps,* http://www.financialstabilityboard.org/publications/r_091107e.pdf

[39] http://www.financialstabilityboard.org/publications/r_111006.pdf

2012, beyond the end-2011 date called for by the G20. The Boards decided to extend certain project target completion dates because stakeholders voiced concerns about their ability to provide high-quality input on the large number of planned major Exposure Drafts. The Boards report that they will not issue a new standard until they have considered whether re-exposure is necessary and until they have considered feedback, so as to promote the high quality of any final standard.

The convergence process is taking longer than initially expected in some areas, such as classification, measurement and provisioning, and it appears that the Boards are diverging with respect to their ongoing projects on hedge accounting. The FSB is encouraging the Boards to redouble their efforts to seek converged standards in these important areas.

With regard to the netting/offsetting of derivative contracts and other financial assets and financial liabilities, where different approaches result in significant differences in the total assets of large financial institutions, the Boards plan to maintain their different current offsetting rules while issuing new requirements for common disclosures about gross and net positions to improve transparency. This follows the Boards' issuance of a joint Exposure Draft in January 2011 on a converged approach to balance-sheet netting. However, instead of the 2011 Exposure Draft, comments from the US generally supported the current FASB netting rules and those using IFRS generally supported current IASB rules, with many investors seeking both gross and net information. Derivatives dealer banks, both inside and outside the US, generally wanted the FASB (net) approach in order to avoid the massive grossing-up of their balance sheets.[40]

Further progress has been made toward FSB recommendations for improved, converged accounting standards as follows:

- **Measurement of loans**: In recommending that the IASB and FASB develop improved converged standards for financial instruments and their valuation, the FSB noted its particular support for standards that would not expand the use of fair value in relation to the lending activities of financial intermediaries. The IASB issued IFRS 9 in 2009 which included an amortised cost category for certain assets, including loans, but there was potential for divergent accounting standards due to a FASB proposal in May 2010 to use fair value measurement on the balance sheet for loans. However, following extensive outreach, the FASB has decided in its revised approach to use amortised cost as a measurement basis for loans.
- **Impairment of financial assets**: Following the FSB's recommendation that accounting standards for impairment should be moved to an expected loss model, the IASB and the FASB are now working to finalise a joint expected-loss provisioning approach that incorporates more forward-looking information about credit losses into impairment measurements and provides for earlier recognition of expected losses.

[40] One concern in this area was that differences in offsetting/netting standards would adversely affect the efforts to develop an internationally comparable leverage ratio for capital purposes. However, while the IASB and FASB have decided to maintain their different accounting rules for netting/offsetting, the FASB netting approach and the netting approach that will be carried forward to the Basel III international leverage ratio are similar in their effect because both recognise netting/offsetting based on legally enforceable master netting agreements. Thus, from a bank supervisory perspective, there may be more convergence for leverage ratio purposes than is first apparent.

- **Addressing valuation uncertainty in fair value measurement guidance:** The FSB has recommended that standard setters and supervisors explore whether firms should be required to hold valuation reserves or to otherwise adjust valuations to avoid overstatement of income when significant uncertainty about valuation exists. Further enhancements to IASB and FASB fair value measurement standards in 2011 have aligned requirements about how to measure fair value, including guidance on measurement when markets become less active, and to address valuation uncertainty.
- **Derecognition and disclosures about off-balance sheet special purpose entities:** The FSB has encouraged improved IASB accounting and disclosure standards for off-balance sheet vehicles. The FSB had also expressed concern that the IASB's consultation proposal on derecognition would require repurchase agreements to be treated as sales and forward contracts in certain situations (thus leading to off-balance-sheet treatment), instead of as financing transactions on the balance sheet as under current IFRS. The IASB decided not to move forward with its proposal. The IASB's final disclosure standards in 2011 enhance information about risk exposures that remain when a financial asset has been derecognised (e.g. securitised), including improved information about unconsolidated structured entities, and are broadly aligned to FASB disclosure requirements.

The G20 Leaders also encouraged the IASB to further improve the involvement of stakeholders, including those from emerging market economies, as part of its independent standard-setting process. The IASB has a programme to further improve the involvement of various stakeholders, including through enhanced technical dialogue with prudential authorities, market regulators and representatives of emerging market economies. For example, the IFRS Foundation (the trustees of the IASB) established in 2011 an Emerging Economies Group to enhance the dialogue with emerging economies in the development process of IFRS. Furthermore, the IFRS Foundation's strategy review should be completed in the next few months, which will include an enhanced Trustees' oversight function to ensure greater accountability that will reinforce expanded involvement by key stakeholders, including emerging market economies.

VIII. Strengthening adherence to international financial standards

The FSB has taken a number of steps to enhance its monitoring of implementation. In particular, it has developed a coordination framework to monitor the implementation of G20/FSB financial regulatory reforms, in collaboration with SSBs. It has undertaken six peer reviews over the past year and will complete three more by early 2012, and is currently undertaking a review of its experience to date with peer reviews in order to identify lessons and improvements to the programme. It has also updated the FSB *Compendium of Standards*, which provides a one-stop reference for the standards that are accepted by the international community as important for sound financial systems. Finally, good progress has been made in the FSB's initiative to encourage global adherence to international cooperation and information exchange, including by identifying non-cooperative jurisdictions.

1. Coordination framework for monitoring the implementation of G20/FSB financial reforms

The FSB is responsible for coordinating and promoting the monitoring of the implementation of agreed G20/FSB financial reforms and reporting on it to the G20. In order to enhance the effectiveness of implementation monitoring, the FSB, in collaboration with the relevant SSBs, has established a Coordination Framework for Implementation Monitoring (CFIM).[41] The CFIM addresses the questions of what to monitor; how to monitor; who should monitor; and to whom the information should be reported and disseminated.

The objectives of the FSB's CFIM are to:

- ensure that implementation monitoring processes are comprehensive, rigorous and timely, and that they promote the overall coherence and consistency of implementation across sectors and functions;
- generate comprehensive and consistent information on the nature and pace of implementation of agreed G20/FSB recommendations so that it can be reported to the G20 and to the public;
- identify and help to reduce impediments to, and gaps in, implementation by providing political impetus and leveraging peer pressure; and
- identify useful lessons from experience on the effectiveness of the policy reforms and the associated standards as well as on any unintended consequences.

The FSB Plenary will determine priority areas where consistent and comprehensive implementation of reforms is particularly important for global financial stability. The CFIM will ensure that these areas are subjected to more intensive monitoring and detailed reporting, including on a country-by-country basis. They include the Basel II, II.5 and III frameworks; OTC derivatives market reforms; compensation practices; resolution frameworks; policy measures for G-SIFIs; and shadow banking. The FSB will continue to monitor implementation of all G20/FSB recommendations through its Implementation Monitoring Network, which will be upgraded for this purpose and will remain the FSB information hub on implementation progress.

2. FSB peer reviews

The FSB's most intensive monitoring mechanism is the peer review programme undertaken through its Standing Committee on Standards Implementation (SCSI). FSB member jurisdictions have committed, under the FSB Charter, to undergo periodic peer reviews focused on the implementation and effectiveness of international financial standards developed by SSBs and of policies agreed within the FSB.

Over the past year, the FSB has completed thematic peer reviews of mortgage underwriting and origination, risk disclosure practices, and a follow-up review of compensation practices (see below). It has also completed country peer reviews of Italy, Spain and Australia.[42] Three

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41 http://www.financialstabilityboard.org/publications/r_111017.pdf

42 http://www.financialstabilityboard.org/list/fsb_publications/tid_141/index.htm

more peer reviews – a thematic peer review of deposit insurance systems and country peer reviews of Canada and Switzerland – will be completed in early 2012. One of the recommendations from the peer review of mortgage underwriting and origination was for the FSB to develop an international principles-based framework for sound underwriting practices. The FSB has since published in October draft principles for consultation.[43]

The FSB is also undertaking a review of experience to date with FSB peer reviews in order to identify lessons and make recommendations to improve the functioning of the peer review programme, and revise the *Handbook for FSB Peer Reviews* accordingly. The review will be completed by end-2011.

3. Follow-up peer review on compensation practices

The FSB's thematic peer review on compensation practices published in October 2011[44] assesses progress made both by national authorities and by significant financial institutions in implementing the FSB *Principles for Sound Compensation Practices* and their *Implementation Standards*. The review, which follows an earlier review completed in March 2010, found that relevant authorities and firms in FSB member jurisdictions have made good progress in implementing the Principles and Standards. Many national authorities have taken the necessary regulatory actions, supervisory oversight has intensified, and the governance of compensation schemes at firms has improved. However, the review also found that more work is necessary to achieve sound compensation practices – both to address remaining implementation gaps, and to address concerns over different interpretations of the standards that may give rise to an uneven playing field in the market for highly skilled employees. The review accordingly makes a number of recommendations to promote full implementation by national authorities and firms.

Achieving lasting change in behaviour and culture within firms is a long-term challenge that requires a sustained commitment. The FSB will undertake ongoing monitoring and public reporting on the implementation of the Principles and Standards as part of its coordination framework for monitoring agreed G20/FSB financial reforms. In addition, the report recommends that national supervisors work bilaterally to verify and, as needed, address specific level playing field concerns raised by their institutions. Specifically, the national supervisors should report the nature of the concerns, the actions taken to address them and the outcomes at least annually to the FSB. Based on the findings from the ongoing monitoring, the FSB will consider the scope and appropriate timing for a follow-up peer review on compensation practices as well as any decision to issue additional FSB guidance on the interpretation of the definition of material risk takers.

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[43] *FSB Principles for Sound Residential Mortgage Underwriting Practices:* http://www.financialstabilityboard.org/publications/r_111026b.pdf

[44] http://www.financialstabilityboard.org/publications/r_111011a.pdf

4. International cooperation and information exchange initiative

In March 2010, the FSB launched an initiative to encourage the adherence of all jurisdictions to regulatory and supervisory standards on international cooperation and information exchange, including by identifying non-cooperative jurisdictions and assisting them to improve their adherence. The initiative responded to a call by the G20 Leaders at their April 2009 Summit for the FSB to develop a toolbox of measures to promote adherence to prudential standards and cooperation. The FSB has prioritised about 60 jurisdictions for evaluation, including all 24 FSB member jurisdictions and non-FSB jurisdictions that rank highly in financial importance.

In a progress report published in April 2011,[45] the FSB reported that the initiative was making good progress. All but a few of the jurisdictions prioritised for evaluation either already demonstrated sufficiently strong adherence to the relevant standards, or were in the process of implementing reforms to strengthen their adherence. To recognise the progress that jurisdictions have made toward addressing weaknesses in international cooperation and information exchange, and to incentivise improvements by those jurisdictions not cooperating fully, the FSB published ahead of the Cannes Summit the names of all jurisdictions evaluated, including non-cooperative jurisdiction, which are not cooperating fully with the evaluation process or which show insufficient progress in addressing weak compliance with internationally agreed information exchange and cooperation standards.[46]

5. Compendium of Standards

The FSB's Compendium of Standards provides a one-stop, easy-to-understand reference for the various economic and financial standards that are accepted by the international community as important for sound financial systems. It was first developed in 1999 by the Financial Stability Forum[47] and has been updated periodically. The Compendium includes both the key standards in 12 policy areas that the FSB has designated as deserving priority implementation depending on country circumstances, and other standards that are complementary in nature and cover particular functional areas.

The FSB has recently undertaken a comprehensive review of the Compendium. As part of that work, the FSB approved revisions to the list of key standards in early 2011.[48] This involved the addition of a new policy area on 'Crisis Resolution and Deposit Insurance', reflecting its importance as illustrated in the recent financial crisis, as well as the inclusion of the CPSS-IOSCO *Recommendations for Central Counterparties*[49] and the International Association of Deposit Insurers (IADI)-BCBS *Core Principles for Effective Deposit Insurance Systems.*[50]

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45 http://www.financialstabilityboard.org/publications/r_110429.pdf

46 http://www.financialstabilityboard.org/publications/r_111102.pdf

47 The Financial Stability Forum was founded in 1999 by the G7 Finance Ministers and Central Bank Governors. The Financial Stability Board was established in April 2009 as the successor to the Financial Stability Forum.

48 http://www.financialstabilityboard.org/cos/key_standards.htm

49 http://www.bis.org/publ/cpss64.pdf

50 http://www.iadi.org/NewsRelease/JWGDI%20CBRG%20core%20principles_18_June.pdf

The FSB will publish its updates to the other standards featured in the Compendium in late 2011. It has also agreed on a process for periodic reviews of the Compendium in general, and of the key standards in particular. Presentation of the Compendium on the FSB's website will be enhanced in order to facilitate its use and to enhance its visibility.

IX. Other issues

1. Reducing reliance on credit rating agency (CRA) ratings

In October 2010, the FSB published a set of principles for reducing reliance on CRA ratings, and requested standard setters and regulators to consider next steps to translate the principles into more specific policy actions, with a view to transition to a reduced reliance on CRA ratings over a reasonable medium term timeframe, but with clear milestones.

The FSB's review of the steps taken to date, as well as plans to translate the principles into specific policy actions, has found that work to reduce reliance remains at an early stage, both at standard setters and at many national authorities. The FSB will further discuss what actions can be taken to accelerate progress. Future progress reports will provide more detailed information not only of the work of SSBs but also national and regional regulators, as well as the milestones for future actions.

Standard setters report the following actions.

- The BCBS's Basel III framework includes several measures for minimising cliff effects and addressing negative incentives arising from the use of ratings in the Standardised Approach for credit risk and credit risk mitigation techniques. It is reviewing the securitisation framework to reduce reliance when assigning regulatory capital, and will undertake further work in 2012 to analyse, and ultimately reduce, reliance on external credit ratings under Basel III.
- IOSCO's reviews to date have not identified any area where it concludes that its principles for securities markets need to be revised to reduce reliance on ratings. However, it continues to examine national regulations relating to the use of ratings by market participants.
- The IAIS has begun taking steps to translate the principles into policy recommendations for the insurance sector. As part of its revision of the Insurance Core Principles, it is reinforcing the need for insurance companies to make their own credit assessment of assets and counterparties, and recently began developing a discussion paper that considers alternative means of assessment.
- The CGFS plans to hold a workshop at which central banks can share experiences on their use of credit ratings and ways to reduce reliance. Otherwise, reduction in reliance by central banks has been left to national jurisdictions.
- The Organisation for Economic Cooperation and Development (OECD)'s Working Party on Private Pensions (WPPP) plans to discuss in November 2011 reliance on CRA ratings as the basis for a proposal for revisions to the OECD Core Principles in

this area, to be approved by the WPPP by end-December 2012 and by the OECD Council by early 2013.

Due to the lack of an international standard-setter for margin agreements, work to translate the principles into specific policy actions in this area has not yet begun. The forthcoming FSB shadow banking workstream on securities lending and repos, and any resulting policy options, may provide a framework in which the issue of ratings reliance in margin agreements can be addressed.

A number of national and regional regulators have begun to take steps to reduce reliance on CRAs in their laws and regulations.

- In the US, the Dodd-Frank Act requires federal agencies to remove all references to or requirements for credit ratings from regulations and substitute alternative standards of creditworthiness determined by the agencies to be appropriate. US regulators have conducted consultations, made proposals where possible, and adopted a first set of rules removing references to CRAs to address this Dodd-Frank requirement.
- The European Commission has proposed action with respect to banks as part of its Capital Requirements proposal in July 2011 and will do so for the insurance, asset management and investment fund sectors by end-2011.
- Japan has also reviewed the use of credit ratings in securities regulations, and has removed requirements for references to credit ratings from the process of securities registration.
- Financial authorities in Mexico have amended their regulatory framework for banking institutions to reduce the reliance on CRA ratings.

2. Financial stability issues in emerging market and developing economies (EMDEs)

At the Seoul Summit, the G20 Leaders asked the FSB, IMF and the World Bank to deliver a report on financial stability issues that are of particular interest to EMDEs. A task force of FSB members, staff of the IMF and World Bank, and senior policymakers from some EMDEs outside the FSB prepared the report, which focuses on five key issues: (i) application of international financial standards; (ii) promoting cross-border supervisory cooperation and information exchange; (iii) adjusting the regulatory and supervisory perimeter to reflect the growth in, and the risks arising from, small-scale non-bank lending and deposit-taking institutions; (iv) managing foreign exchange risks; and (v) developing domestic capital markets.

The report makes recommendations on how national authorities in EMDEs can address these issues and on how the international community can support them in this.[51] Its recommendations include: that the international community send a clear and consistent message on the appropriate pace of adoption of Basel II and III in EMDEs; that promotion of

[51] http://www.financialstabilityboard.org/publications/r_111019.pdf.

the development of supervisory capacity in EMDEs through targeted and well-coordinated technical assistance and other capacity building activities should continue; and that home supervisors for large international banks should provide host supervisors, particularly when those banks are systemically important in the host jurisdiction, with timely, accurate and comprehensive information on the parent bank.

The report stresses the need to continue to bring issues of relevance for EMDEs to the attention of the international community, and notes that the IMF, the World Bank and the FSB, particularly through its regional consultative groups, have an important role to play in that regard. It also calls for international bodies to take into account EMDE-specific considerations and concerns in designing new international financial standards and policies.

3. Consumer finance protection

In the wake of the financial crisis, national efforts to strengthen financial consumer protection policies to promote financial stability have intensified. FSB members have explored a number of different options for strengthening consumer protection frameworks, including establishing consumer protection authorities, implementing responsible lending practices, and intervening early in the product lifecycle. While progress to strengthen consumer protection frameworks is being made, more work is needed. At the request of the G20, the FSB in cooperation with the OECD has taken forward work to advance consumer finance protection.[52]

The FSB issued in October 2011 a report,[53] written in collaboration with the OECD and other international organisations, which focuses on issues related to consumer credit, including mortgages, credit cards, and secured and unsecured loans. The report provides a global overview of policy initiatives to strengthen consumer protection frameworks; presents a comprehensive picture of evolving institutional arrangements; and reviews the work of regulators and prudential supervisors in various areas of consumer protection. It identifies gaps where additional international work could help to advance consumer finance protection and financial stability.

The OECD has taken the lead in developing principles on financial consumer protection that are high-level and applicable across all financial services sectors.[54] The principles are designed to assist G20 members and other interested economies to enhance financial consumer protection.

4. Market integrity and efficiency

In response to G20 Leaders' request at the Seoul Summit, IOSCO published in October 2011 policy recommendations to promote markets' integrity and efficiency and, in particular, to

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[52] The FSB Charter includes consumer protection in the mandate of the FSB: "The FSB will promote and help coordinate the alignment of the activities of the SSBs to address any overlaps or gaps … relating to prudential and systemic risk, market integrity and investor and consumer protection …" (article 2(2)).

[53] http://www.financialstabilityboard.org/publications/r_111026a.pdf

[54] http://www.oecd.org/dataoecd/58/26/48892010.pdf

mitigate the risks posed to the financial system by the latest technological developments.[55] The report examines the most significant technological developments and related micro-structural issues that have arisen in financial markets in recent years, notably high frequency trading, and their impact on market structure, participants' behaviour, price discovery and formation, and availability and accessibility of liquidity.

In support of the recommendations, IOSCO will carry out follow-up work:

- consider the development of additional tools to deal with these technological challenges to effective market surveillance.
- analyse the evolving markets' structure, in order to assess the specific issues raised with regard to market efficiency and integrity, and consider whether and what recommendations may be needed to address any risks.

IOSCO also issued in May 2011 a set of *Principles for Dark Liquidity*.[56] These Principles have been designed to assist regulators in dealing with the issues, particularly with respect to transparency, posed for their oversight of markets by the expanded use of dark liquidity and the development of dark pools.

In addition to the work by IOSCO, the FSB is monitoring key financial innovations such as high frequency trading in order to identify potential emerging vulnerabilities at an early stage, with input from its members including the BIS Markets Committee and OECD.

5. FSB regional consultative groups

The FSB announced in November 2010 plans to establish regional consultative groups to bring together financial sector authorities from FSB member and non-member jurisdictions to exchange views on vulnerabilities affecting financial systems and on initiatives to promote financial stability. More specifically, the FSB regional groups will provide an institutional mechanism for:

- interaction of FSB members with non-members regarding FSB initiatives;
- promoting implementation of international financial policy initiatives; and
- the regional group members to share amongst themselves and with the FSB their views both on FSB initiatives and on other measures that could be taken to promote financial stability.

Six groups are being set up, covering the Americas, Asia, the Commonwealth of Independent States, Europe, Middle East & North Africa, and Sub-Saharan Africa, with invitations sent to around 70 countries from outside the FSB. It is planned that the first meetings will take place by end-2011.

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[55] The IOSCO Final Report *Regulatory Issues Raised by the Impact of Technological Changes on Market Integrity and Efficiency* is available at http://www.iosco.org/library/pubdocs/pdf/IOSCOPD361.pdf

[56] http://www.iosco.org/library/pubdocs/pdf/IOSCOPD353.pdf

6. FSB capacity, resources and governance

In response to a request from the G20 Seoul Summit, the FSB Chair submitted to the Cannes Summit proposals to strengthen the FSB's capacity, resources and governance.

The FSB has made improvements to its transparency, public accountability and internal processes. The FSB has expanded the information available to the public on its website, including publication of the composition of the FSB Plenary, Steering and Standing Committees, and has made increasing use of public consultation. To enhance the accountability of FSB members, a coordination framework for monitoring implementation (CFIM) of G20 and FSB financial regulatory reforms is being established.

Internally, the FSB has agreed to establish a Standing Committee on Budget and Resources to assess more systematically capacity and resource needs, and recommend to the Plenary options for generating the resources as needed. The composition of the FSB's Steering Committee will be rebalanced, through the inclusion of representatives from ministries of finance and from regions and major financial centres that are not currently represented.