RESTORING CONFIDENCE, CREATING RESILIENCE:

An Industry Perspective on the Future of International Financial Regulation and the Search for Stability

Institute of International Finance

July 2009

The Board of Directors of the Institute of International Finance (IIF) and the IIF's Special Committee on Effective Regulation are pleased to present this *Report* to the international financial community, and in particular to the official sector as they move toward a reformed framework of financial regulation.

This *Report* sets out a global industry perspective on financial regulation at the national and international levels and on the reforms being developed under the broad auspices of the G-20 and the Financial Stability Board (FSB). It draws on the insights and experience of the IIF membership. The IIF is the premier global association of financial institutions, with over 375 member firms including most of the world's largest banks. Our members also encompass a broad range of other financial institutions, including a growing number of insurance companies, hedge funds, asset management firms, and sovereign wealth funds.

Weaknesses and failings in industry practices, and deep flaws in important parts of the market—in particular the securitization market—contributed to a grave crisis, compounded by gaps and errors in regulation and supervision and global macroeconomic imbalances.

Moving toward greater financial stability is essential. Equally essential is that we do so in a manner that does not inhibit sustainable global growth—and this is necessarily a shared endeavor. The industry has made significant strides over the past year in addressing the failings revealed by the crisis. With the leadership of the authorities, important advances have been made in correcting vulnerabilities in the market, while at the same time, much progress has been made on the development of more robust regulatory frameworks.

Lasting stability depends upon the interaction of well-designed regulation and effectively functioning international markets, the latter exercising discipline on their participants and reinforcing best industry practices. To bring this about requires, *inter alia,* reforms to ensure that any firm that is in danger of failing can exit the market in an orderly fashion—regardless of its size or scope of activities. The objective should be a system in which such exits would not have undue impact on a more-resilient market infrastructure, with the burden of loss being appropriately shared by the firm's investors and creditors (other than those who are formally protected) and minimizing any residual risk to taxpayers. Such an approach requires stronger international coordination and better cooperation between supervisors, including better cross-border crisis management arrangements.

Regulatory reform should be built on an integrated view of markets and regulation. It should promote higher levels of risk-adjusted capital than those prevailing in many areas prior to the crisis, as well as more effective management of liquidity. At the same time, regulatory requirements demand careful calibration—there are many pitfalls that could hinder recovery, limit expansion of credit to the real economy, and threaten renewed job creation. These include arbitrary restrictions on firm size or business

models or, conversely, treating certain firms as too big to fail. Good progress has been made: now it is essential to avoid any rush to regulation without full consideration of the cumulative impact of proposed changes; care must also be taken not to fragment globalized markets by well-meant but ultimately counterproductive national measures that are not adequately coordinated or harmonized.

We have all recognized the need to intensify our work on developing better means of detecting and reducing systemic risk. By definition this requires a cross-border approach that recognizes systemic risk may well be a function of the interconnectedness among markets, firms, and products across national boundaries. Approaches to systemic risk should be built around this fundamental understanding and not just focused on a limited number of financial institutions. Reinforced regulation on a well-integrated, globally consistent basis is now, more than ever, of paramount importance.

In a spirit of shared endeavor this *Report* sets out, on the one hand, *Commitments* addressing those aspects where improvements and enhancements are required of the industry, and on the other, *Recommendations* outlining the views of the IIF to the official sector as it carries out the next phase of its critical work.

The Institute is grateful for member firms' time and expertise, which has made the development of this *Report* possible. A list of Committee members is included.

We look forward to a continued and deepened dialogue with the official sector as they press forward with their work to reform the regulatory and supervisory framework and, together with the industry, develop a more resilient and efficient set of markets and better managed institutions—ultimately providing for greater financial stability and resilience.

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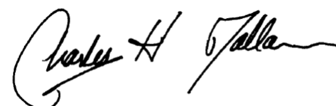

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Contents

	Foreword	i
	Board of Directors of the Institute of International Finance (IIF)	1
	IIF Special Committee on Effective Regulation	3
	Executive Summary	7
	Introduction	15
1.	Importance of Coordination in an International Market	19
2.	A Shared Responsibility to Achieve Resilience	25
3.	Achieving Resilience Through the Cycle With Prudential and Accounting Standards	35
4.	Financial Stability Through Macroprudential Oversight	55
5.	Improving Market Infrastructure and Mitigating Risks of Interconnectedness	65
6.	Resisting Fragmentation of International Markets	73
7.	Cross-Border Crisis Management and Financial Firm Resolution Regimes	77
	Commitments and Recommendations	83

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Executive Summary

The only sure foundation for sustainable globalization and rising prosperity for all is an open world economy based on market principles, effective regulation, and strong global institutions. —G-20, London, April 2, 2009

The crisis that developed two years ago revealed widespread weaknesses in many financial firms' business practices, as well as notable deficiencies in market operations. At the same time, the crisis exposed misalignments and gaps in regulatory and macroeconomic policies. ***Much progress has been made by the official sector in developing a strengthened regulatory framework***—one geared more toward containing systemic risk.

At the same time, the financial industry has firmly recognized the need for wide-ranging improvements in business practices—and has made tangible progress on implementation. These improvements include significantly enhanced risk management; more effective liquidity management; greater transparency; and compensation policies aligned with long-term, risk-adjusted performance. Deepening these reforms by the industry is, together with improved market discipline, a *sine qua non* for greater systemic stability and an essential underpinning to more effective regulation and supervision.

Asset-backed securities markets have been damaged by the crisis, even "vanilla" products that were exempt from the problems of resecuritizations. **Restoring the critical role of these markets is essential** to a sound recovery and can be achieved by greater transparency and reduced complexity, which are shared market goals. Markets worked where assets, procedures, and infrastructure were well-understood. The industry has made significant progress on improving underwriting, documentation, and transparency in securitization markets.

This *Report* reaffirms ***the commitment of IIF members to continue raising market practices to the high standard*** set out in the *July 2008 Final Report of the IIF Committee on Market Best Practices* (the *Market Best Practices Report*), building on the substantial progress made to date.

The IIF agrees that far-reaching regulatory reforms are necessary to guard against systemic vulnerabilities, ensure robust markets including liquid and transparent asset-backed credit markets, and encourage beneficial innovation. This would also help ensure that the industry follows through with its commitments. However, it is ***crucial that the cumulative effects of reform be consistent with market efficiency, avoiding rigidities that could stifle growth, job creation, and innovation, or increase the cost of financial services to customers.***

1. Importance of Coordination in an International Market

The G-20 has catalyzed a potentially important new level of international coordination. However,

recent developments suggest that there has nonetheless been "fragmentation" that could weaken the capacity of the global economy to return to sustainable growth. It is essential that agreement on the high-level principles of reform translate into a ***high degree of convergence*** on specific regulation. This represents an important challenge for the Financial Stability Board (FSB) and other international organizations. The IIF is committed to deepening its dialogue on these issues with the FSB and with each of the international standard-setters.

2. A Shared Responsibility to Achieve Resilience

Lasting financial ***stability depends on the effective interaction of markets, firms, and regulation***. Stability will not be achieved by reliance on one without the others. All must work in concert to achieve resilience, stability, and the efficiency necessary to support sustainable global growth.

The Industry's Demonstrated Commitment to Change

Fundamental questions about the pre-crisis business conduct of many financial firms have damaged the industry's credibility. Strengthening the ability of firms, market infrastructure, and markets themselves to withstand stress and cyclical downswings is essential. The industry reaffirms its commitment to strengthening all lines of defense to achieve long-term stability and to restore the health of the sector and the global economy.

While significant advances are being made, much work remains to be done by the industry to act on lessons learned in critical areas. ***The industry has made substantial progress on, and is committed to, the following***:

- ***Materially Improved Risk Management***, including more robust risk governance, strengthened capabilities in risk aggregation, improved stress testing, improvement of market-risk management, and significant investment in risk systems and data.
- ***Increased and Better Quality Capital*** compared to the position prior to the crisis, in response to market and official-sector requirements. ***The challenge now, for both the industry and the official sector, is to develop an appropriate analysis of the levels of capital needed to weather times of stress*** while avoiding overshooting or misaligned incentives and assuring that financial stability is balanced with objectives for economic growth.
- ***Better Liquidity Risk Management***, including more robust analysis of funding needs and sources, wide application of stress-testing techniques, and more substantial liquidity buffers.
- ***Reducing Procyclicality*** by analyzing its causes, refining provisioning practices, and making more extensive use of "through-the-cycle" approaches to capital.
- ***Reducing Leverage***, both on a systemic and individual-firm basis, based on a clear recognition of the negative effects of excessive leverage.
- ***Material Improvement on Disclosure and Transparency*** through Pillar 3, together with ***Industry Initiatives to Reform Securitization***, working toward more transparent, liquid, and standardized markets, and also clarifying firms' ***Off-Balance Sheet Exposures***.
- ***Significant Reforms of Compensation Practices*** to align them with long-term shareholders' interests and firm-wide profitability, taking account of overall risk and the cost of capital. ***The IIF reaffirms the wide commitment to implementation of the Compensation Principles set out in the*** **Market Best Practices Report** ***and***

***welcomes the FSB* Principles for Sound Compensation Practices.**[1]

- Development with the official sector of a ***Better Understanding of the Sources and Mitigants of Systemic Risk,*** using this understanding in risk management, and working with the official sector on macro-prudential means through which it can be identified, addressed, and mitigated.
- Significantly enhanced risk management, processing, transparency, and systems and market infrastructure for carrying on ***Credit Default Swaps (CDS) and other Over-the-Counter (OTC) Derivatives*** business.

The IIF's *Market Best Practices Report*, together with reports such as the Senior Supervisors Group Report,[2] have become benchmarks for large international firms. The industry welcomes the use of these reports in the supervisory assessment of the quality of risk management of firms. It would also be beneficial to arrange an annual review involving authorities and firms collectively to consider trends, progress, and shortcomings across the financial sector.

Effective Regulation, Enhanced Supervision, and Meaningful Market Discipline

Better regulation requires clear objectives, good dialogue, and robust impact assessment, while the best supervisory response to the crisis is a more rigorous, outcomes-focused approach providing clear incentives to strong risk management. Firms must ensure that their ***interaction with regulation and supervision is positive and non-defensive***. Better regulation requires clear objectives, good dialogue, and robust impact assessment.

Regulation needs to operate in tandem with meaningful market discipline. For markets to discipline firms effectively, it must be possible for firms to exit the market in an orderly manner, whatever their size or degree of interconnectedness, with consequences for creditors and investors.

Withdrawal Strategies—Restoring Normal Markets

While public interventions to secure stability have been necessary, it is necessary now for governments, central banks, and regulators to develop clear strategies for withdrawal from their emergency interventions so as to avoid competitive distortions and restore an effectively functioning marketplace.

3. Achieving Resilience Through the Cycle With Prudential and Accounting Standards

Current capital, liquidity, and accounting requirements need to be better adapted to times of stress or economic downturn. Measures need to be taken to reduce procyclicality. Revised standards need to be implemented through ***strong international coordination***.

Overall levels of capital relative to pre-crisis levels need to be increased within the framework of a revised Basel II risk-based approach; capital must also respond to system-wide cyclical risks and times of stress. Resources must be built up in good times that are genuinely able to be drawn upon when needed, and the ***quality of capital needs to be reviewed***. International consistency in interpretation of capital rules is needed. There will be a continuing important role for Tier 2 capital.

Leverage in the system was too high and needs to be kept under control in the future. Focus on leverage as a backstop to capital requirements makes sense—provided there is worldwide consistency—but the IIF counsels

[1] FSB *Principles for Sound Compensation Practices,* April 2, 2009.

[2] Senior Supervisors Group Report, *Observations on Risk Management Practices during the Recent Market Turbulence,* March 6, 2008.

against hardwired "Pillar 1" ratios, which do not take into account actual portfolio composition and may create misaligned incentives. More nuanced leverage indicators should figure in the Pillar 2 supervisory review process.

A comprehensive, high-level dialogue on current accounting standards in light of the crisis, involving all relevant parties, remains essential. ***The most critical need is rapid convergence of international standards as mandated by the G-20. Work currently in progress to review fair-value and accrual accounting for financial institutions should continue with urgency.*** Authoritative guidance should be issued to allow the use of reasonable interpretation in assessing loan loss provisioning under the incurred-loss model, pending the in-depth review of provisioning (which itself is a high priority).

The IIF has argued that ***local self-sufficiency or stand-alone approaches to liquidity regulation should be resisted***. While acknowledging local market liquidity needs, the drain on systemic resilience created by "trapped pools of liquidity" must also be recognized. ***Any new liquidity regulation will be counterproductive unless internationally coordinated.*** It is of course necessary to hold adequate liquidity buffers; however, overly mechanistic approaches, including mandatory core-funding ratios, should be avoided.

Simpler, more-transparent securitizations, based on good underwriting and improved transparency, are essential to restoring the flow of credit to important consumer sectors. Industry work on the needed improvements continues. ***It is equally essential that regulatory and accounting changes foster the return of robust securitization markets.***

The development of a comprehensive ***global standard for the supervision and regulation of internationally active insurance firms on a group-wide basis*** is urgently needed. International solvency standards need to be developed, as do effective colleges of supervisors for insurance firms.

Cumulative Effects, the Cost of Error, and Timing

Conservatism in the design of the new regulatory regime is appropriate to allow for uncertainty and unknowns. Nonetheless, ***material error in the calibration of new prudential requirements would have major negative effects, not just on the financial industry but on national economies—and ultimately on the global economy.***

It is sometimes overlooked in discussions of remedies that ***generation of reasonable returns is the foundation of firms' viability*** and ability to meet clients' financial needs—and thus to stimulate economic activity. ***Although it has in certain cases been abused, innovation remains essential to future progress, in a context of stronger risk management, good governance, and effective supervision.*** Care must be taken to preserve the benefits of positive innovation.

All practicable steps should be taken to assess the cumulative impact of proposed measures, to consider their effect on the availability of credit and other financial resources to the wider economy, and to calibrate the new measures as accurately as possible. If not well assessed, the burdens on intermediation can become so great that global economic activity is materially adversely affected, with additional costs to consumers and businesses, increased unemployment, and overall negative impacts on welfare. The IIF recognizes the challenges of carrying out such assessment and offers to work with the regulatory community on ***objective analysis of the cumulative net impact of proposed regulatory changes.***

Proposals need to be produced, agreed upon, and implemented in a timely manner. However, time is needed to ensure the appropriate design, assessment, and calibration of new and often radical proposals. The dangers of rushed regulation must be avoided. In order not to compound short-term procyclical effects, ***the***

introduction of any new measures needs to be carefully timed to avoid inhibiting economic recovery.

4. Financial Stability Through Macroprudential Oversight

The IIF agrees that all market participants whose activities could materially affect systemic stability should fall within the framework of macroprudential oversight, including all significant financial markets, products, and risks.

It would be a ***mistake, however, to create formal or public categories of firms subject to separate systemic regulation.*** To do so would run counter to the multifaceted and quickly evolving nature of systemic risk. It would give rise to a mistaken sense that systemic risk had been corralled within such a category of firms and would distract from the real problem of identifying risk in the interaction of firms, markets, and products. Further, it would incentivize risk migration and opacity, creating market distortions and moral hazard. That said, supervisors should ***take into account the varying degrees of systemic relevance or interconnectedness of different firms*** in carrying out risk-based supervision.

Restricting the size or activities of banks or other financial firms will not provide effective protection against systemic risk, which has been triggered by firms of many different shapes and sizes. More importantly, systemic risk does not reside in single entities but in the interconnectedness of firms, markets, and players. Artificial restrictions on size are likely to produce material distortions and unmanageable risk patterns within the system.

Large institutions play an important role in supporting the global economy. They must be required to meet the highest standards of risk management and corporate governance and be subject to appropriately intensive risk-based supervision. They must be subject to meaningful market discipline, enforced by a real risk of loss by their investors and creditors (other than depositors and policy holders). ***Accordingly, it should be a priority to implement the infrastructural, legal, and process reforms necessary to ensure that all firms can exit the market in an orderly fashion*** and without causing a systemic crisis, regardless of their size, nature, or range of activities. No firm should be considered "too big to fail."

Given this objective, the ongoing dialogue between large firms and the authorities should include consideration of all the information necessary to plan for the orderly exit of the firm should that prove necessary. While some have suggested firms make "wills" to be used in case of their failure, it is more likely to be productive for firms to examine with the authorities the risks that their roles in markets and products create—to help the authorities assess what would happen in event of their failure. Such a dialogue would need to be carried out in confidence between the firm and its relevant authorities. Mitigating actions can then be taken to the degree regulators deem necessary.

Any new regulations and the overall new regime need to be appropriately differentiated and risk based. Lines of business such as banking and insurance can share exposures to similar risks and yet exhibit real differences that should be reflected in the regulatory approach.

The IIF's recently-established ***Market Monitoring Group (MMG)*** is committed to identifying and assessing emerging vulnerabilities and potential dynamics in the markets giving rise to systemic risk, and to dialogue on developments of concern with the official sector.

5. Improving Market Infrastructure and Mitigating Risks of Interconnectedness

The global financial services system has become highly interconnected. This has brought many

benefits—but also brings significant risks. The IIF regards it as ***important that measures be put into place that will retain the benefits of an interconnected and sophisticated global financial system while reducing the associated risks***. Particular enhancements are needed to ensure the resilience of the system when facing the failure of a major participant.

For this to be accomplished, it is important to be clear about what went wrong and what did not. Many parts of the system, including equities markets and payment, clearing, and settlement systems, performed robustly. In addition, many derivatives markets, including settlement for credit derivatives, performed well despite difficult conditions.

However, it is necessary to reduce the opacity of transactions and of counterparty risk exposures in the CDS and certain other OTC markets. In line with the commitments already made by industry, all eligible standardized transactions should be cleared through a central counterparty (CCP). It is important that end-users remain able to use these tools to hedge against specific situations. Accordingly, standardization should not be pursued to the extent that it eliminates the flexibility achievable through bespoke transactions.

Authorities' intervention in the area of market infrastructure needs strong global coordination. Market infrastructure is highly international in nature, so artificial distinctions across borders are likely to invite arbitrage and create market distortion.

6. Resisting Fragmentation of International Markets

Some responses to the crisis are having a "fragmenting" effect on the market. An open question is whether the long-term legacy of the crisis will be protective retrenchment or a more positive, international regime creating a robust and stable financial services platform for a reinvigorated global economy. Fragmentation of the international market would make financial stability oversight more difficult to achieve.

Fighting fragmentation should be a key part of the FSB's mandate. Measures should be taken to address the confidence deficit that motivates inward-looking, nationally driven, and uncoordinated responses. Significantly strengthened frameworks for cross-border crisis management and financial firm resolution are as important as regulatory convergence. A *non-binding, intergovernmental financial services accord* should be established to provide a firm new footing for cross-border collaboration and confidence.

7. Cross-Border Crisis Management and Financial Firm Resolution Regimes

Confidence in the ability of the system to deal effectively with cross-border crises and to manage the orderly exit of a large cross-border financial institution is basic. Such confidence, or its absence, has a fundamental impact on the way firms and markets are regulated and on how authorities cooperate in the ongoing supervision of international firms. The FSB should, as a priority, develop a *convention on cross-border crisis management*. Cross-border crisis simulation exercises should be carried out regularly. Burden-sharing agreements are needed, based on criteria established by the FSB.

Authorities should have in place ***special regimes for bank resolution,*** including power of early intervention; making the protection of the financial system a primary objective; and ensuring alignment with financial-markets law (for example, settlement finality, set-off, and collateral rights). Any winding up of a cross-border financial firm should aim to maximize the outcomes for creditors of the group as a whole without discrimination between creditors by nationality or location.

Conclusion

Effective regulation and effective markets are interdependent. Markets in financial services must be made to work more effectively than they have previously. Transparency must be improved. Incentives must be better aligned. Creditors must be at risk in order to bring a much more effective market discipline to bear.

Regulation needs to be enhanced in scope, impact, and quality, and should be extended to address systemic stability risk. However, the cost of materially misjudged or inefficient regulation will have sustained adverse effects. It is essential that regulatory reform be implemented on the basis of an integrated regulatory and market perspective, a robust assessment of cumulative impact, a risk-based approach, international coordination, and effective dialogue.

Introduction

A year ago the IIF published the *Final Report of the IIF Committee on Market Best Practices*[3] ("*Market Best Practices Report*"), which provided a frank analysis of the failings and weaknesses in many firms' practices leading up to the recent financial crisis. The *Report* set out clear and detailed recommendations for firms' governance, business practices, and day-to-day risk management.

The analysis and recommendations contained in the *Market Best Practices Report* remain centrally important. They support demonstrated progress and a continuing effort across the industry to reform how it does business, including with respect to corporate governance, risk management, and compensation. The IIF membership reaffirms its commitment to the implementation of the recommendations set out in the 2008 report.

It is now clear, in light of the traumatic events of the intervening 12 months, that the roots of the problem were more profound than previously had been understood. The question now is not simply how to make necessary improvements but how to make the structural and regulatory changes necessary to ensure that the likelihood of such systemic events in the future is significantly reduced.

A number of reports have appeared over recent months addressing the question of how financial regulation and market functioning should be reformed to seek to avoid a recurrence of the events of the past two years.[4] Taken together, these reports represent a major achievement. Developed over a short period of time, the reports identify, elaborate, and provide the necessary framework for consideration of most of the central issues to be determined over the period to come.

The present *Report* seeks to address a number of the issues that are raised in those reports and are currently under wide consideration. It attempts neither to be comprehensive nor to present detailed views on issues where others are better placed to develop the necessary analysis and propose solutions. Rather, it has the objective of putting forward an industry perspective on a relatively few themes where decisions made now will have a formative

[3] *Final Report of the IIF Committee on Market Best Practices,* July 17, 2008, http://www.iif.com/regulatory/cmbp.
[4] These include G-20 *Declaration on Strengthening the Financial System*, April 2, 2009, together with its Working Groups' reports *Enhancing Sound Regulation and Strengthening Transparency*, March 25, 2009, and *Reinforcing International Cooperation and Promoting Integrity in Financial Markets*, March 27, 2009; the Geneva report on the *Fundamental Principles of Financial Regulation*, July 2, 2009; the Group of Thirty report *Financial Reform: A Framework for Financial Stability*, January 15, 2009; the report of the de Larosière High-Level Group on Financial Supervision in the EU, February 25, 2009; the Turner Review: *A Regulatory Response to the Global Banking Crisis*, March 18, 2009; the U.S. Treasury proposals for financial regulatory reform *A New Foundation: Rebuilding Financial Supervision and Regulation*, June 17, 2009; and most recently the UK Treasury document *Reforming Financial Markets: Impact Assessment*, July 8, 2009.

impact on global economic well-being for a long time to come.

Section 1 considers the benefits of international financial markets and the importance of cross-border coordination and cooperation. It reemphasizes the important role of the expanded Financial Stability Board (FSB) and international standard-setters. It sets out the need to take all the measures necessary to ensure the effectiveness and appropriate consistency of international colleges of supervisors for cross-border groups. It also identifies the need for international solvency standards for insurance firms.

Section 2 discusses the shared responsibility of the industry and regulators for achieving high levels of confidence and resilience in the international financial system. It considers the need for the industry to improve its practices and the strong progress already made, the dual responsibility of firms and supervisors to achieve high-quality supervisory outcomes, the importance of ensuring that regulation is effective and efficient to maximize social outcomes, and the need for markets to perform effectively to underpin resilience and confidence. This requires that firms be allowed to fail and then exit the market in an orderly manner.

Section 3 deals with reform of prudential and accounting standards, in particular to ensure resilience of the system throughout the economic cycle. Reform and enhancement are necessary across a significant number of areas. However, it is important that such reform be well-coordinated internationally, based on a clear understanding of the likely impact and cost, come from an integrated view of all the different moving parts, and remain risk based.

Section 4 considers financial stability and macroprudential oversight. It considers the thorny question of systemic relevance and concludes that this cannot be captured by formal, or bright-line, categories but rather is a multifaceted and dynamic concept that must be addressed by comprehensive oversight and review at the macrolevel and sophisticated risk-based supervision at the microlevel. It argues that seeking to address the problem by artificial restrictions on firms' size or activities is likely to fail and to do harm, and that instead what is required is a matrix of measures to protect against systemic risks.

Section 5 addresses systemic issues associated with market infrastructure and the high degree of interconnectedness in financial markets. It supports the advances achieved, and further commitments made, by the industry in the curtailment of counterparty risk arising from credit default swaps (CDS) and other over-the-counter (OTC) markets and in the introduction of significantly enhanced transparency to support a more-liquid and simpler securitization market for the future. It also draws attention to those important parts of the market infrastructure that demonstrated considerable resilience during even the deepest point of the crisis.

Section 6 identifies the growing threat of fragmentation of international markets. It notes that to a certain extent this represents a comprehensible reaction by authorities to the crisis. However, it calls for a forward-looking reinvigoration of international markets and not a backward-looking retrenchment that will lead to lesser outcomes for all. It suggests ways in which this reinvigoration can be achieved.

Section 7 deals with the key topics of cross-border crisis management and financial firm resolution regimes. To a material extent, the way with which cross-border crises and bank failures are dealt determines how international coordination and cooperation function during the ongoing life of a cross-border financial services firm. It is clear that there have been significant weaknesses in the way in which

both crisis management and firm failures have been managed. This is to a significant extent due to problems deriving from the national basis of financial services and insolvency legislation. The section identifies the need for improvement in these areas and puts forward suggestions.

SECTION 1

Importance of Coordination in an International Market

The G-20 agreed in London in April "to establish the much greater consistency and systematic cooperation between countries, and the framework of internationally agreed high standards, that a global financial system requires."

The IIF welcomes this commitment. It is important that firms be able to operate effectively and efficiently across borders and to avoid material regulatory divergence, both jurisdictional and sectoral.

With the great array of regulatory proposals that are currently under consideration, it is essential that authorities carry through with a strong commitment to coordinate their actions.

1.1. BENEFITS OF INTEGRATED FINANCIAL MARKETS AND CROSS-BORDER INSTITUTIONS

A globalized financial system:

1. Provides savers and users of funds the greatest choice in terms of portfolio allocation and financing options;
2. Enables the efficient transfer of funds from countries with "excess" savings to locations in need of capital for investment; and
3. Provides financial firms with the flexibility to determine the scale, scope, and reach of their intermediation operations, including to emerging markets.

An increasingly integrated financial market has, over the past 20 years, provided an important basis for new levels of global economic growth, which has delivered improved economic conditions for many individuals in many countries.

Cross-border financial groups play a critical role in the efficient allocation of capital. Moreover, during country-specific crises, the "internal markets" of cross-border groups have shown themselves helpful to mobilizing resources in circumstances where external markets may be less available. Therefore, cross-border groups that are able to manage their liquidity and capital prudently on a group-wide basis are likely to act as a material source of systemic stability. They are in a position to leverage the flexibility and resilience of the group to deliver liquidity and capital where and when it is needed.

1.2. POSITIVE STEPS

In line with the commitment of the G-20, much progress has been made in the coordination of cross-border regulatory reform.

The industry warmly welcomes the broadened mandate of the FSB to include not only assessing vulnerabilities and promoting coordination and information exchange among authorities responsible for financial stability, but also coordination of international standard-setting bodies, setting guidelines for supervisory colleges, and managing contingency planning for cross-border crisis management.

Financial markets play an essential role in supporting global markets. Strong, sustainable growth across the world depends on financial markets that are increasingly integrated, regulated

consistently, and capable of marshaling private credit for investment needs as they arise.

1.3 IMPORTANCE OF COLLEGES

A further welcome decision is the establishment of colleges of supervisors for all major international financial firms. The concept of colleges is a powerful one and, properly executed, colleges working with individual firms can do a great deal to advance the goals of coordination and convergence of regulation and cooperation among supervisors. Moreover, they can facilitate a substantial increase in supervisory efficiency as well as effectiveness by aligning the efforts of multiple supervisors; allocating responsibilities among them; avoiding duplication of effort; developing better and more consistent information for both home and host supervisors about large groups; establishing common reporting formats and requirements for firms; coming to common decisions about important matters such as the Pillar 2 Supervisory Review Process; and assessing overall regulatory effectiveness.

As discussed in Section 4, well-functioning colleges of supervision can also play an important role in implementing the microprudential aspects of macroprudential oversight.

Parts of the G-20 mandate implicitly expand the remit of colleges. For example, supervision of liquidity risk management in large firms will certainly need to be coordinated through colleges.

On their side, firms need to dedicate resources and ensure they engage with their colleges on a fully committed basis. Yet effectiveness is a two-way street. Firms' investment of time and resources in working with colleges depends on making the productivity of the process fully evident. Here, it must be recognized that firms' experiences with colleges previously organized for Basel II purposes has been decidedly mixed. Some have usefully increased supervisory efficiency, clarity, and consistency, but this has not always been the case.

Colleges impose a significant burden on the home supervisor and require cooperation and a balanced sense of priorities from host supervisors. To some extent, this reflects the fact that colleges are based purely on good intentions among their participants and lack a clear legal foundation, at least outside the EU, once current proposals are implemented.

To achieve the kind of results that the G-20 expects from colleges, the role of the FSB in insisting on coordinated, consistent, and well-directed operation by colleges will be essential. The IIF welcomes the commitment of the FSB, in its press release of June 27, 2009, that it "will set guidelines for and oversee the establishment and effective functioning of supervisory colleges, and will monitor and advise on best practice in meeting regulatory standards with a view to ensure consistency, cooperation and a level playing field across jurisdictions."

In the medium term, it is likely that the FSB and the G-20 will find it necessary to request that states give their supervisors a clear mandate to act on a basis of international cooperation, as well as on the basis of their traditional national mandates, to achieve good results. The G-20 took a step in this direction by agreeing that all regulatory authorities ought to have a financial stability mandate; a similarly agreed mandate for international cooperation would make sense.

Commitment I: *The IIF membership will dedicate the necessary resources and engage with their colleges of supervisors on a high-priority, fully committed basis.*

Recommendation 1: *The FSB should proceed quickly and with continued determination in taking the steps necessary for the establishment and operation of well-functioning colleges of supervisors for internationally active banks. Ensuring effectiveness, high-quality cooperation, and appropriate consistency in the operation of these colleges should be a high-priority task for the FSB and supervisory authorities.*

1.4 ENHANCED SIGNIFICANCE OF INTERNATIONAL STANDARD-SETTERS

The new role of the FSB does not diminish, and indeed should enhance, the importance of the role of the Basel Committee and other standard-setters that participate in the FSB. Their task becomes more important—and more complex—because of their expansion to include additional major economies, but the substantive importance of their tasks is all the more important as well. Achievement of convergence and consistency, at a practical as well as a theoretical level, is essential to a well-functioning future financial system that will be free of regulatory arbitrage and unfair anomalies or vulnerability-creating loopholes.

Basel Committee Leadership

As the discussions of capital and related matters in Section 3 make clear, the Basel II Accord remains absolutely essential to the future soundness of firms and the resilience of the system. Getting the planned changes right is of the greatest importance, as is the need for timely and consistent implementation of the Accord across all major jurisdictions, including the United States. It will be most important if the G-20's coordination mandate is to be carried out for the Basel Committee to maintain leadership on capital, leverage, and similar issues.

Substantively, the international consistency and level playing field that only the Basel Committee can achieve will be absolutely essential to international stability. The origins of the Basel process show incontrovertibly the dangers of international capital divergence. As discussed further in Section 6, those dangers are today real. Keeping the Basel Committee in the lead on these processes—and avoiding front-running by individual jurisdictions that may become impatient with the process—will be one of the FSB's and G-20's most important tasks.

Added Roles of the International Organization of Securities Commissions

The crisis has raised issues of market and conduct-of-business regulation as well as prudential regulation. The International Organization of Securities Commissions (IOSCO) has done fine work over the years in developing internationally recognized standards for securities regulation as well as effective models for cooperation on information sharing and enforcement.

As it has become clear that market regulation has an effect on systemic stability as well as prudential regulation and solvency requirements, the role of IOSCO will necessarily grow.

Matters such as hedge fund regulation, regulation of credit-rating agencies, product transparency, and the like all too easily lead to national deviations or are based on as-yet unreconciled national traditions. The recent experience with uncoordinated short-selling regulations shows clearly the need for international coordination in the securities sector, a need IOSCO fully recognizes.

In addition to attending to specific regulatory issues, IOSCO has the opportunity to contribute to enhanced cross-border cooperation.
In particular, the IIF welcomes the recent statement of Jane Diplock, Chair of its Executive Committee, calling for the renewal of discussions on mutual recognition between securities authorities as well as the Committee of European Securities Regulators' (CESR) consultation paper on the topic.[5]

[5] Jane Diplock, Speech at Centre for European Policy Studies, Brussels, April 22, 2009; *CESR: Call for Evidence on Mutual Recognition With Non-EU Jurisdictions*, June 8, 2009.

***Recommendation 2**: National authorities should coordinate closely in respect of the wide array of regulatory proposals that are currently under consideration, working through the relevant international standard-setting bodies. Such coordination should go beyond the level of principle or direction and ensure consistency of specific regulation. There should be timely and consistent global implementation of Basel II, appropriately modified. Coordination becomes increasingly important given emerging fragmentation.*

1.5. TIME TO MOVE TO INTERNATIONAL SOLVENCY STANDARDS FOR INSURANCE

While it is evident and reasonable that insurance regulation has not been an area of focus during the crisis, this does not mean that policymakers should miss this opportunity to address what is perhaps the key priority area on insurance regulation: a global standard for the supervision and regulation of internationally active insurance groups on a group-wide basis.

In this *Report* we have analyzed in detail the issue of how to promote an effective framework for the supervision of internationally active financial firms. In insurance, despite the efforts by a number of jurisdictions to organize meaningful colleges for international firms, the results have been less than optimal. Without a common framework, efforts by supervisors from different jurisdictions are focused on their own territories, and much remains to be done to develop a comprehensive, meaningful, and effective supervisory arrangement for an international insurer.

Insurance supervisors continue to work through a patchwork of different regulatory systems. This situation ought to change. The financial crisis has made it evident that truly international approaches to regulation are essential. Therefore, current efforts on regulatory reform should give impetus to the development of an international regulatory standard on solvency for insurance companies, which could be based on the original proposals for the EU Solvency II directive (including strong group-supervision provisions).

The International Association of Insurance Supervisors (IAIS) is well placed to take up this task provided that there is commitment from all major jurisdictions. The IIF membership is committed to playing a responsible and constructive part in this dialogue.

***Recommendation 3:** A global framework for the supervision and regulation of internationally active insurance firms on a group-wide basis should be developed under the leadership of the IAIS.*

1.6. TROUBLING DEVELOPMENTS

The G-20 stated in London that any retreat into financial protectionism, and in particular measures that constrain worldwide capital flows, should be avoided. Unfortunately, recent months have seen a growing number of measures, the effect of which is to cause fragmentation of the international market along national boundaries.[6]

The attachment of explicit or implicit domestic lending requirements to government assistance betrays a strong and troubling tendency to home bias. Measures based on self-sufficiency concepts designed to increase the protection of domestic stakeholders even though the effects on the global system are negative are equally troubling. This issue of fragmentation is discussed in more detail in Section 6.

[6] For a more detailed elaboration of different fragmenting measures of recent months, see recent IIF Staff Paper, *Fragmentation of the Financial System: Analysis and Recommendations*, June 11, 2009, http://www.iif.com/regulatory/article+363.php.

1.7. NEED FOR WITHDRAWAL STRATEGIES

While government interventions to secure stability over the recent period have been welcome and important, it is necessary now to develop withdrawal strategies for governments to exit their holdings in financial firms. Well-formulated and executed plans in this regard are essential to avoid competitive distortions and ensure a level playing field both within and across countries and to restore an effectively functioning marketplace.

Such plans should take into account not only the time frame for reducing budget deficits but also the need to deal with looming pension and health care problems. Failure to present credible withdrawal strategies in a timely and convincing manner could add to the currently rising volatility of interest rates and government bond yields, hurting the chances of global economic recovery.

Public-sector withdrawal strategies need to include consideration by the central banks of the transition back from the exceptional facilities put in place during the crisis to support markets and to provide liquidity support to money markets. This will require defining a "new normal" state of central bank liquidity facilities that will certainly not be identical to the exceptional facilities of the past year. The new normal will also most likely not be identical to the *status quo* ante 2007 and, as discussed further in the *Market Best Practices Report*, it will be important to design rather broader, more-uniform collateral and other policies for the central banks' regular role in money markets in the new regime. Formalizing emergency liquidity and collateral policies for future use should also be part of the withdrawal process.

It will be important for both normal and emergency policies to be internationally harmonized and coordinated to the maximum extent possible. Definition of new central bank policies will require reconsideration of the appropriate degree of "constructive clarity" regarding central bank roles in markets—a critical aspect of systemic stability—while also conserving an appropriate degree of "constructive ambiguity" concerning lender-of-last-resort measures for individual firms that fall into difficulties (see *Market Best Practices Report*, pp. 58–62).

Recommendation 4: *Clear strategies should be developed for the withdrawal of governments from ownership positions in financial institutions and for ending extraordinary liquidity and market support measures. Such strategies should be carefully coordinated internationally to be fully effective and minimize the risk of unanticipated consequences.*

SECTION 2

A Shared Responsibility to Achieve Resilience

The G-20's Working Group 1 said that the objective of regulatory reform is to build a financial system that will support growth and rising living standards across the globe while reducing the risk of financial instability. [7] It notes that financial crises have very large social costs. At the same time there are large social benefits to all from a dynamic and efficient financial system that transforms savings into productive investments and helps households and businesses manage risks.

Building and maintaining a high degree of resilience in financial markets, while ensuring that excessive caution does not overwhelm efficiency and innovation, stifling future growth, depends on the effective interaction of markets and regulation and on the quality and success of the relationship between authorities and firms. Achieving financial stability is a shared responsibility.

The IIF's *Market Best Practices Report* was published in July 2008. It detailed the wide range of weaknesses and vulnerabilities in firms' business practices that contributed to the development of the crisis. It set out a large number of recommendations for change.

Since then, there has been an active dialogue among IIF members to assess implementation of recommendations of the *Report*. To facilitate the process, the IIF has made available a model methodology for self-assessment, which provides a framework through which members can evaluate internal policies, processes, and procedures against the recommendations of the *Report*. The IIF also has organized knowledge-sharing meetings among member firms to allow them to share their experiences of self-assessment.

Member firms in major markets have reported that they have concluded gap analysis against the IIF Recommendations and parallel recommendations (for banks) of the Senior Supervisors Group and other groups. This analysis has indicated in general a good deal of progress regarding implementation of the Recommendations. Firms are in the process of remedying identified shortcomings, most of which will be addressed by the end of 2009.

[7] G-20 Working Group 1: Enhancing sound regulation and strengthening transparency, March 25, 2009.

2.1. RISK MANAGEMENT—A SECULAR CHANGE IN PROGRESS

Significant progress is being made by firms to address the weaknesses identified in the *Market Best Practices Report* and by regulators.

Work on risk management goes beyond simple improvements. Rather, a step change in firms' approaches to risk management is starting to be evident. This is essential as strong risk management is the first line of defense in ensuring the soundness of firms. Reforms include the following:

- Improvement in the governance of risk management, with revised responsibilities and oversight functions of senior managements and boards;

- At some firms, an overhaul and comprehensive revamping of the risk systems and infrastructure, including personnel decisions aimed at bringing in top talent to guide these efforts;
- Making more robust the process of defining and enforcing the firm's risk appetite;
- Especially in highly affected firms, consciously addressing deficiencies of risk culture;
- Revision and improvement of internal risk models, with particular emphasis on Value at Risk (VaR) and understanding and managing its limitations to assess risk during times of economic stress;
- Investment in risk-related information technology, including quicker and more reliable aggregation capabilities;
- Significant improvement in stress-testing techniques and capabilities, including approaches to develop firm-wide views on the impact of adverse economic scenarios;
- Enhanced liquidity management, including adequate internal pricing of liquidity to avoid "free lunch" use of liquidity, as well as increased liquidity buffers;
- Increased capital in many firms (in response to market and official demand);
- Substantially improved valuation, especially of less-liquid assets, assisted by methodological improvements and improved external pricing infrastructure;
- Enhanced accounting, in line with evolving guidance by the standard-setters; and
- Greatly enhanced transparency in securitization businesses, thanks in large part to industry initiative as well as enhanced Pillar 3 transparency on risk management.

In addition, the IIF is developing a report (to be issued in late November 2009) taking stock of implementation and formulating an updated view of the issues raised in the *Market Best Practices Report*. This upcoming report will summarize the state of the industry, highlighting changes and improvements in the industry's landscape since the release of the *Market Best Practices Report* in July 2008 and identifying open issues that still need to be addressed by the industry or regulators. It also will provide additional recommendations on a number of matters related to risk management.

Commitment II: *The IIF membership will as a matter of first-order priority continue the good progress to bring their risk management and other business practices into alignment with the recommendations of the* Market Best Practices Report.

Commitment III: *The standards set out in the* Market Best Practices Report *have become a benchmark for large, internationally active firms. The industry welcomes the use of this and other reports, such as the* Senior Supervisors Group Report *of March 6, 2008, in the supervisory assessment of the quality of risk management of such firms.*

Compensation

Early in the crisis, industry bodies recognized that mismanaged compensation incentives were a factor in the build-up of risk within firms, thereby contributing to market instability. The IIF's 2008 *Market Best Practices Report* set out seven Principles of Conduct to guide the industry in its restructuring of compensation practices. By way of follow-up, the IIF conducted an industry survey of the status of compensation reform earlier this year. The survey results, published in collaboration with the management consultants

Oliver Wyman in March 2009,[8] were widely disseminated and shared with key regulators.

The survey showed that while much progress has been achieved, further work remained to be done, including on the adjustment of performance compensation to the time horizon of risk and the cost of capital and on the governance of compensation within firms. The survey results also helped crystallize a set of recommended leading practices which further amplify and enhance the seven Principles of Conduct of the earlier report.

Since early this year, the FSB has issued *Principles for Sound Compensation Practices*[9] while several national authorities have also issued guidelines providing a broad framework for the governance of compensation policies and approaches to their supervision. The financial services industry has generally welcomed the principles-based approach set out in the official statements, which are broadly consistent with the IIF principles and recommended leading practices.

The industry is determined to proceed with ongoing reforms in this critical area to ensure that industry practices are aligned with the core IIF principles and leading practices as well as with FSB principles.

[8] *Compensation in Financial Services: Industry Progress and the Agenda for Change,* March 30, 2009, http://www.iif.com/press/press+101.php.

[9] April 2, 2009.

***Commitment IV**: The industry is committed to continue to implement reforms in compensation practices so as to align these practices with the IIF* Principles *and recommended leading practices, as well as with the FSB* Principles. *In this regard, the IIF intends to monitor developments in industry practices and to provide an informal assessment in the forthcoming report of the IIF Steering Committee on Implementation in November 2009 and to conduct a survey of industry practices in 2010.*

***Recommendation 5**: Regulatory authorities should develop appropriate supervisory guidelines on compensation, in line with the FSB* Principles, *in a timely manner so as to reduce market uncertainty. The FSB should ensure that these guidelines are consistent, in all important respects, across jurisdictions and that a reformed regulatory environment also provides for a level playing field on compensation between the regulated and non-regulated segments of the financial market.*

Securitization

One frequently cited cause of the crisis was the precipitous decline in value of many complex securitizations. At the same time, securitization as a broad asset category served major markets extremely well for many years prior to mid-2007. Securitization of credit card receivables, student loans, automobile loans, and “vanilla” or standard mortgages was an essential source of credit for the real economy. To achieve a robust recovery, such securitization needs to return to a significant role in credit generation.

As discussed further in Sub-section 3.1 and Section 5, where structures are not complex, assets are well understood, underlying lending standards are maintained, and adequate trans-

parency of the underlying assets exists, vanilla securitizations have been relatively resilient even in difficult markets.

Bank balance sheets will certainly not be able to replace credit securitization as it has been provided in recent decades. Rather, simpler structures based on good underwriting standards, well-understood assets, and ongoing transparency are the answer.

There are several dimensions to achieving this. These include uniform, high standards of underwriting; better analysis by institutional investors; and ratings reform, as discussed in Section D.V of the *Market Best Practices Report*.

These issues are being addressed by firms in the market, by the rating agencies, and by the regulators, especially with respect to standards applicable to origination of the underlying lending, in particular mortgages.

Nothing is more essential than providing ongoing transparency as to the assets underlying securitizations and, as mentioned in more detail in Section 5, the product specialist associations in the securitization sphere have made very significant strides to improve availability to the market of information on underlying assets and overall documentation.

Taken together, all these changes, when complete, will provide a solid basis for the return of widespread use of the kinds of simple, transparent securitizations that will ensure a renewed flow of credit to important consumer sectors while avoiding recent excesses, subject to regulatory and accounting changes as discussed in Section 3.

2.2. EFFECTIVE SUPERVISION IS A TWO-WAY PROCESS

Successful regulation and supervision, like successful policing, is highly dependent on the attitude and approach of the community being regulated and supervised. It is as much incumbent on the industry to make regulation and supervision work successfully as it is on the official sector.

High-Quality, Critical Analysis and Receptive Engagement by Firms

Strong and effective supervisory engagement between firms and supervisors depends on a mutual commitment to a dynamic, high-quality dialogue of critique and challenge.

This commitment requires that the industry engage positively and non-defensively with supervisors. This is by no means an easy challenge, as profit and loss are at stake. Success depends on the creation of appropriate incentives for personnel and the creation of a strongly supportive culture within the firm.

The more-intense supervisory engagement advocated by many as a lesson learned of the crisis clearly requires a large number of highly qualified supervisors, appropriately resourced to develop strong analysis, and with levels of seniority and authority to engage firms in a strong, critical, and analytical dialogue.

An Improved Culture

The cultural response to supervisory intervention differs across firms. In some, it is mature and healthy. In others, it is less so.

It is necessary that firms take engagement with supervisors not as a necessary evil but as essential to normal management. Engaging constructively with supervisors can be a valuable process for continual improvement of products and returns to shareholders, as well as a means to reduce financial, legal, and reputation risk.

Work being carried out by the IIF suggests not only that specific cultural traits are critical to healthy risk management within a firm but also that it is possible to implement specific measures to foster a positive risk culture within a relatively short period of time. This is an area of important continuing work. The IIF will publish the results of its work in this area in the November report mentioned above.

Many firms have been actively addressing internal cultural issues uncovered by the crisis, and all firms should take the steps necessary to create a sound risk culture in accordance with the recommendations of the 2008 *Market Best Practices Report.*

Setting Clear Principles and Holding Firms to Them

The IIF has long been supportive of outcomes-focused regulatory approaches that rely to a large but well-considered extent on principles, as opposed to over-reliance on detailed rules. As was said in the 2006 *Proposal for a Strategic Dialogue on Effective Regulation*,[10] "at a general level, the IIF is supportive of 'principles-based' regulation, but is realistic about what this entails. Principles-based regulation requires more dialogue, greater willingness by regulators to make and stand by judgments of what constitutes acceptable compliance, and readiness by firms to accept those judgments."

There will always be a need for a material rules-based component of financial regulation. However, this should never be allowed to give rise to a tick-box mentality in which formal adherence to rules outweighs thoughtful compliance with sound principles. All participants—in firms and authorities—should act on a strong understanding of relevant activities and products and of their risks, using good judgment on the basis of and constrained by rigorous principles.

What is needed, accordingly, is an approach that strives for a good balance and well-considered interaction between principles and rules. This balance should seek to maximize resilience by prioritizing the use of analytical judgment across the system and to optimize the alignment of incentives toward efficiently prudent industry behavior and clearly understood regulatory outcomes.

Putting the focus on management judgment, as opposed to reliance on a few numbers from risk management systems or ticking regulatory boxes, puts more, not less, pressure on management to act prudently in accordance with the firm's articulated risk appetite. It also puts more pressure on supervisors to evaluate the substance and quality of a firm's risk management as opposed to formal compliance.

Among the fundamental lessons of the crisis are that risk systems are of little avail if not used critically and with good judgment by management and that supervisory challenges must go beyond looking at numbers and checking that rules are not transgressed. As the 2006 *Proposal* acknowledged, principles-based regulation is in fact harder for all concerned, but the crisis demonstrates that good judgment measured against actual outcomes is the bottom line of success for both management and supervisors.

Providing Risk-Based Supervision

Risk-based approaches to supervision will be essential to achieving desired objectives for the future. While important before, these approaches become of even greater significance in light of the recognized need for an enhanced supervisory role in respect of risk to financial stability.

The industry accepts that to the extent that risks are greater, the intensity of supervision should increase. It sounds a note of caution, however, for all to be watchful for the potential for unintended consequences if the new requirements cause risks to migrate to less-regulated parts of the system, where they are more difficult to identify and manage.

Aligning Incentives

The correction of procyclical tendencies in the current Pillar 1 of Basel II mandated by the G-20 and discussed further below at Sub-section 3.2 will come at a cost. A full analysis of the actual extent of the procyclicality of the Accord is still needed, but it is possible that the new regime

[10] *Proposal for a Strategic Dialogue on Effective Regulation,* December 13, 2006, http://www.iif.com/regulatory/effreg.

may be less sensitive to risk. As we have seen in the past, non-risk-sensitive capital requirements can pose or amplify systemic risks. Perverse incentives set by non-risk-sensitive capital requirements under Basel I have been among the root causes of this crisis, and there is the danger of similar problems' emerging depending on how cyclicality is addressed and if overly rigid measures are introduced on leverage (discussed in Sub-section 3.4).

Appropriate incentives will need to be provided through Pillar 2 enforcement tools. Capital add-ons are the primary tool for setting incentives under Pillar 2 and should be subject to a balanced system of surcharges and discounts reflecting the full range of findings from supervisory scrutiny. In addition, there are further options for tangible reward and penalty reflecting an institution's record under the Pillar 2 review and evaluation:

- Well in line with the logic of a risk-based approach to microprudential supervision, an institution's Pillar 2 record should drive the frequency and intensity of the supervisory review and evaluation process.
- An institution's Pillar 2 record also should inform the size of qualitative adjustments applied under the advanced measurement approach to operational risk.
- Increasing microprudential supervision will be costly, and a significant escalation in supervisory fees assigned to the industry can be expected in the relevant jurisdictions. Here as well, risk- and incentives-based criteria should and can be easily combined to develop a fee allocation formula that rewards or penalizes as appropriate an institution's behavior.

Microprudential Implementation of Macroprudential Oversight and Analysis

As discussed in Sub-section 4.4, a very important aspect of the new framework will be the focus on systemic risk. The translation of macroprudential analysis into effective oversight and microprudential action creates significant new challenges for supervision. As an international consensus on the scope, goals, and modalities of macroprudential scrutiny of market and economic developments still needs to be developed, so too do the means of implementation. International consistency on the goals and means of implementation of the new mandate for macroprudential oversight will be essential to avoid competitive and even economic distortions. A sophisticated, risk-based, outcomes-focused approach to incorporating macroprudential inputs into microprudential supervision based on continuous improvement of internal risk management will be a necessity.

More sophisticated microprudential supervision will need to be complemented by effective feedback from the microprudential level to macroprudential oversight. The macroprudential process will be most effective if it uses bottom-up insights from supervisors and colleges as well as top-down macroeconomic analysis. To achieve this, a new dimension of horizontal, thematic work across peer groups of institutions and across jurisdictions will be necessary.

The microprudential implementation of macroprudential oversight and analysis will make the demands on supervisors all the more challenging. The proper calibration of capital add-ons, supervisory directions regarding the countercyclical draw-down or build-up of additional risk buffers, and supervisory measures to remedy identified deficiencies of broader market practices will require robust risk analysis and difficult judgment calls when translating the analysis into supervisory action.

The implications are obvious. In addition to the general need for enhanced capability, microprudential supervision will require significantly more resources, broader expertise, and a wider set of skills. In order to help identify systemic vulnerabilities and cyclical risks they will have to develop a deeper understanding of institutions'

businesses and business models, of their risk measurement and management practices, of their governance, and of the national and global markets in which they are operating.

> ***Commitment V:*** *The IIF membership will undertake the efforts and investment necessary to promote the success of more outcomes-focused, judgment-based supervision. This will include developing standards and norms of behavior to underpin a better quality of relationship with supervisors.*
>
> ***Recommendation 6:*** *Authorities should continue to develop a more consistently outcomes-focused, judgment-based approach to regulation. The IIF recommends increasing the resources, expertise, and skills of supervisors to implement macroprudential oversight.*

2.3. MAKING REGULATION EFFECTIVE

A Robust Approach to Developing Financial Regulation

There has been growing agreement between policymakers and industry participants on the merits of an integrated approach to developing effective regulation.[11] The process consists broadly of the following:

1. Problem identification and market-failure analysis;
2. Definition of objectives;
3. Development of policy options and impact assessment;
4. Consultation with stakeholders;
5. Policy decision; and
6. Review once the policy has been implemented and enforced.

[11] See, for example, European Commission, *Impact Assessment Guidelines,* January 2009; CESR–CEBS–CEIOPS, *Impact Assessment Guidelines,* April 2008.

A "market-failure" based approach to regulation is sensible and by now well grounded in extensive academic and supervisory literature. Regulation usually is justified where necessary to achieve better outcomes than could be achieved by participants left to themselves.

Market-failure analysis should remain the basic justifying premise for financial regulation. At the same time, we do not believe that the use of market-failure analysis should become unduly narrow or trapped in the application of overly rigid econometric techniques designed to prove or quantify market failure. Such techniques can be useful as a point of reference but should not detract from the need to make sound, whole-picture judgments as to whether or not markets need assistance in delivering desired outcomes.

Understanding Impacts, Weighing Benefits

Any debate as to the need for specific regulations needs a robust understanding of the likely impact in terms of incentives, costs, and expected benefits. This has been a long-standing view of the IIF[12] and remains equally valid today.

However, it does not always add to the quality of the discussion to try to put precise *monetary* values on the impacts or potential implications of different regulatory proposals. Trying to attach monetary values to impacts that often are diffuse and long-term, so as to make them meaningfully weighable against the putative benefits, can in certain circumstances undermine the importance of high-quality impact analysis. As we said in our 2006 *Proposal*, "costs and benefits are often hard to quantify, and impacts should not be assessed solely or even primarily on the basis of narrow efforts at quantification."

High-quality impact analysis, taking into account the effects of proposals on the overall efficiency of the system as well as effects on individual firms, remains essential to achieving effective and efficient regulation. It is of the

[12] See *A Proposal for a Strategic Dialogue on Effective Regulation.*

utmost importance that the potential impact be assessed rigorously and having regard to the best data and information that is reasonably practicably achievable. These impacts then are effectively weighed against the benefits likely to be achieved.

Incentives-Directed Regulation

It is important that regulation be based as much as possible on engagement with market incentives. To lever the incentives of firm management is likely to be both more effective and more efficient than simply to impose requirements.

To give an example, an approach that rewards strong and effective risk management within a firm is likely to produce much better results in the long run than an approach that prescribes separate sets of requirements that become a pure compliance exercise divorced from the way the firm is run.

Appropriate Differentiation

Reflecting a risk-based approach, the revised regulatory framework should be appropriately differentiated. Similar activities, such as banking and insurance, can share similar risks and, at the same time, exhibit real differences that should be reflected in the regulatory approach.

For example, insurers are primarily funded by advance premium payments, which in most cases cannot be withdrawn on demand or prematurely (exceptions are certain life insurance policies). This means that the different liquidity profile of insurance business should be recognized. Similarly, recognition must be given to the different nature of insurance risks, which tend not to be correlated with market risk.

Recommendation 7: *It is essential that regulation be effective while ensuring that markets remain as efficient as possible. The principles of effective regulation should be followed, including:*

- *Clearly identified objectives;*
- *Clear understanding of impacts, both positive and negative (but avoiding mechanistic or purely quantitative methods);*
- *An incentives-focused methodology; and*
- *Incorporation of consultation and dialogue.*

Dialogue on Effective Regulation

One aim of the IIF's 2006 *Proposal* on effective regulation was "to establish an ongoing, strategic dialogue between the two groups, focused on a clearer appreciation of common goals, effective and efficient regulatory approaches, and methods by which these objectives can best be achieved."

In view of recent events and of the scale of the challenge that lies ahead, there would be considerable merit in taking this proposal forward at this stage. The FSB recently has been expanded and provided with a considerably enhanced mandate. It has announced the establishment of a Standing Committee for Supervisory and Regulatory Cooperation.

The next step is to establish a mechanism for structured dialogue between the FSB and industry representatives to focus on the achievement of effective regulation during the period immediately ahead, when resolution of the crisis will create the opportunities to improve the regulatory architecture substantially. The FSB is uniquely placed to ensure that the dialogue transcends the traditional sectoral boundaries within the financial services industry—banking, securities, and insurance—and the traditional allocations of responsibilities between prudential conduct of business and market regulators, while also taking on board the new macroprudential perspectives.

> ***Recommendation 8:*** *There should be a structured, ongoing dialogue between the FSB, the standard-setters, and the industry to support high-quality, effective, and well-coordinated international regulatory reform. This should cover all financial sectors and all types of regulation (prudential and conduct of business).*

2.4. RELYING ON MARKETS TO ACHIEVE STABILITY

A central question in the development of the new international regulatory framework is the extent to which—in light of the events of the past two years—markets can be relied on generally to tend toward financial stability. To the extent that this is not the case, regulation is more necessary to protect the system against damage.

The case for significantly reduced reliance on markets is made succinctly in the *Turner Review*, one of several voices calling into question the "efficient market" theories of the past 30 years. It contends that there are increasingly effective criticisms that markets cannot be relied on, that the rationality of individual actors' pursuing their own goals does not ensure collective rationality, and that individual behavior is in any event not entirely rational.

It has long been recognized that markets have important failings. One key failure is that participants can be expected to manage their risks effectively up to the point where the cost of doing so makes sense from their own point of view. To the extent that costs are necessary to protect others, markets do not reward or incentivize firms to do so.

Equally, regulation has its limits. As Gary Stern, President of the Federal Reserve Bank of Minneapolis, has noted, an approach that relies unduly on regulation at the expense of market discipline could conceivably succeed in diminishing risk taking, but only at significant cost to credit availability and economic performance.

To achieve meaningful market discipline, it is important that creditors other than protected depositors or policyholders be at real risk of loss in the event of the failure of a firm. Absent perceived risk of loss, risks will be taken on the assumption that ultimately the taxpayers will bear such loss.

Two Complementary Paths

The belief that firms were too big or too interconnected to be allowed to fail with loss to creditors appears to have been prevalent during the recent period. Accordingly, the level of discipline was reduced.

Two complementary types of effort are needed.

On the one hand, as discussed above, it is necessary that regulation and supervision be enhanced to ensure these risks are better understood by the community as a whole and better addressed at both microprudential and macroprudential levels.

On the other hand, there should be strong incentives so that investors—in particular, creditors with limited share in the upside of the risk taking—take action to reward prudent behavior and penalize undue risk taking. Market discipline failed in many cases to operate effectively in the period leading up to the crisis. Accordingly, in addition to developing a framework of enhanced regulation, an essential focus of effort should be to ensure that market discipline operates much more effectively for the future.

Financial Firm Failure and Resolution Frameworks

To increase the perceived chance that a significant firm will be able to exit the market in an orderly manner, significant enhancement of international regimes for dealing with failing institutions should be a top priority. Means need

to be developed for early intervention in, and the orderly winding-up of, such institutions in such a manner as not to cause undue damage to the overall system while allowing losses to be borne by creditors in line with applicable rules concerning priorities in insolvency proceedings. This issue is discussed at length in Section 7. The changes outlined there are essential to the operation of strong market discipline for the future and thus to the success of the revised regulatory framework.

Making it possible for a major firm to exit the market without causing severe disruption to the entire system also will require considerable further attention to how to ameliorate the risks arising from the high degree of interconnectedness of firms in the financial system without diminishing the substantial benefits that interconnectedness produces. We consider these issues in more detail in Section 5.

Transparency

Another reason why market discipline failed to operate was that there was insufficient transparency of critical products and activities, for example, in respect to the underlying assets of structured products and their riskiness and to the risk profiles of counterparties. The industry fully agrees that levels of meaningful transparency need to be significantly increased.[13] This issue is discussed in more detail in Section 5. Much has already been done, and more is under way. However, it will be necessary to review further whether this achieves everything that is necessary to ensure effective market discipline.

The industry is committed to continue to work with the official sector and market participants generally to achieve high levels of transparency to support an effective market discipline regime.

Other Means to Increase Market Discipline

There may be other means available to increase overall levels of market discipline in the system. As part of the reform process, the industry as well as the official sector should give close consideration to all possible ways of increasing the effectiveness of market discipline. The greater the extent to which this can be achieved, the sounder and more efficient will be the system, the less intrusive the necessary regulation, and the lower the ultimate risk to fiscal authorities and taxpayers.

In addition, the orderly withdrawal of extraordinary state support of firms and markets discussed in Sub-section 1.7 should be conducted with the reinvigoration of market discipline as one of its principal goals.

> ***Recommendation 9:*** *Resilience depends in large part on the risk management of firms and the functioning of markets. Regulation cannot do the job on its own. It is essential to restore and enhance market discipline, in particular by ensuring that creditors of financial institutions (other than depositors and insurance policyholders, and subject to the rules of priority in insolvency) are at risk of appropriate loss in the event of failure. Reform should lever and seek to enhance the positive dynamic between markets operating under effective discipline and more effective regulation.*

[13] See *Market Best Practices Report,* Section D.VI.

SECTION 3

Achieving Resilience Through the Cycle With Prudential and Accounting Standards

In this section, we provide an industry view on what is required to enhance the role capital and liquidity requirements and accounting standards play in absorbing market and systemic shocks. Experience shows that current requirements need to be better adapted to times of stress or economic downturn. In particular, measures need to be taken to reduce procyclicality. The overall outcome should be to ensure that protection is available when most needed.

3.1. REGULATORY CAPITAL ISSUES

Capital adequacy is a central issue being considered as the industry and the regulatory community ponder fundamental changes in the global financial regulatory framework. Assuring adequate capital requirements and the necessary shock absorption capacity without stifling credit generation is a tremendous challenge and requires an informed debate about the level of stress capital should insure against. In achieving the right balance it is fundamental to get the capital foundation right. At the same time, it is necessary to keep in mind that capital is not a panacea for all problems; liquidity buffers, good management, rigorous risk management, robust corporate governance, and strengthened supervision all have important roles to play.

This discussion follows most of the debate in the wake of the crisis in focusing on capital for banks and investment firms. It should be kept in mind that, while crisis issues need to be taken into account in making policy decisions as to parallel insurance requirements, the specificities of the insurance business also need to be weighed carefully, and hasty conclusions should be avoided.

Need for Enhancement

It is widely agreed that levels of capital in many parts of the system leading up to the crisis were insufficient, and a risk-based increase in such capital is necessary. The analysis must focus on how to determine reasonable levels of capital that serve the purposes of ongoing resilience of the system against future shocks but also underpin sustainable credit provision.

Quantity is, of course, not the only dimension to be considered. The quality of capital (availability and loss absorption capacity), the adequate control of leverage, and the management of cyclical volatility of capital all must be addressed in order to achieve a comprehensive framework for financial institutions' capital.

Enhanced capital regulation must be globally consistent to ensure a level playing field and avoid competitive distortions. This is certainly recognized in the Basel Committee's agenda and several of the regulatory proposals recently issued including the *Turner Review* and the recent U.S. Treasury proposals.

Clear Objectives

The consensus as to the need to reform overall capital in the system has so far left unanswered the questions of how to achieve an appropriate increase, the allocation of any increase across

risks and businesses and, indeed, the actual goals intended to be reached, beyond a general desire for greater stability. Clarity as to goals at a somewhat more precise level is important. A "zero failure" objective would be ultimately highly damaging and must be resisted. Getting the levels right will not be easy. As has been made evident in the case of the trading book capital proposals, a well-informed, technically alert back-and-forth between the public and private sectors on the basis of careful impact studies is essential to get to a more stable but balanced and coherent set of requirements.

Basel II Remains the Correct Basis

Even though public capital injections have been necessary in several cases, the industry has raised large amounts of capital from private sources despite adverse conditions. Revisions to portfolio composition and asset divestitures are already resulting in reduced risk and greater capital adequacy.

The IIF shares the G-20 view that, with necessary adjustments, Basel II remains by far the best framework for setting the regulatory capital requirements of financial institutions and that all jurisdictions, including the United States, should move expeditiously to effective implementation of the new Accord. In addition to setting capital requirements on a rigorous basis, Basel II will continue to increase resilience by inducing ongoing improvement in risk management. Industry participants agree that the first step is the Basel Committee's current revision of the risk-capturing features of Basel II. This follows the conviction that unless risk is appropriately captured, minimum regulatory capital ratios (whether 8% or above) will not be meaningful nor serve their purpose.

Recent changes by the Basel Committee aimed at improving the risk capture of Basel II address the most pressing deficiencies evidenced by the crisis: the capital treatment of resecuritizations, exposures to off-balance sheet vehicles, and trading book capital needs. Equally, strengthening risk management practices through additional Pillar 2 guidance (addressing fundamental issues such as adequate stress testing, management of risk concentrations, and firm-wide risk management) will reinforce on a consistent basis the work being done by firms to improve internal risk management.

Requirements Should Reflect the Risk Profile of the Business

The IIF has long advocated that regulatory requirements should, in order to achieve robust outcomes and to avoid competitive distortions, reflect the risk profiles of different business lines. This should be reflected in, for example, recognition of the different risk features of different business activities such as banking, insurance, asset management, or investment advice. As stated, the important issue is not the legal nature of the entity but rather the risk profile of the activities carried on.

The Need for an Integrated Perspective and Aggregate Assessment

This work needs to be conducted within an integrated perspective. It is clear that the combination of current capital requirements under Basel II, the effects of the inclusion of downturn default data and reduced ratings into banks' internal ratings-based (IRB) models, and the capital resulting from the implementation of the various enhancements to Pillars 1 and 2 proposed by the Basel Committee will deliver significantly greater capital levels.

New capital requirements for resecuritizations and trading book assets will dramatically increase Pillar 1 regulatory capital. Indeed, the original proposals would have substantially overshot the significant increase of capital for the trading book that is agreed to be necessary by industry and regulators alike. Although the final standards published in July 2009 appear to be an improvement, a careful impact assessment needs to be done, and the industry is still studying the

revised standards. As with all aspects of Basel II, consistent implementation of the new trading book regime will be critical, all the more so because of the international nature of the trading markets. Thus, it is important that the pending Capital Requirements Directive amendments in Europe be modified on the lines of the final Basel version and that the United States and other countries faithfully implement it promptly.

Additional Pillar 2 amounts determined by regulators, including the potential impact of new stress tests, will likely add significantly to the overall impact. Similar effects will result from additional capital buffers and measures designed to lessen procyclicality on a basis as yet to be determined, a potential leverage ratio constraint, and a new and perhaps more limited definition of Tier 1 capital. Furthermore, requirements for liquidity buffers need to be considered jointly with capital requirements, given the effects they will have on cost structures and funding strategies. All this needs to be evaluated on an aggregate, not on a proposal-by-proposal, basis. The implementation of Pillar 2 was discussed further in Sub-section 2.2.

Despite the evident need of integrated assessment, there is not as yet an estimation of the magnitude of the capital effects the pending changes will produce. Therefore, there is an urgent need for a thorough study of the overall impact of the new regime by the Basel Committee in close consultation with the industry. This analysis should be aimed at determining the actual level of total and Tier 1 capital resulting from the various enhancements and additions to the Basel II framework, combined with the impact of liquidity and other changes. This is critical because of the danger of damaging unintended consequences for the whole market from overshooting a reasonable and necessary increase.[14] Nothing is more important than getting a complex new system right. Given that immediate problems of the crisis have largely been addressed, time should be allowed for meaningful impact assessments and analysis before finalizing new requirements.

The timing of such an evaluation is critical. While there is a need to act decisively, capital deficiencies in most large firms are being addressed. The effects of all the changes that are being proposed will require adequate time for analysis. The analysis should be free of artificial deadlines, and finalization of each change of the prudential capital regime should be made subject to appraisal of the likely all-in effects of the coming changes.

Although the final standards published in July 2009 correct in substantial part what could have been very serious unintended consequences for correlation trading, and the industry is still studying the revised standards, it is clear that not all unintended consequences, including disruption of risk management of existing positions and likely impacts on the market prices of certain instruments, have been addressed. The industry looks forward to continuing to work with the Basel Committee on the projected further refinements as the Basel Committee's impact analysis continues.

Earnings Capacity

While capital and other protective measures are of essential importance, earnings and the capability to generate revenue commensurate with a reasonable return are the foundation of firms' viability. Solid, sustainable earnings and the market confidence that go with them are essential to developing lending capability and longer term resilience—and thus to financial system stability. Indeed, earnings capacity has appropriately been examined in conjunction with

[14] The Quantitative Impact Study currently being conducted by the Basel Committee covers only the trading book and market risk proposals (that is, excluding the impact of Pillar 1 requirements for securitizations in the banking book and exposures to off-balance sheet vehicles, as well as the very comprehensive changes to Pillar 2 in the areas of stress testing, firm-wide risk management, valuation, and so forth).

capital in crisis-related, official-sector stress tests of individual firms' ability to weather possible further downturns. On a more macro basis, the solidity and diversification of earnings across the financial services industry is an important aspect of its ability to contribute to recovery and then sustained growth. Thus, balancing capital and other safeguards with the capacity to generate earnings is absolutely necessary, although often overlooked in public discussions of capital and prudential issues.

Innovation

Over the past 50 years, market-driven innovation has made tremendous contributions to economic welfare. It can also, of course, be misused. Certain recent innovations have compounded complexity and opacity, obscuring underlying risks, which became grossly disproportionate to any benefits. These problems have been recognized widely, and are being dealt with by several initiatives. The IIF is committed to building upon the progress already made to achieve the levels of transparency and market discipline necessary to avoid such dangers in the future. Innovation remains essential to future progress, and will proceed in a context of stronger risk management, good governance, and effective supervision based on the lessons learned of the crisis. In carrying out regulatory reform great care must be taken not to define requirements so narrowly as to constrict or cut off future innovation.

Strategic Considerations for Capital Raising

Importantly, both the industry and supervisors will need to consider whether the framework is adequate to attract equity investors with medium- to long-term investment views as a part of the overall problem of improving the incentives to which the industry responds. The roles that hedge funds, sovereign wealth funds, insurance companies, and pension funds can play are crucial but will require reconsideration of various regulatory requirements that affect their investments. A lengthy discussion of where capital is to come from as state investments are reduced is not within the scope of this report. It is, however, vital that this issue be given a higher profile in international public- and private-sector discussions.

International Coordination and Good Timing Essential

Among the most fundamental needs felt by IIF members are for international policy coordination and adequate timing of the reforms. Changes in the capital regime should be consistent internationally and not create market distortions or make unlevel the playing field. Similarly, although the point is certainly recognized by the Basel Committee, it is important not to introduce new requirements that would contribute to short-term procyclicality by diminishing further the already reduced credit capacity of the system. Rather, introduction of new requirements should be phased in once recovery is well established.

Credit Capacity and Securitization

Until recently, securitization remained the main source of credit outside of bank balance sheets. However, the cumulative effects of the various changes may end up seriously hobbling the system's lending capacity.

While complex resecuritizations should be subject to significantly increased capital charges (although the market for them seems unlikely to return in any case), they should be clearly differentiated from the more vanilla or standard types of securitization that have been essential to provision of credit for asset categories such as automobile finance, student loans, credit cards, and the familiar types of mortgages, which have performed well for many years until the problems originating with sub-prime mortgages spiraled out of control.

There remains a serious danger that the accretion of proposals for securitization, including increased capital requirements, accounting changes, rating agency changes, and "skin-in-the-game" retention requirements, may make it difficult to securitize the necessary volume of assets to sustain adequate lending capacity.

It is important not to force transactions on-balance sheet, either by accounting or by regulatory requirements, beyond what is necessary to correct true excesses of the prior period. In getting the balance right, not only should the need to maintain the conditions under which securitization can continue to be done be factored in, but also the fact that substantial improvements in disclosures of off-balance sheet positions via Pillar 3 have already been promulgated (see Sub-section 5.4).

The support of securitization by some of the government intervention programs shows its importance. Yet it is not clear that the overall effects of pending changes on this vital and reliable means of finance are being evaluated carefully, as new requirements are being developed individually.

Finalization of a new regime for securitization needs to take into account the interaction of all the various proposals under consideration. Some issues are still being debated, such as the derecognition and consolidation rules of accounting, and the IIF is making its contributions to that debate, as on the corresponding prudential regulatory and disclosure requirements regarding off-balance sheet exposures. Others, including some of the recent Basel risk-weight modifications for resecuritizations, are relatively uncontroversial, although the impact of treatment of securitizations in the new trading book requirements is yet to be analyzed fully.

"Skin-in-the-game" retention requirements have been debated at length and are still going through the political process but appear likely to be implemented. Without belaboring what has already been an extensive debate, there remain doubts about whether the requirements will achieve their stated goals. Moreover, there is concern that their downsides of making securitization less attractive for certain firms, more costly in capital terms, and more complex to manage both as a business matter and for purposes of risk management, will outbalance any gains. Concerns about the quality of transactions that have prompted these proposals—which are quite legitimate looking only at the period prior to July 2007—are in fact well on the way to being addressed by other means.

As important as taking the aggregate effects of changes into account is close international alignment of all such requirements, which will have a significant effect on how future transactions are done.

Substantial industry initiatives are under way to upgrade the documentation and transparency of securitization, including the European Securitisation Forum's *RMBS Issuer Principles for Transparency and Disclosure*[15] and the American Securitization Forum's *Project RESTART.*[16] These initiatives should make it possible for securitized finance to resume its essential role without recreating the risks that now well-understood excesses raised. Transparency is discussed further in Section 5 below. Moreover, extensive changes in origination of underlying assets and in underwriting standards and practices are being made as a result of regulatory requirements and industry recommendations such as those in the *Market Best Practices Report.*

[15] December 2008, see http://www.europeansecuritisation.com.

[16] July 2008, see www.americansecuritization.com/restart.

Commitment VI: *Levels of capital in many parts of the system were insufficient. The IIF agrees that overall levels need to be increased, within the framework of the Basel II risk-based approach, as compared to pre-crisis levels. The IIF membership stands ready to work with the regulatory community on objective analysis of the cumulative net impact of proposed regulatory changes.*

Recommendation 10: *The cumulative impact of proposed enhancements of capital requirements and other regulatory and accounting changes should be fully assessed prior to final decisions being made.*

Recommendation 11: *The timing of introduction of new requirements should be carefully considered to ensure that they do not hinder recovery.*

3.2. ADDRESSING CAPITAL CYCLICALITY

It is agreed that measures need to be taken to reduce levels of cyclicality in regulatory capital requirements. Firms also are considering this from an internal risk management perspective. For example, firms are adopting a longer perspective on capital planning, even at the level of the definition of risk parameters. A dialogue on the basis of the official sector's parallel work under the G-20 mandate will be necessary as that work becomes more fully available. The related issue of cyclicality of loan loss provisioning is discussed further below in this section.

Various ideas have been floated to address procyclicality. The industry generally is supportive of the concept of measures to reduce the procyclicality of regulatory requirements, including consideration of time-variable capital buffers or reserving. But the devil is in the details, and there is as yet no consensus on how to achieve what is in fact a difficult technical goal. Furthermore, there is a need for thorough analysis and hard data in order to develop a confident understanding of the real nature and extent of procyclicality in the regulatory capital framework.

Buffers Must Be Able to Be Drawn in a Downturn

It is important that any measure be objective, transparent, and free of unintended consequences (in particular, in how it could affect the way firms manage risks internally). If there are to be capital buffers, or reserves, it is of fundamental importance that they be truly available to be drawn down in economic downturns. Without this the result would be wasteful overcapitalization without real benefit. This requires not only a regulatory commitment but also buy-in from the rating agencies and the market. The Basel Committee needs to give a high priority to this aspect of the problem.

Clarity Is Essential as to Aims

Furthermore, debate is needed as to whether buffers should be specifically countercyclical or aimed only at mitigating artificial procyclicality of the regulatory capital framework. While both objectives deserve consideration, explicit countercyclical buffers present additional challenges. Not only would such buffers be extremely complex to use, but they also would require vesting extensive discretionary powers in regulators and central bankers, which could subject them to unmanageable political pressures that would compromise their independence and the achievement of their properly regulatory goals.

Discretion Should Be Limited

Given that cycles will vary somewhat by country, determination of where in the cycle a specific jurisdiction is (and the related decision of whether or not banks should be able to draw from the buffer) is a central question. Alternative approaches include discretionary mechanisms

(by individual firms, prudential regulators, or systemic regulators) and formulaic (non-discretionary) mechanisms. At this point, and subject to more detailed debate, the industry's view is that discretionary elements should be reduced to a minimum in order to make the process objective, predictable, and transparent.

The Approach Should Be an Integrated One

Importantly, consideration also is needed as to the relationship between potential future international capital buffers or reserves and the capital buffer mandated by regulators in various jurisdictions as a result of crisis-driven "stress tests." In particular, it is necessary to determine the specific objective sought by each measure in order to avoid potential overlapping and inefficient requirements.

Coordination Is Important

More broadly, international coordination on any decision to impose capital buffers or reserves on top of other capital requirements is of vital importance. While the economic cycle can vary across jurisdictions, it is important that objective criteria be established so that competitive distortions do not arise.

> ***Commitment VII:*** *The IIF supports measures to counter cyclicality by building resources in good times that can be drawn down in bad times.*
>
> ***Recommendation 12:*** *Buffers, whether created by capital or reserves, should be able to be drawn on when needed without adverse consequence.*
>
> ***Recommendation 13:*** *There should be dialogue between the official sector and the industry to develop effective approaches to the very difficult task of evaluating the cycle and deciding when to apply buffer mechanisms, on the upside or the downside.*

3.3. DEFINITION OF CAPITAL

The definition of regulatory capital is an important variable as international standard-setters consider the specific contours of a revised regulatory capital framework. IIF members agree that a review of the quality of regulatory capital and its definition as interpreted in different jurisdictions should be undertaken.

Market Developments Must Not Exclude Debate

To some extent, market demand has already started to drive the process of revising what should be the components of firms' capital. However, it is imperative that a thorough analysis and debate take place before making policy decisions on the regulatory definition of capital, as current market pressures may not be the right guide for a long-term definition of capital.

International Consistency Is Essential

International consistency is essential. Any review must be highly coordinated in order to achieve convergence of interpretation and implementation. A "common language," avoiding major interpretative divergences in the future, would help avoid competitive disparities and inefficiencies in how regulators and markets deal with financial crises and bank insolvencies.

The Basel Committee is undertaking an analysis of the definition of capital. The industry is committed to participating in this discussion constructively, guided by the overall objective of ensuring high-quality Tier 1 capital, including common equity, retained earnings, and robust forms of preferred stock or instruments with similar loss absorption capabilities, subject to internationally agreed deductions.

Accounting and Tax Effects Should Be Considered

Some disparities across jurisdictions derive from inconsistencies between International Financial

Reporting Standards (IFRS) and Financial Accounting Standards Board (FASB) accounting standards. Hence, accounting harmonization is part of the solution on issues related to the elements of capital. Similarly, tax inconsistencies play an important role and must be resolved if a truly harmonized, stable framework is to be achieved. Inconsistent treatment of different instruments for tax purposes within national regimes and further inconsistencies across national regimes also have a major effect on firms' incentives as they approach their capital strategies, their choices of instruments, and their relationships with the markets.

While the tax issue is complex, and problems of revenue neutrality of any change must be recognized, it puts to the test governments' willingness to develop a truly international regime on capital. The tax dimension is fundamental to any discussion of firms' capital structures, and its discussion should not be avoided.

Tier 2 Remains Important

The current quasi-exclusive focus on Tier 1 capital is a further source of concern. While focus on Tier 1 is warranted, complete disregard of Tier 2 capital is not. As the system emerges from the crisis, it will be important to renew recognition of instruments such as subordinated debt, which are effective as bank capital elements, particularly on a gone concern basis where protection of depositors becomes the more relevant. This will be all the more important if a more robust international resolution regime emerges, which will make having a full range of instruments available important.

Moreover, it will be important to give careful consideration to the role of Tier 2 capital that is convertible into Tier 1. Firms with buffers of convertible Tier 2 instruments as part of their contingency plans were well served by them. There is, of course, a question of the market's assessment of such instruments from time to time; however, a sound regulatory capital framework would not put impediments in the way of banks' using such instruments when market conditions permit.

Importantly, it seems premature to adopt any final decision on the distribution of capital between Tiers 1 and 2. The original concept of Pillar 1 is that it is a measure of risks in the bank and careful study should be given before any adjustment of the original ratios of Tier 1 and 2, in terms of impact on the overall economy as well as on the prudential solvency of firms.

Tier 3 Also Should Be Considered

Debate also is required on the future of Tier 3 capital, aimed at supporting short-term trading exposures. As with Tier 2 capital, there should not be a rush to judgment, but rather the future role of Tier 3 capital should be reevaluated once the whole picture on the regulatory capital treatment of the trading book is clear and firms' adjusted business models have settled down in the new market that will emerge.

Impact Assessment Is Needed

As with other changes that have an effect on the cost of capital and the cost of sustaining credit businesses, any changes to the international definition of capital should be undertaken only once there is a confident assessment of the cumulative impact of all other changes under consideration.

Commitment VIII: *The IIF agrees that the quality of capital required needs to be reviewed. The IIF membership is ready to work closely with the official sector to achieve an outcome that reflects the lessons learned from the recent period.*

Recommendation 14: *Consistent international requirements for the definition and quality of capital, in particular Tier 1 capital, should be developed. They should be applied consistently on a global basis. The benefits of Tier 2 capital, including convertible Tier 2, should not be underestimated.*

3.4. CONTROLLING LEVERAGE

There is agreement that excessive leverage had developed in the system, and this must be controlled in the future. Significant progress has been made by the industry in reducing leverage as evidenced by various recent analyses. While this trend continues, there also is appropriate concern about the speed of deleveraging and its effects on the real economy.

Best Means of Control?

Fundamentally, it is essential to have a debate on how to design leverage measures that will achieve the goal of having a backstop to capital requirements without putting a brake on well-managed risk-taking and without creating disincentives to business in low-risk assets. In so doing, it should be kept in mind that the more robust capital regime will also have a substantial effect on leverage in the regulated financial sector, which underscores that any additional measures against excessive leverage should be designed as true backstops to correct anomalies or outlier behaviors, not to supplant sound capital requirements.

Moreover, if the goal is to prevent firms from gearing up to excessive leverage, supplemental prudential measures are appropriate. However, it would not be appropriate to conflate leverage control measures with the separate issue of whether in individual cases there should be limits on growth, scale, or diversification of the business conducted by a given firm (see Section 4).

Design Criteria

As part of the debate on establishing at the international level supplemental tools to control leverage, it is important to underscore some basic design criteria. Any measure should do the following:

- Take into account differences between accounting standards[17] (in particular, regarding on- and off-balance sheet items);
- Take into account netting, hedges, off-balance sheet items, and differences in business models as differences in funding structures;
- Allow flexibility so that its application does not result in discriminatory treatment of certain business models or certain jurisdictions; and
- Be internationally agreed and consistently applied across jurisdictions. The macro-effects of any supplemental measures to control leverage must be examined carefully, both on a domestic and on an international level.

More fundamentally, supervisory tools to contain leverage may be useful, but only if correctly applied. Experience during the crisis of banks operating under jurisdictions with a leverage ratio demonstrates that its benefits are not always evident, even if combined with other regulatory tools. Consideration of leverage should clearly be part of each firm's dialogue with its supervisor. Rather than operating as a hard, Pillar 1 type of mandatory requirement, a supplemental measure looking at leverage should be used as one indicator among many, under a Pillar 2 approach.

If well designed, this Pillar 2 approach can result in appropriately targeted supervisory intervention, including increased monitoring, targeted remedial requirements, or additional capital requirements. Under Pillar 2, specific measures would be adopted only after supervisory dialogue has taken place, taking into account all the facts and circumstances, including such issues as the components of the assets included in the

[17] The industry is glad to see that the official sector (including in particular the Basel Committee on Banking Supervision and the European Commission) has recognized this problem but reiterates that it is fundamental.

calculation (for example, government paper and less-risky, standard mortgages), as well as the appropriate way to cover off-balance sheet assets without resulting in exaggerated and disproportionate effects. Rather than a mechanical tool, supplemental measures of leverage have great potential as determinants of enhanced supervisory dialogue. By contrast, any simplistic, gross measure, applied across the board, is likely to reflect poorly firms' actual short-term liquidity situations, might induce firms to take on a riskier mix of assets than would otherwise be the case, and can distort business incentives and encourage arbitrage.

It goes without saying that the foregoing discussion is focused on the widely discussed issue of supplemental leverage measures for banks. As the leverage issues facing insurance businesses are quite different, it should not be taken to apply to them.

> ***Commitment IX:*** *The IIF agrees leverage was too high and needs to be appropriately controlled in the future.*
>
> ***Recommendation 15:*** *A simple leverage ratio runs the risk of undermining its own objectives. Any measure to contain leverage should take account of differences in business models and funding structures, major differences in risk profiles, distinct market practices and characteristics, and differences in accounting standards. Leverage should be addressed as a supervisory tool for use as part of the Pillar 2 dialogue between a firm and its supervisor.*

3.5. ACCOUNTING

This section highlights considerations for the official sector that remain compelling as discussions of accounting and regulatory developments enter a critical phase.

High-Level Dialogue

In the *Market Best Practices Report* and subsequent statements, the IIF has called for a comprehensive, unbiased, high-level dialogue on current accounting standards in light of the crisis, involving all relevant parties. Although consultative processes have been initiated, the need for a comprehensive and integrated high-level review of all aspects of accounting issues in light of experience in the crisis remains high.

> ***Recommendation 16:*** *There should be a comprehensive, high-level dialogue on current accounting standards in light of the crisis and the changing regulatory environment. This should involve all relevant parties while respecting the independence of the standard-setting process.*

Role of Accounting Standards in Promoting Confidence

There should be a thoughtful review of the role of accounting standards in international capital markets. Transparency, reliability, and representational faithfulness are objectives that should be the key drivers of any reform in the context of reviewing the existing accounting regime. By the same token, such a review should, wherever possible, include consideration of efforts to contain financial instability.

The G-20 mandate "to reduce the complexity of accounting standards for financial instruments and enhance presentation standards to allow the users of financial statements to better assess the uncertainty surrounding the valuation of financial instruments" is a step in the right direction. The IIF supports the accounting standard-setters' efforts to date in this regard. It is important to conclude the current reform program expeditiously.

Convergence

The G-20 and more recent official statements, such as the U.S. Treasury's proposals on regulatory reform, have consistently stressed the importance of international accounting convergence. It cannot be reiterated enough that expedited convergence of accounting standards is a prerequisite to strengthening the comparability of financial statements for investors and regulators as well as to preventing "accounting arbitrage."

Nevertheless, there remains ample risk of fragmentation and national solutions, which may result from inefficient communication between standard-setters and official-sector decision-making bodies, given perceived tardy responses by the standard-setters to emerging crisis-related issues.

Rapid progress on reform and convergence is essential to preserving the credibility and independence of the standard-setters. Their efforts to this end will need the active support of all concerned, including especially securities regulators and other authorities with oversight responsibilities. The standard-setters and other concerned authorities should reaffirm prior commitments in a clear plan for expeditious adoption of converged standards, eliminating existing directional and timing uncertainties.

There have been issues on which extraordinarily rapid action has been required, as discussed further below. Even so, however urgent responses to current issues or to parts of the G-20 agenda may be, these responses should remain well-coordinated and lead toward convergence.

Recommendation 17: *Achieving overall convergence in international accounting standards requires active support from all concerned, including the industry and securities and prudential regulators. There should be a renewed commitment by all stakeholders to a clear plan for timely adoption of a single, high-quality set of accounting standards.*

Standard-Setting Process

The IIF has continuously endorsed the independence of accounting standard-setters. It is, however, part of the responsibility of independence to take account of economic and financial developments and respond in a manner coordinated between boards to achieve consistency across the main international standards.

Consistent with the recommendations of the G-20, it is in the best interests of independent standard-setters and all market participants that the standard-setting process involve input from all stakeholders, including preparers and users of financial statements, as well as prudential and securities regulators (including those of emerging markets). This is not only a procedural matter but also a substantive one that will improve transparency and confidence in the standard-setting process and thus lead to a broader consensus on accounting issues.

The IIF is supportive of the International Accounting Standards Committee (IASC) Foundation Monitoring Board as a means to embrace regulatory participation in the standard-setting process; however, prudential supervisors should participate fully in this scheme.

There is a clear need for expedited due process to develop interpretive guidance or revisions of standards on occurrence of extraordinary events or on rapidly changed market conditions or business practices. An established, expedited process would contribute to avoiding divergence between the major standards, facilitate greater consistency in the application of accounting standards, and reduce uncertainty and the risk of a non-level playing field. A consistent expedited amendment process for official guidance, standard setting, and disclosure also is essential to avoid *ad hoc* amendments to standards that, in turn, may lead to voluminous and burdensome requirements that ultimately increase the complexity in financial reporting. Clearly it is vital for expedited procedures to be designed to further the goal of convergence for the benefit of users of financial statements.

> ***Recommendation 18:*** *Exceptional processes should be in place to provide guidance on as expedited a basis as possible while allowing for rapid consultation with stakeholders in the event of extraordinary occurrences.*

Valuation and Impairment

Valuation- and impairment-related issues caused great difficulties in the financial crisis. Accounting guidance recently issued or currently being debated on fair-value measurement in less-active markets is consistent with the goals of achieving clarity in the standards and promoting convergence. There has been wider recognition of the appropriate role of management judgment in valuation discussions and the need to avoid mechanistic mark-to-market responses.

However, more can, and should, be done. On valuation, the consistency of application of accounting guidance for valuation in difficult markets across firms and over time needs to be solidified. More work in particular needs to be done to integrate valuation adjustments into the process on an appropriate and transparent basis. The process should codify, on a fully convergent basis, guidance on use of valuation adjustments for liquidity and other risk factors in various market conditions.

Transparency of the valuation process is essential and, again, changes in guidance to date have been helpful but need to be integrated to ensure clear understanding by all issuers, large and small. While understanding of difficult market conditions has improved and the role of judgment is better understood, distortions caused by interpretation issues will be avoided only when final and converged guidance and standards are available and fully accepted by auditors and regulatory authorities.

Open discussion of the informational quality provided by existing impairment models has begun but needs to be pursued as a top priority. The recent changes made by the FASB illustrate the problem that analysis of credit deterioration may give value signals that are distinctly dissimilar to other risk factors (for example, liquidity) that affect market valuations. Now it is imperative for the standard-setters to quickly turn to the plan to develop common models that reduce the existing multiplicity and complexity of different impairment schemes. New, simpler approaches should be established on a basis of use of all available, relevant information, as the G-20 has mandated.

> ***Recommendation 19:*** *While progress has been made to date on valuation in less-active markets, more needs to be done. Standard-setters should develop a common framework that reduces the complexity and multiplicity of existing impairment models on the basis of all available relevant information. This should be done on a fully convergent basis, taking into account the lessons learned from the crisis.*

Fair-Value Accounting

The IIF continues to be of the view that, while fair-value accounting has clear benefits for both users and preparers of financial statements for certain financial instruments, fair-value measurement may not always provide the best reflection of cash flows due to a reporting entity operating on a longer term business model. Work is in progress to improve the present mix of fair-value and accrual accounting for financial institutions. It is important to stress that the next few months' work by the two accounting boards, in consultation with the industry and other interested parties, will be crucial. Much can be done. The IIF proposed suggestions for the classification of financial instruments to the International Accounting Standards Board (IASB) in connection with its joint project with the FASB on simplifying accounting for financial instruments.

The IIF proposals are based on the premise that consistency between the accounting framework and the reporting entity's business model is paramount for faithful representation of the economic substance of transactions. Factoring in the firm's business model provides a robust, objective standard and relates directly to fundamental business realities, facilitating market discipline. Improvements to the allocation of assets between amortized-cost and fair-value categories (as the IIF has proposed) will provide better information to users by aligning reported values with the business model and use of assets. This approach also would allow the standard-setters to address a number of the criticisms of fair-value accounting in the current environment.

One particularly important aspect is the impact of any near-term changes in the classification model on the financial statements of insurance entities. Insurance business models include holding financial assets for the medium to long term to back insurance liabilities and for risk and asset liability management. Any change requiring measuring such assets at fair value through profit and loss would lead to artificial earnings volatility and accounting mismatches, given that insurance liabilities are not measured on the same basis. It is vital for insurance entities to be able to maintain the current "fair value through other comprehensive income" category of investments, at the very least until new standards on insurance contracts are effective.

Dealing effectively with classification between fair-value and accrual accounting also should provide the basis for avoiding further divergence between financial accounting and regulatory capital requirements. Whereas it has been a goal of all parties for years to maximize convergence between the two regimes, an unfortunate effect of crisis-driven accounting controversies has been to cause some to conclude this may not be feasible. Convergence rather than divergence between the two should remain a high-priority goal of all concerned. A good result would contribute to transparency and ultimately to stability.

Furthermore, existing rigidities in hedge accounting[18] lead to disincentives for preparers to elect hedge accounting treatment for financial instruments carried at amortized cost. This contributes to earnings volatility, as the hedging instrument will be carried at fair value while the hedged item is not. The fair-value option has helped reduce this volatility, as it provides users with the ability to achieve economic hedge accounting without the associated risks and has a legitimate role in a simplified scheme, provided that issues related to gain and losses on an entity's own credit are resolved.

> ***Recommendation 20:*** *Fair-value accounting has clear benefits in appropriate contexts. However, questions have been raised concerning its effects on cyclicality, and it may not always provide the best reflection of cash flows due to a reporting entity. Work currently in progress to review fair-value and accrual accounting for financial institutions should continue with urgency. It should also address, as part of the comprehensive simplification of financial instrument reporting, existing rigidities in hedge accounting.*

An Entity's Own Credit

Reflection of changes in an entity's own credit standing in its earnings is another source of concern to many. While opinions on the utility of recognizing changes in an entity's own credit to provide meaningful information to investors are divided, it is clear there is much discomfort with this aspect of fair-value accounting. The controversy about recognition of own-credit changes extends both to the substance of the current rules and also to the range of practices in their

[18] Hedge accounting requirements under U.S. GAAP and IFRS require extensive documentation and substantial resources for assessment and measurement of hedge effectiveness.

implementation. Importantly, it does not reflect management's view of a firm's liabilities.

Extreme movements in credit spreads over the past two years illustrate the widely made argument that recognizing changes of own credit in earnings often are not meaningful. This is because it is commonly not possible for an entity to realize the benefit of own-credit deterioration by transacting in its own liabilities to any great extent. The existence of credit deterioration may indicate that an entity is not in sufficient economic health to expend cash to realize the earnings benefit of retiring debt for less than its notional amount.

The IIF supports the current reconsideration of own-credit issues, which should include a close examination of such factual issues, how they complicate the use of the fair-value option, their impact on insurance accounting, and questions arising from the range of practice in implementation of the current rules.

> ***Recommendation 21:*** *Reporting changes in an entity's own credit in earnings is a source of controversy. The debate should consider whether elimination of recognition of changes in the reporting entity's own credit quality in reported earnings would provide simpler, more direct, and more decision-useful information to the market.*

Procyclicality and Loan Loss Provisions

Several official-sector commentaries have criticized the current incurred-loss provisioning model for exacerbating procyclicality on grounds that, because of non-recognition of inherent loan losses in portfolios, it may contribute to market pressure for high levels of dividends and share buybacks and to distortion of compensation calculations. Current accounting standards, in principle, permit considerable management judgment in establishing provisions.

However, in recent years, securities regulators have criticized "excess" provisions, with the result that preparers and auditors often have taken a much more restrictive approach to establishing provisions than reasonable judgment about loan losses would suggest. Consequently, it appears that a narrow interpretation of the incurred-loss model has become widespread in practice. This has had the unintended consequence of delaying the recognition of portfolio loan losses, exacerbating the effect of procyclicality.

In line with the recommendations of the FSB, the IIF has called for interpretive guidance, authoritatively backed by the official sector, to enable practitioners to apply reasonable judgment in assessing loan losses by taking into consideration a broader range of available credit information. This will result in more consistent and less procyclical loan loss practices that are consistent with existing accounting literature. The issue is whether management will feel comfortable exercising judgment accordingly, and this depends largely on whether the auditors and securities regulators follow the standard-setters' guidance and accept provisions based to a greater extent on professional judgment.

Several official-sector reports, including those of Working Group 1 of the G-20 and the FSB,[19] recommended a medium-term broader review of loan loss provisions by analyzing alternative models that incorporate wider ranges of credit information. With the objective of advancing the discussion, the IIF submitted to the Financial Crisis Advisory Group on behalf of members two alternative proposals that incorporate credit information that is not currently utilized under the incurred-loss model. One is a revised version of the Spanish dynamic provisioning method intended to recognize impairment earlier in the economic cycle; the other is a proposal for a

[19] FSB, *Report of the Financial Stability Forum on Addressing Procyclicality in the Financial System*, April 2, 2009.

change of standards to put provisioning on an expected-loss basis similar to that in the Basel capital accord. These proposals are now being debated as part of the reconsideration of the existing provisioning model.

On the related issue of the treatment of accounting provisions for regulatory capital purposes, it is clear that the regulatory capital framework should not create disincentives for adequate provisioning; however, contrary to a fear some have expressed, it does not appear to the IIF that the present rules limiting the inclusion of provisions in Tier 2 capital have a substantial effect on provisioning decisions. On the contrary, given that provisions will be more readily usable if treated as reserves (that is, not included in regulatory capital), the present limited use of provisions in capital should not be expanded.

It is, of course, essential that provisions—as with any capital buffers or related reserves—actually be usable against incurred losses as finally taken; any solution should be designed to allow provisions to be usable without accounting, regulatory, or market impediments. Therefore, consideration should be given to excluding provisions from capital altogether as a way to make provisions usable and also limit capital volatility. Whichever regulatory treatment of provisions is decided on, it is fundamental that adequate transparency be provided, as users of financial accounts should be able to determine clearly how firms create and use provisions.

However, regulatory policies on provisioning cannot deal with the issue of incentives in isolation. Tax rules play a fundamental role in provisioning decisions and ought to be considered as part of any comprehensive review.

> ***Recommendation 22:*** *Consistent guidance should be issued by the major standard-setters to allow the use of reasonable interpretation in assessing loan losses under the incurred-loss model. Such guidance should be given the unambiguous backing of securities regulators in order to help avoid the overly narrow applications that have contributed to procyclicality. The current review to consider the reflection of a wider range of credit information in standards for loan loss provisioning must be given priority.*

The discussion above highlights challenges arising from the financial crisis that are still being faced by accounting standard-setters. While progress has been made to date, and the IIF applauds these efforts, many issues remain outstanding that require discussion and deliberation by all constituents. It is important to maintain an open and transparent dialogue that includes all interested parties, takes into account issues raised by the crisis, and balances the need for urgent action with assessment of feasible implementation.

3.6. LIQUIDITY

The IIF issued an extensive discussion of liquidity risk management in March 2007, updated in the July 2008 *Market Best Practices Report*, including recommendations for assessment of liquidity risk, liquidity buffers, and other risk mitigants. The Basel Committee published in September 2008 its *Principles for Sound Liquidity Risk Management and Supervision*. There is general consistency between the IIF recommendations and the Basel *Principles*, which the FSB found to meet the G-20's initial concerns on liquidity.

The Basel *Principles*, if properly enforced, define a rigorous approach to liquidity risk management and supervision. For reasons noted below, any moves beyond those principles need to

be carefully debated to avoid material unintended consequences.

Firms have already enhanced their liquidity risk management and, subject to difficult market conditions, have been building liquidity buffers and working toward compliance with the Basel principles. In addition, they continue to manage their liquidity to ensure that local liquidity needs can be met, using conservative assumptions and setting local limits where appropriate.

As banks have been working to meet the Basel Committee's principles, the insurance industry will need time to work with the IAIS to make sure the quite different liquidity issues that arise from insurance activities are appropriately addressed.

Commitment X: *IIF members have already enhanced their liquidity risk management and, subject to difficult market conditions, have been building liquidity buffers and working toward compliance with the IIF and Basel liquidity principles. In addition, they continue to manage their liquidity to ensure that local liquidity needs can be met. IIF Members will continue the ongoing enhancement of their approach to liquidity management.*

Self-Sufficiency Approaches and Trapped Pools of Liquidity

Both firms and the global financial system will be more resilient if firms are able to manage their liquidity needs on a group-wide basis. Central treasury oversight of the firm's liquidity operations is essential to good risk management and proper internal pricing of liquidity. Major firms' internal liquidity flows can contribute significantly to sustaining liquidity in a global system. For these reasons, IIF members have argued strongly against local requirements that create "trapped pools of liquidity." Unnecessary local requirements that "trap" liquidity will unduly increase each firm's group-wide third-party credit exposure, balance-sheet leverage, and capital needs and also reduce unused wholesale funding capacity, ultimately lessening the efficiency of the financial system overall.

Following the Basel and IIF *Principles*, firms have substantially reinforced their liquidity risk management. They increasingly set limits and assess needs in each market. One aim of internal liquidity risk management—and of its supervision by regulators—is to make sure that conservative assumptions are used and limits set. Firms may use more centralized or more decentralized approaches, but the assessment of local market needs is always taken into account. The special needs of smaller currencies are, of course, part of the analysis. And, of course, regulatory attention to the quality of liquidity risk management has been substantially increased.

The UK Financial Services Authority (FSA) has announced a proposal to require firms to "ring-fence" assets of UK subsidiaries of foreign firms in order to prevent another case of assets being swept from a local operation prior to a firm's failure, as in the Lehman Brothers collapse.[20] Other countries have announced somewhat comparable measures.

From any country's point of view, maximum requirements might appear prudent, but this can only put the brakes on global recovery, global finance capacity, and ability to respond to global liquidity problems. The FSB *Principles for Cross-Border Cooperation on Crisis Management* acknowledges that local ring-fencing complicates firms' funding plans.

Any local requirements should take into account not only domestic needs and risks, but also the cumulative effects of such requirements on the global system. Also, whereas the risks of market funding are now widely recognized, it is paradoxical that ring-fencing may make local offices of global groups—which often do not have extensive retail deposit bases—more dependent

[20] UK FSA Consultation Paper 8/22, *Strengthening Liquidity Standards*, December 2008.

on wholesale market funding. Above all, such requirements should be consistent with the Basel principles and not implemented without careful international coordination through the Basel Committee and the FSB.

An Industry Contribution to Be Explored

One great obstacle to enhanced global regulatory integration, and a significant cause of resurgent jurisdiction-specific self-sufficiency, is a fear that in the event of the failure of a group, the stakeholders of the jurisdiction in question will find themselves prejudiced in favor of stakeholders in other jurisdictions.

It has been suggested that one way for the industry to help would be for the parent company of a group to provide guarantees for its subsidiaries. This, however, does not solve the problem, as in the end this produces a burden of broadly similar dimension for the group as a whole in terms of combined liquidity and capital requirements. In other words, it would replicate, in modified form, the inefficiency that is sought to be avoided.

An alternative suggestion would be for cross-border groups to seek to carry on their liquidity management in a manner such that in the event of a failure of the group or part of the group, the extent to which losses fall disproportionately on one jurisdiction as compared with another would be minimized. The aim would be to avoid the undue prejudice of one jurisdiction over another. The operation of such an approach might be tied to the proposal in Section 4 for large or highly interconnected firms to examine with their authorities the risks that their role in markets and products create to help the authorities assess what would happen in the event of their failure.

Such an approach would take into account the legal structure of the group and be subject to the constraints of law, including differences of insolvency laws across jurisdictions. The effect of this might be to achieve a combination of "top-down" calculations of the liquidity needs of the group with a more jurisdiction-focused approach to allocation. Such an approach could give significant reassurance to national supervisors by avoiding liquidity voids.

It remains unclear at this stage whether such an approach would be feasible given legal constraints, differing risk management techniques, and so forth. However, industry participants wish to explore with the official sector the extent to which such an approach might be feasible and productive. This could be a useful issue for the FSB to take up in its capacity as coordinator of the activities of colleges of supervisors.

Commitment XI: *Good liquidity risk management should take into account local market needs. In addition, the IIF is committed to exploring ways in which firms could organize their cross-border business to reduce the concerns of authorities that individual jurisdictions would suffer disproportionate loss in the event of an insolvency. This should take place in the context of the ongoing dialogue between large firms and the authorities concerning the information necessary to plan for the orderly exit of the firm should that prove necessary as discussed in Section 4. Such an approach would take into account the legal structure of the group and differences in insolvency laws across jurisdictions. The IIF stands ready to work with the official sector to reduce the real dilemmas that the tensions between global and local goals for good liquidity management present.*

Recommendation 23: *Although the serious issues raised by failures of major market participants need to be addressed, the significant drag on system efficiency created by "trapped pools of liquidity" also is important and needs to be taken into account. Self-sufficiency or stand-alone approaches to liquidity regulation should be resisted by regulators.*

Liquidity Buffers

Liquidity buffers raise different cyclicality issues from capital buffers. Whereas loan loss expectations naturally move with the credit cycle, liquidity risk is not smoothly cyclical but instead tends to move suddenly in response to market incidents. Thus, an extremely conservative approach to liquidity buffers would require very high liquidity buffers at almost all times as insurance against "perfect-storm" conditions that would be much less predictable than credit cycles. This would be counterproductive from an economic viewpoint.

As part of the further development of international practice on liquidity buffers, it is important to agree on when or under which scenarios a bank can actually use its liquidity buffers. The circumstances under which buffers will be able to be drawn down must be clearly defined and accepted by all parties in order to have the desired effect.

Prior IIF work has demonstrated at length that regulatory liquidity requirements cannot be applied across the board and that one-size-fits-all requirements will end up with distorted incentives and missed risks.

Commitment XII: *It is necessary to hold liquidity buffers against liquidity risk. This is an important part of a robust overall approach to liquidity risk management.*

Recommendation 24: *In determining a firm's liquidity buffer, mechanistic approaches that do not take into account the overall business model, funding profile, and market context of the firm are likely to be counterproductive and should not be adopted.*

Eligible Assets for Liquidity Buffers

The UK proposals confine assets eligible for liquidity buffers narrowly to a limited list of state obligations.[21] Such requirements are not without logic from one viewpoint, but they go too far and may have several unintended consequences if adopted broadly.

A restrictive definition of eligible assets, and the need for extensive portfolios of such assets for liquidity buffer purposes, will necessarily affect the markets for eligible and ineligible assets. Eligible assets, if defined too narrowly, may actually become significantly less liquid, as they will need to be held in large amounts for liquidity buffer purposes. The negative effects on non-eligible traded debt markets will delay their recovery, increasing reliance for finance on bank loans, thereby creating pressure on bank liquidity.

The mark-to-market effects of many firms' disposition of a narrow category of eligible assets also need to be taken into account. If, in a systemic event, many firms sought to use the same assets, prices would be depressed, and markets could seize up, triggering another downward spiral.

Rather than setting *a priori* requirements, it would be better both for overall liquidity and for the market as a whole if requirements allow for a range of solutions, based on objective liquidity analysis. Any analysis that excludes a class of asset that is eligible at major central banks in ongoing operations should be carefully

[21] From *Strengthening Liquidity Standards*: "The assets in the buffer should be the most liquid by virtue of the significant depth and resilience in stressed conditions of the established markets in which they are traded. We consider these to be:

- Highly liquid, high-quality government debt instruments as follows: gilts, plus bonds rated at least Aa3 issued by the countries of the European Economic Area, Canada, Japan, Switzerland, and the United States; and
- Reserves held with the Bank of England's reserve scheme and with the central banks of the United States, the EEA, Switzerland, Canada, and Japan."

considered; exclusion of a central bank–eligible instrument may have significant and unnecessary consequences, depending on the facts and circumstances. IIF recommendations always have made clear that the first line of defense is not the central bank; however, central bank–eligible assets will generally have the ability to generate cash by sale, repo, or other use as collateral in the market.

In determining the marketable assets available for liquidity buffers, the specific range of liquidity needs to be met must be considered. Assets that can be monetized (that is, disposed of or used as collateral) on a one-week basis may provide substantial coverage, whereas limitation of buffers to, say, assets that can normally be monetized overnight may add unnecessary rigidity. Going further, a firm may have spare stable funding from relationship deposits; dependable, unused capacity from wholesale sources; or reliable commitments. Thus, the important issue is to have a high degree of confidence, demonstrable to the supervisor, that these sorts of liquidity will be accessible when needed. It also will often be appropriate for smaller institutions to hold paper issued by larger institutions as part of a diversified portfolio of assets.

Recommendation 25: *Overly narrow definitions of eligible liquid assets for liquidity buffers should be avoided as a matter of proportionality and to avoid unintended consequences. The definition of eligible assets should be both coordinated internationally and developed in tandem with revised (and coordinated) central bank lists of eligible collateral for ongoing monetary operations and (non-emergency) liquidity purposes.*

Tools, Metrics, and Benchmarks

As the IIF work on liquidity argues, and as recognized in the Basel *Principles* and the FSA consultative paper, it is unlikely that one metric will be prudent or useful to set liquidity limits across many firms. Rather, rigorous definition of the metrics and limits to be applied to a given firm's business needs to be subjected to extensive stress testing, as also discussed in prior work. Assumptions, hurdle amounts, and other parameters need to vary with the circumstances of a given firm in its markets, taking into account legal entity and other considerations, and they need frequent reevaluation.

It would, however, be desirable to develop international agreement on standard liquidity reporting requirements and formats (as, indeed, the UK FSA has suggested). Having to produce inconsistent external reporting requirements will create substantial burdens and chances for error by firms, distracting management attention from the more acute and actionable internal liquidity metrics, and undermine the cause of international regulatory cooperation. This is not just a matter of the formats, scope, and granularity of reporting but instead goes to the need to harmonize fundamentals, such as definitions of ratios and basic terms.

Another issue concerns the extent of public disclosure. While it is appropriate to disclose information on liquidity risk management frameworks, disclosure of liquidity positions as such can be destructive of liquidity, and any new requirement should be studied carefully to provide market-useful information while at the same time not undermining systemic stability.

Recommendation 26: *There should be comprehensive international coordination. This includes liquidity reporting requirements, as proliferation of detailed but inconsistent requirements across jurisdictions will impose undue burdens and costs, contribute to systemic vulnerability, raise compliance risk, and distract from the clarity of internal reporting to management.*

Core Funding

A firm's funding is central to the equation. On the one hand, stability and diversification of funding may lessen the chance of recourse to buffers; on the other hand, excessive reliance on wholesale funding without adequate planning can be fatal, as with Northern Rock. Considerations for firms' funding plans are discussed extensively in the prior IIF reports.

The UK's *Turner Review* calls for consideration of a core-funding ratio to "ensure sustainable funding of balance sheet growth" and it is understood that this topic features in current regulatory discussions. In these discussions, there is a tendency to stress the importance of deposit funding, and this is appropriate. However, it must be remembered that a hard-target core-funding approach would likely reduce overall lending capacity, as there are limits to the extent of reliance on "retail" deposit funding. The assumption that retail deposits (however defined) are the most "sticky" may obscure the fact that certain classes of small and medium enterprises (SME) and corporate and institutional wholesale deposits, may, in fact, be highly stable "relationship deposits" for a number of business reasons, whereas some forms of retail deposits (for example, brokered and "teaser-rate" deposits) may be less stable. In fact, overly rigid requirements to build retail deposits would lead to competition for them, which would actually make them less sticky and less stable. Thus, as in many other areas, a funding ratio may be a useful point of reference, but it should not become a rigid quota.

Commitment XIII: *The IIF agrees that a significant component of funding should be comprised of stable elements, as part of well-understood overall funding plans.*

Recommendation 27: *A strict, mandatory core-funding ratio should not be adopted. Such an approach is unlikely to reflect different degrees of stability and would be prone to material unintended consequences (such as an increased volatility that would result from enhanced competition for deposits).*

SECTION 4

Financial Stability Through Macroprudential Oversight

4.1. SYSTEMIC RISK AND THE NEED FOR CHANGE

Significant consensus has been reached that the financial system as a whole—on both the market and regulatory sides—was poorly equipped to deal with systemic risks. Progress has already been made to rectify this problem. For example, recent months have seen the reconstitution of the Financial Stability Forum as the FSB, the enhancement of its mandate, and the expansion of its membership. The role of the International Monetary Fund (IMF) has been expanded and the importance of the IMF–FSB nexus emphasized.

Some Industry Steps

The industry fully shares the view that this is a key area for significant attention. The IIF's MMG, under the cochairmanship of Jacques de Larosière and David Dodge, and consisting of seasoned experts from across financial markets and sectors, will consider market developments, vulnerabilities, and potential dynamics giving rise to systemic risk in the form of mispriced assets, crowded trades, concentration risk, or emerging risks of which the industry must be aware.[22] It will explore ways to mitigate such risks, and share its concerns and views with official-sector bodies, in an effort to strengthen systemic soundness.

[22] See www.iif.com/press/press+99.php.

Challenges Ahead

Despite progress, it is clear that many significant challenges remain to be overcome, including the establishment of an effective response mechanism at the international level to ensure that macroprudential analysis is effectively "translated" into practical proposals to address emerging risks. The IIF has previously proposed establishment of a Global Financial Regulatory Coordinating Council made up of central banks and supervisors and responsible to the FSB, and continues to believe that this would be helpful.

Whatever institutional form is adopted, what is important is the ability to bring a focused and technically complete analysis to bear in developing policy proposals for giving effect to macroprudential concerns identified by the IMF and others.[23] The newly mandated FSB is an essential first step, but it is likely that its resources will need to be augmented to achieve these goals.

In this section we focus on a few aspects of financial stability and macroprudential oversight.

[23] We note the reasoning contained in the European Commission's communication of May 27, 2009, on European financial supervision: that individual finance ministries should not be included in the European Systemic Risk Council (ESRC) as this could be perceived as blurring its role in providing independent technical analysis of macroprudential risks.

Commitment XIV: *The IIF's recently-established Market Monitoring Group is committed to identifying and assessing systemic vulnerabilities and issues emerging in the markets. It stands ready to discuss such developments with the official sector.*

Recommendation 28: *Macroprudential analysis at the international level will need to be translated into actionable measures for implementation. Given the G-20's mandate to the FSB, the FSB's resources should be augmented for this purpose.*

4.2. SYSTEMIC RELEVANCE

An Important Consensus for Change

The G-20 leaders agreed at their April 2, 2009, meeting that all systemically important financial institutions, markets, and instruments should be subject to an appropriate degree of regulation and oversight. In particular, the leaders agreed to amend their regulatory systems to ensure authorities are able to identify and take account of macroprudential risks across the financial system and to limit the build-up of systemic risk. They said that large and complex financial institutions require particularly careful oversight given their systemic importance.

This theme has been widely echoed in, for example, the de Larosière Group report, the *Turner Review*, and the recently published U.S. Treasury proposals.

The IIF agrees that financial stability oversight needs significant enhancement. Risks developed in the system that neither the industry nor official-sector participants were in a position to manage. It is essential that for the future a full complement of macroprudential and financial stability oversight techniques be firmly in place—from surveillance and risk identification, through analysis and dialogue, to tools for intervention.

All Systemically Relevant Entities to Fall Within Macroprudential Oversight

While the goals, means, and implications of financial stability oversight and regulation need much further consideration, certain aspects already can be identified.

Financial stability is not a fixed or static concept; it is rather the ability of the whole matrix of financial entities and relationships, products, and infrastructure to support economic activity, manage risks, and absorb shocks on an ongoing and reasonably predictable basis, without major disruption or discontinuity. Effective regulation and oversight must be designed and developed having regard to the continually evolving and multifaceted nature of the risk.

Oversight must extend, therefore, not only to financial firms but also to markets and products, risks, and incentives. The IIF has taken the position that all market participants whose activities could materially affect systemic stability should fall within the framework of macroprudential oversight, including all significant financial markets, products, and risks. In respect to firms, this should apply regardless of legal nature or form of license. Oversight and information gathering, of course, need to be distinguished from more substantive forms of direct regulation.

A Question of Degree in the Systemic Relevance of Firms

Systemic relevance is a question of degree and relates to a spectrum of potential impacts of failure. It is thus not a binary question whether a particular firm should be categorized as "systemically relevant" or not. The manner in which the failure of different firms could give rise to systemic effects takes a wide variety of forms.

For example, some firms may be neither particularly large nor highly interconnected with the overall system. Nonetheless, they can have a material degree of systemic relevance owing to a concentrated role in particular markets or

products or to the impact that their failure would have on confidence. Similarly, as discussed in Sub-section 2.3, it is important to differentiate appropriately between different activities such as banking and insurance which give rise to varying risk profiles.

The establishment of a formal category of institutions deemed systemically relevant—whether public or not—would be unlikely to produce positive outcomes. It would inevitably be drawn either narrowly—thus giving rise to undesirable rigidities and incentives to manage around boundaries, and other unintended consequences—or broadly so as to undermine its meaningfulness. Moreover,

- The fact of the definition of such a category would tend to reinforce the impression that the main sources of systemic risk had been identified and were being controlled. This could lull the markets and contribute to the tendency in benign periods to underestimate risks.
- Risks would tend to migrate away from this category of firms to other, perhaps less-well-understood or -controlled holders. Such dispersion would not mean that the risks had been reduced or eliminated, but it could contribute to underestimation of risk in the system.
- Perception of firms formally categorized as highly systemically relevant would be distorted. They would likely be seen as considered officially too big to fail and as benefiting from some form of implicit state guarantee thus increasing moral hazard. By reducing market discipline, this would render the system less, not more, resilient.
- Identifying and obtaining a clear understanding of systemic relevance in all its varieties and forms is essential. The most important reason to do so is to ensure that the most effective means to mitigate such risks are in place. A multifaceted understanding of the many forms and features of interconnectedness should be developed so that well-adapted mitigating techniques can be put in place. A tendency to see systemic risk mainly through the prism of a certain number of large firms would not be the most conducive to achieving this.
- Many of the concerns associated with systemic relevance can be mitigated through addressing the interdependencies of firms in the market. Thus, central counterparties and improvement of regulation for many OTC products, reinforcing payment systems, and managing interbank exposures through large-exposure limits, all of which are being developed in relevant jurisdictions, will do much more than conceptually and technically difficult limits on a defined category of firms.

Systemic Relevance of Firms Key Issue for Supervisors

Although sharp or formalistic definition of a category of systemically relevant firms is likely to be counterproductive, as discussed in Section 2 a risk-based approach including systemic risk is an essential component of high-quality supervision. It is necessary for supervisors to develop a clear understanding of the degree to which, and the manner in which, any particular firm can pose a threat to systemic stability, either individually or collectively with others. Supervisors should tailor their approach to supervision, including its intensity, having regard to such analysis and understanding.

The IIF welcomes the fact that the IMF, in consultation with the FSB and the Bank for International Settlements (BIS), is developing common international framework and guidelines to help authorities deal with the question of the scope of financial stability oversight and regulation and the intensity of risk presented. We look forward to engaging with the IMF, FSB, and other organizations as this process advances.

Information and Power to Intervene

It is essential that those responsible for financial stability oversight have access to all relevant and material information to permit them to carry out risk identification and analysis. They should have the power to bring sources of newly identified risks within the scope of direct regulation, subject, of course, to due process and deliberation.

There is, however, concern that, perhaps understandably in the immediate circumstances, supervisors often request very large amounts of information from firms without it being wholly clear how this information can, in fact, be assimilated and used and for what purpose. It is very important that information gathering be useful, proportionate to the ends in view, and based to the maximum extent possible on consistent international reporting formats and requirements.

Commitment XV: *The IIF agrees that authorities will require access to all relevant and material information to carry out effective financial stability oversight. The industry will work with regulators to identify and provide such information.*

Recommendation 29: *It would be counterproductive to create a formal or published category of highly systemically relevant firms. Systemic risk does not reside in single entities but in the interconnectedness of firms, markets, and players. It is a rapidly evolving and multifaceted concept that should be addressed using appropriately sophisticated and adaptive techniques, which avoid distortions and moral hazard.*

4.3. ROLE OF LARGE BANKS

Closely related to the issue of systemic relevance is the question of whether some firms are so large that they pose an unacceptable risk. "Too big to fail" has become a subject of intensive international discussion.

The IIF agrees that how to address the risks associated with the existence of very large participants is an issue that requires consideration. However, the solution lies in a number of approaches rather than in any one measure focusing on the variable of size.

There appears to be an emerging, but not yet universal, consensus among the official as well as the private sectors that it would be very difficult and ultimately undesirable to seek to limit the size of particular firms.

Even if putting *a priori* limits on firm size were achievable, there is a real possibility that the systemic risk associated with large entities would simply come to reside in a number of smaller but interconnected entities that would have become in effect "large by network" rather than by corporate structure.

Similarly, we do not consider that the case has been made for "narrow bank" or "new Glass–Steagall" business restrictions on certain banks (generally those with access to deposit insurance and central bank liquidity), as has been recently suggested by some.

Benefits of Large, Diversified Banks

As discussed in Section 1, significant benefits come from large, cross-border banks engaging in a range of activities.

Such institutions play a key role in supporting a globalized economy. They make a significant contribution to ensuring diversity of choice for both investors and users of funds and facilitating the efficient transfer of funds from countries with "excess" savings to locations in need of funds.

Large, globalized commercial and industrial firms benefit from large, global financial partners that they can rely on for sophisticated, high-value services on a consistent basis. Requiring them to shift to smaller providers would certainly increase the cost and complexity of their business.

Large, well-managed banks make an important contribution to systemic resilience. In circumstances in which external markets are

under pressure, the "internal capital markets" of such institutions can continue to provide capital and liquidity in places where it is badly needed.

Artificial Restrictions Not the Answer

The IIF concludes on the basis of members' experience that the artificial restrictions that have been suggested by some would deprive the global economy of the benefits provided by large, diversified institutions. At the same time, such restrictions would not make a positive contribution to the resilience of the system or to ongoing stability.

Indeed, the unintended consequences of such restrictions, which would inevitably warp incentives, would be severely deleterious. Risk distributions would likely become distorted and more difficult to identify and manage. The overall resilience of markets founded on robust competition between well-managed firms would be undermined, as might be the capacity of firms to invest in further development of risk management.

As discussed above, systemic risks do not reside simply in single large entities but rather in the full constellation of interconnected firms, markets, and products. As was pointed out by the de Larosière Group, significant risks can arise as a result not of the failure of one large firm but from the common exposure of many financial institutions to the same risks. It would therefore be mistaken to believe that the problem of systemic risk can be addressed by limiting the size or activities of firms.

For example, many of the systemic events of recent times were triggered by problems in institutions that would not be considered particularly large. Trust and confidence are two essential ingredients of a functioning financial system, and once these are undermined, events can unfold very quickly, irrespective of which particular institutions trigger events. This was clearly shown in the current crisis, in which comparatively small or "narrow" institutions such as Northern Rock, IKB, Sachsen Landesbank, Hypo Real Estate, or IndyMac were casualties with perceived systemic impact as the crisis developed.

As is stated in the UK Treasury's proposals *Reforming Financial Markets*, "there is little evidence to suggest that artificial restrictions on a financial institution's size or complexity, including introducing a distinction between commercial and investment banking activity, would automatically reduce the likelihood of firm failure...." [24]

During the recent crisis, many groups found resilience in diversified business models, and one of the most successful national responses (Canada's) was based on resilient universal banks. By requiring certain activities to be carried out elsewhere or size to be limited, such natural resilience would be lost.

Moreover, while a number of large firms as well as small ones found themselves in difficulties during the recent period, it was other large firms that were in a number of important cases called on to play a key role in the safe resolution of less-well-managed firms that were on the brink of failure.

Moreover, there would be considerable practical difficulties in the imposition of global size or business-model restrictions. It would be very difficult, if not impossible, to determine the appropriate size limits and to implement them as firms approached the limits. As for activity restrictions, to proscribe certain activities would be likely to significantly hamper firms in providing a reasonable range of expected services to their client base and would certainly restrict the future pace and scope of innovation within the environment of sound risk management that well-managed and well-supervised large firms can provide.

It is important to the future success of the global economy that the financial services industry be run both soundly and profitably. This means that leading participants need to be able to engage in a range of activities covering a variety of risk types. In addition, firms' ability to partic-

[24] July 2009, p. 74.

ipate in markets and take positions is important to their ability to support the economic activity of real-economy businesses. To limit the ability of firms to engage in well-managed proprietary activities is likely to have a very distorting effect and ultimately to hinder a return to full ability to serve clients and maintain markets.

Better Solutions

The presence of large, diversified, cross-border institutions brings many benefits to the global economy and to individual countries and their citizens. As imposing artificial limits on size or activities would be harmful in practice and unlikely to succeed in reducing overall levels of systemic risk, the question becomes how best to address the problem of the potential impact of the failure of such institutions (and, indeed, other institutions of systemic importance).

Improved Risk Management

First, large, diversified, cross-border institutions must achieve a very high degree of soundness, stability, and quality of risk management. With the publication of the IIF *Market Best Practices Report* last year, the industry collectively began the task of achieving higher quality risk-management standards across the piece. Work is continuing strongly across the industry to implement the recommendations in that report (see Section 2). The standards set out in the report have become widely accepted as sound standards of risk management and have become an important part of supervisors' dialogue with firms.

Enhanced Regulation and Supervision

The range of regulatory reform that is under way will make a significant contribution to ensuring high levels of soundness and quality of risk management in large banking institutions. Key aspects of this regulatory reform agenda are discussed in Section 3 of this *Report*, and we do not repeat them here.

Moreover, as discussed above, the IIF supports a risk-based approach to supervision, where the determination of risk involves weighing both the probability of an event and its likely impact. It is both desirable and appropriate for supervisors to give a central role to systemic risk in the determination of their approach to the supervision of a particular firm. It should be expected that the supervision of a firm will be more intensive where the failure of the firm would have a material impact on the system.

In general, while it may be appropriate to apply more intensive supervision to larger firms, for the reasons discussed above we do not believe that it is appropriate to apply different regulations to firms purely based on the size or because they are determined to fall within a predetermined category of high systemic relevance.

However, in accordance with a risk-based approach to supervision, it is appropriate for supervisors to take into account the degree of systemic relevance of a firm in carrying out its supervisory review of the firm. This means that supervisory measures applied to a firm including, for example, requirements to improve risk management or, ultimately, to require additional capital, should legitimately take account of the systemic impact of such a firm should it fail.

Commitment XVI: *The IIF agrees that the degree of systemic relevance of a firm may require more intensive supervision. Members are committed to working with supervisors to make such an approach effective.*

Commitment XVII: *The IIF agrees that the supervisory review process applied to firms should be founded on a risk-based approach. Accordingly in determining what if any supervisory measures should be taken, supervisors should incorporate analysis of the nature and degree of a firm's impact on the system should that firm fail. Members are committed to working with supervisors to make such an approach effective.*

More Resilient Infrastructure

Recent history shows that the interconnectedness of firms in global markets is much more a cause for concern than size or business model as such. It is possible to enhance the resilience of the system as a whole, including its interconnectedness, by improving infrastructure so as to make it much less prone to instability and risk contagion in the event of the failure of a large firm. The progress that has already been made by the industry and the official sector in reducing the level of bilateral counterparty exposure arising from credit derivatives and from OTC derivatives generally through the increased use of CCP techniques is a good example of this. Work should continue over the coming months to consider further improvements that might be made to reduce systemic risks arising for infrastructural and interconnectedness reasons. Similarly, the risks of securitization markets are now much better understood, and the structures for simpler, more transparent, and more liquid markets are already being developed (see further Section 5).

Making Orderly Exit Possible

As already discussed at Sub-section 2.4, the plausible threat of loss is the foundation of market discipline. An important part of making it credible that investors and creditors of a major firm would suffer the consequences of failure will be to put in place significantly enhanced procedures and mechanisms for dealing with financial crises, in particular cross-border crisis, and for the winding-up of large or systemically important institutions. The essential goal is to make it feasible for such institutions to fail in a non-disruptive fashion, that is, to be able to exit the market in an orderly and reasonably predictable manner (see Sections 6 and 7).

Contingency Planning for Insolvency

Experience with the Lehman Brothers failure in particular has shown that insolvency of a large and complex firm operating in multiple jurisdictions poses many technical as well as legal problems. This has in turn suggested that the task of the administrators and regulators coping with the aftermath of a failure would be made easier and the process more orderly if there were more prior planning.

Gov. Mervyn King put it that "making a will should be as much a part of good house-keeping for banks as it is for the rest of us."[25] It is debatable whether this analogy is tenable for a large, ongoing business. It is more likely to be productive for firms to examine with the authorities the risks that their roles in markets and products create, so as to help the authorities assess what would happen in event of their failure. Moreover, given the objective of making failure a realistic threat, the ongoing dialogue between large firms and their authorities should include consideration of all the information necessary to plan for the orderly exit of the firm should that prove necessary.

Such planning should be developed in close collaboration with supervisory colleges. The IIF firmly believes that for such an approach to be successful, it is essential that such dialogue be carried out in confidence between the firm and its relevant authorities. Public disclosure could undermine stability by giving market counter-parties a road-map to the firm's intentions, facilitating the taking of positions against it.

In summary, therefore, the too-big-to-fail question is a legitimate one for debate. The solution lies not in fiat limits on size but in a range of measures designed first to ensure soundness and the highest quality risk management in such firms and second to make it more practicable for major firms to exit the market in an orderly manner, should that prove necessary.

[25] Mansion House Speech, June 17, 2009.

Recommendation 30: *Artificial restrictions on size or diversification should be avoided. Large, complex institutions play an important role in supporting the global economy. Restrictions on size or diversification could produce materially distorting effects and unmanageable risk patterns within the system. The industry agrees, however, that in addition to ensuring that such institutions meet the highest standards of risk management, it is essential that they be subject to effective market discipline. To this end, there should be developed the infrastructural, legal, and process reforms necessary to ensure that all firms can exit the market in an orderly fashion without causing undue trauma to the system.*

Recommendation 31: *Restrictions on the business models or range of activities of firms should be avoided. While it may be appropriate to require additional capital in respect of higher risk activities, there is no good case to prevent firms from engaging in a full range of financial activities in accordance with sound and well-managed business models. Far from being a source of vulnerability, diversified, well-managed, and profitable firms provide a source of real resilience for the overall system.*

Commitment XVIII: *Consistent with the principle that no firm should be designated too big to fail, large or highly interconnected firms should examine with the authorities the risks that their role in markets and products create, to help the authorities assess what would happen in event of their failure. The ongoing dialogue between such firms and their authorities should include consideration of all the information necessary to plan for the orderly exit of the firm should that prove necessary.*

Commitment XIX: *Riskier activities should be subject to appropriately risk-weighted capital requirements. Such capital requirements should be calibrated so as to reflect the risk of those activities and consideration should also be given to relevant cost of funding issues.*

4.4. MICROPRUDENTIAL SUPERVISION

As discussed in Section 2, developing effective techniques for the microprudential supervisory implementation of macroprudential oversight is a significant challenge. The new task of incorporating macroprudential analysis and insights into the microprudential supervision of firms will require an outcomes-focused, risk-based approach that creates incentives for strong risk management.

Global Supervisory Colleges ... Role of the FSB

As discussed in Sub-section 1.3, group-wide effective and efficient supervision, in both the macro- and microprudential dimensions, requires integration, ideally seamlessly, of supervisory activities and macroprudential analysis across all relevant regulators. The smooth operation of global supervisory colleges is crucial, and the industry welcomes recent progress that has been made in this regard under the leadership of the G-20.

In order to ensure the effective "bridging" of macroprudential oversight and microprudential practice, the FSB should do the following:

- Develop and regularly review joint international strategies that set the macroprudential framework for the supervisory activities at the microprudential level;
- Implement these strategies through coordinated horizontal and, as appropriate, thematic work across the peer group and across the responsible national microprudential regulators; and
- Ensure close coordination and cooperation within and, importantly, consistency across the supervisory colleges set up for the multinational firms in the peer group.

In addition, it will be necessary for colleges to look to the efficiency and consistency of the

regulatory process across each group, for example on reporting and Pillar 2 analysis.

> ***Recommendation 32:*** *The FSB should coordinate the engagement of supervisory colleges in the implementation of the policy conclusions arising from macroprudential oversight and analysis, as well as in the assessment of emerging financial stability risks.*

Interaction with the Industry

The IIF stands ready to contribute via its MMG (see Section 4) to the FSB's macroprudential analysis and the formulation of international strategies setting the macroprudential framework for the microprudential activities of the global colleges. The MMG would be well placed to bring to the fore the industry's view on systemic vulnerabilities and cyclical risks. It also could draw the FSB's attention to possible improvements of market practices and infrastructures.

In contrast, the implementation of strategies through microprudential activities and the day-to-day operation of the global colleges will warrant a separate dialogue with the industry. The FSB may wish to consider replicating the approach taken in the EU, where there has been established an industry platform representing the large European banking groups subject to college-based supervision. This platform interacts directly with a Committee of European Banking Supervisors (CEBS) sub-group mandated to help coordinate college-based supervision of the participating banking groups.

A similar platform representing the multinational financial institutions for which global supervisory colleges have been established would provide feedback on the microprudential operation of the global colleges. It could help communicate and implement the FSB's macroprudential strategies into the microprudential activities of the global colleges across the peer group. Significant added value could be expected in particular from the interaction and cooperation with the industry platform in relation to the horizontal, thematic work of the global colleges.

> ***Recommendation 33:*** *To achieve macroprudential aims effectively and efficiently, a structured international dialogue should be put in place between authorities and firms. This should involve an industry platform, representing firms subject to FSB colleges and the supervisors involved in those colleges.*

SECTION 5

Improving Market Infrastructure and Mitigating Risks of Interconnectedness

5.1. BENEFITS AND RISKS

A wide range of factors contributed to the emergence and rapid deepening of the financial crisis, acting in combination. No one or two on their own would have caused the damage that has occurred.

The global financial services system has become highly interconnected in a rich variety of ways. These include a dense and complex infrastructure for entering into and processing transactions and for handling assets, a significantly enhanced ability to parse and transfer risk around the system, the enormous number and complex configuration of direct and indirect connections between market participants, the emergence of correlated exposures to risks not previously understood, and a system-wide increase in speed of change of asset values.

Such interconnectedness brings many benefits to the global economy and thus to welfare across the world. However, it also is clear that such interconnectedness carries significant risks and that these risks have been neither fully understood nor well managed in the period leading up to the financial crisis.

The IIF regards it as important that measures be put into place that will retain the benefits of an interconnected and sophisticated global financial system while reducing the risks to acceptable levels.

It is important to be clear about precisely which parts of the system have shown vulnerabilities, or may be prone to doing so, and which did not. Owing in part to the identification of potential weaknesses and action taken over recent years, key components of the system in fact showed significant resilience through the past 18 months.

It also is important to remain sharply focused on the precise nature of the vulnerability that a measure is intended to address. For example, requiring a product to be largely cleared by a CCP has a different purpose and will achieve very different outcomes from a requirement that it be exchange traded, yet the two issues of central clearing and exchange trading have often been conflated and confused in the course of the debate. It is important to keep remedies focused on the ills they are meant to cure.

5.2. MARKET INFRASTRUCTURE

Robust market infrastructure is as important as a strengthened regulatory and supervisory system. Important global wholesale markets and their supporting infrastructures have stood the test of this crisis. OTC market infrastructure and payment, clearing, and settlement systems have on the whole demonstrated good robustness and largely normal operation throughout the crisis. The default of Lehman Brothers, despite its wider impact, was handled without untoward or unpredictable impact on clearing and settlement systems, and settlement of related derivatives transactions generally functioned as intended.

Many wholesale products, CDS included, cannot be blamed as main drivers of the crisis per

se. However, they did play a contributory role, in particular as a means of loss transmission and through heightening of uncertainty concerning the potential damage to credit quality of market participants. In certain markets, the absence of transparency contributed to the expansion of opaque counterparty exposures across the system. Significant enhancements can be achieved in order to strengthen both market efficiency and financial stability.

In addition, it is clear that where market participants engaged in significant levels of activity in respect to the products for which they had developed neither sufficient understanding nor appropriate risk management ability, losses were likely to occur.

Other types of infrastructure developments also will improve the overall resilience of the system. Certain of these are now being debated in the official sector but will make a significant difference in the medium term. An example is expanding and making more consistent depositors' expectations from deposit guarantee schemes, which will at the same time clarify depositors' risks, the risks of national systems, and supervisors' expectations, thereby increasing market clarity as the current extraordinary measures are withdrawn.

Similarly, large-exposure regulation will make a difference to the resilience of the interbank market controlling interdependencies. Also important to control interdependencies is the development of CCPs for many OTC products, as discussed further in this section. Finally, the IIF is convening an infrastructure group to look at additional ways to improve resilience and better manage interconnectedness, including in cash and securities settlement systems.

Progress Made

Major progress has been made and continues to be made in improving the operation of the OTC derivatives market, including CDS. Since 2005, the industry, through the Operations Management Group, has been closely engaged with supervisors in a range of initiatives to improve risk management, processing, transparency, and the systems and procedures for carrying on OTC derivatives business. Over the recent period, this effort has continued at an increased pace.

The industry and infrastructure operators, in line with agreements with regulators, have collectively begun the process of centralized clearing of CDS trades. Progress is continuing rapidly in both the United States and Europe to broaden and deepen this process. The IIF notes that most CDS contracts are already recorded in a trade repository, Depository Trust and Clearing Corporation's (DTCC's) Trade Information Warehouse, and that efforts are reaching completion to extend this repository to those contracts not yet so recorded.

The OTC interest rate swap market already benefits from a relatively high level of centralized clearing. There are plans to expand this further in terms of membership, product, and participation of the buy-side community. In the equity derivatives markets, 50% of notional trade is already cleared via exchanges and their associated clearing houses.

The global FX market is one of the most liquid, transparent markets in the world, with a daily turnover of over $3 trillion. Continuous linked settlement (CLS) ensures payment versus payment settlement in central bank funds. Under this system, the Lehman Brothers' default was handled smoothly, with few FX deals where Lehman was a counterparty being rescinded. However, the possible role for a CCP backed up by a default fund should be considered. A CCP solution could cover the replacement risk on forward contracts, currently not covered by CLS. It is important, however, in general, to avoid unintended consequences in areas where the market has been shown to be working well.

In June of this year, members of the industry entered into a number of further commitments concerning the operation of these markets. This included a commitment in respect of all trades that are not cleared through a CCP to universal recording of CDS trades, interest rate derivatives trades, and OTC equity derivatives trades in a trade repository to be achieved over identified timescales. The IIF fully supports this commitment.

Standardization

As stated, robust centralized clearing of trades can reduce significantly systemic risks and should apply to eligible standardized OTC derivative products.

At the same time, it is important to note that bespoke OTC derivatives are vital for the risk management and hedging needs of the real economy. A move to fully standardized products would come at the cost of much less-effective risk hedging. Clients would be prevented from utilizing hedge accounting techniques, resulting in increased earnings volatility and potentially increased risks. Striking the right balance is crucial in order to preserve the significant benefits bespoke OTC derivative products offer to the real economy.

The market for CDS and other OTC derivative contracts is international. Its international nature provided many benefits in terms of both the depth of markets and the ability to hedge risks. Authorities should ensure that their initiatives are coordinated internationally so as not to introduce distortions. They also should avoid artificially fragmenting markets so that they become less effective and efficient and, ultimately, less resilient. The industry should ensure that standardization efforts are coordinated internationally.

Commitment XX: *In line with the commitments already made by industry participants, and reiterated in the industry letter of June 2, 2009, to the President of the Federal Reserve Bank of New York, and building on ongoing progress, industry is committed to CCP clearing of eligible standardized CDS contracts and OTC transactions.*

Commitment XXI: *In line with the continuing work of the International Swaps and Derivatives Association (ISDA), standardization of CDS and other OTC contracts should be pursued to an appropriate degree.*

Recommendation 34: *It is important, however, that end-users of CDS and other OTC contracts remain able to effectively hedge against specific situations. Accordingly, standardization should not be pursued to the extent that it eliminates the flexibility achievable by the continuing availability of bespoke transactions.*

Recommendation 35: *Authorities' intervention in the CDS and OTC markets should be strongly coordinated internationally. The market is international, and the establishment of artificial boundaries should be avoided.*

Managing Risks of Increased Use of Central Counterparties

It is of great importance that central counterparties be operated under robust risk management frameworks. Systemic risk will not be reduced and may, indeed, increase if poorly set up clearinghouses are allowed to proliferate and risk management standards allowed to erode. It is important that risks not be increased by requiring clearinghouses to deal with contracts that do not meet their systems, liquidity, or other general requirements.

Changes to risk management standards to allow lower margin levels should be monitored carefully. Furthermore, clearinghouses should not be allowed to offer new products or develop materially increased flows without having developed sufficiently robust risk management methodologies. Price competition is healthy but must not be allowed to lead to reduced standards. The process for introduction of new products should be overseen carefully by the appropriate supervisors.

> ***Recommendation 36:*** *Systemically relevant infrastructure providers should have access to central banks' emergency liquidity provision.*

Enhancing Transparency, Disclosure, and Price Discovery Mechanisms

Transparency is key for robust, smoothly functioning markets providing reliable price discovery mechanisms. The IIF fully supports increased market transparency and disclosure in OTC derivatives through widespread transaction reporting via regulated transaction repositories to the relevant regulatory authorities. This transparency will assist in regulatory oversight to prevent market abuse and manage concentration risk.

Transaction reporting already is well under way in CDS via DTCC's Trade Information Warehouse. The industry is committed to providing transaction reporting to a trade repository of all credit derivative trades that are not subject to CCP clearing.

The IIF fully supports the continuing strong progress toward enhanced levels of transaction reporting for other derivative transactions as agreed in the industry letter of June 2, 2009, to the President of the Federal Reserve Bank of New York.

As pointed out in the International Swaps and Derivatives Association (ISDA) response to the *Turner Review* of June 18, 2009, however, note should be taken of the confidential nature of transactions between buyer and seller and the likely detrimental effect on liquidity provision before considering publication of information regarding individual transactions (trade reporting) to a wider audience.

A variety of pre-trade price discovery mechanisms for OTC markets already exist, with dealers providing price information for flow products to clients during trading hours, including live posting of dealable prices. The industry will continue to support the provision of such services going forward, with increased pricing availability via electronic systems and greater aggregation of market prices across dealers via electronic multi-dealer trading platforms and making use of data consolidators such as Markit or other providers. Availability of market prices is therefore not dependent on a shift of all OTC trading business to an established exchange.

> ***Commitment XXII:*** *In line with the industry letter of June 2, 2009 to the President of the Federal Reserve Bank of New York, to the extent that CDS contracts, OTC interest rate derivative trades, and OTC equity derivative trades are not subject to CCP clearing, they will be recorded in a trade repository to ensure appropriate transparency of the market.*

Enhancing Other Post-Trade Infrastructure

The IIF supports the views expressed by ISDA in its response to the UK FSA's *Turner Review* concerning collateral management in the context of OTC derivative transactions. Considerable progress has been made in this area, including with respect to portfolio reconciliations, metrics on position and market value breaks, and mechanics for dispute reconciliation. We welcome and support the objective of developing a "best practices" document to be published by June 2010.

Enhancing Payment Infrastructure

As noted before, the existing payment infrastructures operated successfully, including around the failure of Lehman Brothers. Volumes and values processed remained close to normal, and despite heightened risk management measures, no undue frictions or delays occurred.

This resilience is largely due to the fact that the operation of payment systems is underpinned by a relatively small group of direct participants with exceptionally high-quality risk management systems and processes and the willingness to provide the necessary liquidity even in periods of severe stress.

Key principles are sound intraday limits, their monitoring and management on a global or regional basis with near-time adjustments, and globally aligned cut-off times (COT), as well as extensions of payment infrastructures between the central banks and system providers in order to allow payment processing without frictions throughout and across regions. It will be important to ensure that these principles are given ongoing robust effect.

An area that displayed vulnerability and acted as an amplification mechanism was the interbank funding market. A sudden and widespread loss of market confidence contributed to a chain reaction involving banks, money market funds, and other financial-sector participants in a difficult-to-arrest spiral of fear and withdrawal. As the market contracted, prudent risk management on the part of individual firms, guarding liquidity in case of need or in case of their own funding difficulties, contributed to a seizing up of the market at all but the shortest maturities.

It is therefore desirable to consider the operation of the interbank markets and whether techniques may be developed to render them more resilient to this type of chain reaction effect.

The IIF's published work on liquidity, including a major report in 2007 and the *Market Best Practices Report* of 2008, addressed the liquidity-specific question. Now the IIF is establishing a work program to look further into infrastructure aspects of this issue. The Institute looks forward to engaging with the official sector as the work proceeds.

5.3. RATING AGENCIES

The *Market Best Practices Report* sets out a number of recommendations and principles regarding both the oversight of rating agencies; their own risk management and quality assurance; and how banks, other financial firms, and investors should approach the use of their ratings.

The IIF believes that the provision of a reliable mode of communicating issues of credit quality in a manner that is meaningful between market participants remains a matter of central importance and presents a difficult challenge for the future.

The IIF welcomes and broadly supports the proposals for the oversight of rating agencies developed by IOSCO and the EU, among others. However, we note that in this area there has not to date been a strong commitment to international coordination by all parties. This lack of commitment carries a continuing risk of achieving sub-optimal outcomes.

While welcoming in general terms the development of these new approaches to the oversight of rating agencies, the Institute contends that, despite the good work done by IOSCO and others, there should be a special role for the Basel Committee in setting high-level standards for ratings agencies recognized for bank capital purposes. In particular, we believe that the Basel Committee and bank supervisors should set additional *standards* for the quality of processes of model validation and monitoring in rating agencies. Amplifying the discussion in the *Market Best Practices Report*, the IIF has suggested to the Basel Committee that it develop further standards for the quality of processes of model validation and monitoring in rating agencies, and has proposed independent verification of rating

agency processes of model validation, governance, and monitoring, perhaps to be implemented by a self-regulatory organization or independent international review body.

> ***Recommendation 37:*** *The Basel Committee should develop further standards for model validation and monitoring in rating agencies, especially for structured products. There should be independent verification of rating agency processes of model validation, governance, and monitoring by means of a self-regulatory organization or a new independent international review body.*

5.4. TRANSPARENCY

The 2008 *Market Best Practices Report* also identified increased transparency as key to both the restoration of confidence and the maintenance of stability for the future. Achieving optimal levels of effective transparency remain central to both a stable and effective market infrastructure and to mitigating the risks of a highly interconnected system while retaining the benefits.

We have discussed above the ongoing progress that is being made in achieving increased transparency in respect of OTC derivative markets, including CDS.

Another crucial area for the development of enhanced transparency is the securitization markets. As discussed in Sub-section 3.1, securitization, at least in its less-complex forms, has been essential to the provision of credit of many important types such as automobile finance, student loans, credit cards, and the familiar types of mortgages. However, the absence of transparency in respect of certain types of structured products lay at the heart of the crisis. The industry is fully committed to transformation of this situation in order to restore important securitization markets and place them on a sound footing for the future. The IIF strongly supports the efforts being made in that direction, in particular the *Global Joint Initiative to Restore Confidence in the Securitization Markets* of the American, European, and Australian Securitisation Forums and the Securities Industry and Financial Markets Association.[26]

Closely related to issues of improving the transparency and viability of securitization is the question of transparency of firms' off-balance sheet exposures. The Institute and other associations have worked with the Basel Committee on developing new Pillar 3 guidelines on off-balance sheet exposures, and on propagating understanding of the new disclosures in the market.

Among the measures that have been developed by the industry are the European Securitisation Forum's *RMBS Issuer Principles for Transparency and Disclosure,*[27] a set of recommendations targeted at issuers of European residential mortgage-backed securities (RMBS). The American Securitization Forum has established *Project RESTART,*[28] which seeks to reduce the opacity in securitization markets by developing detailed recommendations for greater transparency, disclosure, and due diligence. By making data more accessible, such efforts will help investors distinguish poorly underwritten loans from higher quality pools and create greater market discipline and more accurate valuations.

Taken together, these developments represent significant advances ensuring that, both pre-issuance and post-issuance, investors and supervisors are able to obtain meaningful, comparable, and effective information to underpin robust risk assessment, measurement, and management in respect of securitized products.

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[26] See *Restoring Confidence in the Securitization Markets*, December 3, 2008, and related publications.

[27] December 2008.

[28] See www.americansecuritization.com/restart.

There are, of course, also important regulatory initiatives in this area. These include IOSCO's *Consultation Report on Unregulated Financial Markets and Products.*[29] The industry is closely engaged with the official sector to optimize the results of such efforts.

[29] May 2009.

***Recommendation 38:** The industry and the official sector should continue to work together to build on the new foundations already developed to ensure high levels of transparency for securitization products and markets so that securitization can continue to play its important role in providing finance for key asset classes.*

SECTION 6

Resisting Fragmentation of International Markets

Section 1 sets out the benefits of an integrated international market in financial services and the importance of enhanced coordination between authorities in the regulation of those markets.

6.1. FRAGMENTING MEASURES

As discussed there, recent months have seen considerable levels of coordination led by the G-20 and reflected in the enhanced mandate of the FSB and the heavy work programs of organizations such as the Basel Committee and IOSCO. However, despite this progress, including the achievement of important agreements at the level of principle by the G-20, other developments have been much less positive and have given rise to significant concern.

General Home Bias Measures

Many governmental actions have sought to ensure that the benefits of fiscal support accrue to each domestic economy, in particular making the receipt of government support subject to explicit or implicit requirements to support domestic clients.

Moreover, even actions designed to promote competition have lent themselves to the *de facto* reinforcement of home bias. The European Commission's responses to review of state aid to specific businesses tend to require focus on "core business," which may lead to retreat to home territory, to the detriment in particular of Eastern Europe. This approach is at odds with the long-standing commitment to greater financial services integration in a single European market.

Regulatory Self-Sufficiency Measures

Proposals that are grounded in national regulatory authorities' seeking to limit the damage to national stakeholders in the event of a firm or market failure by requiring local market self-sufficiency have a strong appeal if looked at from a national perspective only; however, they risk undermining the resilience and effectiveness of the global system.

A leading example can be found in the UK FSA's proposals for a new liquidity framework, including a so-called self-sufficiency requirement that UK subsidiaries and branches of non-UK groups meet liquidity requirements on a stand-alone basis (see Section 3).

Similar ring-fencing or self-sufficiency approaches are also beginning to be seen emerging in other countries. There is no doubt that if such an approach is formally adopted by a large jurisdiction significant in the field of financial services it will rapidly be followed by others both as a logical conclusion as to their own defensive needs and perhaps in retaliatory mode.

Regulatory Non-coordination

In recent months there have been a number of examples of national or regional non-coordination in the development of new regulatory standards. This is doubly regrettable, as there has never before been so much consensus as to

the need for regulatory reform and such strong momentum to achieve reform in a coordinated manner. Failures of coordination have incurred in respect of proposals for securitization reform, for the oversight of rating agencies and hedge funds, for credit derivatives markets, for the control of short-selling, and for the regulation of liquidity risk management.

Extraterritoriality

In addition, the U.S. Treasury's *Financial Regulatory Reform* proposals[30] to extend criteria for identifying Tier 1 financial holding companies (FHCs) to foreign firms—including considering "applying the criteria to the worldwide operations of the foreign firm"—raise concerns as to multiple systemic stability regimes with significant overlap, with additional complexity created by extraterritoriality in lieu of international cooperation.

6.2. A CAUSE FOR REAL CONCERN

However understandable some of these measures may be, viewed from the perspective of individual jurisdictions and given the concern to protect domestic taxpayers, their negative global consequences are significant, and the net result is a negative-sum outcome.

It seems clear that self-sufficiency approaches, such as that proposed by the UK FSA in respect of liquidity management, will not be limited to a few jurisdictions. Rather, once adopted by one major jurisdiction, a logical consequence will be that such measures will be adopted by many if not all jurisdictions.

It is difficult to conceive of an enhanced global economy delivering strong sustainable growth across the world on the basis of financial markets that have become substantially more inward looking and forced into a nationally self-sufficient mold in the way they are conceived, regulated, and run.

[30] *Financial Regulatory Reform: A New Foundation*, June 2009.

Lessened Resilience

The adoption of a ring-fencing approach, while it may give additional immediate comfort to any given jurisdiction, is likely to render the overall system less resilient, both in terms of groups' ability to marshal resources to meet large needs and in terms of their ability to respond to crises.

The direct costs associated with a widely adopted ring-fencing approach will be neither modest nor moderate—nor fully predictable until the full scope of fragmentation can be appreciated, by which time much will be lost.

As compared with a top-down perspective whereby the prudential situation of a group is considered as a whole, the cost of a bottom-up, jurisdiction-by-jurisdiction approach adopted across the full gamut of regulatory requirements is likely to be very substantial.

Danger of Ill-Considered Cumulative Effects

There is a real risk that the overall outcome of current national responses to the crisis will be a highly fragmented, very inefficient system wherein the general levels of capital, liquidity, and other prudential requirements are raised, based on decisions of the international regulatory standard-setters, and in addition self-sufficiency requirements are imposed, based on bottom-up, uncoordinated actions by individual jurisdictions. It is essential that such an outcome be avoided.

Paradoxically, the many changes in regulation, supervision, governance, and internal risk management that are already well started should make it possible for greater, not less, reliance on home supervisors. If well designed, these measures will succeed in producing a more resilient system. Failure to take this into account in local responses will likely undermine the benefit of all that is being done.

Finally, an international approach that tolerates fragmentation and does not calculate the cumulative effects of international and national measures would represent a dramatic change of the general development of the global economy

since 1945. There is a real risk that, over the coming years, inward-looking, control-driven regulation could replace the drive toward the realization of mutual benefits. Despite the clear intent of the G-20 and FSB to the contrary, there is a danger of a loss of global integration and cooperation, as happened between 1914 and 1945. Resolute steps should be taken to avoid this.

6.3. FIGHTING FRAGMENTATION

Authorities that adopt inward-looking measures face genuine dilemmas resulting not only from political pressures arising from the cost of the crisis but also from the fact that firms remain "national in death." Moreover, the difficulties faced result from deep coordination problems arising from the stage of development of international cooperation, wherein much remains on a state-based footing. Such problems cannot be fully resolved simply by doing more of what has been done before, although a return to the growing cooperation seen until recently could continue incremental progress. Fresh ideas and renewed political determination are necessary.

Bodies Taking up the International Challenge

The FSB's new mandate includes the responsibility to promote coordination and to advise on how countries perform in meeting regulatory standards. Members agree, *inter alia,* to maintain the openness of the financial sector, to adhere to agreed international standards, and to undergo peer review.

The IIF proposes that a further task of the FSB should be to monitor regulation or other official-sector actions that have a materially fragmenting effect from the global perspective, to raise those matters for discussion, and to issue public reports including alternative suggested approaches to address the problems motivating national authorities. Fragmentation also could be added to the FSB's peer-review program.

In addition, countering financial fragmentation can be furthered by the activities of the IMF, particularly in the context of its Article IV surveillance and through a consistent, objective, and even-handed Financial Sector Assessment Program (FSAP) process.

> ***Recommendation 39:*** *The FSB should, together with the IMF, make addressing fragmentation of the international financial market a permanent objective. This should complement the FSB's important task of ensuring enhanced cooperation and coordination among authorities.*

Substantive Measures and Steps to Address the Confidence Deficit

Ultimately, what drives a jurisdiction-focused, self-sufficiency approach is failure of confidence in other authorities and in the global market. That is, authorities consider that in the event of the failure or near-failure of a cross-border group, stakeholders in the jurisdiction—depositors, creditors, the financial system, and taxpayers—will suffer disproportionately as compared with stakeholders in other jurisdictions.

It is necessary to take significant new actions to address this issue. To that end, several recommendations of this *Report* relate to the establishment of significantly revised arrangements for dealing with cross-border crisis management and financial firm resolution. These issues are dealt with in detail in Section 7.

A New Foundation for International Cooperation

Experience in many areas of international coordination and cooperation has been that a point is reached at which it is necessary to establish mutual commitments on objectives and principles in order to overcome the coordination problems that hinder enhanced mutual reliance. In respect of international markets in financial services, the world is at such a juncture now.

Thus, the time is right for an *inter-governmental accord on financial markets and financial services* among the G-20.

Such an accord at this stage probably could not be a binding international treaty but could articulate, at a sufficient level of granularity to create confidence in reliable execution by major countries, the objectives and aims, principles, and parameters agreed to be essential to the financial system of each jurisdiction as well as of the global financial system. This would provide a firm basis for enhanced mutual confidence and trust.

Such an accord could provide the impetus to significantly enhanced cross-border cooperation including renewed progress on mutual recognition.

It would provide a basis of clear expectations for authorities' dealings with each other on cross-border financial services issues.

An accord would make a significant contribution to the restoration of confidence in financial markets. By expressing agreement on a range of topics currently viewed, perhaps incorrectly, as difficult or divisive, it could rebuild and reinforce mutual confidence across jurisdictions.

Also, it would provide a clear framework within which national authorities could approach their international responsibilities. For example, it could provide the necessary basis for meaningful progress on cross-border crisis management, the need for which is discussed in Section 7.

Recommendation 40: *The point has been reached where international cooperation and coordination should be put on a firmer footing. We recommend the development of a non-binding* inter-governmental accord on financial markets and financial services.

SECTION 7

Cross-Border Crisis Management and Financial Firm Resolution Regimes

7.1. A MISSING LINCHPIN

Clear arrangements for the effective management of crises affecting large, cross-border institutions will be critical to restored confidence in and resilience of a strongly functioning international market in financial services. As the Group of Thirty report stated, "The most pressing and complex of those [needed] enhancements relate to making crisis management coordination more effective and operational by agreed protocols."[31]

The most effective forms of cooperation between authorities in the ongoing supervision of cross-border entities will be difficult to achieve without an effective and fair mechanism for managing and resolving crisis events affecting individual institution.

A host supervisor is less likely to trust the judgment of a home supervisor if it believes that in a crisis the home supervisor will be led to make decisions prejudicial to the interests of the host jurisdiction. Equally, it is more difficult for a home supervisor to rely on the decisions of a host supervisor if the potential to "free ride" remains open to the latter in a time of crisis.

7.2. INSTITUTIONAL CONTEXT

A primary challenge for the FSB is to make significant and rapid progress in putting in place effective crisis management and resolution arrangements for international institutions. We welcome that its mandate has been expanded to include contingency planning for cross-border crisis management. We also welcome the establishment by the FSB of a Cross-Border Crisis Management Working Group.

The FSB should develop a comprehensive framework of planning and preparation for crises and their management. It should put in place a strong regime for the governance of crisis management. Building on its position as a neutral but deeply informed participant, the FSB should develop a coordination, advisory, and non-binding mediation role in the preparation of crisis management arrangements in respect to individual groups to help ensure optimal coordination between the authorities directly involved in a particular crisis.

7.3. GOVERNING ARRANGEMENTS IN CROSS-BORDER COOPERATION

The FSB (then the Financial Stability Forum) published in April *Principles for Cross-border Cooperation on Crisis Management*. The *Principles* include joint work between home and host supervisors to consider barriers to crisis coordination and the development of common crisis management tools, information sharing, and annual meetings that also include central banks and finance ministries relevant to the group. Authorities are to strive to find internationally coordinated solutions that take account of the impact of the crisis on the financial systems and real economies of other countries.

[31] *Financial Reform—A Framework for Financial Stability*, January 2009.

However, as is clear from the high-level nature of the principles and the aspirational language of important parts of the document, there remains a lot to be done to develop a robust and reliable framework for cross-border crisis management.

The FSB should as a matter of high priority enhance its principles to establish an FSB *convention on cross-border crisis management* to which all FSB members would adhere. This could ultimately be included in an *international financial services accord* as discussed in Section 6. It should include:

- A commitment to coordinated responses to crises and a clear statement of the objectives of such coordination;
- Specification of the normal-time activities to be carried out by "cross-border stability groups" to be established in respect of each firm and the responsibilities (and rights) of the home and host authorities, working closely with the colleges of supervisors for such groups;[32]
- A detailed list of data and information to be maintained and shared during normal times;
- Establishment of requirements for normal-time preparations for crisis events including, most importantly, regular crisis simulation exercises (see further below); and
- Detailed rules and guidelines for cooperative handling of a crisis situation, including early intervention and the specification of cooperation mechanisms.

The Institute is encouraged that the recently established FSB Cross-Border Crisis Management Working Group will be developing a framework to implement the FSB's principles and recommend that its work include the aspects outlined above.

[32] Building on the relevant college, a cross-border stability group would also include representatives of relevant finance ministries and central banks.

Recommendation 41: *The FSB, as a priority, should develop a* convention on cross-border crisis management. *The FSB should develop a coordination and non-binding mediation role in preparation of arrangements for cross-border crisis management concerning individual groups.*

7.4. SIMULATION EXERCISES

Significant enhancement of cross-border crisis simulation exercises involving participants and authorities will be essential to building credibility for crisis management. The IIF noted the benefits of such simulation exercises in the 2006 *Proposal for Strategic Dialogue on Effective Regulation*, and it is now all the more apparent that such exercises, based on a strong commitment of all concerned, would be a significant way in which crisis management could be improved.

Not only can such exercises make a significant contribution to the performance of participants in crisis situations and bring to light barriers to the achievement of optimal coordinated outcomes, they also can foster the spirit of cooperation and mutual understanding necessary to achieve those outcomes.

Recommendation 42: *Cross-border crisis simulation exercises should be carried out on a regular basis and with strong participation by relevant authorities and market participants.*

7.5. BURDEN SHARING

A Coordination Problem

In the absence of a reliable mechanism for the allocation of the costs of financial interventions to support or resolve troubled cross-border banks, the decision whether or not to intervene will fall on the home authorities, and they will have little incentive to take into account the costs to other jurisdictions in determining their course of action.

However good cooperation among supervisors is during normal times, the fact that support or resolution decisions will be taken on a home-country basis, generally by authorities other than the supervisor, will always color the ability of supervisors to rely on each other. Without a more robust international regime, the logical conclusions from this can lead national supervisors to self-sufficiency or ring-fencing precautions, as is emerging today. It is essential to break this cycle.

Fiscal Burden Sharing

It will be necessary to envisage the means for governments to intervene collectively to resolve or recapitalize firms. To do this effectively, it will be necessary to have binding agreement on how the burden of fiscal interventions will be allocated among involved governments. It will be necessary to develop criteria for the allocation of fiscal burdens of government interventions having regard to the extent to which each country will benefit relative to others in the achievement of stability and consumer protection objectives.

The only way is for countries to work urgently together, under the auspices of the FSB, to develop criteria. A good starting point for this is the criteria identified by the de Larosière Group: the deposits of the institution, its assets, its revenue flows, its share of payment system flows, and the division of supervisory responsibility—the country responsible for supervisory work, analysis, and decision being also responsible for an appropriately larger share of the costs.

It would be necessary that the commitment to burden sharing in accordance with agreed criteria be enshrined in a high-level, binding, international agreement. This should be agreed, for example, under the auspices of the G-20 and administered by the FSB and could be developed in the context of the *convention* discussed in Sub-section 7.3.

The agreements as to the sharing of burdens in respect of individual firms should be reached through the FSB. It would be necessary to embed rules of decision-making concerning whether to intervene with financial support.

Constructive Ambiguity and Clarity

It often is said that agreements on burden sharing are not possible without undermining the "constructive ambiguity" concerning government intervention that is necessary to avoid undue levels of moral hazard. This concern, although certainly a legitimate subject for debate, is not justified. As the de Larosière Group pointed out, there is an important distinction to be made between agreement as to how burdens will be shared should it prove necessary to intervene financially to rescue a financial institution and a decision that such an intervention should actually be carried out.

A Common Fund

The resolution of crises affecting individual institutions frequently involves costs, in particular in ensuring that depositors and other protected parties do not suffer loss. In the context of the failure of a large and interconnected cross-border group, this can, depending on the manner in which the group fails, give rise to a disproportionate burden on the fiscal authorities and deposit or policyholder protection scheme of one or other jurisdiction.

Consideration could be given to the establishment of a common fund which, being made available in conjunction with the agreed burden-sharing criteria, could be used to facilitate orderly resolution or disposition of the failing cross-border group and equitable depositor or policy-holder protection. However, neither the political nor operational challenges associated with such a fund should be minimized.

> ***Recommendation 43:*** *Under the auspices of the G-20 and subject to coordination by the FSB, criteria of burden sharing between jurisdictions in the event of the need for financial intervention should be agreed among the major countries.*

7.6. CROSS-BORDER BANK AND FINANCIAL FIRM RESOLUTION REGIMES

When an international bank is in danger or fails, governments should ensure that they have the necessary legislative, administrative, and legal powers in place to enable themselves to conduct such interventions in a swift and effective fashion, in cooperation with authorities in other jurisdictions. They particularly should ensure that they have in place all of the relevant powers and authorities identified in the IMF/World Bank *Overview of the Legal, Institutional, and Regulatory Framework for Bank Insolvency.*[33]

Special Regime for Bank Resolution

General Principles of Intervention

Any government intervention in a failing firm should be the following:

1. *Rapid*—No significant period of uncertainty should exist between the announcement of intervention and the intervention itself.
2. *Transparent*—Creditors and counter-parties of the institution concerned should be clear as to how the intervention affects their rights.
3. *In line with market practices*—Intervention should not violate clearing, settlement, payment finality, netting, set-off, or collateral systems and procedures.

Overriding Public-Good Objectives

When a government intervenes in the insolvency of a financial firm, it is by definition doing so in order to avoid damage to society and the economy, that is, it is pursuing the public good of systemic stability—very often protection of the payments system—or consumer protection. The effective achievement of this public good should—to the extent necessary—override the ordinary principles of bankruptcy. Thus, all authorities involved should be empowered and required to act so as to promote that objective.

Governments should not have to grant themselves *ad hoc* powers in such cases. The idea that government may act on an *ad hoc* basis depending on a particular case creates deep uncertainty in the markets and damages the legal certainty underpinning those markets.

Government intervention in a failing institution should be possible at a time when the institution is in difficulty or is in breach of its regulatory obligations. There should therefore be "regulatory" as well as "solvency" grounds for government intervention in the affairs of the relevant bank.

Obligation to Pursue the Public-Good Objective

The person or persons charged with the conduct of the rescue or disposition of a bank, where such intervention is justified by public-interest considerations, should be placed under a positive obligation to pursue that objective. This should

[33] IMF, April 17, 2009.

include the power to affect the rights of creditors in certain limited circumstances. Although the principle of equal treatment of creditors is a fundamental principle of insolvency law, in the case of bank rescues it should, in appropriate cases, give way on a well-understood basis before the overriding objective of reducing systemic damage.

Thus, for example, an administrator, receiver, debtor-in-possession, or similar party appointed to control a firm in insolvency ("office holder") should have defined powers to deliver securities and make payments to close out transactions in order to avoid systemic disruption, even before the full list of creditors and assets has been drawn up.

Any such powers must, to the greatest extent possible, be constrained within the existing law. The creation of broad discretionary powers to vary existing contracts would make restructuring existing institutions easier. However, the market uncertainty that this would create would have a substantial detrimental effect on every market contract, create major blockages to innovation, and do significant damage to the markets as a whole.

The basis of financial markets is legal certainty and in particular the confidence of counterparties that settlement finality, set-off, and collateral rights will be respected in the insolvency of any particular system participant. Thus, for example, in the recent failure of Lehman Brothers, the reason why the credit derivative markets remained robust was because market participants had confidence that the set-off provisions contained in open contracts would survive and be effective in the insolvency. If there had been doubt as to this point, it is likely that the impact of the failure on the system as a whole would have been substantially greater than it in fact turned out to be. The powers of office holders described in this discussion should be designed to ensure such market-reinforcing results in future insolvencies.

Cross-Border Issues in Bank Failure

Multinational banks have complex corporate structures, and in the event of the failure of such a bank, there will not be a single court or office holder charged with the liquidation of the group. It is in fact more than likely that an international bank will operate through more than one significant subsidiary, as well as through a number of less-significant subsidiaries. Therefore, there are likely to be several different courts seized of different parts of the group restructuring.

Facilitation of International Cooperation Is Key

The issue therefore is how governments should best manage the process of a failure of an international bank group. The first important step would be to create a situation in which office holders of individual parts of the failed institution should be required to have regard to the situation of the group as a whole and should be permitted expressly to work with office holders of other parts of the group and the management of any group entities that are not insolvent or the subject of proceedings in order to maximize returns to creditors and to minimize disruption to the financial markets as a whole.

In general, national legislation does not mandate and may not permit cooperation among administrators, curators, liquidators, or other office holders appointed in different jurisdictions. The Institute contends that governments should explore establishing broad principles for cooperation in the failure of international institutions, permitting office holders to act collectively with office holders appointed in other jurisdictions over other parts of an insolvent group.

No Discrimination Based on Nationality or Place of Residence

The aim of such cooperation should be to maximize the position of creditors of the group as a whole. Governments should consider explicitly permitting national courts to approve a scheme

that could result in creditors in its own jurisdiction being potentially worse off provided that creditors of the group as a whole are better off in aggregate.

In other words, the available assets should be used to settle claimants' rights as fairly as possible without discrimination based on jurisdiction, subject to the usual priorities and to netting and settlement considerations as already mentioned.

A similar principle should apply in respect of depositor and policyholder protection schemes. Governments derive their tax revenue from their domestic taxpayers and may feel that the first call on such revenues is the compensation of domestic customers of a bank. This principle would be unobjectionable if applied consistently, because it would result in a position where each government compensated customers in its jurisdiction regardless of the place of establishment of the bank.

However, in the absence of a global intergovernmental agreement it is unlikely that each government will adopt identical policies and that customers in different jurisdictions will all be equally protected. As a result, the resolution of such crises may be slowed by (and in extreme cases prevented by) a suspicion of free-riding or unequal benefit, such as may arise from exclusive priorities for domestic deposit guarantee schemes to certain assets, to the detriment of the principle of non-discrimination across jurisdictions.

It should be noted that this issue is in fact wider than just deposit protection schemes, because it also may arise in regard to guarantees or other sureties that governments may offer during crises to depositors or other creditors of troubled institutions.

Desirability of an International Bank Resolution Regime

In considering the appropriate policy response to this range of issues, it is important to be realistic about what can be achieved. It may well be true that the optimal way of dealing with the failure of an international banking group would be the establishment by treaty of an international insolvency regime. But this is unlikely to be achieved in the short term.

The most important short-term practical steps would be for governments to engage in intense dialogue with each other about how to deal with creditors, depositors, policyholders, and other claimants in respect of the failure of a cross-border institution. Such discussions might be conducted in the context of the convention on cross-border crisis management suggested at Sub-section 7.3. Establishment of broad principles, such as the principle of non-discrimination among creditors by nationality and the principle that office holders should be clearly empowered and encouraged to work in concert in resolving a large group, would be highly beneficial in laying the groundwork for more orderly resolutions in the future.

Recommendation 44: *Under the auspices of the G-20 and subject to coordination by the FSB, authorities, as a matter of priority, should ensure that they have in place special regimes for bank resolution:*

- *They should have the power of early intervention.*
- *On determination that an institution is systemically significant, the winding-up of such institution should have as a primary objective the protection of the international financial system.*
- *In order to preserve market certainty and confidence, financial markets law (for example, concerning settlement finality, set-off, and collateral rights) must be respected.*
- *In the context of the winding-up of a cross-border financial firm, the objective should be, subject to preserving the integrity of the financial system, to maximize outcomes for creditors of the group as a whole. There should be no discrimination between creditors on grounds of nationality or geographical location.*

Commitments and Recommendations

Importance of Coordination in an International Market

Commitment I: *The IIF membership will dedicate the necessary resources and engage with their colleges of supervisors on a high-priority, fully committed basis.*

Recommendation 1: *The FSB should proceed quickly and with continued determination in taking the steps necessary for the establishment and operation of well-functioning colleges of supervisors for internationally active banks. Ensuring effectiveness, high-quality cooperation, and appropriate consistency in the operation of these colleges should be a high-priority task for the FSB and supervisory authorities.*

Recommendation 2: *National authorities should coordinate closely in respect of the wide array of regulatory proposals that are currently under consideration, working through the relevant international standard-setting bodies. Such coordination should go beyond the level of principle or direction and ensure consistency of specific regulation. There should be timely and consistent global implementation of Basel II, appropriately modified. Coordination becomes increasingly important given emerging fragmentation.*

Recommendation 3: *A global framework for the supervision and regulation of internationally active insurance firms on a group-wide basis should be developed under the leadership of the IAIS.*

Recommendation 4: *Clear strategies should be developed for the withdrawal of governments from ownership positions in financial institutions and for ending extraordinary liquidity and market support measures. Such strategies should be carefully coordinated internationally to be fully effective and minimize the risk of unanticipated consequences.*

A Shared Responsibility to Achieve Resilience

Commitment II: *The IIF membership will as a matter of first-order priority continue the good progress to bring their risk management and other business practices into alignment with the recommendations of the* Market Best Practices Report.

Commitment III: *The standards set out in the* Market Best Practices Report *have become a benchmark for large, internationally active firms. The industry welcomes the use of this and other reports, such as the* Senior Supervisors Group Report *of March 6, 2008, in the supervisory assessment of the quality of risk management of such firms.*

Commitment IV: *The industry is committed to continue to implement reforms in compensation practices so as to align these practices with the IIF* Principles *and recommended leading practices, as well as with the FSB* Principles. *In this regard, the IIF intends to monitor developments in industry practices and to provide an informal assessment in the forthcoming report of the IIF Steering Committee on Implementation in November 2009 and to conduct a survey of industry practices in 2010.*

Recommendation 5: *Regulatory authorities should develop appropriate supervisory guidelines on compensation, in line with FSB* Principles, *in a timely manner so as to reduce market uncertainty. The FSB should ensure that these guidelines are consistent, in all important respects, across jurisdictions and that a reformed regulatory environment also provides for a level playing field on compensation between the regulated and non-regulated segments of the financial market.*

Commitment V: *The IIF membership will undertake the efforts and investment necessary to promote the success of more outcomes-focused, judgment-based supervision. This will include developing standards and norms of behavior to underpin a better quality of relationship with supervisors.*

Recommendation 6: *Authorities should continue to develop a more consistently outcomes-focused, judgment-based approach to regulation. The IIF recommends increasing the resources, expertise, and skills of supervisors to implement macroprudential oversight.*

Recommendation 7: *It is essential that regulation be effective while ensuring that markets remain as efficient as possible. The principles of effective regulation should be followed, including:*

- *Clearly identified objectives;*
- *Clear understanding of impacts, both positive and negative (but avoiding mechanistic or purely quantitative methods);*
- *An incentives-focused methodology; and*
- *Incorporation of consultation and dialogue.*

Recommendation 8: *There should be a structured, ongoing dialogue between the FSB, the standard-setters, and the industry to support high-quality, effective, and well-coordinated international regulatory reform. This should cover all financial sectors and all types of regulation (prudential and conduct of business).*

Recommendation 9: *Resilience depends in large part on the risk management of firms and the functioning of markets. Regulation cannot do the job on its own. It is essential to restore and enhance market discipline, in particular by ensuring that creditors of financial institutions (other than depositors and insurance policyholders, and subject to the rules of priority in insolvency) are at risk of appropriate loss in the event of failure. Reform should lever and seek to enhance the positive dynamic between markets operating under effective discipline and more effective regulation.*

Achieving Resilience Through the Cycle With Prudential and Accounting Standards

Capital

Commitment VI: *Levels of capital in many parts of the system were insufficient. The IIF agrees that overall levels need to be increased, within the framework of the Basel II risk-based approach, as compared to pre-crisis levels. The IIF membership stands ready to work with the regulatory community on objective analysis of the cumulative net impact of proposed regulatory changes.*

Recommendation 10: *The cumulative impact of proposed enhancements of capital requirements and other regulatory and accounting changes should be fully assessed prior to final decisions being made.*

Recommendation 11: *The timing of introduction of new requirements should be carefully considered to ensure that they do not hinder recovery.*

Commitment VII: *The IIF supports measures to counter cyclicality by building resources in good times that can be drawn down in bad times.*

Recommendation 12: *Buffers, whether created by capital or reserves, should be able to be drawn on when needed without adverse consequence.*

Recommendation 13: *There should be dialogue between the official sector and the industry to develop effective approaches to the very difficult task of evaluating the cycle and deciding when to apply buffer mechanisms, on the upside or the downside.*

Commitment VIII: *The IIF agrees that the quality of capital required needs to be reviewed. The IIF membership is ready to work closely with the official sector to achieve an outcome that reflects the lessons learned from the recent period.*

Recommendation 14: *Consistent international requirements for the definition and quality of capital, in particular Tier 1 capital, should be developed. They should be applied consistently on a global basis. The benefits of Tier 2 capital, including convertible Tier 2, should not be underestimated.*

Controlling Leverage

Commitment IX: *The IIF agrees leverage was too high and needs to be appropriately controlled in the future.*

Recommendation 15: *A simple leverage ratio runs the risk of undermining its own objectives. Any measure to contain leverage should take account of differences in business models and funding structures, major differences in risk profiles, distinct market practices and characteristics, and differences in accounting standards. Leverage should be addressed as a supervisory tool for use as part of the Pillar 2 dialogue between a firm and its supervisor.*

Accounting

Recommendation 16: *There should be a comprehensive, high-level dialogue on current accounting standards in light of the crisis and the changing regulatory environment. This should involve all relevant parties while respecting the independence of the standard-setting process.*

Recommendation 17: *Achieving overall convergence in international accounting standards requires active support from all concerned, including the industry and securities and prudential regulators. There should be a renewed commitment by all stakeholders to a clear plan for timely adoption of a single, high-quality set of accounting standards.*

Recommendation 18: *Exceptional processes should be in place to provide guidance on as expedited a basis as possible while allowing for rapid consultation with stakeholders in the event of extraordinary occurrences.*

Recommendation 19: *While progress has been made to date on valuation in less-active markets, more needs to be done. Standard-setters should develop a common framework that reduces the complexity and multiplicity of existing impairment models on the basis of all available relevant information. This should be done on a fully convergent basis, taking into account the lessons learned from the crisis.*

Recommendation 20: *Fair-value accounting has clear benefits in appropriate contexts. However, questions have been raised concerning its effects on cyclicality, and it may not always provide the best reflection of cash flows due to a reporting entity. Work currently in progress to review fair-value and accrual accounting for financial institutions should continue with urgency. It should also address, as part of the comprehensive simplification of financial instrument reporting, existing rigidities in hedge accounting.*

Recommendation 21: *Reporting changes in an entity's own credit in earnings is a source of controversy. The debate should consider whether elimination of recognition of changes in the reporting entity's own credit quality in reported earnings would provide simpler, more direct, and more decision-useful information to the market.*

Recommendation 22: *Consistent guidance should be issued by the major standard-setters to allow the use of reasonable interpretation in assessing loan losses under the incurred-loss model. Such guidance should be given the unambiguous backing of securities regulators in order to help avoid the overly narrow applications that have contributed to procyclicality. The current review to consider the reflection of a wider range of credit information in standards for loan loss provisioning must be given priority.*

Liquidity

Commitment X: *IIF members have already enhanced their liquidity risk management and, subject to difficult market conditions, have been building liquidity buffers and working toward compliance with the IIF and Basel liquidity principles. In addition, they continue to manage their liquidity to ensure that local liquidity needs can be met. IIF Members will continue the ongoing enhancement of their approach to liquidity management.*

Commitment XI: *Good liquidity risk management should take into account local market needs. In addition, the IIF is committed to exploring ways in which firms could organize their cross-border business to reduce the concerns of authorities that individual jurisdictions would suffer disproportionate loss in the event of an insolvency. This should take place in the context of the ongoing dialogue between large firms and the authorities concerning the information necessary to plan for the orderly exit of the firm should that prove necessary as discussed in Section 4. Such an approach would take into account the legal structure of the group and differences in insolvency laws across jurisdictions. The IIF stands ready to work with the official sector to reduce the real dilemmas that the tensions between global and local goals for good liquidity management present.*

Recommendation 23: *Although the serious issues raised by failures of major market participants need to be addressed, the significant drag on system efficiency created by "trapped pools of liquidity" also is important and needs to be taken into account. Self-sufficiency or stand-alone approaches to liquidity regulation should be resisted by regulators.*

Commitment XII: *It is necessary to hold liquidity buffers against liquidity risk. This is an important part of a robust overall approach to liquidity risk management.*

Recommendation 24: *In determining a firm's liquidity buffer, mechanistic approaches that do not take into account the overall business model, funding profile, and market context of the firm are likely to be counterproductive and should not be adopted.*

Recommendation 25: *Overly narrow definitions of eligible liquid assets for liquidity buffers should be avoided as a matter of proportionality and to avoid unintended consequences. The definition of eligible assets should be both coordinated internationally and developed in tandem with revised (and coordinated) central bank lists of eligible collateral for ongoing monetary operations and (non-emergency) liquidity purposes.*

Recommendation 26: *There should be comprehensive international coordination. This includes liquidity reporting requirements, as proliferation of detailed but inconsistent requirements across jurisdictions will impose undue burdens and costs, contribute to systemic vulnerability, raise compliance risk, and distract from the clarity of internal reporting to management.*

Commitment XIII: *The IIF agrees that a significant component of funding should be comprised of stable elements, as part of well-understood overall funding plans.*

Recommendation 27: *A strict, mandatory core-funding ratio should not be adopted. Such an approach is unlikely to reflect different degrees of stability and would be prone to material unintended consequences (such as an increased volatility that would result from enhanced competition for deposits).*

Financial Stability Through Macroprudential Oversight

Commitment XIV: *The IIF's recently-established Market Monitoring Group is committed to identifying and assessing systemic vulnerabilities and issues emerging in the markets. It stands ready to discuss such developments with the official sector.*

Recommendation 28: *Macroprudential analysis at the international level will need to be translated into actionable measures for implementation. Given the G-20's mandate to the FSB, the FSB's resources should be augmented for this purpose.*

Commitment XV: *The IIF agrees that authorities will require access to all relevant and material information to carry out effective financial stability oversight. The industry will work with regulators to identify and provide such information.*

Recommendation 29: *It would be counterproductive to create a formal or published category of highly systemically relevant firms. Systemic risk does not reside in single entities but in the interconnectedness of firms, markets, and players. It is a rapidly evolving and multifaceted concept that should be addressed using appropriately sophisticated and adaptive techniques, which avoid distortions and moral hazard.*

Commitment XVI: *The IIF agrees that the degree of systemic relevance of a firm may require more intensive supervision. Members are committed to working with supervisors to make such an approach effective.*

Commitment XVII: *The IIF agrees that the supervisory review process applied to firms should be founded on a risk-based approach. Accordingly in determining what if any supervisory measures should be taken, supervisors should incorporate analysis of the nature and degree of a firm's impact on the system should that firm fail. Members are committed to working with supervisors to make such an approach effective.*

Recommendation 30: *Artificial restrictions on size or diversification should be avoided. Large, complex institutions play an important role in supporting the global economy. Restrictions on size or diversification could produce materially distorting effects and unmanageable risk patterns within the system. The industry agrees, however, that in addition to ensuring that such institutions meet the highest standards of risk management, it is essential that they be subject to effective market discipline. To this end, there should be developed the infrastructural, legal, and process reforms necessary to ensure that all firms can exit the market in an orderly fashion without causing undue trauma to the system.*

Recommendation 31: *Restrictions on the business models or range of activities of firms should be avoided. While it may be appropriate to require additional capital in respect of higher risk activities, there is no good case to prevent firms from engaging in a full range of financial activities in accordance with sound and well-managed business models. Far from being a source of vulnerability, diversified, well-managed, and profitable firms provide a source of real resilience for the overall system.*

Commitment XVIII: *Consistent with the principle that no firm should be designated too big to fail, large or highly interconnected firms should examine with the authorities the risks that their role in markets and products create, to help the authorities assess what would happen in event of their failure. The ongoing dialogue between such firms and their authorities should include consideration of all the information necessary to plan for the orderly exit of the firm should that prove necessary.*

Commitment XIX: *Riskier activities should be subject to appropriately risk-weighted capital requirements. Such capital requirements should be calibrated so as to reflect the risk of those activities and consideration should also be given to relevant cost of funding issues.*

Recommendation 32: *The FSB should coordinate the engagement of supervisory colleges in the implementation of the policy conclusions arising from macroprudential oversight and analysis, as well as in the assessment of emerging financial stability risks.*

Recommendation 33: *To achieve macroprudential aims effectively and efficiently, a structured international dialogue should be put in place between authorities and firms. This should involve an industry platform, representing firms subject to FSB colleges and the supervisors involved in those colleges.*

Improving Market Infrastructure and Mitigating Risks of Interconnectedness

Commitment XX: *In line with the commitments already made by industry participants, and reiterated in the industry letter of June 2, 2009, to the President of the Federal Reserve Bank of New York, and building on ongoing progress, industry is committed to CCP clearing of eligible standardized CDS contracts and OTC transactions.*

Commitment XXI: *In line with the continuing work of the International Swaps and Derivatives Association (ISDA), standardization of CDS and other OTC contracts should be pursued to an appropriate degree.*

Recommendation 34: *It is important, however, that end-users of CDS and other OTC contracts remain able to effectively hedge against specific situations. Accordingly, standardization should not be pursued to the extent that it eliminates the flexibility achievable by the continuing availability of bespoke transactions.*

Recommendation 35: *Authorities' intervention in the CDS and OTC markets should be strongly coordinated internationally. The market is international, and the establishment of artificial boundaries should be avoided.*

Recommendation 36: *Systemically relevant infrastructure providers should have access to central banks' emergency liquidity provision.*

Commitment XXII: *In line with the industry letter of June 2, 2009, to the President of the Federal Reserve Bank of New York, to the extent that CDS contracts, OTC interest rate derivative trades, and OTC equity derivative trades are not subject to CCP clearing, they will be recorded in a trade repository to ensure appropriate transparency of the market.*

Recommendation 37: *The Basel Committee should develop further standards for model validation and monitoring in rating agencies, especially for structured products. There should be independent verification of rating agency processes of model validation, governance, and monitoring by means of a self-regulatory organization or a new independent international review body.*

Recommendation 38: *The industry and the official sector should continue to work together to build on the new foundations already developed to ensure high levels of transparency for securitization products and markets so that securitization can continue to play its important role in providing finance for key asset classes.*

Resisting Fragmentation of International Markets

Recommendation 39: *The FSB should, together with the IMF, make addressing fragmentation of the international financial market a permanent objective. This should complement the FSB's important task of ensuring enhanced cooperation and coordination among authorities.*

Recommendation 40: *The point has been reached where international cooperation and coordination should be put on a firmer footing. We recommend the development of a non-binding* inter-governmental accord on financial markets and financial services.

Cross-Border Crisis Management and Financial Firm Resolution Regimes

Recommendation 41: *The FSB, as a priority, should develop a* convention on cross-border crisis management. *The FSB should develop a coordination and non-binding mediation role in preparation of arrangements for cross-border crisis management concerning individual groups.*

Recommendation 42: *Cross-border crisis simulation exercises should be carried out on a regular basis and with strong participation by relevant authorities and market participants.*

Recommendation 43: *Under the auspices of the G-20 and subject to coordination by the FSB, criteria of burden sharing between jurisdictions in the event of the need for financial intervention should be agreed among the major countries.*

Recommendation 44: *Under the auspices of the G-20 and subject to coordination by the FSB, authorities, as a matter of priority, should ensure that they have in place special regimes for bank resolution:*

- *They should have the power of early intervention.*
- *On determination that an institution is systemically significant, the winding-up of such institution should have as a primary objective the protection of the international financial system.*
- *In order to preserve market certainty and confidence, financial markets law (for example, concerning settlement finality, set-off, and collateral rights) must be respected.*
- *In the context of the winding-up of a cross-border financial firm, the objective should be, subject to preserving the integrity of the financial system, to maximize outcomes for creditors of the group as a whole. There should be no discrimination between creditors on grounds of nationality or geographical location.*