



## IV SPECIAL FEATURES

### A RECENT POLICY INITIATIVES TO STRENGTHEN THE RESILIENCE OF THE FINANCIAL SYSTEM

*This special feature summarises the main policy initiatives that are aimed at strengthening the resilience of the financial system, both at the international and at the European level. Because events in financial markets are continuing to unfold, triggering prompt responses by governments and supervisors, this special feature can, at this stage, only provide an interim overview of the major initiatives taken thus far.*

#### INTRODUCTION

At the Eurogroup summit in Paris on 12 October, the euro area countries adopted a concerted action plan with the aim of restoring confidence in the markets and promoting the proper functioning of the financial system. A few days later, on 15 and 16 October, the EU summit endorsed the principles laid down in the Paris declaration. In accordance with the principles on improving the liquidity and solvency conditions for financial institutions, national governments and central banks in Europe have taken a number of extraordinary measures that range from offering government guarantees for bank debt issuance and retail deposits to providing additional capital resources to distressed banks.

While these measures were taken to cope with the recent intensification of strains in the financial sector, reflection on possible regulatory measures to strengthen the financial system had started at the international and European level with the onset of the turmoil in August 2007. This reflection led to concrete initiatives seeking to address the weaknesses identified thus far, including proposals on revising the regulatory framework and strengthening authorities' ability to respond to crisis situations.

At the international level, regulatory and supervisory initiatives are being coordinated by the Financial Stability Forum (FSF). The framework for policy responses to the financial turmoil was set up in April 2008, when the FSF

published its "Report on Enhancing Market and Institutional Resilience".<sup>1</sup> The report, which has been endorsed by G7 finance ministers and central bank governors, and has thus become an international benchmark, consisted of a comprehensive set of recommendations for regulatory and supervisory authorities, as well as for central banks. The FSF report called for action in the following five main areas: (i) strengthening capital, liquidity and risk management in the financial system; (ii) enhancing transparency and valuation; (iii) changing the role and use of credit ratings; (iv) strengthening authorities' responsiveness to risks; and (v) putting in place robust arrangements for dealing with stress in the financial system.

At the European level, the Ecofin Council set out a work programme ("Roadmap") in October 2007, in which it defined actions with regard to (i) enhancing transparency for investors, markets and regulators, (ii) improving valuation standards, including illiquid assets, (iii) reinforcing prudential rules and risk management in the financial sector, and (iv) improving the functioning of markets, including the role of credit agencies. The Roadmap was revised and updated at the Ecofin Council meeting on 14 May 2008 and, since then, follow-up work has been taking place continuously in order to provide consistency and ensure an effective coordination with other international fora, in particular the Financial Stability Forum.

#### THE IMPLEMENTATION OF THE POLICY INITIATIVES

In accordance with the work programmes defined by the FSF and the Ecofin Council, authorities have been undertaking substantial efforts to implement the recommendations and action plans in a timely and coordinated manner. Since the onset of the turmoil, these efforts have resulted in a number of concrete steps being

<sup>1</sup> See Financial Stability Forum, "Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience", April 2008.

taken. The priority recommendations identified by the G7 in April were all addressed on time, and the implementation of the Ecofin Council's Roadmap is also on track. As to the current status of the implementation measures, the following short summary can be provided.<sup>2</sup>

### PRUDENTIAL OVERSIGHT OF CAPITAL, LIQUIDITY AND RISK MANAGEMENT

The competent authorities have identified imperfections in banks' risk management systems and risk governance as factors contributing substantially to the accumulation of risky exposures over the last few years, both on and off the balance sheets.<sup>3</sup> In addition, substantial weaknesses in the related regulatory and supervisory framework have also been identified by policy-makers. Therefore, in order to address the lessons learnt thus far, regulators have launched a number of initiatives pertaining to the revision of the current regulatory setting for the prudential oversight of capital, liquidity and risk management.

With regard to *capital* issues, the revision of the Basel II capital requirements, carried out under the auspices of the Basel Committee on Banking Supervision (BCBS), is considered a core element of the regulatory response. In this context, proposals related to the revision of capital requirements for securitisation exposures and the associated liquidity facilities will be set out by the BCBS later this year. In addition, the BCBS and the International Organization of Securities Commissions (IOSCO) proposed a number of modifications to the current framework of trading book regulation in July. In this regard, capital requirements for banks' trading book exposures will be raised, as set out in the "Guidelines for Computing Capital for Incremental Risk in the Trading Book".

In line with international initiatives on capital regulation, the revision of the Capital Requirements Directive (CRD) is also under way in the EU, with the envisaged adoption of two comitology directives and one co-decision proposal in early 2009. As a direct follow-up to

the Ecofin Council's Roadmap, the modification of the CRD aims at providing a long-term response to the turmoil. In this context, the rules on large exposures, capital quality, securitisation and liquidity risk management, as well as on supervisory cooperation, are being revised.

With respect to *liquidity* issues, the BCBS published a document on the "Principles for Sound Liquidity Risk Management and Supervision" in September. The timely and effective implementation of the principles is expected to substantially improve the risk management standards of banks, as well as their resistance against prolonged liquidity shocks. In this connection, the BCBS also intends to achieve greater convergence in liquidity supervision for cross-border banking groups.

As a closely related initiative at the EU level, the Committee of European Banking Supervisors (CEBS) published its advice on liquidity risk management, including 30 principles-based recommendations for financial institutions and supervisory authorities, on 18 September.<sup>4</sup> The recommendations aim at ensuring that adequate liquidity risk management is in place at financial institutions, both for normal circumstances and for times of stress. As they are generally consistent with the BCBS principles, the CEBS recommendations build on the diversification of funding sources, appropriate liquidity buffers, robust stress tests and regularly tested contingency funding plans. The document assigns ultimate responsibility for defining an institution's liquidity risk strategy and risk tolerance to the Board of Directors, emphasising that it should be appropriate to the institution's funding profile, its current and prospective activities and the robustness of its risk management. In addition, clear responsibilities

2 This summary is partly based on Financial Stability Forum, "Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience. Follow-up on Implementation", October 2008.

3 See Special Feature B in this Review for more details on the risk management lessons learnt from the turmoil.

4 See Committee of European Banking Supervisors, "CEBS's technical advice on liquidity risk management (second part)", September 2008.

and proper incentives should be laid down by senior management, reflecting the long-term objectives of the respective institution. With regard to supervisory issues, the document calls for enhanced coordination between authorities, notably through the active use of supervisory colleges.

To complement the work carried out by the BCBS and CEBS, the Banking Supervision Committee (BSC) has also prepared a report on EU banks' liquidity stress testing and contingency funding plans<sup>5</sup>, providing a typology of EU banks' practices in this field.

Based on these documents, and in line with both the Ecofin Council's Roadmap and the FSF recommendations, the European Commission has proposed changes to the CRD. These proposals concern the development of liquidity risk management policies and systems, including, among other things, the improvement of stress testing practices and conditions for cross-border liquidity transfers, as well as a strengthening of the role of senior officers in defining risk tolerance levels.

As to the issue of *supervisory oversight* of risk management, the BCBS is enhancing its guidance on the oversight of firm-wide risks and the management of securitisations and other off-balance-sheet exposures, as well as of concentration, reputation and liquidity risks. As an element of reinforcing the supervisory review process under Pillar 2 of the new capital framework, the BCBS will also be developing principles for sound stress testing practices by the end of this year.

Finally, as regards *compensation policies*, the turmoil has revealed that flawed incentives, created by inadequate remuneration policies of banks and other financial intermediaries, have also played a role in the accumulation of vulnerabilities in the financial sector over past years. Therefore, the revision of these policies is considered by international bodies to be a necessary precondition for increasing the long-term stability of the financial system, thus

also protecting taxpayers' money. Indeed, the FSF recommended in April that the financial industry align its compensation models to long-term, firm-wide profitability and that regulators and supervisors work with market participants to mitigate the risks arising from inappropriate incentive structures.

In order to comply with this request, two industry groups have recently addressed compensation issues. First, the Institute of International Finance (IIF) published its report on market best practices in July,<sup>6</sup> including, among other things, principles of conduct on compensation policies. In a similar report published in August, the Counterparty Risk Management Policy Group III (CRMPG III) also identified compensation schemes as one of the primary driving forces of the turmoil, concluding that compensation practices should be based on the performance of the bank as a whole.<sup>7</sup> More recently, both the European Council and the Ecofin Council have emphasised that the real performance of company executives should be reflected in their remuneration, including their severance pay, and that care should be taken to ensure that the system of remuneration does not lead to excessive risk-taking or any extreme concentration on short-term objectives.<sup>8</sup>

#### TRANSPARENCY AND VALUATION

As regards *transparency*, in its report of April 2008, the FSF urged financial institutions to make robust risk disclosures and set up a disclosure framework with the aim of expanding the scope and reliability of information made available to the public about banks' risk exposures, valuation practices,

5 See, ECB, "EU banks' Liquidity stress testing and contingency funding plans", November 2008.

6 See Institute of International Finance, "Final Report of the IIF Committee on Market Best Practices: Principles of Conduct and Best Practice Recommendations", July 2008.

7 See Counterparty Risk Management Policy Group III, "Containing Systemic Risk: The Road to Reform. The Report of the CRMPG III", August 2008.

8 See Meeting of the European Council, Brussels, 15 and 16 October 2008 and meeting of the Ecofin Council, Brussels, 7 October 2008.

off-balance-sheet entities and related policies. The implementation of the enhanced disclosure framework is being strongly encouraged by supervisors and national authorities worldwide. These efforts have led to more detailed qualitative and quantitative information about risk exposures already being given in the mid-year reports of large financial institutions.

At the EU level, in October the CEBS published the findings of an analysis on the application of its best practice recommendations, as set out in the “Report on banks’ transparency on activities and products affected by the recent market turmoil” of June 2008. In the follow-up report, the CEBS concluded that more than three-quarters of the banks provided detailed disclosures on the impact of the market turmoil and on exposure levels, indicating an improvement in comparison with the previous assessment. However, their disclosures on business models and risk management practices, as well as on accounting and valuation practices, proved to be less detailed, giving rise to the need for banks to undertake further efforts to comply with the good practices identified by the CEBS in its previous report. Since enhancing disclosure is considered by authorities to be an important prerequisite for restoring confidence, the implementation of good practices is being strongly promoted by the CEBS’s members.

With respect to the revision of *valuation standards*, the International Accounting Standards Board (IASB) finalised its guidance on the valuation of financial instruments in illiquid markets in October, bringing it into line with similar guidance issued by the Securities and Exchange Commission (SEC) and the Financial Accounting Standards Board (FASB) in the United States. In the same vein, the standards for the consolidation of off-balance-sheet entities and related risk exposures are also being revised by the IASB and the FASB. Indeed, the principle that any distortion of treatment between US and European banks due to differences in accounting rules should be avoided was underlined by the Ecofin Council

on 7 October. The IASB and the FASB have also taken steps to enhance convergence with regard to the issue of asset reclassification.

As regards the related supervisory tasks under Pillar 2 and Pillar 3, the BCBS issued a consultative paper, “Supervisory guidance for assessing banks’ financial instrument fair value practices” in November 2008, for comments by February 2009.

### CREDIT RATINGS AND THE FUNCTIONING OF MARKETS

The expansion of the *originate-to-distribute business model*, where credit originators no longer hold their credit exposures in their books, but securitise and sell them to a wide variety of investors, has led to an explosive growth of the outstanding amount of securitised assets and related derivative instruments over the past two decades or so. These developments in securitisation were supported by the increasing role played by credit rating agencies (CRAs) in the process, which aimed at mitigating the substantial informational asymmetries between issuers and investors.

However, the lack of transparency in these markets, as well as the over-reliance of market participants on external ratings, together with a poor understanding of the nature of ratings and weaknesses in the rating process (including certain conflicts of interest between CRAs and their clients), seriously undermined investor confidence, once complex financial products had been downgraded. Thus, the shortcomings of this business model and the opacity of the markets made it difficult for market participants and authorities to identify where the risks were accumulating in the system and to assess the possible losses from these exposures.

In this context, the ECB, in cooperation with the BSC, prepared a report that discussed the incentive structure of the “originate-to-distribute model” that revealed a range of misaligned incentives that had been created by

a variety of principal-agent relationships in the business model.<sup>9</sup> These shortcomings resulted in lax lending standards being applied by originators, as well as in inadequate due diligence and monitoring by investors, financial intermediaries and credit rating agencies.

With regard to regulatory proposals on *credit rating agencies*, authorities have launched a number of initiatives that are aimed at improving the quality of the rating process, managing conflicts of interest and enhancing the due diligence performed by the parties involved in structured finance. In this context, the revision of the IOSCO's "Code of Conduct Fundamentals for Credit Rating Agencies", published in May 2008, can be considered a major step towards this end. The adoption of the Code by CRAs will be reviewed by the IOSCO, with the findings scheduled to be published in January 2009.

At the EU level, in July 2008 the European Commission launched a public consultation on a draft regulatory proposal on the conditions for authorisation, operation and supervision of CRAs in the EU. The formal proposal on CRAs was adopted by the Commission on 12 November 2008.

#### SUPERVISORY COOPERATION AND CRISIS MANAGEMENT

Enhancing *cooperation* and improving the *exchange of information* between authorities are key to dealing with the challenges posed by the financial turmoil. In particular, initiatives that have recently been launched by authorities in this field focus primarily on addressing cross-border issues, an important element of which is the development of protocols for establishing supervisory colleges for major global financial institutions under the auspices of the FSF. At the European level, the CEBS has reviewed good practices for colleges and an assessment of their operation is expected to be carried out early next year.

In the same vein, the European Commission's proposal on the revision of the CRD seeks to enhance exchanges of information between authorities, also by increasing the rights to information of host country supervisors of systematically relevant branches.

As regards *crisis management*, authorities in Europe are paying special attention to the effective implementation of the Memorandum of Understanding (MoU) on cross-border financial stability that was signed by central banks, supervisors and finance ministries in 2008. In that context, as part of the follow-up work agreed by the Ecofin Council in 2007 for strengthening the EU arrangements for financial stability, the authorities have been requested to implement the common framework for assessing the systemic impact of a crisis by the end of this year.

In the forthcoming revision of the CRD, the powers of the consolidating supervisor will be reinforced and the allocation of responsibilities in crisis situations will be clarified further. In particular, a provision will impose an obligation on the consolidating banking supervisor to alert interested central banks and communicate to them all necessary information whenever an emergency situation arises that has the potential to jeopardise financial stability in any of the Member States in which the banking group concerned is present through subsidiaries or systemically relevant branches.

Finally, the existing crisis resolution policies are currently being analysed by the BCBS, with special emphasis on the allocation of responsibilities and legal frameworks, in order to identify possible ways of improving the cross-border crisis resolution procedures.

With respect to *depositor protection*, in April 2008 the G10 countries agreed to review and strengthen their deposit insurance

<sup>9</sup> See ECB, *EU banking structures*, October 2008.



arrangements, taking into consideration the “Core Principles for Deposit Insurance” that had been drafted by the International Association of Deposit Insurers (IADI) in spring 2008. The revision process, partly accelerated by fading public confidence vis-à-vis banks in a number of countries, had resulted in fundamental changes to various national arrangements. In this context, in line with the commitments made by the EU finance ministers on 7 October, the European Commission has recently initiated a revision of EU rules on deposit guarantee schemes, setting out a proposal to increase the minimum level of coverage for deposits from €20,000 to €50,000 with immediate effect, and to €100,000 within one year. In addition, it is planned to abandon the provisions for co-insurance that currently allow Member States to reimburse only 90% of frozen deposits within the scope of their national deposit guarantee schemes, and the suggestion has been put forward to reduce the reimbursement period from three months to three days. Moreover, the finance ministers agreed to take all the measures necessary to protect the deposits of individual savers, triggering political commitments by certain governments in Europe to provide unlimited coverage for depositors.

#### FUTURE PRIORITIES

Authorities around the world have launched a series of initiatives to address the weaknesses of the current regulatory and supervisory framework. The process of implementing the various recommendations and action plans is on track, and a number of concrete results have already been achieved. However, as the turbulence in various market segments continues to unfold and the impact on the real economy is gradually becoming apparent, both market participants and policy-makers have to face new types of challenges.

In this context, ensuring the consistency of the policy responses and identifying possible interactions between the various measures are of primary importance. Against this backdrop,

authorities are making an effort, under the auspices of the FSF, to analyse these issues at the international level.

In addition, due consideration has to be given to systemic concerns, as well as to the possible impact of regulatory and supervisory measures on the overall economy when assessing options for policy responses. To that end, the FSF has launched an initiative to explore possible ways of mitigating the pro-cyclicality in the financial system that could have an adverse impact on the real economy as well. In this connection, four work streams have recently been set up to analyse the related regulatory challenges, stemming from the capital regime, loan-loss provisioning practices and compensation arrangements, as well as from valuation methods and leverage. As regards initiatives at the EU level, at its informal meeting on 12 and 13 September, the Ecofin Council also agreed to set up a working group to assess the range of policy responses that could reduce the potential pro-cyclical effects of the financial system.

Finally, looking further ahead, the reassessment of the scope of financial regulation is considered to be a priority by policy-makers. In this process, the FSF also intends to play a leading role, putting special emphasis on institutions, instruments and markets that are currently unregulated. In addition, the leaders of the G20 countries, who held an initial meeting in Washington on 15 November 2008, agreed on a comprehensive action plan to implement certain common principles for reform, including strengthening the regulatory regimes, prudential oversight and risk management, as well as ensuring that all financial markets, products and participants are regulated or subject to oversight, as appropriate to their circumstances. The finance ministers were requested to work to ensure that the immediate tasks and the medium-term actions defined by the action plan are fully and vigorously implemented, drawing on the ongoing work of relevant international bodies.