Overview of Progress in Implementing the London Summit Recommendations for Strengthening Financial Stability

Report of the Financial Stability Board to G20 Leaders

25 September 2009

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At the London Summit, G20 Leaders set out actions to strengthen transparency and accountability, enhance sound regulation, promote integrity in financial markets and reinforce international cooperation. The Financial Stability Board (FSB) was asked to monitor progress in implementing these recommendations and to provide a report to the G20 Finance Ministers and Governors in November.

This interim progress report describes the measures that have been taken and other progress made since April to implement the London Summit and relevant FSB recommendations.

I. Establishment of the Financial Stability Board

At the London Summit, the G20 Leaders established the FSB with an expanded membership and a broadened mandate to promote financial stability. At its inaugural meeting on 26-27 June, the FSB set up the internal structures needed to address its mandate, including a Steering Committee and three Standing Committees: for Assessment of Vulnerabilities; for Supervisory and Regulatory Cooperation; and for Standards Implementation. The FSB also established a Cross-border Crisis Management Working Group, and an Experts Group on non-cooperative jurisdictions. With these structures, the FSB has taken forward its work to advance the London reform agenda:

- The Steering Committee has overseen the progress and coordination of international policy development across the range of the London Summit recommendations and their consistent implementation internationally.
- The Standing Committee on Assessment of Vulnerabilities (SCAV) has set up enhanced processes for identifying and assessing vulnerabilities affecting the global financial system and for proposing the policy responses needed to address them. The SCAV's first assessment was presented to the FSB plenary in September and will be part of the joint International Monetary Fund (IMF)-FSB Early Warning Exercise.
- The Standing Committee for Supervisory and Regulatory Cooperation has set out next steps to strengthen the operation of supervisory colleges, including the development of a protocol to improve information exchange and coordination among home and host supervisors. The Committee will be developing policy responses for addressing the problem of "too-big-to-fail" institutions.

[1] This note follows the order of the recommendations of the London Summit Declaration.

- The Cross-border Crisis Management Working Group is formulating and overseeing action to implement the FSB *Principles for Cross-border Cooperation on Crisis Management* endorsed by G20 Leaders at the London Summit. Firm-specific cross-border contingency planning discussions have been scheduled for all the main global financial institutions. The group is setting out the expectations and deliverables for these discussions.
- The Standing Committee for Standards Implementation has begun work to develop a peer review mechanism to strengthen adherence to international prudential and regulatory standards, and to identify and incentivise improved compliance by non-cooperative jurisdiction. Its deliverables are described in detail in this note.
- The FSB's Working Group on Sound Compensation Practices has reconvened and is delivering to the Pittsburgh Summit guidance detailed specific proposals to strengthen implementation of the FSB *Principles for Sound Compensation Practices* endorsed by the London Summit.

The FSB's Charter will be presented to the Pittsburgh Summit. It sets out the FSB's objectives, mandate, membership and commitments deriving from membership, and organisational structure.

II. International cooperation

Supervisory colleges

Supervisory colleges have now been established for more than thirty large complex financial institutions identified by the Financial Stability Forum (FSF) as needing college arrangements, the final few needed having been established in recent months.

The FSB committed to review the college arrangements in 2009 and to work to ensure consistency in approaches. Over the summer, the Basel Committee on Banking Supervision (BCBS) conducted a detailed survey of college arrangements and practices in the banking sector, at the request of the FSB. The FSB carried out a stocktaking of existing college arrangements in the insurance sector, working with the International Association of Insurance Supervisors (IAIS).

The surveys highlighted a number of issues for further consideration by the FSB and standard setters:

- Some of the colleges are broader in membership than may be most effective. A balance needs to be found between the desire for an inclusive membership and the need to keep the college effective. There is a need to consider whether colleges with broader membership function effectively, so that issues are targeted at those sets of regulators best placed to take these forward, making appropriate use of core, regional and wider college arrangements.
- There is scope for information exchange within colleges to be made more effective, including through the establishment of a wide range of communication channels.

- There is a need to consider ways by which adequate exchange of information with host supervisors that are not members of the (core) college membership can be achieved while avoiding unnecessary burdens.
- A successfully operating college should change the way that national supervisors work, as it should give them a better understanding of the risk profile of the firm and avoid duplication of efforts. While the existing college arrangements have entailed some joint work or the sharing of tasks among supervisors, colleges are not undertaking joint work among their member supervisors as a matter of course.
- Supervisory colleges could play a useful role as a conduit for sharing information in crisis-management work. While there is no single approach to ensuring that information is shared effectively in a crisis, good practices on the role of colleges in assisting cross-border crisis management should be developed.

Drawing on the results of the stocktaking, and recognising the need to maintain flexibility in designing college structures, the FSB will explore the scope for capturing good practices in the operation of colleges and information sharing in a protocol, drawing on the work of the BCBS to develop guidelines on the efficient establishment and operation of colleges, as well as the work of the IAIS to develop guidance on the use of supervisory colleges for insurance groups.

Cross-border crisis management and deposit insurance

Work is ongoing to implement the FSB *Principles for Cross-border Cooperation on Crisis Management*. Schedules for firm-specific cross-border contingency planning discussions for banks requiring an FSB core supervisory college have been set out and will take place in 2009 and the first half of 2010. The Cross-border Crisis Management Working Group is preparing a list of the main elements to be included in contingency planning discussions, including a template for resolution plans to be prepared by the firms. Resolution plans will consider both “going concern” and “gone concern” scenarios. They will cover options the firms would need to consider to exit risky positions and scale back their activities, in an orderly fashion and without government intervention (“de-risking”), as well as actions that promote the resolution or wind-down in a rapid and cost-effective manner.

Progress is being made in two international initiatives now underway on bank resolution frameworks, namely the Cross-Border Bank Resolution Group (CBRG) of the BCBS and the initiative by the IMF and the World Bank on the legal, institutional and regulatory framework for national bank insolvency regimes.

- The CBRG is focused on ways in which national authorities can improve the efficiency and effectiveness of cross-border crisis management and resolution while recognising the constraints that arise from the application of national resolution regimes and their focus on the protection of national stakeholders’ interests. In September, the CBRG published for consultation a report, which includes recommendations for authorities on effective crisis management and resolution processes for large cross-border institutions. These processes should include enhanced national resolution powers, frameworks for a coordinated resolution of financial groups, procedures to facilitate the cross-border implementation of measures and arrangements for information sharing. Resiliency and wind-down contingency planning should become a regular component of supervisory oversight and take into account cross-border interdependencies and the implications of complex group structures for effective resolution. National authorities should encourage simplification of group structures in a manner that facilitates effective resolution. The CBRG also recommends that jurisdictions enhance the resilience of critical financial or market functions during a crisis or resolution of financial institutions. The report also covers the lessons learned from the current crisis.

- The initiative by the IMF and the World Bank builds upon the "Global Bank Insolvency Initiative" launched in 2002 and covers the legal, institutional and regulatory framework that countries should consider for dealing with bank insolvency both in periods of financial stability and in those of systemic crisis. In April this year, the IMF and World Bank published an expanded and updated version of the 2002 report. The final report, to be finalised in the spring of 2010, will review the principal impediments to effective resolution of a cross-border financial institution, and outline proposals for future work. This will include proposals for high-level principles for the resolution of cross-border firms, identification of alternative approaches for resolving cross-border banks, and proposals for a roadmap for seeking a convergence on views on the key reforms necessary for strengthening cross-border bank resolution, also drawing on the work of the CBRG. The report will also include practical steps to achieve more consistency among national laws concerning criteria for intervention and rules for bank resolution.

The IAIS has recently initiated work to develop a supervisory paper on crisis management and cross-border resolution and will draw from the work of the other organisations, adapted as appropriate for the insurance sector.

The BCBS and the International Association of Deposit Insurers (IADI) jointly developed the *Core Principles for Effective Deposit Insurance Systems,* which were published in June. The Core Principles are designed to be adaptable to a broad range of country circumstances, settings and structures. They are a voluntary framework for effective deposit insurance practices. The FSB is planning to include the Core Principles in the FSB Compendium of Standards. A methodology for the assessment of national deposit insurance systems is now under development, and will be completed in 2010.

IADI, jointly with the IMF, has reviewed current plans to unwind the exceptional level of deposit guarantees provided by some countries and regions during the crisis, and provided feedback to the FSB. This will be considered in the context of the discussion on exit strategies from exceptional measures of support introduced during the crisis. In some countries, deposit insurance schemes have recently been modified or are under review, and changes are expected to be in line with the Core Principles. For instance in Switzerland, a significant enhancement of the overall capacity and the establishment of an ex ante funding component is under review. The European Commission has recently published a consultation document on a review of the Directive on Deposit Guarantee Schemes.

Early Warning Exercise

The initial, "dry run" Early Warning Exercise (EWE) was presented to the International Monetary and Financial Committee (IMFC) meeting in Washington on 25 April. The IMF Managing Director and FSB Chairman noted that, despite an improving tone in markets, significant challenges remained in a number of areas, including strengthening bank balance sheets, restoring a market environment supportive of credit extension, establishing fiscal sustainability and setting out a clear path for regulatory reform.

In preparation for the next iteration of the EWE, to be jointly presented at the IMFC meeting in October, the IMF and FSB have further refined their analytical tools and processes. The two partners have agreed on a process of collaboration involving regular consultations and exchange of ideas and analyses. The FSB's contribution will draw on the work of its Standing Committee on Assessment of Vulnerabilities (SCAV), which has identified a number of priority vulnerabilities together with proposals for policy responses to mitigate these risks. The IMF, through its membership in the SCAV and through regular contact between IMF staff and the FSB Secretariat, has contributed to this process and has also drawn on the SCAV's work in developing its own assessments and analysis.

Going forward, the partners will draw on the experiences of the first two EWEs to further refine their methodologies and modes of collaboration as they prepare for the April 2010 presentation and subsequent rounds. The SCAV, which was only formally constituted in July 2009, will be able to make use of a full six-month cycle to conduct in-depth analysis of risks and policy responses. Issues that were identified in the October 2009 EWE will be investigated in more depth and progress on actions to mitigate previously identified concerns will be assessed.

III. Prudential regulation

Capital requirements

The Group of Central Bank Governors and Heads of Supervision, the oversight body of the BCBS, reached agreement in September on the following key measures to strengthen the regulation of the banking sector:

- Raise the quality, consistency and transparency of the Tier 1 capital base. The predominant form of Tier 1 capital must be common shares and retained earnings. Appropriate principles will be developed for non-joint stock companies to ensure they hold comparable levels of high quality Tier 1 capital. Moreover, deductions and prudential filters will be harmonised internationally and generally applied at the level of common equity or its equivalent in the case of non-joint companies. All components of the capital base will be fully disclosed.
- Introduce a leverage ratio as a supplementary measure to the Basel II risk-based framework with a view to migrating to a Pillar 1 treatment based on appropriate

review and calibration. To ensure comparability, the details of the leverage ratio will be harmonised internationally, fully adjusting for differences in accounting.

- Introduce a framework for countercyclical capital buffers above the minimum requirement. The framework will include capital conservation measures such as constraints on capital distributions. The BCBS will review an appropriate set of indicators, such as earnings and credit-based variables, as a way to condition the build-up and release of capital buffers. In addition, the BCBS will promote more forward-looking provisions based on expected losses.

The BCBS will also assess the need for a capital surcharge to mitigate the risk of systemic banks.

The BCBS will issue concrete proposals on these measures by the end of this year, consistent with the timelines established by the G20 and the FSB. To date:

- The BCBS issued in July final standards to raise capital requirements for the trading book, resecuritisations and the treatment of liquidity lines to asset-backed commercial paper conduits. As a result of these proposals, average trading book capital requirements for the major internationally active banks will more than double between now and the end of 2010 when the new rules take effect. This does not factor in the higher charges for securitisations that will be applied to the trading book, which could add significant additional capital requirements for trading books. The BCBS also has started a review of the role of external ratings under Basel II and its treatment of securitisations.

- The BCBS has developed objectives for what a countercyclical capital buffer should achieve and concrete proposals for how it could work. An integrated proposal will be developed by year-end. Proposals for contingent capital can be integrated into this work program, for example by assessing the pros and cons of meeting a portion of the capital buffer with certain contingent capital instruments. The BCBS is also actively engaged with accounting standard setters to move provisioning practices towards an expected loss framework. Finally, the BCBS continues to work on approaches to address any excessive cyclicality of minimum capital requirements.

The agreed measures will result over time in higher capital requirements and less leverage in the banking system, less procyclicality and greater banking sector resilience to stress. The Group of Central Bank Governors and Heads of Supervision endorsed the following principles to guide supervisors in the transition to a higher level and quality of capital in the banking system:

- Building on the framework for countercyclical capital buffers, supervisors should require banks to strengthen their capital base through a combination of capital conservation measures, including actions to limit excessive dividend payments, share buybacks and compensation.

- Compensation should be aligned with prudent risk-taking and long-term, sustainable performance, building on the FSB *Principles for Sound Compensation Practices*.

- Banks will be required to move expeditiously to raise the level and quality of capital to the new standards, but in a manner that promotes stability of national banking systems and the broader economy.

Going forward, the BCBS will carry out an impact assessment at the beginning of next year, with calibration of the new requirements to be completed by end-2010. Appropriate implementation standards will be developed to ensure a phase-in of these new measures that does not impede the recovery of the real economy. Government injections will be grandfathered.

Risk management

Standards for risk management have been raised. The BCBS has strengthened guidance for use in the Pillar 2 supervisory review process of Basel II to address key lessons of the crisis, covering governance, the management of risk concentrations, stress testing, valuation practices and exposures to off-balance sheet activities. National authorities have also strengthened their guidelines for risk management practices following the shift to Basel II, including requirements for stress tests.

Efforts are also underway to ensure effective risk management for financial institutions that have hedge funds as counterparties. The BCBS is reviewing the treatment of counterparty credit risk under all three pillars of Basel II. Concrete proposals will be presented at the December 2009 BCBS meeting. National authorities are in the process of strengthening their existing guidance on the management of exposures to leveraged counterparties and conclusions are expected by end-2009 or early 2010.

Liquidity

The BCBS is working to further increase the harmonisation of international liquidity risk supervision in order to raise banks' resilience to liquidity stresses globally and strengthen cross-border supervision of funding liquidity. In September, the Group of Central Bank Governors and Heads of Supervision agreed to introduce a minimum global standard for funding liquidity that includes a stressed liquidity coverage ratio requirement, underpinned by a longer-term structural liquidity ratio. Work on these new standards is progressing rapidly and a proposal is to be finalised by end-2009, with impact assessment and calibration to be completed in 2010.

These efforts will substantially raise the bar for global liquidity risk regulation, but do not substitute for sound risk management approaches at banks as set out in the September 2008 *Principles for Sound Liquidity Risk Management and Supervision*. The BCBS is therefore monitoring banks' implementation of these Principles, and will make a thorough review of the progress of implementation in the first half of 2010.

The BCBS and the Committee on the Global Financial System (CGFS) have formed a joint working group to investigate aspects of systemic funding liquidity risk. The working group will develop a framework for assessing system-wide liquidity risk that could serve as a basis for internalising within individual banks the externalities that their activities create, develop policy options, and explore potential early warning indicators of the build-up of pressures on systemic liquidity (see below). The group will provide an interim update in November and complete its work by May 2010.

The Senior Supervisors Group has conducted a survey on risk management leading practices and the lessons learned associated with the most critical liquidity issues that surfaced during the market turmoil in 2008. Based on the key findings, the group will issue a report on risk management this fall.

IV. Developing macroprudential frameworks and tools

Aside from the work to address procyclicality noted elsewhere in this report, the FSB and its members are developing quantitative tools to monitor and assess the build-up of macroprudential risks in the financial system. These tools aim to improve the identification and assessment of systemically important components of the financial sector and the assessment of how risks evolve over time.

The tools to monitor and assess the evolution of aggregate risk over time are focused on analysis and measurement of systemic liquidity risk, margins and haircuts, and other system-wide indicators, including leverage. In addition, the IAIS has submitted to the FSB a progress report on its development of macroprudential tools relating to insurance companies.

- The BCBS and CGFS project on systemic liquidity risk described above will explore potential early warning signals and propose policy options to contain the risks. A related Bank for International Settlements (BIS)/IMF project on data collection on systemic liquidity risk will be launched once the analytical project is completed.
- On margins and haircuts, a CGFS group has conducted over the summer interviews with market participants on how margining practices in securities financing and over-the-counter (OTC) derivatives transactions evolved during the crisis. This fact-finding is being used as a basis for evaluating the benefits and costs of policy options for reducing the procyclical links of margining practices to financial leverage and asset prices. The project will be completed by January 2010.
- On other macroprudential indicators, the BIS and CGFS are developing data to provide a framework and a common vocabulary that will facilitate discussions of current financial conditions and risks. This work will enhance the input into FSB analysis of vulnerabilities and the joint FSB/IMF EWE. Particular emphasis will be put on indicators that capture the interaction between markets and institutions in the monetary transmission process. A first version of these indicators has been prepared for review in September. Following the recommendation in the FSF April 2009 Report on procyclicality, aggregate indicators of financial leverage will also be developed.[2]

The IMF, BIS and FSB have been working jointly to respond to the G20 Leaders' request for guidelines for national authorities to assess whether a financial institution, market or instrument is systemically important. The objective is to ensure that all

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[2] Work on these aggregate measures of financial leverage will complement the BCBS work to calibrate and limit leverage ratios in individual banks.

systemically important institutions, markets and instruments are subject to an appropriate degree of oversight and regulation. A report will be delivered to G20 Finance Ministers and Governors in November. It will outline conceptual and analytical approaches to the assessment of systemic importance, and discuss a possible form for high-level principles that support consistent implementation across countries.

The BCBS has established a working group on macroprudential supervision that will cover supervisory tools to address the externalities of systemically important banks; stress testing that links macro shocks with micro-level measures; assessment of the systemic impact of changes to the regulatory framework; and information exchange on practical implementation of macroprudential supervision. The group will also assess the need for a capital surcharge to mitigate the risk of systemic banks. The IAIS has reinforced a high level task force on financial stability to define the scope of systemic risk as it relates to insurance and to consider a framework for macroprudential surveillance.

Efforts to establish system-wide oversight and macroprudential policy arrangements are also ongoing at the national and regional level. For instance, in the United States (US), the Treasury Department has forwarded proposed legislation to Congress that calls for the establishment of a Financial Stability Services Oversight Council, the creation of a Tier 1 Financial Holding Company (FHC) regime for large, interconnected institutions, and the establishment of the Federal Reserve as a single, independent macroprudential regulator of Tier 1 FHCs and of critical payment, clearing and settlement infrastructure. In the European Union (EU), the European Commission has developed a financial supervision legislative package that includes measures to establish a European Systemic Risk Board (ESRB), which shall be responsible for the macroprudential oversight of the EU financial system as a whole. The ESRB would collect and analyse all the information relevant for assessing potential threats to financial stability that arise from macroeconomic developments and from developments within the financial system as a whole. It would issue warnings of a general nature or concerning individual members where risks are deemed to be significant and, where appropriate, issue recommendations for action to deal with these risks. The ESRB would also monitor compliance with its recommendations.

The use of macroprudential tools will require that authorities expand data collection on the financial system. The IMF and FSB have launched a joint initiative to identify and address data gaps. Work to make existing data more accessible and timely and to identify the main data gaps is underway via a project, chaired by the IMF, through the new Inter-Agency Group on Economic and Financial Statistics.[3] A joint FSB-IMF Conference took place in July, to explore how best to strengthen data availability to enable a better, forward-looking and targeted identification of risks to global financial stability. There was also an understanding that changes to data collection frameworks are costly and that priorities must therefore be established among the various potential improvements. Drawing on that conference and the work of the Inter-Agency Group,

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3 See http://principalglobalindicators.org. The members of the Inter-Agency Group are the BIS, ECB, Eurostat, IMF, OECD, UN and World Bank.

the IMF and FSB will submit a report outlining priorities and workplans to G20 Finance Ministers and Governors in November.

V. The scope of regulation

Hedge funds

The International Organization of Securities Commissions (IOSCO) published in June a set of high-level principles on hedge funds. The six principles include requirements on mandatory registration, regulation and provision of information for systemic risk assessment purposes. They also state that regulators should cooperate and share information to facilitate efficient and effective oversight of globally active hedge fund managers/hedge funds.

IOSCO will continue its work in this area. In particular, it will:

- monitor progress in domestic regulatory regimes for the hedge fund sector and review how those align with the IOSCO principles. A written update will be provided to the G20 in September.
- evaluate the principles of best practice for hedge fund managers issued by some key industry associations and liaise with the industry players to agree how these industry best practice principles can support the regulatory aims. IOSCO discussed these issues with the industry associations in early September.
- consider the type of information to be made available by the hedge fund sector (and their counterparties) to enable regulators to assess the systemic importance of individual actors and identify possible financial stability risks. IOSCO will make an interim report on this workstream by February 2010.
- conduct further work – together with the Joint Forum (see below) – to consider how to define systemically important hedge fund players and what type of requirements (including capital requirements) might be necessary for such players. IOSCO will make an interim report on this workstream by February 2010.
- develop principles on regulatory cooperation in the supervision and oversight of market participants whose operations cross international borders, which will be relevant to IOSCO's work on hedge funds, and consider the establishment of a general framework for exchanging information among supervisors with respect to the activity of hedge funds. Final principles and a draft framework will be published in February 2010.

National and regional initiatives are also underway in key jurisdictions. In the US, the Treasury Department has submitted legislation that would require all advisers to hedge funds (and other private pools of capital, including private equity funds and venture capital funds) whose assets under management exceed some modest threshold to be registered. The advisers would be required to report information on the funds they manage that is sufficient to assess whether any fund poses a threat to financial stability. The European Commission's draft Directive on Alternative Investment Fund Managers (AIFMs) aims to create a comprehensive and effective regulatory and supervisory framework for AIFMs, including hedge funds. The Directive proposes authorisation requirements above a certain threshold; suitability requirements; requirements to provide detailed information in a number of areas, including planned activity, identity and characteristics of the AIF managed, governance, risk management, valuation, asset safe-keeping and audit arrangements; and regulatory reporting requirements. The AIFMs would also be required to hold a minimum level of capital.

OTC derivatives and other unregulated markets and products

Initiatives are underway to promote the establishment of central counterparties (CCPs) for credit default swaps (CDS) contracts, with an initial focus on CDS indices. A number of CDS clearinghouses have begun operation in the United Kingdom (UK), US and continental Europe, and progress is being made in Japan towards the establishment of a CDS clearinghouse. Proposed legislation in the US seeks to require standardised OTC derivatives to be cleared through regulated CCPs, which will impose robust margin requirements. The European Commission has launched a consultation concerning possible ways to enhance the resilience of OTC derivatives markets and intends to present appropriate initiatives on the basis of the outcome of the consultation before the end of the year.

As for CDS standardisation, some of the major issues have been addressed by the industry. The International Swaps and Derivatives Association published in April and July 2009 two supplements to its 2003 *Credit Derivatives Definitions* (the "Big Bang" and "Small Bang" protocols), which adopt the auction mechanism globally to settle most types of CDS contracts in the event of a default or bankruptcy, and set up a new system for settling payment under CDS contracts when the reference company is forced to restructure.

The CPSS and IOSCO have created a joint working group to strengthen existing standards for CCPs and expand them to better address risks associated with the central clearing of OTC derivatives. They will also propose guidance on how central counterparties for OTC derivatives may meet the standards. The working group will coordinate with other regulatory authorities and consult with the industry, as appropriate, and will complete its report by the middle of 2010.

IOSCO published in May a consultation report on regulatory issues related to securitised products and CDS and finalised the report in September. The report recommends approaches to be considered by financial market regulators in introducing greater transparency and oversight in securitisation and CDS markets, and improving investor confidence in, and the quality of, these markets. The recommendations address the following:

- Securitisation market: strengthen market practices, including:
    - reviewing the due diligence practices and associated disclosures of participants in the securitisation chain;
    - better informing and protecting investors by requiring greater disclosure by issuers, including initial and ongoing information about underlying asset pool performance

- reviewing and, as appropriate, strengthening investor suitability requirements;
- as securitisation markets restart, adjusting measures as appropriate.

- CDS market: address counterparty risk and needed transparency, including:
  - providing sufficient regulatory structure, where relevant, for the establishment of CCPs to clear standardised CDS;
  - encouraging financial institutions and market participants to work on standardising CDS contracts to facilitate CCP clearing;
  - facilitating appropriate and timely disclosure of CDS data relating to price, volume and open-interest by market participants, electronic trading platforms, data providers and data warehouses;
  - supporting efforts to facilitate information sharing and regulatory cooperation between IOSCO members and other supervisory bodies in relation to CDS market information and regulation; and
  - encouraging market participants' engagement in industry initiatives for operational efficiencies.

IOSCO's report urged jurisdictions to assess the scope of their regulatory reach and consider which enhancements are needed to regulatory powers to support the recommendations in a manner promoting international coordination of regulation.

The BCBS is working on revisions to ensure that capital requirements for OTC derivatives adequately reflect the risks of derivatives, taking into account the benefits of central clearing, the impact of collateralisation and other counterparty credit risks. New standards will be issued by end-June 2010.

Differentiated nature and scope of regulation

The Joint Forum is analysing regulatory gaps in order to help to ensure that the scope and the nature of financial regulation are appropriate and as consistent as possible. It has five key areas of focus:

- *Differences in the nature of financial regulation*, focusing on the fundamental objectives of financial regulation and examining the three sectoral sets of core principles (for banking, insurance and securities markets) against these objectives.
- *Consolidation and group-wide supervision*, including differences in the scope of a group for purpose of consolidation; differences in treatment of intra-group transactions and exposures among entities within a group; and differences in obligations of unregulated entities within consolidation, particularly unregulated parent companies/ non-operating holding companies of regulated entities.
- *Hedge funds*, focusing on options for prudential regulation – such as capital requirements, internal organisation and risk measurement/management, and reporting – to supplement the work by IOSCO on regulation of hedge funds and/or hedge fund managers...

- *Consistent underwriting standards* for financial products even when sold by different types of institutions. This was most notably a problem with mortgage originators.
- *Risk transfer products***,** focusing on CDS and financial guarantee insurers – to supplement work by IOSCO in this area.

The Joint Forum will present its views on possible ways to address the identified issues and gaps in each of these focus areas by year-end. A progress report will be presented to the G20 Finance Ministers and Governors in November.

For the insurance sector, the IAIS is currently developing a guidance paper on the treatment of unregulated entities which will take into account lessons learned from the crisis in this area and will draw on the work of the Joint Forum. The IAIS is also researching the design and practicality of a common assessment framework for insurance group supervision.

A number of initiatives are also underway at the national level to review the adequacy of domestic regulation and fill identified regulatory gaps, including as part of broader financial sector reform proposals.

VI. Compensation

The BCBS, IAIS and IOSCO are working to support consistent implementation of the FSB *Principles for Sound Compensation Practices* across jurisdictions. The BCBS integrated the Principles in Pillar 2 of Basel II in July, with an expectation that banks and supervisors begin implementing the new Pillar 2 guidance immediately. IOSCO is considering incorporating the FSB Principles into its *Principles for Periodic Disclosure*, published in July as a consultation paper planned to be finalized this fall. The IAIS has initiated work on the development of a standard and guidance paper on remuneration that will take into account the FSB Principles for cross-sectoral consistency purposes and the specific character of the insurance industry.

The BCBS is now assessing how the FSB Principles are being implemented in practice and has created a task force that will promote a consistent and effective implementation of the FSB Principles. In this context, a survey on the implementation of the FSB Principles was conducted in July-August by the BCBS in coordination with the FSB, as a basis for more detailed work on actual bank and supervisory practices.

Many national and regional initiatives are underway to implement the FSB Principles. For example, the UK Financial Services Authority finalised in August rules for reforming financial services remuneration structures, which will enter into force in January 2010. Consultation packages on remuneration were also issued by the Swiss and Australian authorities in May and June, respectively, and final rules are expected to come into force at the beginning of 2010. Binding rules on payout parameters were issued in France in August for enforcement by the supervisory authorities from September. Other countries have incorporated remuneration aspects into existing requirements on risk management and/or internal controls or issued national principles and related guidance in implementation of the FSB Principles. At the European level, the Committee of European Banking Supervisors published in April a final set of principles for remuneration policies; and the European Commission issued in July proposed amendments to the Capital Requirements Directive to reflect new guidance on bankers' remuneration and updated guidance on directors' remuneration first issued in 2004, with a proposed date for implementation of end-2010. In the US, bank supervisors are considering options to support implementation of the FSB Principles, and are separately developing guidance that incorporates the Principles. Legislation is also being proposed that would provide shareholders a non-binding vote on compensation packages and enhance the independence of compensation committees. The US Securities and Exchange Commission proposed rules in July 2009 to enhance disclosure on compensation and corporate governance and to require companies that have received federal financial recovery assistance to permit shareholder advisory votes on executive compensation.

Because the FSB Principles were often the driver for change, these initiatives are broadly consistent in substance and have affected both regulatory frameworks and supervisory actions and practices. At the same time, the breadth and nature of the initiatives vary across countries. In particular, some countries have opted to translate the FSB Principles into more detailed domestic requirements, while others have asked their home institutions to implement the FSB Principles directly. In some cases, these two approaches have been combined. A number of supervisory actions have also been taken to assess compliance by the industry with the FSB Principles, through requests for self-assessment, assessments by the supervisors themselves, or both.

In most cases, this is work in progress, as regulations are being developed or are under consultation. Some countries have noted that the different pace of implementation across countries is resulting in pressures from the industry to dilute implementation of the Principles because of concerns over international competitiveness.

VII. Strengthening adherence to international supervisory and regulatory standards

All FSB members have undertaken or are about to undertake a review of adherence to international regulatory and supervisory standards through the IMF/World Bank Financial Sector Assessment Program (FSAP) and the Reports on the Observance of Standards and Codes (ROSC).[4] The FSB is compiling a matrix of compliance with these standards by its members, drawing from published ROSC assessments, and will provide to the G20 the relevant information. The matrix is intended to be published and will be maintained on an ongoing basis.

FSB members have also committed to undertaking periodic peer reviews of adherence to financial standards and of implementation of other initiatives in the regulatory and supervisory areas agreed by the FSB, using among other evidence the findings of FSAPs and ROSCs. Peer reviews will take the form of both single-country and thematic reviews: single-country reviews will examine the adherence to standards and other

[4] FSAPs for China, Indonesia and the United States have started or are about to start. Argentina's FSAP took place in 2001 but was not completed due to the financial crisis that year. All other FSB members have completed an FSAP, with a number of them having also undertaken or scheduled an FSAP Update.

regulatory and supervisory initiatives and progress in addressing shortcomings; thematic reviews will focus on the implementation of FSB policy recommendations or G20 action items or on the implementation of a specific standard across all FSB member countries. Both modalities will be developed in parallel. Actual reviews will start by end-2009. Work is progressing on the development of a mechanism for peer reviews, drawing on the experiences of other organisations and bodies, as well as the identification of priority themes and countries.

Progress is also being made towards promoting adherence to cooperation and information sharing standards in the financial regulatory and supervisory area. The FSB has established an Experts Group under the Standing Committee for Standards Implementation that will develop criteria for identifying jurisdictions of concern due to a combination of their weakness in compliance and systemic importance; develop an approach and a toolkit of progressive and proportionate measures to engage non-compliant jurisdictions; identify jurisdictions of concern based on the criteria approved by the Committee; develop an evaluation process to complement FSAP and ROSC assessments; assess compliance by jurisdictions of concern, using FSAP/ROSC information and mutual evaluations; and engage non-compliant jurisdictions as appropriate. Over the next six months, the FSB will work as quickly as possible to develop:

- a global compliance "snapshot" for the relevant standards building on FSAP assessments where available and any other information related to cooperation and information exchange, by the November G20 meeting;
- criteria for identifying jurisdictions of concern, by the November G20 meeting;
- procedures for an evaluation process to build on and complement FSAP assessments, to be launched by February 2010 at the latest; and
- a toolbox of measures (both positive and negative incentives) to promote adherence and cooperation among jurisdictions, by February 2010 at the latest.

VIII. Strengthening accounting standards

At the London Summit Leaders called on "the accounting standard setters to work urgently with supervisors and regulators to improve standards on valuation and provisioning and achieve a single set of high-quality global accounting standards" and said, "We also welcome the FSF recommendations on procyclicality that address accounting issues." As summarised below, standard setters have taken actions or are developing proposals in the accounting areas highlighted by the G20 and FSB recommendations, working with supervisors and regulators as appropriate. Many FSB members have been actively involved in reviewing and commenting on the proposals.

In addition to the specific international convergence activities noted in this section, which were the main focus of the G20 and FSB recommendations, nearly all FSB member jurisdictions have programmes underway to converge with or adopt the standards of the IASB by 2012. These programmes were mostly underway before the London Summit.

Fair value in illiquid markets

The IASB published in May an exposure draft (proposed accounting standard) on fair value measurement that directly incorporates the staff guidance issued in April by the US Financial Accounting Standards Board (FASB) to better identify inactive markets and determine whether transactions are orderly. Comments are due by end-September, with the final standard expected in 2010. Also, in June the IASB published a discussion document on the effects of fair value gains arising from deterioration in a company's own credit risk, with comments due by the beginning of September. Based on its review of comments the IASB will decide how to address this issue in its standard or guidance on fair value measurement.

Off-balance sheet activities

The IASB is working to enhance the accounting and disclosure standards for off-balance sheet entities. Proposals related to off-balance sheet items were issued in December 2008 (consolidation) and March 2009 (derecognition). The IASB's consolidation proposal would establish a single standard for consolidation with (i) a uniform definition of control and related application guidance that can be applied to all entities and (ii) enhanced disclosures about consolidated and unconsolidated entities (including special-purpose entities) and related risks. The derecognition proposal seeks to reduce the complexity of the IASB's requirements and provide users with better information about an entity's exposure to the risks of financial assets transferred, for example, through securitisations. In June, the IASB held round tables on the consolidation and derecognition proposals, in conjunction with the FASB, in the UK, Canada, and Japan. A number of commenters on its proposals had noted that the IASB's existing consolidation and derecognition standards had held up pretty well during the financial crisis. The IASB plans to finalise the consolidation standard by the end of 2009 and the derecognition standard in the second half of 2010.

In June 2009, the FASB published its final standards, Financial Accounting Statements No. 166, *Accounting for Transfers of Financial Assets*, and No. 167, *Amendments to FASB Interpretation No. 46(R)*, which change the way entities account for securitisations and special-purpose entities and require improved disclosures. Under the new standards certain special-purpose entities are no longer exempt from the FASB's consolidation requirements and companies must use improved approaches when they consider whether they must consolidate certain special-purpose entities initially and on an ongoing basis. To the extent that institutions have continuing involvement with securitisations (e.g., through the ability to direct the most significant activities governing assets in securitisations and the right to receive benefits or absorb losses from those assets that are potentially significant), gain-on-sale accounting for securitisations will be reduced. Also, enhanced disclosures are required about the risks that a transferor continues to be exposed to, for example, because of its continuing involvement in transferred financial assets and other risk exposures arising from special-purpose entities. The new standards will impact financial institution balance sheets beginning in 2010, and more special-purpose entities are expected to be consolidated under the new rules. The impact of both new standards has been taken into account by US banking supervisors in the recent stress tests and US banking supervisors are considering how the implementation of these standards should affect their capital adequacy requirements.

The original IASB and FASB standards on consolidation and derecognition differed considerably and the efforts to revise them were designed to address needed enhancements to their respective standards under accelerated timeframes. Therefore, the IASB's proposals and the FASB's final standards are not fully converged. For example, the IASB's proposal on derecognition would require repurchase agreements to be treated as sales and forward contracts (thus leading to off-balance sheet treatment), instead of as financing transactions on the balance sheet, as under current IASB and FASB standards.[5] However, the IASB and FASB are continuing discussions about how to converge their standards over time.

Reducing complexity of accounting for financial instruments

The IASB plans to address the G20 Leaders' call for reduced complexity of accounting standards for financial instruments through the development of three new standards, based on exposure drafts issued in 2009. The IASB issued an exposure draft in July on classification and measurement of financial instruments and the IASB plans to issue a final standard by year-end for optional use in 2009 financial statements, with mandatory implementation in 2012. The proposal would simplify the requirements by reducing the number of categories of financial assets and liabilities to two (fair value and amortised cost) and only use one credit-loss-focused impairment approach (today, several approaches are used, including some based on fair value). One outcome of this simplification would be that all the present impairment and "recycling" rules relating specifically to available-for-sale financial assets would be eliminated. Furthermore, the IASB proposed that the restrictive tainting rules affecting held-to-maturity assets be replaced by simply showing the gains and losses on sales of financial instruments measured at amortised cost separately from other gains and losses.

To complete this accelerated timetable, the IASB's July exposure draft was open for comment until mid-September and the IASB held joint public roundtables with the FASB on its classification and measurement exposure draft in Japan, the UK and US in September.

This work is part of the IASB's project to replace its overall standard on the recognition and measurement of financial instruments (IAS 39), with proposals on the remaining portions of IAS 39 – covering an expected loss approach to provisioning (see below) and hedge accounting – to be issued by the end of 2009. The revisions are intended by the IASB to respond to other issues raised by the G20, the FSB, and securities regulators.

In April 2009, the BCBS established a working group to work specifically on the replacement of IAS 39. Based on the work of this group, in July the BCBS proposed to

[5] When requesting improved standards for off-balance sheet vehicles, the G20 and FSB did not request that repurchase agreements, traditionally reported on the balance sheet, should be treated as off-balance sheet activities.

the IASB high level principles for the replacement of IAS 39, including principles on complexity, provisioning, fair value and disclosures.

The FASB intends to issue only one exposure draft in the first half of 2010 that incorporates a single, comprehensive model for accounting for financial instruments. The FASB believes that these issues (i.e., classification and measurement, impairment, and hedge accounting) are interrelated and that deliberations on one aspect of the project can also inform other aspects of the project. Also, a comprehensive approach will result in a standard that is more coherent, making it easier for constituents to react to and understand. In addition, since the FASB had provided in April new rules, that are already effective, on how to determine other-than-temporary impairment for available-for-sale and held-to-maturity securities based on credit losses and other aspects of the changes in fair value, the FASB does not see an urgent need to issue proposed revisions by end-2009. Subsequent to the issuance of the exposure draft for comment, the FASB will re-deliberate significant aspects of the project based on public comments received before issuing the final standard.

The FASB published its tentative approach to inform and solicit comments from its constituents. Unlike the IASB, the FASB is preliminarily moving toward an approach that is based on fair value measurement for all financial instruments, which will include balance sheet categories for (i) financial instruments for which changes in fair value are recognised in net income and (ii) financial instruments (including loans) for which fair value changes are recognised in "other comprehensive income". The timelines and preliminary project directions have raised concerns among stakeholders that the IASB and FASB approaches are diverging. The IASB and FASB are discussing their respective plans for their exposure drafts and other project developments in order to consider possibilities for achieving convergence. For example, the FASB plans to consider comments received by the IASB on its classification and measurement exposure draft, the joint roundtables in September and constituent comments later this year before issuing a comprehensive exposure draft in early 2010.

Procyclicality accounting issues – provisioning and valuation

The IASB is working to enhance its provisioning standards and guidance on an accelerated basis, including by considering a proposed impairment standard based on an expected loss (called an "expected cash flow") approach to loan loss provisioning for issuance in October 2009. The IASB is working with the BCBS on provisions as part of the project to replace IAS 39. Also, the IASB met with prudential supervisors who have implemented dynamic provisioning, and has been exploring with financial institutions, the BCBS and other stakeholders its expected loss approach. The IASB published initial proposals in June to seek input regarding the feasibility of this expected loss approach before it issues an exposure draft in October 2009. The FASB has not yet developed alternative approaches to measure loan loss provisions but will be considering comments received on the IASB's approach. However, the FASB issued guidance as noted above that improves the impairment model for debt securities. When certain criteria are met this guidance allows recognition of only the credit impairment portion of fair value changes through income rather than the entire difference between cost and fair value. While the IASB has not made this change its classification and measurement exposure draft seeks to improve its impairment rules for all financial assets.

With regard to valuation, the IASB and FASB have issued guidance or proposals to improve their guidance on fair value measurement, and are consulting on some aspects of revising IAS 39. It is not clear what actions will result from a number of FSF recommendations to explore valuation alternatives. Specifically, the FSF Report on procyclicality recommended that accounting standard setters and supervisors explore whether firms should be required to hold valuation reserves or to otherwise adjust valuations to avoid overstatement of income when significant uncertainty about valuation exists; and that they examine possible changes to relevant standards to dampen adverse dynamics potentially associated with fair value accounting – including the use of fair value for financial instruments of credit intermediaries[6]; allowing transfers between financial asset categories (e.g., particularly to address periods of severe illiquidity); and simplifying hedge accounting requirements.

While their exploration of alternatives is still preliminary, the IASB and FASB have not yet decided to issue standards incorporating those alternatives. For example, the FASB's planned approach to revamping its financial instruments standards is moving toward a requirement for all financial instruments to be measured at fair value and may not permit reclassifications between financial asset categories. The IASB's proposal in July to simply the classification and measurement of financial instruments would also not permit reclassifications between financial asset categories. At the same time, the IASB is giving further consideration to a possible approach to address significant valuation uncertainty through clarifying its existing guidance on valuation adjustments as part of its plan to finalise its exposure draft on fair value measurement. While both the IASB and the FASB may be exploring the FSF recommendation to examine the use of valuation adjustments when significant uncertainty about valuation exists, neither has taken action to include such valuation adjustments.

Dialogue with prudential supervisors, regulators and other stakeholders

The IASB is working together with supervisors in key areas, including provisioning and valuation, and has had a number of meetings with the BCBS on these issues. In addition, supported by the FSB, the IASB has established a dialogue with senior officials and technical experts of prudential authorities, market regulators and their international organisations to discuss financial institution reporting issues in August 2009. Its first meeting included senior representatives from a number of emerging market economies that are FSB members. The IASB shared its efforts to address consolidation and derecognition issues, valuation, simplification of financial instruments accounting standards, convergence and provisioning, and discussed issues raised by participants. FSB supervisory and regulatory members welcomed and strongly supported this constructive dialogue and the IASB plans to continue this dialogue in upcoming months.

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[6] The IASB is currently consulting on this as part of its July 2009 Exposure Draft on classification and measurement of financial instruments.

The Basel Committee has issued for consideration by accounting standard setters principles for the revision of accounting standards for financial instruments, agreed by all G20 banking supervisors, that address issues related to provisioning, fair value measurement and related disclosures.

The Financial Crisis Advisory Group of the IASB and FASB, which included participants representing market regulators, prudential supervisors, investors, preparers and other stakeholders, issued its report in July, which offers recommendations as to the matters that standard setters should emphasise as they work to improve their standards based upon what they have learned.

The IASB and FASB also held roundtables and other meetings involving a variety of stakeholders, including those noted earlier in this section.

IX. Credit rating agencies

IOSCO published in March 2009 a report assessing the degree to which credit rating agencies (CRAs) have adopted codes of conduct that reflect the updated provisions of the *IOSCO Code of Conduct Fundamentals for Credit Rating Agencies*. The report found that a larger proportion of the CRAs reviewed had taken steps to incorporate the provisions of the IOSCO CRA Code into their codes of conduct than when they were previously surveyed for IOSCO's first implementation review in 2007.

National and regional initiatives are ongoing to strengthen oversight of CRAs:

- In its regulatory reform proposal of June 2009, the US Administration announced that the Securities and Exchange Commission would continue its efforts to tighten the regulation of CRAs, including measures to require that these firms have robust policies and procedures that reduce conflicts of interest, differentiate between structured and other products and otherwise promote the integrity and transparency of the rating process. Legislation along these lines was proposed in July. In September, the SEC adopted rules to provide greater information concerning ratings histories and to grant CRAs access to data that would enable them to offer unsolicited ratings for structured products. In addition, the SEC proposed several other rules aimed at strengthening oversight of CRAs, and issued a concept release seeking comment on increased civil liability for CRAs.
- In the EU, the new regulation on CRAs will shortly enter into force following adoption by the European Council. This will put in place a common regulatory regime for the issuance of credit ratings in the EU. All CRAs that would like their credit ratings to be used in the EU will need to apply for registration, and will have to comply with rules requiring that (i) ratings are not affected by conflicts of interest; (ii) they remain vigilant on the quality of the rating methodology and the ratings; and (iii) they act in a transparent manner. When CRAs issue credit ratings for structured finance instruments, those ratings must be clearly differentiated by using an additional symbol which distinguishes them from other ratings.

- In Japan, a bill introducing a new regulatory framework for CRAs including a registration procedure was adopted by the Diet in June 2009 and will be in force by June 2010. The bill aims to ensure the independence of CRAs, the prevention of conflicts of interest, quality and fairness in the rating process and transparency for market participants.
- Some other countries have also developed or are in the process of developing a new regulatory framework for CRAs based on the IOSCO CRA Code.

Attention is needed to avoid requirements coming into place in different jurisdictions that have features that fragment rating markets or impose unnecessary burdens on CRAs. Earlier this year, the EU, US and Japan began discussions to resolve any significant inconsistencies or frictions that may arise as a result of differences among their new CRA regulations. IOSCO is also assessing how various regulatory programs for CRAs being implemented by jurisdictions promote the goals of the IOSCO CRA Principles, and is engaged with CRAs to identify whether there are differences in the regulations that can cause operational frictions or inconsistent compliance obligations.

With the aim of promoting greater interaction between CRAs and regulators, and greater coordination among regulators overseeing globally active CRAs, IOSCO is exploring options for supervisory colleges and/or bilateral cooperation arrangements and their possible use in the oversight of CRAs. These arrangements would be particularly useful for the large global CRAs. Through supervisory colleges and/or bilateral arrangements, regulators would be able to get a more complete picture of a CRA's operations.

The FSF April 2008 Report called for investors to address their over-reliance on ratings, and for authorities to review their use of ratings in the regulatory and supervisory framework. Various efforts are ongoing to this end. IOSCO published in July 2009 its report on *Good Practices in Relation to Investment Managers' Due Diligence when Investing in Structured Finance Instruments*. The report contains guidelines aimed at assisting both investment management industry participants and regulatory bodies in assessing the quality of their due diligence procedures regarding investments in structured finance instruments by collective investment schemes offered to retail investors. In June 2009, the Joint Forum released the final version of its paper *Stocktaking on the use of credit ratings,* covering the uses of external credit ratings by regulatory authorities in the banking, securities and insurance sectors. National and regional authorities either have taken or are considering ways of lessening undue reliance on ratings in rules and regulations, including the US where a review is taking place to determine where references to ratings can be removed from regulations. The BCBS is also reviewing proposals to address a number of inappropriate incentives arising from the use of external ratings in the regulatory capital framework, such as insufficient independent risk assessment by banks and "cliff" effects. Its concrete proposals will be presented in December 2009. The IAIS will consider the use of credit ratings in its guidance paper on regulatory requirements for investment for solvency purposes.