Improving Financial Regulation

Report of the Financial Stability Board to G20 Leaders

25 September 2009

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1. Since the London Summit, the Financial Stability Board (FSB) and its members have advanced a major program of financial reforms based on clear principles and timetables for implementation that are designed to ensure that a crisis on this scale never happens again.

2. Much has already been achieved, and much is underway that when implemented will result in a very different financial system than the one that brought us this crisis. However, policy development is not completed, and detailed implementation of the full set of needed reforms will take time and perseverance.

3. In a globally integrated market economy, where concerns about a level playing field and protectionist pressures are real, it is vital that G20 Leaders strongly support the international policy development underway and signal their determination to implement fully and consistently the reforms at national levels.

4. In recent months, expectations have taken hold in some parts of the private financial sector that the financial and regulatory system will remain little changed from its pre-crisis contours. These expectations – that business will be able to go on just as before – need to be dispelled.

5. Our objective is to create a more disciplined and less procyclical financial system that better supports balanced sustainable economic growth. This system will not allow leverage to increase to the extent that it did. Nor will we allow risks to be taken where profits accrue to individual actors but ultimate losses are borne by governments and the wider public.

6. To these ends, our program includes substantially higher requirements for the quantity and quality of capital and liquidity at financial institutions. It also includes reforms to accounting standards and compensation regimes that improve transparency and limit incentives to excessive risk taking. We will constrain risks in trading-related activity by improving market infrastructure and by significantly raising capital charges for trading books.

7. Our reform plans set reasonable implementation windows to avoid aggravating the present crisis. While the financial system will continue to face challenges for some time, the faster our financial systems and economies recover, the faster we should implement finalised reforms.

8. This crisis has highlighted the moral hazard risks posed by institutions that have become too big to fail or that, by their interconnected nature, are too complex to resolve. We need to address the deeper-seated challenges that these institutions

pose. We are committed to developing the solutions to these problems over the next twelve months.

9. In recent quarters, many financial institutions have returned to profitability. These profits owe much to the extraordinary official measures taken to stabilise the system, many of which remain in place. It is imperative that these profits be retained in financial institutions to rebuild capital necessary to support lending, allow official support measures to be removed and prepare institutions to meet future higher capital requirements.

10. The international supervisory and regulatory community is agreed that restricting dividend payments, share buybacks and compensation rates are appropriate means to these ends.

11. The support of G20 Leaders will be vital for the major decisions that will need to be made in these important areas, and we ask that you support us in these endeavours.

Achievements to date

12. Bolstering the resilience of the international financial system is a broad project encompassing a considerable number of related measures. Substantial progress has been made on the many measures recommended in the Financial Stability Forum (FSF)'s April 2008 and 2009 Reports, the G20 Washington Action Plan and the London Summit Statement, especially at the level of international policy development. Significant actions have been taken since the London Summit:

- *The shortcomings in the Basel capital framework that generated incentives for off-balance sheet securitisation activity have been removed;*
- *The weaknesses in accounting practices and national standards that generated similar incentives for off-balance sheet activities have been addressed.* New standards have been set out that enhance the consolidation of special purpose vehicles and the transparency of banks' relationships with such entities;
- *The risks that banks assume in their trading activities have been brought under better control.* Substantially higher capital requirements against risks in banks' trading activities have been issued;
- *Strong new risk management standards for financial institutions have been issued and are being implemented,* covering bank governance, the management of liquidity risk, underwriting and concentration risks, stress testing, valuation practices and exposures to off-balance sheet activities;
- *Banks' disclosures of their on- and off-balance sheet risk exposures have been materially improved*. New disclosure standards for banks have been issued covering valuation and liquidity risk, securitisation and off-balance sheet activities;

- *The FSB Principles for Sound Compensation Practices have been integrated into the Basel capital framework*, and international guidance is under development to reinforce their implementation;
- *Central counterparties have been introduced to clear credit default swaps, reducing the systemic risks from this market.* Transparency and standardisation in this market have been increased and dealers have reduced their cross-exposures through trade compression;
- *Stronger oversight regimes for credit rating agencies have been developed.* New legislation creating oversight regimes has been approved in Japan and is close to final approval in the EU; in the US, amendments to the existing oversight regime have been proposed or already made;
- *Internationally agreed principles for the oversight of hedge funds have been issued*, and national and regional legislation has been or is in the process of being introduced to implement them;
- *Good practices for due diligence by asset managers when investing in structured finance products have been issued*, which will reduce their reliance on credit rating agencies;
- *Abusive short selling has been addressed.* Internationally agreed principles have been issued to counteract the abusive use of short selling while maintaining the benefits of short selling for the functioning of the markets, and their implementation will be monitored;
- *Supervisory coordination and cooperation in the oversight of the most important global financial firms have improved.* Supervisory colleges have now been established for all the large complex financial groups that the FSB has identified as needing colleges;
- *Strengthened arrangements for system-wide oversight have been developed in many jurisdictions*, bringing together the relevant authorities to better assess risks to financial stability and identify mitigating actions;
- *Firm-by-firm contingency planning is underway to implement the FSB Principles for Cross-border Cooperation on Crisis Management*. Relevant authorities will hold contingency planning meetings for major cross-border banks within the first half of 2010 and assess the barriers to coordinated action that may arise in handling severe stress at these firms;
- *Depositors will be protected in a more consistent way around the world.* Core Principles for Effective Deposit Insurance Systems have been developed and an assessment methodology is under preparation.

Critical work underway

13. Beyond the areas above, a large body of critical work is underway to take forward other parts of the London Summit Statement. In some areas, policy development is reaching a phase in which difficult decisions will need to be made.

Strengthening the global capital framework

14. The Basel Committee on Banking Supervision is working urgently to build stronger buffers into the financial system, covering capital, liquidity and provisioning, that will raise defences and constrain the procyclical build-up of leverage in the system.

15. New rules will be set out by end-2009, calibrated in 2010 and phased in as financial conditions improve and economic recovery is assured. Government capital injections will be grandfathered. Banks should be retaining profits now to prepare to meet these future additional capital requirements. Restricting dividends, share buybacks and compensation rates is a necessary part of that process.

16. The new rules will require a clear step up in the amount and quality of capital that the system as a whole will need to carry, so that banks holding the minimum required capital levels will be clearly viable in a crisis and confidence in the system as a whole will be maintained.

17. To these ends, the Basel II capital framework is being revised. We are agreed that:

    - the level and quality of minimum capital requirements will increase substantially over time;
    - capital requirements will operate countercyclically, so that financial institutions will be required to build capital buffers above the minimum requirements during good times that can be drawn down during more difficult periods;
    - significantly higher capital requirements for risks in banks' trading books will be implemented, with average capital requirements for the largest banks' trading books at least doubling by end-2010;
    - the quality, consistency and transparency of the Tier 1 capital base will be raised. 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 stock companies;
    - the definition of capital will be harmonised across jurisdictions and all components of the capital base will be fully disclosed so as to allow comparisons across institutions to be easily made;
    - a leverage ratio will be introduced as a supplement 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.

18. We will also examine the use of “contingent capital” and comparable instruments as a potentially cost-efficient tool to meet a portion of the capital buffer in a form that acts as debt during normal times but converts to loss-absorbing capital during financial stress, thus acting as a shock-absorber for the capital position.

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

Making global liquidity more robust

20. The crisis vividly demonstrated that adequate liquidity is a prerequisite for financial stability. The drying up of liquidity at the level of financial institutions, countries and ultimately the global system caused the seizing up of credit provision and of financial flows. Cross-border flows are often the most vulnerable during financial crisis, and emerging markets can face damaging volatility in foreign exchange and liquidity flows.

21. Just as strong capital is a necessary condition for banking system soundness, so too is a strong liquidity base. Many banks that had adequate capital levels still experienced difficulties during the crisis because they did not manage their liquidity in a prudent manner. The lesson is that banks’ resilience to system-wide liquidity shocks – affecting both market and funding liquidity – must be significantly increased and their management of this risk strengthened.

22. To this end, we are substantially raising the bar for global liquidity risk regulation:

    - The Basel Committee will issue by the end of 2009 a new minimum global liquidity standard. This new regulatory framework introduces a liquidity coverage ratio that can be applied in a cross-border setting. It establishes a harmonised framework to ensure that global banks have sufficient high-quality liquid assets to withstand a stressed funding scenario specified by supervisors.
    - The Basel Committee will also formulate a structural ratio to address liquidity mismatches and promote a strong funding profile over longer-term horizons.
    - This new standard complements the supervisory guidance for banks’ liquidity risk management practices, the implementation of which is being assessed in supervisory reviews.

23. Shortages of cross-border liquidity caused problems at the national level for many countries. Ex ante measures to reduce the risk of instability are needed, as well as ex post mechanisms to provide a coordinated official response if shortages arise:

    - Regulators and supervisors in emerging markets will enhance their supervision of banks’ operations in foreign currency funding markets.

- The Committee on the Global Financial System will investigate policy options to reduce system-wide cross-border liquidity risk, including through strengthening the infrastructure of the foreign exchange swaps market and other aspects of funding liquidity markets.
- National and regional authorities and the international financial institutions will use the results of this investigation to review together the scope for improved cooperation over liquidity provision when liquidity shortages arise.

Reducing the moral hazard posed by systemically important institutions

24. Notwithstanding the actions above to strengthen capital and liquidity, additional steps are needed to reduce the moral hazard risks and economic damage associated with institutions that are "too big to fail" (or, more accurately, too big and too complex to fail).

25. Action in this area is essential to contain the costs to governments and economies of future crises. We will develop over the next 12 months measures that can be taken to reduce the systemic risks these institutions pose. Possible measures include specific additional capital, liquidity and other prudential requirements as well as other measures to reduce the complexity of group structures and, where appropriate, encourage stand-alone subsidiaries. More intense and internationally coordinated regulation and supervision of firms presenting greater risks can help to reduce the probability of their failure.

26. For all major cross-border firms we will require the development of specific contingency plans that aim at preserving the firm as a going concern, promoting the resiliency of key functions and facilitating rapid resolution or wind-down, should that prove necessary. The Basel Committee's consultation document on cross-border bank resolution proposes specific actions to achieve an effective, rapid and orderly wind-down of large cross-border financial firms.

27. We will assess the implications of different responses for systemic cross-border institutions with different group structures, and the impact of these different measures for the stability and efficiency of cross-border capital flows. We ask you to support us in this important future work.

Strengthening accounting standards

28. In April 2009, the G20 Leaders stated that standard setters should "make significant progress towards a single set of high quality global accounting standards." There is significant progress in this area and nearly all FSB member jurisdictions have programmes underway to converge with or adopt the standards of the International Accounting Standards Board (IASB) by 2012.

29. In addition, the G20 Leaders welcomed the FSF's procyclicality recommendations relating to accounting and called on "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." Important

steps have been taken to improve existing standards and to enhance dialogue with prudential authorities. But in some instances, achieving improved valuation and provisioning standards alongside the goal of convergence need further attention by standard setters.

30. At present, the IASB and the US Financial Accounting Standards Board (FASB) are considering a variety of approaches which could possibly lead to divergences between IASB and FASB standards with respect to:

- improving and simplifying financial instruments accounting, where FASB is considering an approach that is based on fair value measurement for most financial instruments, which would be proposed by early 2010, while the IASB has proposed a mixed model of historical cost and fair value, to be available for use in 2009 year-end financial statements;
- provisioning and impairment, where the IASB plans to propose a standard using an expected loss or expected cash flow approach to loan loss provisioning in October 2009, which would generally recognise credit losses earlier and mitigate procyclicality,[1] whereas the FASB continues to consider changes to impairment recognition, including an approach based on fair value with plans to issue its proposal by early 2010;
- off-balance sheet standards, where the IASB's proposal on derecognition, which is now subject to consultation, would require repurchase agreements to be treated as sales and forward contracts in certain situations (thus leading to off-balance sheet treatment), instead of as financing transactions on the balance sheet as under current IASB and FASB standards.

31. Moreover, continuing differences in accounting requirements of the IASB and FASB for netting/offsetting of assets and liabilities also result in significant differences in banks' total assets, posing problems for framing an international leverage ratio.

32. Therefore, additional work in the areas above is urgently needed in order to meet the important objectives of convergence, transparency and the mitigation of procyclicality, as standard setters continue their efforts to improve the quality of their standards and reduce the complexity of their standards on financial instruments.

33. We strongly encourage the IASB and FASB to agree on improved converged standards that will:

- incorporate a broader range of available credit information than existing provisioning requirements, so as to recognise credit losses in loan portfolios at

[1] The FSF found that "earlier identification of credit losses is consistent both with financial statement users' needs for transparency regarding changes in credit trends and with prudential objectives of safety and soundness."

an earlier stage as part of an effort to mitigate procyclicality. We are particularly supportive of continued work on impairment standards based on an expected loss model; and

- simplify and improve the accounting principles for financial instruments and their valuation. We are particularly supportive of continued work in a manner that does not expand the use of fair value in relation to the lending activities (involving loans and investments in debt instruments) of financial intermediaries.

34. While respecting the independence of accounting standard setters, the FSB is urging renewed efforts by the IASB and FASB to achieve these objectives, working with supervisors, regulators and other constituents. 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.

35. We welcome the IASB's recent initiatives with respect to provisioning and its enhanced technical dialogue with prudential supervisors and other stakeholders, and encourage the IASB to continue its dialogue with stakeholders as it moves forward. We request G20 Leaders to support the call for action set forth in this section.

Improving compensation practices

36. National regulatory and supervisory initiatives are being taken to implement the FSB Principles for Sound Compensation Practices. The Principles call for wide-ranging private and official sector action to ensure that governance of compensation is effective; that financial firms align their compensation practices with prudent risk taking; and that compensation policies are subject to effective supervisory oversight and engagement by stakeholders.

37. Given competitiveness concerns, speedy and determined coordinated action in all major financial centres is needed to achieve effective global implementation of the Principles. We must ensure that the Principles are rigorously and consistently implemented and applied to significant financial institutions and especially large, systemically relevant firms across the financial services sector.

38. To this end, we have set out in a separate report[2] to the Summit specific implementation standards for the Principles, focusing on areas in which especially rapid progress is needed. These cover:

- independent and effective board oversight of compensation policies and practices;

[2] *FSB Principles for Sound Compensation Practices: Implementation Standards*

- linkages of the total variable compensation pool to the overall performance of the firm and the need to maintain a sound capital base;
- compensation structure and risk alignment, including deferral, vesting and clawback arrangements;
- limitations on guaranteed bonuses;
- enhanced public disclosure and transparency of compensation; and
- enhanced supervisory oversight of compensation, including sanctions if necessary.

39. The Basel Committee, the International Association of Insurance Supervisors (IAIS) and the International Organization of Securities Commissions (IOSCO) will undertake measures to support implementation.

40. We will undertake a FSB thematic peer review of actions taken by national authorities to implement our Principles and implementation standards. We will assess whether these actions have had their intended effect and propose additional measures as required. This review will be completed in March 2010.

41. These actions are in addition to our call for banks to conserve capital by limiting bonus payments today and so be in a better position to meet future additional capital requirements.

Expanding oversight of the financial system

42. In addition to strengthening the buffers in the banking system, work is progressing to ensure that, throughout the broader financial system, all systemically important activity is subjected to appropriate oversight and regulation. In particular:

    - Regarding hedge funds, regulators are working, including through IOSCO, to set out for consideration by legislatures a consistent framework for oversight and regulation of hedge funds and/or hedge fund managers, including requirements for mandatory registration, ongoing regulation, provision of information for systemic risk purposes, disclosure and exchange of information between regulators. Regulators are coordinating their respective work in order to ensure the best possible consistency with regard to implementation of hedge fund regulation in different jurisdictions. By March 2010, IOSCO will report on the level of implementation in these areas and on proposed industry standards.
    - On credit rating agencies, regulators are working, including through IOSCO, to evaluate whether national and regional regulatory initiatives are consistent with the IOSCO Principles and Code of Conduct Fundamentals and to identify whether divergences between initiatives might cause conflicting compliance obligations for credit rating agencies. Regulators should work together towards appropriate, globally compatible solutions as early as possible in 2010.

- Regarding the perimeter of regulation more generally, supervisors and regulators working through the Joint Forum will identify by end-2009 other key areas where the perimeter needs to be expanded.
- By the November 2009 meeting of G20 Finance Ministers and Central Bank Governors, the International Monetary Fund (IMF), Bank for International Settlements and FSB will have developed preliminary guidance for national authorities to assess the systemic importance of financial institutions, markets or instruments.

43. To guard against regulatory arbitrage, it is imperative that initiatives to expand the perimeter of regulation are effectively and consistently implemented across key jurisdictions. The FSB will benchmark the regulations implemented in these jurisdictions to assess whether they are well aligned with each other.

Strengthening the robustness of the OTC derivatives market

44. Global regulatory efforts to reduce systemic risks in the over-the-counter (OTC) derivatives market have intensified since the London Summit. Given the global nature of the market, international standards must be established and consistently applied to address these risks, and regulators must coordinate their efforts.

45. To these ends, the official sector will:

- strengthen capital requirements to reflect the risks of OTC derivatives and further incentivise the move to central counterparties and, where appropriate, organised exchanges. The Basel Committee will issue new standards by mid-2010 to take full account of counterparty credit risks, the benefits of centrally cleared contracts and collateralisation. Regulators need to ensure that equivalent rules are applied outside the banking sector;
- strengthen standards for central counterparties by mid-2010 to address the issues specific to clearing OTC derivatives, and develop international recommendations for OTC derivatives trade repositories, working through the Committee on Payment and Settlement Systems and IOSCO;
- coordinate efforts to oversee and apply international standards to OTC derivatives central counterparties and trade repositories. We strongly support the ongoing work of the OTC Derivatives Regulators' Forum to develop international cooperative oversight frameworks by end-2009, including for sharing information among regulators and developing common expectations for data reporting; and
- identify legal or other impediments to implementing the OTC derivatives market reforms, which regulators or legislative authorities will then take action to resolve.

46. The private sector needs to meet its commitments to supervisors to expand central clearing of OTC derivatives trades; improve risk management for trades that are not cleared, meet increasingly stringent targets for operational improvements and

report data on their performance to their regulators; and report all non-cleared trades to regulated trade repositories. If they do not meet these and future commitments, supervisors will develop alternative approaches to ensure the improvements are made.

Re-launching securitisation on a sound basis

47. The revival of securitisation markets is needed in many countries to support the provision of credit to the real economy. Although industry initiatives are underway to standardise terms and structures, reduce complexity and enhance transparency, the official sector must provide the framework that ensures discipline in the securitisation market as it revives.

48. To this end, during 2010, supervisors and regulators will

- implement the measures decided by the Basel Committee to strengthen the capital treatment of securitisation and establish clear rules for banks' management and disclosure, including:
    - higher risk weights for securitisations and re-securitisations;
    - requirements on banks to conduct more rigorous due diligence of externally rated securitisations, with higher capital requirements imposed where this does not take place;
    - tighter prudential guidance for bank management of off-balance sheet exposures arising from securitisation vehicles; and
    - improved disclosures of securitisation exposures in the trading book, sponsorship of off-balance sheet vehicles, re-securitisation exposures, valuation assumptions and pipeline risks;
- implement IOSCO's proposals to strengthen practices in securitisation markets, including by:
    - 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;
    - considering what enhancements are needed to regulatory powers to allow authorities to implement the recommendations in a manner promoting international coordination of regulation;
- examine other ways to align incentives of issuers with investors, including considering requirements on issuers of securitisations to retain a part of the economic exposure of the underlying assets;

- encourage greater use of the contractual form used in covered bonds, which tie issuers to the instruments by obliging them to act as the de facto guarantor in the event of underperformance by the underlying assets, provided that depositors are not disadvantaged;
- support implementation of industry initiatives to standardise terms and structures, reduce complexity and enhance transparency and, as securitisation markets restart, adjust measures as appropriate.

Adherence to international standards

49. The FSB will put in place by the end of 2009 a framework to strengthen adherence to international regulatory and prudential standards. The framework, which will build upon IMF and World Bank assessments, is envisaged to provide comprehensive and updated compliance information. FSB member countries have agreed to lead by example in disclosing their degree of compliance. The FSB will report on the development of this framework at the November 2009 meeting of G20 Finance Ministers and Central Bank Governors.

50. We will apply this framework to identify non-cooperative jurisdictions with reference to cooperation, information exchange and other prudential standards, focusing on jurisdictions of concern due to weaknesses in compliance and systemic importance. The FSB will work as quickly as possible to develop:

    - a global compliance "snapshot" for the relevant standards building on Financial Sector Assessment Program (FSAP) assessments where available and other relevant information, by November 2009;
    - criteria for identifying jurisdictions of concern by November 2009;
    - 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 to promote adherence and cooperation among jurisdictions, by February 2010 at the latest.

51. Within this framework, we are also developing a system of peer reviews among FSB members, based among other evidence on the findings of IMF and World Bank assessments, and will report on their outcome. These will comprise both single-country and thematic reviews to assess our implementation of international financial standards and of policies agreed in the FSB and determine whether additional steps are needed to reach the intended results. Both modalities will be developed in parallel. Actual reviews will start by end-2009 with the thematic peer review on the implementation of the FSB compensation principles.

The need for perseverance and consistent national implementation

52. While reforms are well underway, as we detail in a separate report,[3] they are far from complete. Effective work to strengthen the global financial system requires policies that are well designed and will be robust over the long run. This necessarily takes time. It is important, therefore, that Leaders send a strong message that they are determined to see these reforms through. Where international policy development is ongoing, we need Leaders' continued support; where such policy work has concluded, we need Leaders' commitment to consistent national implementation.

53. Achieving our objectives of a well regulated open financial system requires the maintenance of a level playing field. Delivering this is one of the reasons why the FSB exists. However, the speed with which jurisdictions develop and change financial regulation differs, and consistency in what comes into place should not be taken for granted. While the FSB can develop coherent policy proposals, only national authorities can assure implementation that is effective and is consistent across borders. Given the commitment we have all made to coherent approaches as we improve the regulation of the system, we must strive to overcome differences in our final rule making. We will continue to take actions to ensure achievement of this end.

54. To maintain ongoing attention to this issue and foster the pace and consistency of implementation, we will launch a project to compare national implementation measures and identify cross-country differences and any need for policy actions to address them.

55. As our economies recover, it is crucial that national momentum for significant reforms be maintained. The FSB will continue to work to ensure that the goals remain ambitious, that clear targets are set to move us forward towards those goals, and that their importance is not lost even if markets seem to be calmer for the time being.

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[3] *Overview of Progress in Implementing the London Summit Recommendations for Strengthening Financial Stability*