11 June 2008

Update on the Implementation of the FSF's Recommendations

Report by the FSF Chairman to the G8 Finance Ministers

I. Current situation of the financial system

Financial markets and institutions continue to make progress in adjusting to the new conditions that have prevailed since the outbreak of market turbulence. Banks and other financial institutions have raised substantial amounts of new capital and further capital raising plans have been announced. Institutions have also moved to reduce leverage and build liquidity. Credit and liquidity risk premia have narrowed since mid-March although more recently there has been some re-emergence of strains.

A number of challenges remain. Despite central bank liquidity operations, term money markets in the major currencies remain subject to volatility and wide spreads. Many securitisation markets remain disrupted and assets continue to accumulate on banks' balance sheets. With housing and commercial property markets and economic growth weakening in several countries, write-downs are likely to persist in the financial sector for some time.

II. Implementation of the recommendations of the FSF Report on Enhancing Market and Institutional Resilience

Authorities are continuing to take appropriate steps to facilitate adjustments in the financial sector and dampen the impact on the real economy. At the same time, it is essential for the restoration of confidence that work to put in place a more resilient financial system for the future maintains its momentum. The guiding principle of the recommendations of our Report on Enhancing Market and Institutional Resilience is to recreate a financial system (a) that is more immune to the misaligned incentives that have we have seen; (b) where leverage is ultimately lower; and (c) where the sources of leverage and their associated risks are better identified and addressed.

II.1. Recommendations identified as immediate priorities by the G7

In endorsing the FSF Report, the G7 communiqué in April identified certain recommendations of the Report as priorities to be implemented within 100 days. All of these priority recommendations are on track, as described below:

- Regarding risk disclosures, supervisors and national authorities have strongly encouraged their internationally active financial institutions to use the recommended leading risk disclosure practices summarised in the FSF Report as part of their upcoming mid-year 2008 reporting. Some early reporting institutions have implemented the disclosures, and authorities expect others to enhance their risk disclosures along the lines proposed in the FSF Report in forthcoming mid-year reports. We will assess the results in September.

- The International Accounting Standards Board (IASB) is accelerating its work to enhance the accounting and disclosure standards for off-balance sheet entities. By end-2008, it will issue for consultation a new proposed standard on consolidation of special purpose vehicles and other entities and related risk disclosures for off-balance sheet entities.
- Also, in response to the FSF recommendations, on 3 June the IASB announced the establishment of an expert advisory panel to assist it in (a) reviewing best practices in the area of valuation techniques and (b) formulating any necessary additional guidance on valuation methods for financial instruments and related disclosures when markets are no longer active. This expert advisory panel will hold its first meeting this week in London.
- As noted above, financial firms are continuing their efforts to strengthen their capital positions. The Basel Committee on Banking Supervision announced on 16 April a series of steps to make the banking system more resilient to financial shocks. These include the issuance of Pillar 2 guidance to strengthen risk management and supervisory practices, including stress-testing practices and capital planning processes.
- The Basel Committee will issue for public consultation global sound practice guidance on the management and supervision of liquidity risks later this month. It plans to finalise the guidance in late September, and will begin work to assess the scope for further international convergence around the supervision of liquidity risks.
- IOSCO finalised the revision to its Code of Conduct Fundamentals for Credit Rating Agencies (CRAs), and released the revised Code on 28 May. The Code sets out materially enhanced expectations for quality and integrity of the rating process; CRA independence and avoidance of conflicts of interest; and CRA responsibilities to the investing public and issuers.

II.2. Other recommendations

Good progress is being made by FSF member institutions and bodies as well as the FSF Working Group on further recommendations, including the following cited in the G7 April communiqué.

- The Basel Committee announced on 16 April that it will publish later this year proposals for establishing higher capital requirements for complex structured credit products; strengthening the capital treatment of liquidity facilities extended to off-balance sheet vehicles; and strengthening the capital requirements in the trading book.
- The Basel Committee is in the process of developing guidance to enhance the supervisory assessment of banks' valuation processes. An outline of what such guidance would cover has been developed, and the Committee plans to finalise the guidance by end-2008.

- IOSCO decided in May to monitor the implementation by CRAs of the revised Code of Conduct Fundamentals for CRAs. It aims to have the results later this year.
- The Joint Forum has launched a stocktaking of the uses of credit ratings by its member authorities in the banking, securities and insurance sectors. It plans to finalise the work by end-2008.
- The FSF WG has formed a small group of supervisors to develop the protocols needed for the establishment of supervisory colleges for the major global financial institutions.
- At a meeting convened by the Federal Reserve Bank of New York on 9 June, major market participants and their supervisors reviewed industry strategy and agreed an agenda for addressing weaknesses in the operational infrastructure of the over-the-counter (OTC) derivatives market. The agenda includes the establishment of a central clearing house for credit default swaps (CDS); bilateral and multilateral netting of contracts; protocol for managing defaults; and targets for greater automation of trading and settlement.

III. The work of the FSF going forward

The FSF WG will assess progress in taking forward the above and other recommendations later this month and in early September. The full FSF will review progress across all recommendations at its meeting on 29 September.

The FSF is also setting in train an examination of the forces that contribute to pro-cyclicality in the financial system and possible options for mitigating it. The FSF WG will discuss the areas to be covered in this examination at its meeting in June.

Continuous support and involvement by the G7/G8 would be helpful to maintain the positive momentum for taking forward the workstreams to enhance the resilience of the financial system. The FSF will present a comprehensive follow-up report at the G7 meeting in October.