



## **BRIEFING FOR THE LONDON SUMMIT BY SECURITIES AND DERIVATIVES INDUSTRY REPRESENTATIVES**

**London Investment Banking Association (LIBA)**

**Securities Industry and Financial Markets Association (SIFMA)**

**International Capital Market Association (ICMA)**

**International Swaps and Derivatives Association (ISDA)**

**Futures and Options Association (FOA)**

**Investment Industry Association of Canada (IIAC)**

**9<sup>th</sup> March 2009**

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**INTRODUCTION AND EXECUTIVE SUMMARY**

This paper, by the London Investment Banking Association (LIBA), the Securities Industry and Financial Market Association (SIFMA), the International Capital Market Association (ICMA), the International Swaps and Derivatives Association (ISDA), the Futures and Options Association (FOA), and the Investment Industry Association of Canada (IIAC), presents a securities and derivatives industry view on some of the issues raised in the 15<sup>th</sup> November 2008 G20 Washington Communiqué and Action Plan. We have drafted it to assist the authorities in preparing for the 14<sup>th</sup> March 2009 meeting of Finance Ministers and the 2<sup>nd</sup> April 2009 London Summit.

We support the Washington Action Plan as an important statement by heads of state and government of the need for both the public authorities and the private sector to take steps to promote more robust and stable financial markets, while also avoiding policies that would be protectionist or erect barriers to trade and investment.

For our part, the industry strongly supports transparent, efficient financial markets that operate with integrity, and where regulators have the information they need to maximise supervisory effectiveness. We are hard at work on a number of initiatives, some of which are global, and several of which are now completed, that address certain market weaknesses that the crisis has revealed (see Section B and Annex 2 below), and will continue to promote and progress them. We ask world leaders to take industry initiatives into account in formulating their views on what more needs to be done, and to ensure that policy development is conducted in consultation and cooperation with market participants.

We are already active participants in discussions and consultations with the relevant international fora on a wide range of issues covered by the Washington Action Plan. We consider that it is important, wherever possible, that the global regulatory reform agenda takes account of and builds from the existing global infrastructure, global standards, and the work that international bodies already have in train that addresses in a globally coordinated fashion the lessons from the market turmoil.

We suggest it will be a key component of the Washington Action Plan's success and credibility that world leaders keep consistently to their November 2008 commitment to global consistency and global cooperation, and that countries' and regions' responses do not become fragmented or disconnected. The need for consistency and cooperation applies both to policy development, and arrangements for supervisory and financial stability coordination (see our detailed comments in Section C and Annexes 3 and 4 below).

We also suggest that there should be a process which rigorously and objectively tracks progress and shows what has been achieved, and catalogues national and regional proposals and examines their impact on other countries. The impact of any

new initiatives should be carefully considered whilst scarce resources are devoted to reaching already agreed goals.

We suggest that world leaders should ensure that regulatory initiatives take into account their systemic and cost impacts in aggregate, not just individually, and in particular their macro-economic implications. This may require the implementation of initiatives to be phased in, if wider unwelcome consequences are to be avoided. Consistency between prudential and macro-economic policy objectives needs to be carefully considered. To assist this process, we identify in Section B below those elements of the Washington Action Plan which, from the point of view of market practitioners, we think have the highest priority.

Ahead of the 15<sup>th</sup> November Washington Summit some associations provided a short statement of what we suggested should be the objectives and guiding principles for the G20 work, a copy of which we include at Annex 1 below for ease of reference.

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## A. PRIORITY ISSUES FOR MARKET PRACTITIONERS

The Washington Action Plan identified those actions to be completed by 31<sup>st</sup> March 2009, and those to be done on a medium-term timescale.

In Section C below we comment in more detail on the Action Plan. This section aims to identify those actions which, from the point of view of market practitioners, we suggest should have particular priority in order to restore market confidence and effective market operation as quickly as possible.

### Working Group 1- Enhancing sound regulation and strengthening transparency

Key priorities to restore market functioning and create conditions for responsible risk-taking:

- Creation of a single high-quality global accounting standard: to deliver a uniform foundation from which firms' solvency can be measured.
- Mitigation of pro-cyclicality, including the review of how valuation and leverage, bank capital, executive compensation, and provisioning practices may exacerbate cyclical trends.
- Review of resolution regimes and bankruptcy laws to ensure that they permit an orderly wind-down of large complex cross-border financial institutions.
- Improved management of liquidity risk and, in due course, robust and internationally consistent approaches to liquidity supervision: reflecting the role of liquidity shortage in transmitting problems from the securitisation markets, via banking, to the macro-economy.
- Ensuring that regulatory policy makers are aware of, and able to respond rapidly to, evolution and innovation in financial markets and products.

Key priorities to create robust infrastructure, transparency, and risk management for when the market returns to more normal conditions:

- Enhanced disclosure of complex financial instruments by firms to market participants, taking account of industry initiatives which are now in place.
- Restored confidence in, and internationally consistent regulation of, Credit Rating Agencies.
- Strengthened risk management, transparency, and capital requirements for structured credit and securitisation activities, which should be carefully formulated to maintain the benefits of these markets while addressing identified failings, and taking account of industry initiatives.
- Improvement of the infrastructure and transparency of Credit Default Swaps and other OTC derivative markets, taking account of industry initiatives.

- Strengthening of firms' risk management practices and policies, including stress testing, in line with international best practices.

Working Group 2- Reinforcing international co-operation and promoting integrity in financial markets

Key priorities to enable regulators and firms to work efficiently through the complex issues that arise in the cross-border context:

- Enhanced regulatory cooperation between authorities at regional and international level, ensuring that regional arrangements mesh well with global cooperation.
- Enhanced information sharing, both within and between nations and regions, about threats to market stability.
- Establishment of supervisory colleges for major cross-border institutions.
- Strengthening of cross-border cooperation, communication, and crisis management arrangements.

In addition to the points in the Washington Action Plan, we suggest that an important priority is to promote investor education, through both industry actions and public sector initiatives, so that there is better understanding of financial markets.

## B. INDUSTRY INITIATIVES

We are keen to highlight significant relevant work that the industry has done in response to the demands of the market, regulators, and politicians, to address the market deficiencies that the financial turmoil has revealed. This section summarises some of the main areas where the industry is working with supervisors to remedy these defects. A full and detailed explanation of these initiatives is in Annex 2 below.

### **1. Industry initiatives to improve the securitisation market**

**(i) Global Joint Initiative on “Restoring Confidence in the Securitisation Markets”** include: increasing accessibility and standardisation of underlying asset information on Residential Mortgage Backed Securities (RMBS); developing market standards of due diligence disclosure and quality assurance practices for RMBS; strengthening and standardising representations and warranties and repurchase procedures for RMBS; improving independent valuations; improving transparency, reliability, and understanding of credit ratings; establishing public reporting on the state of the market and potential stress scenarios; and educational programmes for directors and executives with oversight responsibilities, and for investors.

**(ii) “Ten Industry Initiatives to Increase Transparency in the EU Securitisation Market”** are now largely complete. They cover the regulatory reporting of securitisation exposures; statistical data to enable policymakers to monitor securitisation markets; codes of conduct and transparency and disclosure principles for issuers of securitisations; open access to transaction information; online access to prospectuses, investor reports, and issuer/manager directories; standardisation of reporting templates and definitions; and strengthened investor credit assessment principles.

**(iii) Other national initiatives**, including in the US and Japan, to improve market standards and transparency.

Whilst none of the above initiatives can in and of themselves kick-start the securitisation market, which remains largely shut globally, we strongly believe that they are creating the foundations for a more robust, more transparent, sounder and safer framework which will help restore confidence in this market. Most of their benefits will however become evident only once the securitisation market revives. We expect that, in the EU context, as firms make Pillar 3 disclosures in the coming weeks, the benefits of the improved and more consistent disclosure of securitisation exposures as a result of these industry initiatives will become evident.

### **2. Industry initiatives relating to Credit Derivatives**

This work includes ‘hardwiring’ of the ISDA cash settlement mechanism into ISDA documentation to enhance operational efficiency; faster trade confirmation; ever wider use of electronic confirmation; progress on finality of novation and increasing use of collateral (approximately 50% increase during 2008, to an estimated US\$2.1 trillion); reduction of notional volumes outstanding by US\$30 trillion during 2008 (DTCC Deriv/SERV statistics show that in early February 2009 aggregate gross notional volumes were approximately US\$28 trillion); increased market transparency

(e.g. through provision of trade data from the DTCC trade warehouse), and substantive practical progress towards a central counterparty (CCP) for clearing of Credit Default Swaps.

'Hardwiring' should buttress the successful auction ('cash settlement') mechanism, which operates in relation to all credit events, and has significantly reduced risk and pressure on liquidity. This reduction is over 95%, as measured by DTCC Deriv/SERV for nine selected recent events shown in Annex 2 (including Lehman Brothers), where pay-outs on CDS have required just US\$11.5 billion in aggregate, reflecting the obligations from net 'sellers of protection' to net buyers. Naturally, since: (a) CDS are bilateral contracts; (b) this is an intermediated market; and (c) even net sellers/buyers have offsetting positions within their books, the gross 'flow' of CDS business is much higher (totalling an aggregate US\$ 260.8 billion in our examples). But economic reality dictates settling on the net risk-transfer position, and this is 4.4% of the total flow ( $\$11.5\text{bn} / \$260.8\text{bn} = 4.4\%$ ). For individual credit-event settlements, the highest ratio has been 7.2% (Lehman Brothers). Note that sometimes more than one 'credit event' settles on a single day, and the ratio is lower. Moreover, such positions are routinely collateralised (secured), where interbank exposures are concerned. DTCC Deriv/SERV statistics for CDS contracts that were open as of 3<sup>rd</sup> and 10<sup>th</sup> February 2009, also shown in Annex 2, reinforce the point that the maximum payment obligations would be less than 10% of the gross flow, whether for single name contracts or indices. In practice these payments would be reduced to the tune of any recovery value on the debt of the entity whose default triggered the CDS. In any case, it is highly unlikely that all companies on which the CDS are written would default, let alone jointly.

Faster confirmation has reduced confirmation backlogs by 92% since 2005, thereby increasing confidence. Electronic confirmation, which prevents new backlogs from building up, has increased from 19% of trades in 2006 to 95% of trades in 2008. End-2008 statistics on the use of collateral, which again builds confidence, are due to be available from ISDA in mid-April. The benefits of the CCP will become evident once it becomes operational.

### **3. Industry initiatives to improve global convergence**

This work includes significant analysis and input to IOSCO on international convergence of definitions and standards in a range of areas, including treatment of large shareholdings, stabilisation, and investor classification; a range of initiatives to improve competition, coherence, and legal certainty, and promulgate market standards in equity and fixed income markets; and guidelines on appropriate remuneration practices. In addition, the EU-US Coalition's second report on Regulatory Modernisation identifies a number of areas that lend themselves to further global regulatory convergence.

### **4. Industry initiatives to improve investors education and information**

This work includes the development of principles of transparency, and a range of public information sources for all investors, and in particular retail investors, about financial markets.

### **C. COMMENTS ON SPECIFIC MEASURES IN THE NOVEMBER 2008 WASHINGTON ACTION PLAN**

Most of our detailed comments on the Action Plan relate to the areas covered by Working Groups 1 (see section C(1) below) and 2 (section C(2) below).

We do not comment in detail on the areas covered by Working Groups 3 and 4. However, in the context of drawing lessons from the current crisis we highlight our view that lesson-learning needs to be a considered process, not conducted on a crisis timetable. We also highlight the value we see in adherence to due process, impact evaluation, and consultation in all aspects of policy development in reaction to market turmoil. This is vital to ensure that the lessons identified are the right ones, unintended consequences are minimised, and that remedial measures are appropriately tailored to ensure that the lessons really are addressed.

In all of our comments on specific measures, we emphasise our view of the importance of compatibility of national and regional systems with globalised arrangements. Structural coordination arrangements need to flow from the global level to the regional and national, not the other way round.

The EU has taken a number of initiatives which it is important that it develops within a context of global coordination. These include a series of Finance Ministers' Action Plans on cooperation arrangements between EU Member States on financial stability and supervision; and a series of specific legislative or other policy proposals, including amendments to the Capital Requirements Directive (some of which cover EU colleges, EU 'consolidating supervisor' arrangements, and requirements relating to securitisations); a proposed Regulation on the registration of credit rating agencies; initial steps towards legislation on clearing and settlement of Credit Default Swaps; and consultations on non-regulated entities, products, and markets.

Similarly in the US, legislative initiatives on insurance and reinsurance as well as on CDS should develop within a context of global coordination. It is also important to continue to pursue international standards in the accounting area.

We fully appreciate the need for regional and national authorities to respond to regional or national priorities. These initiatives can be a welcome impetus to global action. But it is also important that any regional or national developments aim for consistency with the needs of users of global markets, and for alignment with standards that are likely to apply at global level. We suggest that the authorities, wherever they are based, should make it a priority to ensure that regional systems and rules remain compatible with the global system, do not cut across the principle of an open global market, and contribute to global cooperation. We recommend that world leaders develop a mechanism whereby national and regional regulatory proposals can be catalogued, and their impact on other countries examined.

We have, in a number of areas, long supported the need for more streamlining of regulatory practices globally. We have identified in Section B above and Annex 2 below work that we have done, and would be happy to make papers available to the relevant Working Groups.

## **C(1). WORKING GROUP 1: STRENGTHENING TRANSPARENCY AND ACCOUNTABILITY; ENHANCING SOUND REGULATION**

### *STRENGTHENING TRANSPARENCY AND ACCOUNTABILITY*

*"The key global accounting standards bodies should work to enhance guidance for valuation of securities, also taking into account the valuation of complex, illiquid products, especially during times of stress." (31.3.2009)*

We support this approach. Both IASB and FASB have done a good job in providing principles-based valuation guidance - including the release of an IASB Expert Panel paper as guidance and a FASB standard on Fair Value Measurement. IASB and FASB should continue to work closely together on this and related topics. Valuation is complex, and not just an accounting issue, but also involves risk management, trading strategy, portfolio construction, and other economic considerations: international work on valuation should also take these factors into account. We suggest that it is also necessary take account of industry initiatives to improve valuation processes in securitisation markets (see Annex 2 below).

*"Accounting standard setters should significantly advance their work to address weaknesses in accounting and disclosure standards for off-balance sheet vehicles." (31.3.2009)*

We agree that disclosures about off-balance sheet vehicles can be improved, and suggest that work should focus on significant risks to which an entity is exposed, to the extent those risks are not already covered in other disclosures (to avoid misleading overstatement of an entity's exposures). FASB has issued an FSP on disclosures for 2008 year end, and IASB has proposed a new standard on consolidation which will include additional disclosures that will most likely come into effect in 2010. We encourage IASB and FASB to continue to work together on this issue to promote a consistent approach. While this work is important to guard against a repetition of recent events, we observe that in the current state of the market, off balance sheet vehicles are not at this stage a significant presence: it may therefore be possible to treat this action as a more medium-term priority.

*"Regulators and accounting standard setters should enhance the required disclosure of complex financial instruments by firms to market participants." (31.3.2009)*

We support the goal of enhanced disclosures, provided it leads to more meaningful disclosures that avoid both duplication and the presentation of information that is not truly useful to investors. Thus we consider that the effort should focus on enhancing users' ability to understand, interpret and compare fair value based measures, distinctions between the objective and subjective figures, and a globally consistent hierarchy for the disclosure of fair value measurements. We suggest that world leaders should use the proposals in the Basel Committee's consultation as the basis for carrying its recommendation forward.

*"With a view toward promoting financial stability, the governance of the international accounting standard setting body should be further enhanced, including by undertaking a review of its membership, in particular in order to ensure transparency, accountability, and an appropriate relationship between this independent body and the relevant authorities." (31.3.2009)*

We endorse the approach put forward in IASCF's December 2008 Discussion Document "Review of the Constitution", which covers what we see as the key issues in regard to the Governance of IASCF/IASB. We emphasise the importance of maintaining the independence and professionalism of the accounting standard-setting process.

*"Private sector bodies that have already developed best practices for private pools of capital and/or hedge funds should bring forward proposals for a set of unified best practices. Finance Ministers should assess the adequacy of these proposals, drawing upon the analysis of regulators, the expanded FSF, and other relevant bodies." (31.3.2009)*

We agree with the Action Plan's focus on a globally coordinated approach, and emphasise the need for any national or regional initiatives to be consistent with it.

*"The key global accounting standards bodies should work intensively toward the objective of creating a single high-quality global standard." (Medium-term)*

We continue to support global moves towards convergence of accounting standards. FASB and IASB are working together to produce a single set of high quality standards. The SEC has also proposed moving in the medium term to IASB's single global standard. There have been moves to bring IFRS and US GAAP valuation standards closer together, and to acknowledge the equivalence of IFRS and other countries' GAAP.

*"Regulators, supervisors, and accounting standard setters, as appropriate, should work with each other and the private sector on an ongoing basis to ensure consistent application and enforcement of high-quality accounting standards." (Medium-term)*

We agree with this recommendation.

*"Financial institutions should provide enhanced risk disclosures in their reporting and disclose all losses on an ongoing basis, consistent with international best practice, as appropriate. Regulators should work to ensure that a financial institution's financial statements include a complete, accurate, and timely picture of the firm's activities (including off-balance sheet activities) and are reported on a consistent and regular basis." (Medium-term)*

Although many aspects of this recommendation are already in place, we would support further work in this area by IASB and FASB and, to the extent appropriate, by regulatory bodies. We consider however that it is important that any additional risk-related disclosures are proportionate to the risks concerned and are of demonstrable value to the users of financial statements. We suggest that the work should therefore aim to achieve specific identifiable improvements to financial

reporting and should be undertaken on a consultative basis that reflects the range of parties interested in this subject (investors, analysts, regulators, auditors, senior management, etc.).

*ENHANCING SOUND REGULATION: REGULATORY REGIMES*

*"The IMF, expanded FSF, and other regulators and bodies should develop recommendations to mitigate pro-cyclicality, including the review of how valuation and leverage, bank capital, executive compensation, and provisioning practices may exacerbate cyclical trends." (31.3.2009)*

We agree that these are important issues to be analysed and understood and we look forward to engaging with the authorities in developing approaches that can mitigate pro-cyclicality.

*"Each country or region pledges to review and report on the structure and principles of its regulatory system to ensure it is compatible with a modern and increasingly globalised financial system." (Medium term)*

We strongly welcome this commitment. See our comments on page 9 above on the consistency of regional and national with global regulation.

*"The appropriate bodies should review the differentiated nature of regulation in the banking, securities, and insurance sectors and provide a report outlining the issue and making recommendations on needed improvements." (Medium term)*

We agree with this recommendation. In conducting this review, we suggest that it will be important to identify and take account of respects in which differences in the regulation of banking, securities, and insurance sectors validly reflect differences in the nature of these markets, and the risks that they pose.

*"A review of the scope of financial regulation, with a special emphasis on institutions, instruments, and markets that are currently unregulated, along with ensuring that all systemically-important institutions are appropriately regulated, should be undertaken." (Medium-term)*

We welcome the proposed review. We think that it is particularly important: (1) to take into account the industry initiatives in the area of CDS and Securitisation; and (2) to adopt a globally consistent approach. We suggest that IOSCO's task forces on these issues should form the basis of the work. IOSCO should aim to find optimal methods of overseeing the financial stability implications of currently unregulated activities and ensuring appropriate market transparency, and take account of the extent to which the regulation of entities may obviate the need for regulation of the products or markets they are active in.

It is important that regional work in this area (e.g. the follow-up to the EU consultation on hedge funds) is consistent with the global approach.

*"National and regional authorities should review resolution regimes and bankruptcy laws in the light of recent experience to ensure that they permit an orderly wind-down of large complex cross-border financial institutions." (Medium term)*

We agree that it is important to make improvements in these areas. However changes must not undermine the steps which market counterparties take to protect their interests in insolvency (e.g. netting).

*"Definitions of capital should be harmonised in order to achieve consistent measures of capital and capital adequacy." (Medium term)*

We agree that more could be done in this difficult area. We consider that the work of the Basel Committee should form the basis for carrying the recommendation forward. Recent work in this area has, however, underlined the importance of ensuring that any changes are given enough time to be effected in order to avoid potentially damaging destabilisation of firms' ability to raise new capital.

#### PRUDENTIAL OVERSIGHT

*"Regulators should take steps to ensure that credit rating agencies meet the highest standards of the international organization of securities regulators and that they avoid conflicts of interest, provide greater disclosure to investors and to issuers, and differentiate ratings for complex products...The international organisation of securities regulators should review credit rating agencies' adoption of the standards and mechanisms for monitoring compliance." (31.3.2009)*

We agree with the high priority the regulatory authorities are giving to establishing more thorough supervision of CRAs and greater consistency in standards. Some investors were insufficiently aware of the limitations of CRA models and of the key assumptions on which they were based, and did not conduct enough independent risk analysis of rated products. There was little or no due diligence done by CRAs on the accuracy of information provided by other parties to transactions. There were limited data to compare the performance of CRAs. Perceived conflicts in CRAs' issuer-funded model and their consulting services impaired investor confidence in ratings. Uncertainties over the accuracy and reliability of ratings and inconsistency of ratings migration have in particular affected willingness to invest in structured securities. We think it is essential that solutions to the issues raised by ratings are designed to raise the standards of credit ratings and their oversight, in particular taking into account these shortcomings. We are however concerned that any move to mandate a different rating symbology for complex products would introduce unnecessary ambiguity and confusion in the marketplace, and not provide meaningful benefit. Additional transparency about the methodologies used to rate complex products, and enhanced disclosure of collateral credit quality characteristics by CRAs (such as inputs to ratings, methodologies and exceptions applied in establishing ratings, and the sensitivities of ratings to key variables) would provide better information to investors.

Credit rating issues are global in nature. So solutions also need to be consistent with the needs of users of global markets and globally coordinated. National or

regional initiatives should be consistent with global standards, based, we suggest, on any necessary development of IOSCO standards, and conducive to globally coordinated oversight. We consider that a more harmonised, convergent global approach is particularly important as regards laws, regulations, best practices, and settlement agreements and other legal requirements that set out the division of responsibilities amongst CRAs, investors, issuers, underwriters, and others, in order to maintain an orderly, transparent, properly functioning global marketplace.

*"Authorities should ensure that financial institutions maintain adequate capital in amounts necessary to sustain confidence." (31.3.2009)*

We agree. Basel II already describes a more comprehensive measure and minimum standard for capital adequacy than Basel 1. The Basel Committee is undertaking a number of studies, under the aegis of FSF, to ascertain any amendments to Basel II needed in the light of the market turmoil. We consider this is an area where it is particularly important that national or regional initiatives are consistent with the needs of users of global markets and do not diverge in ways that are incompatible with the promotion of international standards. We urge all authorities worldwide to seek a consistent global approach in this area.

*"International standard setters should set out strengthened capital requirements for banks' structured credit and securitization activities." (31.3.2009)*

We agree. We consider that, if it is properly organised and supervised, the securitisation market can play an important role in reducing the cost of capital and acting as a buffer against financial instability by diffusing risks widely. This latter function failed in the current market turmoil. In our view, efforts should focus on addressing that failure while maintaining the benefits and viability of the securitisation market. We recommend that world leaders should use the proposals in the Basel Committee's consultation as the basis for carrying the recommendation forward. Again, a globally consistent approach is necessary which aims to raise standards and is consistent with the needs of users of global markets. Further, we consider that it is important to ensure that improved standards provide the right incentives for both originators and investors to undertake proper due diligence and to control risks properly. In this context, current regulatory proposals for better risk management and disclosure requirements are constructive. But it is equally important to ensure that the capital impact of measures such as retention of economic interest in issues and capital charges in the event of failure of due diligence do not run counter to fundamental principles of prudential regulation which require firms to minimise market risk exposure, and do not make it more difficult for credit to revive and governments to meet the commitments in the Action Plan to unwind their temporary support measures, and restore access to credit.

Particularly in implementing this action point, we ask world leaders to take into account the significant work that industry representatives are undertaking to strengthen disclosure and transparency in the securitisation market. See Section B above and Annex 2 for details. We consider that many of the FSF's concerns regarding the Originate To Distribute model have largely been addressed by these initiatives.

*“Supervisors and regulators, building on the imminent launch of central counterparty services for credit default swaps (CDS) in some countries, should: speed efforts to reduce the systemic risks of CDS and over-the-counter (OTC) derivatives transactions; insist that market participants support exchange traded or electronic trading platforms for CDS contracts; expand OTC derivatives market transparency; and ensure that the infrastructure for OTC derivatives can support growing volumes.” (31.3.2009)*

We agree with the priority that the Action Plan gives to the strengthening of OTC derivative markets infrastructure. The development of a clearing house for credit derivatives with a central counterparty is an effective way to reduce and mutualise counterparty credit risk, which in turn will help promote market stability. It will also facilitate regulatory oversight by providing a single location for access to information about the CDS transactions that it processes. The industry is putting in place central counterparty clearing for OTC credit derivatives and more robust operational processes in OTC derivatives markets. See the detailed summary in Section B above and Annex 2. We warn against any national or regional measures requiring market participants to clear CDS trades on particular clearing houses, as this would be inconsistent with the November 2008 Communiqué’s global approach. We note in this context the Communiqué’s warning against protectionism, and the need for ‘cooperation, partnership and multilateralism’ in managing the financial crisis. Artificial bifurcation of a global market is not justified on prudential or economic grounds.

We do not consider that exchange trading for standardized CDS contracts should be mandated: OTC and exchange-traded markets can coexist, and market conditions should determine which market is used in a particular circumstance.

We support the objective of improving the transparency and integrity of the CDS market, although care should be taken to protect information that might harm the competitive positions of market participants. We agree with enhancing risk management of OTC derivatives, such as steps undertaken to improve the derivative market’s infrastructure in the US under the auspices of the Federal Reserve Bank of New York, and emphasise the importance of consistent standards being adopted by different regulatory bodies.

*“Credit Ratings Agencies that provide public ratings should be registered.” (Medium term)*

See our comments on pages 13 and 14 above on credit rating agencies. We agree that CRAs that provide public ratings should be registered and comply with IOSCO standards. Registration should, however, be coordinated on a globally consistent basis.

*“Supervisors and central banks should develop robust and internationally consistent approaches for liquidity supervision of, and central bank liquidity operations for, cross-border banks.” (Medium-term)*

We agree. We suggest that world leaders should use the Basel guidance for supervisors on liquidity management as the basis for robust and consistent approaches to liquidity supervision. Broad global consistency of approach is

important to ensure that firms can manage and mitigate their liquidity risks as effectively as possible. It is also important to take account of potential macro-economic or systemic impacts of liquidity requirements being suddenly tightened up. In addition national or regional requirements which risk trapping liquidity should be avoided.

*RISK MANAGEMENT*

*"Regulators should develop enhanced guidance to strengthen banks' risk management practices in line with international best practices, and should encourage financial firms to re-examine their internal controls and implement strengthened policies for sound risk management." (31.3.2009)*

We agree that regulators should develop enhanced guidance in line with the high level principles within the Basel framework, and that firms should re-examine internal controls and strengthen their risk management policies.

*"Regulators should develop and implement procedures to ensure that financial firms implement policies to better manage liquidity risk, including by creating strong liquidity cushions." (31.3.2009)*

We think it is important that liquidity risk management practices are well coordinated with policy development: see our comments under the Prudential Oversight section of the Action Plan above. Some jurisdictions, for example the UK, are already proposing the introduction of liquidity risk buffers/cushions. It is important to understand the global systemic effect of how cushions will work if applied to all firms in all jurisdictions. National or regional requirements which risk trapping liquidity should be avoided. We suggest that world leaders should commit to international consistency in order not to obstruct effective and efficient liquidity risk management: we look forward to the Basel Committee's thoughts on this issue.

*"Supervisors should ensure that financial firms develop processes that provide for timely and comprehensive measurement of risk concentrations and large counterparty risk positions across products and geographies." (31.3.2009)*

We agree that the management of risk concentrations is a crucially important aspect of risk management. Some work already has been done in this area in the EU through both legislation and supervisory guidelines, but we think that at an international level more could potentially be achieved.

*"Firms should reassess their risk management models to guard against stress and report to supervisors on their efforts." (31.3.2009)*

*"The Basel Committee should study the need for and help develop firms' new stress testing models, as appropriate." (31.3.2009)*

We agree that it is good risk practice to review models and assess stress testing procedures, and to consider carefully how firms should respond to the results of stress testing. Debate has already started with the issue of the Basel consultation on Principles for Stress Testing and at a national level the UK has also issued a consultation to ensure that stress and scenario testing practices are enhanced. We

note that while careful stress and scenario testing should form an integral part of risk management, it is only one component.

*"Financial institutions should have clear internal incentives to promote stability, and action needs to be taken, through voluntary effort or regulatory action, to avoid compensation schemes which reward excessive short-term returns or risk-taking." (31.3.2009)*

We agree that remuneration structures need to be consistent with appropriate risk-taking and effective risk-management. We note that firms have already taken a range of steps to address the issue, and the IIF has developed guidelines for appropriate remuneration practices. We suggest that the international authorities should consider the effectiveness of these and other industry initiatives, and monitor their implementation, before considering specific regulatory action.

*"Banks should exercise effective risk management and due diligence over structured products and securitisation." (31.3.2009)*

We agree. See our comments on page 14 above on structured products and securitisation, and the industry actions which are summarised in Section B above and Annex 2.

*"International standard-setting bodies, working with a broad range of economies and other appropriate bodies, should ensure that regulatory policy makers are aware and able to respond rapidly to evolution and innovation in financial markets and products." (Medium term)*

We agree. To be able to respond rapidly to evolution and innovation, we consider that it is important that regulation is principle-based, supplemented by guidance that enables rapid adaptation as markets change, and subject to effective regulation disciplines, including impact analysis and consultation, when changes are proposed.

*"Authorities should monitor substantial changes in asset prices and their implications for the macroeconomy and the financial system." (Medium term)*

We agree. See our comments in Annex 4 on how increased attention to macro-prudential vulnerabilities could contribute to improved coordination of financial stability management.

## **C(2). WORKING GROUP 2: PROMOTING INTEGRITY IN FINANCIAL MARKETS; REINFORCING INTERNATIONAL COOPERATION**

### *PROMOTING INTEGRITY IN FINANCIAL MARKETS*

*“National and regional authorities should work together to enhance regulatory cooperation between jurisdictions on a regional and international level.” (31.3.2009)*

We fully agree. See our comments on page 9 above on the consistency of regional and national regulation with global regulation.

*“National and regional authorities should work to promote information sharing about domestic and cross-border threats to market stability, and ensure that national (or regional, where applicable) legal provisions are adequate to address these threats.” (31.3.2009)*

We agree with this recommendation. See our comments on page 20 below on how we suggest information sharing might be addressed.

*“National and regional authorities should also review business conduct rules to protect markets and investors, especially against market manipulation and fraud and strengthen their cross-border cooperation to protect the international financial system from illicit actors. In case of misconduct, there should be an appropriate sanctions regime.” (31.3.2009)*

We agree. We suggest that this work should continue to be coordinated by IOSCO, in conjunction with government agencies responsible for fraud and money laundering policy and policing. In our view, work that is in process on short selling should be included under this work stream.

*“National and regional authorities should implement national and international measures that protect the global financial system from uncooperative and non-transparent jurisdictions that pose risks of illicit financial activity.” (Medium term)*

We agree that it is important to continue long-standing internationally-coordinated work in this area.

*“FATF should continue its important work against money laundering and terrorist financing.” (Medium term)*

We agree. We consider that the FATF Task Force 40 Recommendations, supplemented by the 9 Special Recommendations on terrorist financing, should continue to form the basis of this work.

*“Tax authorities, drawing on the work of the relevant bodies such as the OECD, should continue efforts to promote tax information exchange. Lack of transparency and a failure to exchange tax information should be vigorously addressed.” (Medium term)*

We agree. Tax authorities and international bodies such as the OECD should work closely together to agree practical methods of implementing this recommendation.

*REINFORCING INTERNATIONAL COOPERATION:*

*"Supervisors should collaborate to establish supervisory colleges for all major cross-border institutions, as part of efforts to strengthen the surveillance of cross-border firms." (31.3.2009)*

*"Major global banks should meet regularly with their supervisory college for comprehensive discussions of the firm's activities and assessment of the risks it faces." (31.3.2009)*

We agree. We consider that effective supervisory colleges should be the basis for efficient international supervisory cooperation. It is important that regional initiatives to strengthen colleges, such as the proposed amendments to the CRD in the EU, support the effective operation of colleges at global level, to ensure the most effective and efficient international coordination at all levels, and to avoid duplication.

Memoranda of Understanding provide a flexible but effective rubric under which the coordination activity of colleges can be developed and improved over time. We suggest that one or more of the international bodies, such as the BIS, Basel Committee, or IOSCO, could have a role in coordinating the strengthened college arrangements, and developing guidelines for their operation, building on the work that CEBS and CEIOPS have done in the EU.

We consider that colleges should not have formal regulatory powers. Their main functions should be the sharing of information, facilitation of global analysis of risks, and coordination of supervisory activity worldwide.

In Annex 3 we suggest an operational framework for how the activities of supervisory colleges might be coordinated. We suggest that it is important to recognise that supervision covers a range of tasks, and that the most appropriate arrangements for cooperation through the college may need to vary from task to task, to enable well-coordinated and efficient participation by all relevant authorities worldwide, and to allow for different powers and responsibilities of national authorities.

*PROMOTING INTEGRITY IN FINANCIAL MARKETS*

*"National and regional authorities should work to promote information sharing about domestic and cross-border threats to market stability, and ensure that national (or regional, where applicable) legal provisions are adequate to address these threats." (31.3.2009)*

*REINFORCING INTERNATIONAL COOPERATION*

*"Regulators should take all steps necessary to strengthen cross-border crisis management arrangements, including on cooperation and communication with each other and with appropriate authorities, and develop comprehensive contact lists and conduct simulation exercises, as appropriate." (31.3.2009)*

We agree with these action points, and also with the Action Plan's recommendations in the "Reforming International Financial Institutions" section that the IMF and FSF should strengthen their collaboration and take the global lead in integrating regulatory and supervisory responses into the macro-prudential policy framework.

We set out in Annex 4 a detailed analysis of different elements of financial stability and crisis management tasks. We suggest that it is important to identify in each case the best balance between global, regional, and national coordination, in order to achieve the overall objective of global stability. In doing so we think that it is also important to take account of the potential for contagion, and consequent impact on management of risks, between sectors, and the greater range of actors, including governments and central banks, who have a stake and a central role.

We consider that global supervisors should share information in a timely and comprehensive manner, particularly with regard to early identification of the potential causes of a crisis. Data gathering, timely sharing of information, and thorough analysis to enable early identification of stresses and risks; and working knowledge of other relevant bodies sufficient for smooth, predictable and effective cooperation; are important elements of better financial stability oversight. We suggest that the arrangements need to promote international cooperation to limit risks on a global scale, while recognising national responsibilities and accountabilities which are rooted in the Lender Of Last Resort function. In our view, systems of cooperation need to be responsive enough to enable urgent necessary action, adapted to a range of possible future threats to financial stability, and nimble enough to respond effectively to them. Given the speed with which the market situation can change, and the difficulty of identifying problems before they emerge, we think that it is crucial that regulators obtain information that enables them to stay close to financial markets, and to understand what is happening and why.

*"Authorities should ensure that temporary measures to restore stability and confidence have minimal distortions and are unwound in a timely, well-sequenced and coordinated manner." (Medium term)*

We strongly agree with this commitment, which we suggest should be one of the key objectives towards which world leaders should move.

**ANNEX 1 - SUGGESTED OBJECTIVES AND GUIDING PRINCIPLES  
PREPARED BY LIBA, SIFMA, ICMA, ISDA, FOA, AND BBA FOR THE  
NOVEMBER 2008 WASHINGTON SUMMIT**

We believe that public authorities and market participants, whether investors, issuers, or intermediaries, all share common **objectives** to re-establish financial stability, liquidity, and market confidence, and promote efficient allocation of resources. We suggest that these objectives can best be achieved by:

1. enhancing the soundness of the financial system and of systemically important firms;
2. restoring normal market operation, without the need for public sector support, as soon as feasible;
3. enhancing the tools and infrastructure for policy makers and regulators, on a timely basis, to coordinate, cooperate and share information globally;
4. encouraging consistency of outcome in relation to these objectives from country to country;
5. enabling early identification of possible future problems in financial markets, while maintaining enough flexibility to adapt to unforeseen events;
6. ensuring that regulation promotes fair dealing; enables investors to meet their needs and issuers to secure access to capital and funding at reasonable cost; and that regulators have resources and expertise to supervise complex markets and products.

We also suggest the following **guiding principles** to achieve these objectives:

1. Modernisation of the structures and procedures for international financial stability and financial supervisory cooperation must be a longer-term, more measured process, avoiding unforeseen consequences, and distinct from urgent responses to the crisis.
2. The modernisation should distinguish between arrangements for *financial stability* coordination and day-to-day *supervisory* cooperation.
3. In undertaking both market stability efforts and supervisory cooperation, countries and regions should not act in isolation. Allowing for necessary local flexibility, they should seek to act in a globally coordinated way, taking into account the global nature of capital markets.
4. Modernisation should take account of and build from existing frameworks of global cooperation, global infrastructures, and global standards. The governance of the bodies administering these frameworks needs to ensure buy-in by emerging market economies as well as more established economies.
5. Arrangements for both supervisory colleges and financial stability cooperation should be flexible enough to enable well-coordinated and efficient participation by all relevant authorities worldwide.
6. Where global consensus cannot be achieved, no country or region should diverge in ways that impede bilateral or multilateral coordination between authorities anywhere in the world.

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7. Solutions do not lie in greater protectionism or closing of markets to competition.
8. Regulation should continue to be risk-based, based on incentives to adopt good practice, and be more intensive for services on behalf of less expert market users.
9. Recognised standards of effective regulation, including market failure analysis, impact analysis, and consultation with affected parties, remain valid and should always be adhered to.
10. Industry initiatives to improve market practices and reduce systemic and counterparty risk should be recognised and encouraged.

## **ANNEX 2 - INDUSTRY INITIATIVES IN RESPONSE TO MARKET TURMOIL**

This section summarises some of the main areas where the industry is working with supervisors to remedy defects that recent events have revealed.

### **A. Industry initiatives to improve the securitisation market**

#### **(i) Global Joint Initiative : "Restoring Confidence In the Securitisation Markets"**

In December 2008, the Australian Securitisation Forum (AusSF), the American Securitisation Forum (ASF), the European Securitisation Forum (ESF) and SIFMA published (<http://www.sifma.org/news/news.aspx?id=9462>) a report containing a number of practical, action-oriented recommendations to restore confidence in the securitisation markets globally. Based on over 600 interviews and detailed surveys of securitisation market participants, the report identifies four priorities for immediate action by the industry. These are (1) improve disclosure of information on underlying assets for residential mortgage-backed securities (RMBS); (2) enhance transparency with regard to underwriting and origination practices; (3) restore the credibility of CRAs; and (4) improve confidence in valuations, methodologies and assumptions. The full recommendations are:

**To increase and enhance initial and on-going underlying pool information on US non-agency and European RMBS into a more easily accessible and more standardised format.** Purpose: to improve data quantity, granularity, accessibility, comparability; improved valuations.

**To establish core industry-wide market standards of due diligence disclosure and quality assurance practices for RMBS.** Purpose: to improve reliability of information; strengthen originator incentives.

**To strengthen and standardise representations and warranties as well as repurchase procedures for RMBS.** Purpose: to provide greater alignment of originator and investor interests.

**To expand and improve independent, 3rd-party sources of valuations; improve infrastructure and contribution processes for specified types of securitisation and structured finance products.** Purpose: to provide greater number of securities valued; more robust, more transparent valuation processes.

**To improve transparency, reliability, and understanding of CRAs and their ratings.** Adopt July 2008 SIFMA Global CRA Task Force Recommendations ([http://www.sifma.org/capital\\_markets/docs/SIFMA-CRA-Recommendations.pdf](http://www.sifma.org/capital_markets/docs/SIFMA-CRA-Recommendations.pdf)). Purpose: to restore market confidence in CRAs.

**To establish Global Securitisation Markets Group to report publicly on the state of the market, changes in market practices, and potential stress scenarios.** Purpose: to enhance public-private sector partnership at global level; more proactive guarding against future crises.

**To establish educational program aimed at directors and executives with oversight over securitised and structured credit groups, as well as at investors with significant exposure to these products.** Purpose: to enhance understanding of securitisation products and markets; to guard more actively against future crises.

#### **(ii) Ten industry initiatives to increase transparency in the EU securitisation market**

In response to the October 2007 ECOFIN Roadmap, a number of associations (CMSA, EACB, EAPB, EBF, ESBG, ESF, ICMA, LIBA, SIFMA) committed in July 2008 to deliver to the European Commission ten initiatives to improve transparency in the EU securitisation market,; most of which are now complete - see <http://www.eurosecuritisation.com/dynamic.aspx?id=1518> on ESF's Website for further details and updates). These initiatives are:

(1) **Increase Transparency in Reporting of Securitisation Exposures under CRD Pillar 3.** Purpose: To promote sound implementation of securitisation related CRD disclosure requirements. Status: complete.

(2) **Organise Comprehensive, Frequent and Relevant Statistical Data: New Quarterly Securitisation Data Report.** Purpose: To provide transparency to policymakers for monitoring securitisation markets. Status: Complete, ongoing - new Quarterly Securitisation Data Report includes data on issuance, outstanding, ratings changes, spreads, prices and investor types and locations.

(3) **Develop and Monitor Implementation of Asset Backed Commercial Paper Issuer Disclosure Code of Conduct/Principles.** Purpose: To encourage consistent, relevant and regular reporting to investors in the ABCP market. Status: complete.

(4) **Develop and Monitor Implementation of Term Securitisation Issuer Transparency & Disclosure Principles.** Purpose: To encourage consistent, transparent information flow in Residential Mortgage Backed Securities, Commercial Mortgage Backed Securities, Collateral Debt Obligation, consumer Asset Backed Securities, insurance securitisation and other asset classes. Status: RMBS Issuer Transparency & Disclosure Principles complete. Other asset classes to follow.

(5) **Open Access to Transaction Information.** Purpose: To facilitate access upfront and ongoing on EEA-listed public term transactions, via removal of password protection on issuer websites, or making information available from unrestricted sources. Status: complete (covered via Initiative 4 above).

(6) **Develop Industry Data Portals.** Purpose: To allow central online access to prospectuses and investor reports at low/no cost. Status: ongoing - In June 2008, two data providers launched such portals, providing open access to over 1,000 EEA-listed securitisation prospectuses and investor reports; additional providers are developing similar initiatives.

(7) **Centralise access to RMBS and CDO Issuer/Manager Directories on ESF Website.** Purpose: To centralise online access to European originators, issuers, and managers of securitised products. Status: Complete, ongoing - ESF website provides a regularly updated directory of all known EU RMBS issuer and CDO manager websites.

(8) **Improve Standardisation and Digitisation of Reporting Templates.** Purpose: To develop standardised issuance and surveillance report formats so that comparable, more granular information is provided to each CRA and investors. Status: Complete for RMBS and CMBS (as part of initiative 4). CDOs to follow.

(9) **Standardise Definitions.** Purpose: To develop standard core definitions for EU securitisation and map regional variations. Status: in progress.

(10) **Develop Investor Credit Assessment and Valuation Principle.** Purpose: To ensure investors have sound processes to independently assess the credit of a transaction, and do not solely rely on ratings. Status: Complete for asset managers ("Asset Management

Industry guidelines to Address Over-Reliance Upon Ratings" issued); outstanding for bank investors.

### **(iii) Other industry initiatives in the securitisation markets**

In the US, ASF has launched Project RESTART in the middle of 2008 to develop detailed market standards for securitised products, including a proposed standardisation and expansion of existing issuer disclosure for RMBS, to enable investors more easily to compare loans and transactions across all issuers and analyse and evaluate RMBS transactions on the basis of the features and performance of the underlying mortgage loans. For further details, see: <http://www.americansecuritization.com/story.aspx?id=2655>.

In Japan, JSDA is due to finalise in February 2009 self-regulatory rules to ensure the traceability of underlying assets of securitised products and provide standardized information reporting.

## **B. Industry initiatives relating to Credit Derivatives**

Ongoing work to 'hardwire' the cash settlement mechanism into ISDA documentation. This mechanism has allowed successful cash settlement in fourteen credit events including, most recently, the Fannie Mae, Freddie Mac and Lehman Brothers credit events. 'Hardwiring', as referred to in the FSF report on the financial crisis, is designed to ensure operational clarity on this legally well established process. Until hardwiring is complete, the settlement process will continue to be activated as required, case by case. The hardwiring process will be concluded in March 2009.

The following table (which we analyse on page 7 above) shows DTCC Deriv/SERV statistics (all figures in US\$ billion) for:

### (a) Default events (Single-name CDS)

	A. Gross turnover	B. Required payment	Ratio (B/A)
Ecuador	4.0	0.3	7.5%
FHMLC + FNMA + Tembec*	99.0	0.4	0.4%
Glitnir + Kaupthing + Landsbanki*	71.0	4.7	6.6%
Lehman Brothers	72.0	5.2	7.2%
Tribune	14.8	0.9	6.1%
AGGREGATE	260.8	11.5	4.4%

\* Various CDS settled on same day

### (b) CDS exposures

	A. Gross turnover	B. Maximum pay-out	Ratio (B/A)
(i) CDS Market Top 1000			
10th February 2009	14,387	1,416	9.8%
3rd February 2009	14,248	1,411	9.9%
(ii) Indices			
10th February 2009	13,750	1,174	8.5%
3rd February 2009	13,247	1,181	8.9%

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Continuing success, working with international regulators, in **addressing operational goals** faced by the industry, in particular with regard to timeliness of trade confirmation, electronic confirmation, finality around novation, the movement of collateral, and the use of trade compressions to reduce notional volumes outstanding (particularly for CDS).

**Increased transparency**, through the publication of data from the DTCC Trade Information Warehouse.

Progress, in cooperation with international regulators, towards **use of a central counterparty (CCP) for clearing of credit default swaps**: CDS on indices and single name CDS will be centrally cleared from early 2009. Large parts of the interest rate swaps market are already centrally cleared. Market participants are continuing to assist the efforts of central clearing service providers, through dialogue and feedback, on the technical challenges to be surmounted in establishing efficient, sound clearing houses.

See page 4 above for statistics on the impact of industry initiatives on the credit derivatives market.

### **C. Industry initiatives to improve global convergence**

In the course of 2008, the securities industry provided IOSCO with detailed analysis and suggestions to foster international convergence of definitions and standards in a range of areas, including treatment of large shareholdings, stabilisation, and investor classification. In addition, in March 2008 the EU-US Coalition on Financial Regulation issued its second report on cross-border regulation, *"Mutual Recognition, Exemptive Relief and "Targeted" Rules' Standardisation: The Basis for Regulatory Modernisation"*. The Report argues for the adoption of a tailored and progressive regime for establishing a more open, inclusive and effectively regulated transatlantic marketplace to the benefit of all users, including investors, issuers, providers of financial services, market infrastructure providers and regulatory authorities. The Report sets out several prioritised areas of regulation where financial service providers and their counterparties and customers would benefit from greater harmonisation.

A range of initiatives to improve competition, coherence, and legal certainty in equity and fixed income markets, including: the creation of a number of multilateral trading facilities; the creation of the first CCP with an explicitly pan-European mandate; and work to examine whether consistent contractual provisions can be agreed to cover aspects of the difficulties arising from the Lehman default.

Review of ICMA's Rules and Recommendations for the fixed income secondary market: For many years, the Rules have formed a reliable framework for trading in debt and related securities as well as for the clearing and settlement of trades in such securities. In March 2008 ICMA commenced a comprehensive review to take account of legislative and regulatory amendments and market developments as well as to bring about, to the extent possible, consistency with other rules, guidelines and best practices in the market. Consequent amendments were agreed and have been published, with the new version of the Rules effective from 1<sup>st</sup> January 2009.

IIF has issued guidelines on appropriate remuneration practices.

### **4. Industry initiatives to improve investor education and information**

ICMA published a Standard of Good Practice on Bond Market Transparency for Retail Investors in September 2007, and reviewed it in January 2009. ICMA's website [bondmarketprices.com](http://bondmarketprices.com), providing price transparency for retail investors, was launched in December 2007.

In July 2008, ICMA, SIFMA, and LIBA developed global principles for managing the provider-distributor relationship for retail structured products, and global principles for managing the distributor-individual investor relationship for retail structured products.

In December 2008, SIFMA launched [InvestinginbondsEurope.org](http://www.investinginbondseurope.org), (<http://www.investinginbondseurope.org/>), a ground-breaking new financial website which offers retail investors free access to comprehensive, non-commercial and unbiased educational resources and price information on fixed income markets in English, German, French, Italian and Spanish.

### **ANNEX 3 - DETAILED SUGGESTIONS ON THE OPERATION OF SUPERVISORY COLLEGES**

Colleges are already in existence for some groups, but we welcome the November 2008 Action Plan's commitment to establish them for all major cross-border groups. At EU regional level, some formalisation is being introduced via the CRD revision. The impetus from the EU is welcome, but we think it is vital that regional structures work well with global arrangements, to ensure the most effective and efficient international coordination at all levels, and to avoid duplication.

#### ***College arrangements.***

We welcome the Washington Summit's endorsement of Supervisory Colleges as the globally agreed mechanisms for improving coordination and the quality of supervision while reconciling national accountability with international cooperation at global level.

The college of supervisor model has facilitated the exchange of supervisory information and cooperation for several decades. International cooperation has been facilitated by the Basel Committee of Banking Supervision which has issued and revised guidelines for cooperation between home and host supervisors on an international cross-border basis since the 1970s. Over time, and with the gradual improvement of national legislations, the ability to share increasing amounts of supervisory information has been facilitated. Within the EU, gateways to facilitate exchange of information and cooperation agreements, both inside the EU and with authorities outside the EU, have existed at least since the Second Banking Coordination Directive (1989).

Colleges are a model for delivering cooperation and coordination based first and foremost on exchange of information. By pooling information the relevant supervisors are able to form a global view of a group, identify the significant areas of activity, of emerging risks and strengths. Colleges can then facilitate cooperative supervisory activities, depending on whether the relevant local supervisory authorities have the vires to participate or allow other states' involvement. Cooperative arrangements do not have to be static but can develop as circumstances change (either of the financial group or of its supervisors). They thus provide a proven means of delivering immediate improvements. If local legislation facilitates it, it is also possible to deliver many of the relevant supervisory tasks on a holistic group-wide basis, even though globally there is no legal framework that can mandate this outcome.

#### ***Regional colleges***

The concept of supervisory colleges is being introduced into EU legislation at present via amendments to the Capital Requirements Directive. Based on the Commission's proposal, EU colleges are to be set up under the aegis of the "Consolidating Supervisor". Since the composition of the global group of supervisors may be very different from regional arrangements, we consider it is vital that regional arrangements do not make it difficult or impossible for other supervisors in other parts of the world, who may supervise parent entities for the group, and/or other major subsidiary entities of the group, to participate in the regional college on terms that have been set with no consideration of how best to coordinate with other jurisdictions. This could easily lead to the need for parallel global and regional colleges. We are concerned that a lack of coordination between regions and the rest of the world would reduce efficiency and effectiveness, and possibly exacerbate risk.

***Memoranda of Understanding (MoUs) and the operation of colleges***

MoUs are not legal documents. They have no power of enforcement. However, MoUs deliver the rubric by which each college will operate. Different views exist on whether MoUs benefit from being wholly standardised (securities supervisors have tended to go in this direction) or whether they are better tailored to fit the relationships between the specific authorities in question (this experience has been more typical in banking supervision). MoUs do, however, provide clarity of expectation in terms of what can and cannot reasonably be achieved in the context of the specific circumstances of the individual financial group and its family of supervisors. Familiarity with MoUs has increased considerably over the past twenty years and authorities are likely to have improved their ability to state their practical needs and requirements in the MoUs much more effectively than they did in the past. This skill, doubtless, will continue to improve over time. It is also important to bear in mind the extent to which international commitments, building on the November 2008 G20 Communiqué, can be used to provide a political reinforcement to the cooperation arrangements set out in MoUs.

We suggest that it will be important for an international body or bodies, for example the BIS, Basel Committee, IOSCO, to coordinate the strengthened global college arrangements, and to develop guidelines for their operation. We suggest below a blueprint for how global college activity could be coordinated.

In order to identify how global supervision of firms and markets through colleges can best be organised, we think it is helpful to analyse what tasks supervision performs. Prudential supervision is not a single task, but a series of different tasks. The best way of coordinating activity in relation to these tasks may well vary from case to case.

We would therefore argue for college arrangements that allow for different levels of cooperation for different activities and tasks, seeking the optimal arrangement and balance of responsibilities for each activity, and ensuring that formal cooperation structures are adaptable enough to accommodate necessary diversity, either between activities, sectors, or countries/regions, and are not so rigid that they cannot respond to unforeseen stresses.

We identify below the core elements of supervision that we suggest would need to be subject to enhanced cooperation, and the factors that may affect how the arrangements that apply to each cross-border group might best be organised.

*(i) Information exchange and coordination of supervision*

The exchange and pooling of information, and coordination of supervisory activities, including information requests and inspections, are in our view core requirements - to avoid duplication, minimise disruption and cost to the group, and maximise the consistency, coherence, and efficiency of its supervision. We consider it is vital to remove any barriers to these activities.

We suggest that a variety of factors will affect how the arrangements for each group are best established. The relative influence of these factors will typically vary according to the supervisory function that is under consideration. The factors include:

- the systemic significance of the financial group in one or more of its countries of activity;
- the extent to which the financial group relies on group approaches and resources;
- the respective expertise and resources of supervisors in different countries;

- the need to have supervisory access to local activities, and the ability to form an opinion locally, without duplicating tasks, either those of the supervisor, or of the financial group.

In terms of supervisory coordination, we suggest that there needs to be a mechanism to ensure both: that requisite information on the activities and risk profile of the group is available to all relevant supervisors; and that this information is gathered and disseminated in the most efficient manner.

*(ii) Reporting, including deadlines, definitions and formats*

Reporting forms the basis of the supervisory process, whether prudential returns, transaction reporting, transparency or market disclosures. All reporting systems are faced with the tension between: seeking information that is highly consistent across groups/jurisdictions; and management information data that are prepared and formatted for the individual firm or group's management.

In our view, supervisors need consistent, complete, accurate, and standardised data in order to promote the ability to perform industry wide analysis and peer group reviews. While there will always be an embedded expense to the industry when changing reporting formats, there is a potential gain for firms if greater standardisation in international data and reporting requirements can be achieved. Within the EU the ECOFIN Action Plan commitment to seek standardisation of reporting formats is exploring the scope for creating more consistent reporting formats and definitions.

Factors affecting the choice of options would include:

- the degree of consistency of reporting content, format and timing considered desirable/essential/achievable;
- the potential need by individual supervisors to require reporting of supplementary information, depending on the systemic significance of the local entity, or because of the exercise of national discretions;
- the ease with which work on coordination of formats yields consistent streamlining, rather than a mere aggregation of different national requirements.
- whether different issues need to be considered with respect to the reporting requirements driven by prudential requirements or the more market related, and therefore more specific and localised, data reporting requirements that apply in the market supervision field.

*(iii) Setting capital levels for firm/group*

We consider that setting the appropriate capital level for a group and conducting the assessments that are necessary in order to determine the capital level (ie Pillar 2 assessments) represent a particular challenge to potential coordinated supervisory arrangements for both groups and supervisors. From the industry perspective lack of coordination can lead to duplicative reporting programmes, re-running models using different assumptions in different jurisdictions, and different stress tests for liquidity.

Factors which might affect the organisation or group wide capital assessment are notably similar to the factors which are relevant in decisions relating to on-site inspections (see (iv) below):

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- the need to minimise disruption to groups from duplication of assessments;
- the extent to which the group relies on central processes and risk management tools provided by the group, or whether the group is more decentralised; in the latter case there is an argument for additional assessment at local level irrespective of who performs the assessment;
- the expertise of local supervisors;
- the resources of local supervisors;
- the importance of the subsidiary in the local market or economy;
- whether particular activities, significant in the balance of the overall business of the group, take place in one or a limited number of jurisdictions.

### *(iv) On-site inspections*

On-site inspections are one of the most labour-intensive interactions between firms and supervisors. We think that much can be done, through international coordination arrangements, to streamline inspections. Decisions on how to organise this task need to take account of:

- the need to minimise disruption to groups from duplication of inspections;
- the differing expertises of relevant supervisors;
- the resources of local supervisors (including whether local or “home” supervisors would typically outsource such inspections to third party bodies such as consultants or accountants);
- the importance of the subsidiary in the local market or economy;
- whether particular activities, significant in the balance of the overall business of the group, took place in one or a limited number of jurisdictions.

### *(v) Model approval*

We consider that decisions regarding model approval where firms use models (with restrictions) to calculate their minimum capital requirements, as with Pillar 2 assessment and on site inspection, are an area where greater regulatory coordination would be beneficial. It is an area where legal constraints are common. Typically permission must be sought on an entity by entity basis.

However, we think that joint consideration and approval of models which are applied on a unified basis within the group is an important goal for global coordination efforts. Practical issues to consider in taking forward a joint decision making approach include:

- the process should suitably reflect the significance of an activity within a group;
- the practical resources of the relevant supervisors.
- the need for firms to streamline model approval, and use as consistent a model as possible across jurisdictions;

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- the importance of the subsidiary in the local market or economy;
- the extent to which a model relies on local data or seeks to reflect idiosyncratic local market behaviour;
- any exercise of national discretions.

### *(vi) Authorisation, acquisition, enforcement, revocation and restriction of activities*

Globally there is a wide variation in the powers vested in supervisory authorities. However, we think it is important that the exercise of supervisory powers as well as supervisory practices should take account of the need to coordinate and understand the wider group picture, even though decisions relating to authorisation, restriction of activity, acquisition and merger, or revocation will, for legal reasons, have to take place within the jurisdiction in which the entity in question is incorporated. It is also important to note that some regulatory sanctions such as restriction of activities or removal of senior management may have civil and/or criminal law consequences or obstacles.

We suggest that decisions on what arrangements to apply can be made collectively taking account of:

- the need for firms to streamline activities as consistently as possible across jurisdictions;
- the importance of the subsidiary/activity in the local market or economy;
- any exercise of national discretions.

The importance of applying a consistent approach to authorisation and (in particular) revocation or restriction decisions implies that the collegiate responses are important and that, to the extent possible, the parent supervisor should have a strong voice within the college.

Nevertheless, in the field of supervisory powers the final decision making power will almost certainly always rest with the local supervisor. This might mean that the local supervisor will not act in accordance with the views of fellow supervisors, due to concerns about the potential risks to the jurisdiction in which the specific entity is incorporated. We think it is important to find the best arrangements at global level to ensure that the decisions the local supervisor reaches and the actions it decides will take account of the concerns and interests of the parent supervisor and the wider college of supervisors. Such an outcome can promote greater consistency of supervisory approach across a group and greater understanding by supervisors of the scope and nature of the group.

## **ANNEX 4 - DETAILED SUGGESTIONS ON INTERNATIONAL COOPERATION ON FINANCIAL STABILITY AND CRISIS MANAGEMENT**

In order to identify how global cooperation on financial stability can best be improved, we suggest it is important to analyse, as in the case of supervision, what tasks are associated with financial stability operations, and to identify in each case the best balance between global, regional, and national coordination, in order to achieve the overall objective of global stability.

We consider that it is also important to take account of the cross sectoral dimension, which introduces a new layer of complexity of interactions between competent authorities, intervention, crisis and resolution frameworks. The approaches between sectors can be very different – often crucially so in order to reflect the inherent risks. But at a more macro level there is an increasing pressure to gain a comprehensive view of where risk may be located and understand its transmission mechanisms and how it may be mitigated. The relationships between the financial sectors may be, as yet, not wholly understood. But it is essential to take this additional dimension of complexity into account to ensure there is greater understanding and management of risks and to minimise contagion capacity, whether cross border, cross group, cross market or cross sector.

### **Tasks supporting Financial Stability**

#### **(a) Financial Stability Oversight**

*Macroeconomic and macroprudential information gathering, sharing and analysis:* At present there is no system in place that enables supervisors to achieve a high level, across the board view of systemic risks.

We therefore suggest that issues to consider to address that gap include:

- The ability for macro prudential data to be gathered and communicated efficiently between relevant authorities.
- There may be legal obstacles to such transmission that need to be identified and resolved.
- The need to ensure not only that data gathering is comprehensive, and where necessary, sufficiently granular, but also that data gathering covers all relevant sectors and jurisdictions.
- Tasks falling in the field of macro oversight and analysis could be conducted either by a single central body or through an efficient system of exchange in order to build a global picture. We think it is hard to envisage an effective global analysis without some degree of central coordination which might therefore be best delivered by one of the existing international institutions.

We suggest that information gathering and analysis should be coordinated by centralised macro-information-gathering from local and regional sources, and analysis at global level by IMF and FSF.

*Crisis simulation exercises:* We suggest that improving such exercises relies fundamentally on improved cooperation between relevant regulatory authorities.

- There is an essential need for information flows to be effective between authorities.

- Simulation exercises are vital in order to achieve the necessary working-level degree of familiarity and expertise in relevant bodies of how to activate, and if necessary pre-plan or improve, the requisite mechanisms, and cooperate smoothly and efficiently with the appropriate authorities.
- It is however important to consider that simulation exercises are unlikely to mimic or predict any actual crisis, so there is a risk of complacency or of “blind spots” developing. Crucially, 2008 events have shown the unpredictability of issues that arise. Thus we think it is important to avoid over-engineering crisis responses, and to retain flexibility to react quickly to very rapid events.
- Coordination and pre-planning must also be very carefully considered to ensure that it facilitates the ability to manage risk and does not, by limiting authorities’ freedom of action, add to instability rather than control it.

**(b) Early Warning Mechanisms**

*Early intervention tools and triggers for crisis response:* At present there is no global consensus on the most appropriate or effective early intervention tools nor on what indicators can or should act as triggers for crisis response. Similarly no definitions of “crisis” or “failed market” exist.

*Triggers for early intervention or crisis response* Trigger signals might relate to solvency (eg breach of a minimum capital requirement) or liquidity data or perhaps other market indicators (eg share price).

Issues that we see as needing to be considered if there is to be greater coordination and standardisation of trigger events will include:

- Consideration of whether the trigger regime should be “hard” or “soft”: will the trigger indicator automatically require regulatory intervention, or will the authorities have discretion in when or how to intervene? Broadly we think that there is a trade-off between apparent legal certainty (although mandatory mechanisms, particularly if they are based on highly transparent/visible signals may well exacerbate risk because of the risk that they become self-fulfilling) and the ability of the regulator to intervene in a measured way taking account of the particular circumstances of the case at a moment where there may still be the potential to stave off a more full blown crisis.
- Consideration of whether a trigger event in one group entity could be seen as a trigger event for the group as a whole, or indeed for a sector more widely.
- Consideration of whether the trigger signal is indeed a reliable indicator in all jurisdictions of difficulty at firm or systemic level.
- Consideration of whether the trigger should apply (ie be exhibited) at individual firm or group level, and if the triggers are attached to individual entities, what the mechanisms are for the rest of the group entities being affected (or ring fenced).
- Appropriate analysis and political coordination at global level will be needed to consider the implications of, and if necessary remove, inconsistencies between authorities’ approach to similar trigger events.
- It is possible that agreement might be achieved at global level although the global dimension might bring with it a wider range of factors and circumstances that would

have to be taken into account. Regardless of the level at which triggers or tools of intervention are agreed, we propose that there must be additional layers of analysis to ensure that tools have the same outcome in different jurisdictions and that trigger mechanisms deliver a consistent diagnosis across borders.

- Certain choices of trigger factors will bring additional practical considerations, as not all jurisdictions have the legal powers or constitutional right to apply certain mechanisms:
  - With respect to solvency triggers: For example not all countries choose to apply greater than 8% capital ratios to banking groups, whereas other countries use higher than 8% capital ratios as triggers for closer scrutiny and/or power of intervention.
  - A variation of solvency triggers is the leverage ratio: this can be used simply as a general supervisory rule or it can be used as a trigger for specific intervention. At present few jurisdictions apply it, so there would be a major regime shift to introduce it.
  - Triggers based on liquidity indicators would face two main, and not unrelated, issues: first, there is no harmonised liquidity regime on which to base analysis or choose liquidity factors; second, liquidity is the risk area which is most susceptible to behavioural adjustments and therefore potentially least able to be consistently relevant across jurisdictions.

*Early intervention mechanisms:* Early intervention procedures might include: requirements on firms to inject capital; the addition/removal of senior management; requirements to address systems and control lapses; restriction of an individual business line within an otherwise orderly institution.

In considering greater coordination structures, we suggest that the following issues will need to be considered.

- Whether intervention procedures can or should apply to one or all entities within the group.
- Whether a trigger mechanism can be acted on with sufficient speed in more than one jurisdiction.
- Whether certain intervention mechanisms (e.g. restriction of business, segregation of assets or injections of capital) would give rise to claims against the authorities by existing stakeholders under corporate or insolvency law.
- The extent to which certain mechanisms could only be delivered at a national level based on the incorporation of the local entity – for example segregation of assets.

### **(c) Crisis management**

Crisis management tools overlap considerably with those used in early intervention mechanisms. If early intervention tools have failed then it is possible that there is risk of contagion beyond a single entity/group/market/jurisdiction and the magnitude of the tasks and need for coordination likewise intensifies. Tools that are typically considered in relation to crisis management can be categorised quite broadly and include:

## Briefing for the London Summit by LIBA, SIFMA, ICMA, ISDA, FOA, IIAC.

- Liquidity and capital support – whether between group entities (cross border or cross sector);
- Liquidity and capital injection by governments as part of formal rescue plans;
- Segregation of assets (ring fencing); transfer of assets; recapitalisation plans;
- Intervention in management of the entity (or entities);
- Intervention in the business of the entity or group (restriction of parts of business activity); mediation of merger or break up of entity/group whether whole or partial and whether to private or state sector;
- Orderly wind-down - insolvency/administration procedures;
- Investor compensation or depositor protection schemes;
- Direct intervention in markets (e.g. short-selling restrictions).

As we see it, the range of crisis management tasks represents perhaps the most difficult area of assessment and as indicated above, shares some similarity with difficulties that can be faced in early intervention procedures, although broadly it is the case that crisis management will involve the active participation of a wider range of authorities (early intervention tending to be the realm of supervisory authorities). We see the most acute issue, however, as that of funding resource – whether it is possible to broker private sector solutions, or in cases where the scale of difficulty warrants public interest, how much the public purse can pay and what are the mechanisms for delivering such support.

Other issues that we suggest need to be taken into account can include:

- Whether there are obstacles preventing capital and liquidity flowing to where it is needed;
- Whether firms themselves want to be able to cut loose problem subsidiaries or branches;
- Whether national supervisors will be faced with balancing the needs of the national or regional economy and national investors against the wider good of the international market working smoothly;
- If structural solutions (sale of assets/divisions of an entity or insolvency or administration) have been needed then there is an interface with liquidation, winding up, and insolvency laws. There may be a range of rights and claims of the previous shareholders, creditors or even management of an institution/group that is in difficulty and this may inhibit public authorities achieving their preferred outcome.
- These are all part of the many and complex aspects of what to do in a crisis, and who has to pay, and whether those who are forced to pay have been included in or cut out of the chain of decision making. However, it seems that greater consistency will not be easy to deliver. No change would be able to deliver a situation where all parties will consider their rights and protections to be enhanced – rather there will be a re-distribution. This will of itself impede the willingness or ability to agree changes, in particular where legislative amendments (in a wide range of jurisdictions) would be needed. It is important to note that this is an area where the key issues lie in the

legislative fabric as opposed to the structure of the authorities who must act on the basis of the legislation.

In terms of practical coordination, a different set of issues emerges. In our view it is necessary to consider to what extent crisis management tasks can be planned for in advance. In the current crisis, urgent rescue action has been complemented by much liaison between governments and other public authorities, both to maintain coordination and ensure that divergences between national approaches do not give rise to imbalances that could make the position worse, or introduce competitive distortions. The question arises whether, and if so how far, it is possible to plan coordination in advance, or to establish guidelines for national action, in a way that might limit these disadvantages while still enabling national authorities to take the necessary urgent action. A major factor in considering this issue is that each crisis is likely to be different from the last. We suggest that it will therefore be important to ensure that national authorities' ability to act in a responsive and adapted way in future is not limited by constraints which were designed with the current crisis in mind, but which may not be relevant, or may exacerbate risk, in the future.

Perhaps the most important element of any pre-planning for crisis management is therefore to ensure that all relevant authorities have a high minimum level of working knowledge of powers and mechanisms that can be activated, by whom, under what circumstances and who needs to be informed or given authority. This is one very useful area where we think crisis simulation activities have much to offer.

Financial Stability issues, particularly as they pertain to crisis management, involve a much broader range of activities and public authorities than direct financial services supervision. The greater breadth of activities and participants in financial stability issues reflects the significance of such issues in broad economic, fiscal, monetary, and foreign policy terms. The success of any cooperative arrangements or structures prior to any crisis, and indeed in the aftermath, will be demonstrated by the efficiency with which the additional authorities are apprised of essential information and the smoothness of continuing information flow that is maintained between supervisors.

The events of 2008-9 have demonstrated the complexity of the issues involved, and the rapidity with which the authorities and market actors must react to events. Whilst it is important to learn from these events to design the optimal arrangements for identifying warning signs, reacting appropriately, and responding if crisis prevention arrangements do not have the intended effect, we consider that it is also vital to bear in mind that the next crisis, if it occurs, will, almost inevitably, have different causes and raise different issues. The arrangements for international cooperation we design now will need to be adaptable enough to cope with a broad range of possible stresses, and also to avoid strait-jacketing national authorities in ways that could exacerbate risks or prevent effective responses to them.

In our view, this is perhaps the main reason why national and regional financial stability arrangements need to mesh with the global dimension, and to remain responsive to the pressures and limitations affecting authorities elsewhere in the world.

Based on the review of financial stability issues and concerns to be taken into account when deciding where functions should be delivered (i.e. at national, regional or global level) it seems clear that there is no single model that is likely to be able to serve all purposes. In our view, oversight and analytic mechanisms are the least fraught with legislative pitfalls but in other areas we think that there are many potential national obstructions to the effective delivery of various inter-related financial stability tasks on a cross border basis.

We suggest that there is thus a priority for stronger mutual coordination and efficiency amongst the responsible authorities worldwide. We consider that strong but flexible

structures that support mutual cooperation, without cutting across or being blind to national restrictions and obligations, can support a stronger global consensus and ultimately the goal of strengthened financial stability at the global level.

## **ANNEX 5 - Suggested Principles for International Financial Regulation and Supervision<sup>1</sup>**

### Introduction

On 26<sup>th</sup> January 2009, the UK Prime Minister called for a discussion at the London Summit of a charter of principles that would guide financial regulation and supervision. The 22<sup>nd</sup> February 2009 Berlin Summit endorsed the call for a broad charter of principles for financial supervision.

Recognising that capital flows are global, but regulators national, this Annex suggests a possible global charter of principles that could guide national financial regulation and supervision, supporting good outcomes for users of financial markets and effective international financial supervision of those markets.

Many of the international standard setters already have statements of regulatory principles, complete with methodologies for assessing compliance by particular jurisdictions. The IMF and the World Bank have recognised international standards in twelve areas, assess countries' observance, and help them implement reforms where needed. Of these twelve, those of most immediate relevance to financial markets are those of IOSCO, the Basel Committee, the IAIS, the CPSS, and FATF 40+9 recommendations. Also important are what the IMF calls the market integrity standards: OECD's principles of corporate governance, the IASB international accounting standards, and the IFAC auditing standards. The same is true of the three IMF developed Policy Transparency standards on data dissemination, fiscal policy and monetary and financial policy.

We suggest here a set of over-arching "meta-principles", capable of application irrespective of legal and cultural differences between jurisdictions, that set out at a more fundamental level the public policy outcomes that financial supervision, financial stability management, and healthy, well regulated and supervised firms and markets aim to achieve. Rather than focusing regulatory attention on the presence or otherwise of particular rules, we suggest the principles should focus on the fundamental question of whether or not financial markets work well for their users, their effective supervision and enforcement, and measuring whether or not regulatory activity changes the behaviour of firms and markets for the better and reduces international systemic risk.

Our draft suggested global principles aim to support more effective regulation by encouraging regulators to focus on:

- The quality of the financial markets for their users;
- The development of measures to assess that quality; and
- Their ability to manage risks to the quality of those markets.

We believe such principles might help to provide a framework for an effective global regulatory effort by setting out:

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<sup>1</sup> The content of this Annex formed part of a wider paper prepared by Samantha Barrass of LIBA and Richard Britton of ICMA, a copy of which is obtainable by contacting LIBA.

- An overall high-level outcome
- The outcomes (in terms of financial stability; preventing financial crime; protection of investors, issuers, other market users, and of market integrity) that should be observed if financial markets are working well for users of those markets; and
- Outcomes for the effective regulation of those markets.

If such principles are taken forward globally, we believe it would be worth developing an approach to measuring whether or not the global regulatory effort is achieving success against them. Some considerations in framing this work might include:

- The approach to measurement needs to cover both the effectiveness of regulation and how well markets work.
- Analysing legal structure, rule books, enforcement history, and resources devoted to regulation will provide only a partial assessment of the effectiveness of regulation, and no insight into how well financial markets work for their users. The market turmoil illustrates just how important such a focus might be.
- It is not practical to consider developing a comprehensive set of measurement metrics. More feasible might be the development of a small number of significant quantitative metrics that focus on priority outcomes.
- Quantitative measurement metrics could be supported by other accepted methods of qualitative assessment, including application of the various techniques of surveying stakeholders (e.g. surveys of investor confidence in the quality and integrity of relevant markets).
- In predominantly non-retail markets in OECD economies, an assessment of how well competition is working, for example by looking at indicators such as number of participants, or spreads relative to similar markets, is likely to provide useful information on market quality, but only if complemented by an assessment of the quality of risk management in that market, both within firms and across the whole market.
- The measure of regulatory effectiveness should not just be the presence or otherwise of particular rules, but also, bearing in mind the need for predictability and natural justice, the extent to which a regulator is able to use a variety of tools, including supervision and enforcement, to intervene successfully to change the behaviour of market participants in the way intended and ensure risks are well managed.

## **DRAFT GLOBAL REGULATORY OUTCOMES**

### **High-level outcome**

Financial markets are competitive, efficient and resilient, supporting innovation, the entry of efficient firms, and the expulsion of inefficient and dishonest firms and individuals. Users of financial markets are able to conduct their business efficiently and have confidence in the integrity of financial markets.

## **Financial Stability**

1. Firms and market infrastructure providers are financially sound, honestly run and employ adequate risk management systems.
2. Build-up of systemic risk is monitored and controlled. If a firm or market infrastructure provider fails, domestic and international systemic risk is contained and loss to investors and the public purse is minimised.

## **Preventing Financial Crime**

3. The authorities, with support from market users and intermediaries, ensure that financial crime and market misconduct is deterred, detected, and punished.

## **Protection of investors, issuers, and other market users, and of market integrity<sup>2</sup>**

4. Investors, issuers, and other market users can meet their reasonable financial services needs at minimum cost.
5. Investors, issuers, and other market users are capable and confident in their dealings with and in the financial services industry and take due responsibility for their own decisions.
6. Firms conduct their business with integrity, due skill, care and diligence, and act in the best interests of their clients including:
  - (i) Firms manage conflicts of interest fairly, both between themselves and clients and between a client and another client;
  - (ii) Firms pay due regard to the information needs of their clients, provide appropriate information to enable clients to take decisions, and communicate information to them in a way which is clear, fair and not misleading;
  - (iii) When a client is reasonably relying upon a firm's judgment (e.g. in the giving of advice, or making discretionary decisions), the firm takes reasonable care to ensure that it understands the needs of the client and acts in their best interest; and
  - (iv) A firm arranges adequate protection for clients' assets and money when it is responsible for them, including, where appropriate, the legal segregation of the clients' assets and money from the firm's.
7. Financial markets are served by efficient and resilient trading, clearing and settlement, and other infrastructural systems, at minimum cost.
8. Trading systems ensure the integrity of trading and price discovery, in particular, so as to strike an equitable and appropriate balance between the

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<sup>2</sup> Please note that the outcomes in this section are drafted so as to cover circumstances where a 'firm' may act in the market in different circumstances as an issuer, market intermediary, or investor.

interests of different market participants, and to further the efficiency of financial markets more generally.

### **Effective regulation**

9. Domestic and international stakeholders are confident that the regulator is effective in identifying and managing risks to the regulatory outcomes. In particular, they are confident that:
  - (i) In practice (whether or not legally) the regulator is operationally independent and accountable in the exercise of its functions and powers;
  - (ii) The regulator has adequate powers, proper resources and the capacity to perform its functions and exercise its powers including appropriate standards of confidentiality;
  - (iii) The regulator ensures an effective and credible identification of and response to the circumstances in which market forces alone will not deliver the outcomes sought;
  - (iv) The regulator ensures an effective and credible use of inspection, investigation, surveillance and enforcement powers, and implementation of an effective compliance program;
  - (v) The legal and regulatory framework supports
    - (a) the effective detection and deterrence of manipulation and other unfair trading practices domestically and internationally;
    - (b) the investigation and prosecution of third parties whose actions can impact on the outcomes but who do not have any regulatory status;
    - (c) the proper management of significant risks to domestic and international financial stability;
    - (d) the co-operation with other regulators necessary for the achievement of the regulatory outcomes in other domestic jurisdictions and markets operating across two or more jurisdictions.
10. The costs and benefits of regulation are proportionate. In particular, before intervening the regulator demonstrates:
  - (i) The presence of a market failure that is unlikely to be resolved through market forces;
  - (ii) The results of a cost benefit analysis supporting the case that the chosen method of intervention will produce a net benefit.
11. Regulated entities and individuals understand and comply with what is expected of them by regulators.