

## **REGULATORY RESPONSES TO FINANCIAL MARKET TURBULENCE**

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### **Introduction**

This paper examines how governments and their financial regulators in Australia and around the world have been, and are responding to the challenges posed by financial market turbulence of recent months, and outlines the key reports which are guiding current policy thinking.

Generally, active and flexible approaches to supporting system liquidity in national jurisdictions have been and remain crucial to deal with immediate market problems. In regard to strategic policy responses to dealing with the sources of the problems there are two perspectives on regulatory responses to financial market turbulence. The first comes from the United States and to a lesser extent the European Union, where financial institutions were directly affected by exposures to the sub-prime crisis and the ensuing credit market problems. The second perspective is that from countries like Australia and Japan where the effects were indirect.

These different perspectives have resulted in more intense domestic responses where the problems have been felt most directly, particularly in the United States which has been the source of the turbulence. The focus of national responses in the US, the UK, and to a lesser extent, other European Union countries has been on liquidity and solvency threats to systemically important financial institutions and related real economy threats. There have also been a macroeconomic policy responses in the affected jurisdictions. Management of current market problems is focussed at the national level, and in particular on actions to address a largely US set of policy challenges in relation to asset price adjustments and poor credit quality fuelled by persistent global imbalances, and compounded by shortcomings in regulatory oversight arrangements.

The Australian financial system has weathered the financial turbulence well, reflecting, among other things, its strong regulatory and prudential policy underpinnings. This has been important in differentiating the Australian experience from that of the countries in the first group. The main effects of the international financial market turmoil have included: higher funding costs for banks and other intermediaries; extremely limited activity in Australian securitisation markets; volatility in share markets; and several high profile corporate failures. From a regulatory perspective the situation has demanded close monitoring of financial institutions and the provision of system liquidity support at crucial times.

As a result of the problems being felt most intensely in the major economies of the US and European Union international responses to the market turbulence has primarily been driven by the G-7 tasking the Financial Stability Forum (FSF) with examining and making recommendations. In

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<sup>1</sup> The comments in this paper are the personal views of the author and do not represent the official position of the Australian Government or the Department of the Treasury.

this work there is close collaboration with the International Monetary Fund (IMF). The IMF has also played a significant role in analysing the causes of market turbulence. Its primary focus is directed to strengthening its role in crisis prevention.

The G-7 has identified recommendations by the FSF that it considers need to be taken urgently in order to restore confidence and improve the functioning of financial markets. This includes actions that need to be taken by banks and market participants to improve risk management practices and transparency of reporting, including in relation to risk disclosures and off-balance sheet entities. It also includes proposals for revised liquidity risk management guidelines and code of conduct for credit rating agencies. The FSF in its assessment of the financial crisis noted that to date none of the problems at individual institutions have required a coordinated international response from authorities but considered it prudent to ensure that well established international arrangements are in place should the need arise.

Internationally, public sector and private sector initiatives are currently underway in areas identified by the FSF. The FSF is seeking to facilitate coordination of these initiatives and oversee their timely implementation, with the object of preserving the advantages of integrated global financial markets and a level playing field across countries.

Australia is making a significant contribution to the public sector initiatives through international forums to implement the recommendations of the FSF. These actions are in addition to the measures already undertaken by Australian regulators domestically to address liquidity issues.

Before going on to summarise the key work that is being done under the auspices of the FSF and IMF, it is worthwhile to put to look at the immediate regulatory responses that were carried out in Australia to deal with the consequential effects of international market turbulence on the domestic financial markets.

### ***Regulatory Responses in Australia***

The Australian domestic regulatory framework has demonstrated its effectiveness through the period turbulence. The main impact of the financial crisis on Australian banks has been through the disruption to usual sources of funding as the market for asset backed securities closed down and the cost of financing rose. Australia's financial regulators have maintained regulatory confidence in uncertain markets by taking judicious action at appropriate times.

In recent weeks, improved sentiment in the Australian debt markets has been seen. While securitisation market price readjustment may take some to reach a stable point the situation is moving in an encouraging direction. While it remains too early to declare the turbulence over, banks have secured adequate funding both onshore and offshore, though at relatively high rates, for terms of a year or longer. Wholesale short term interest rates have stabilised. The Australian Prudential Regulation Authority (APRA) assesses that bank capital positions are sound. Losses attributable to the sub-prime crisis are small and there has been no increase in distressed debt.

### ***Financial System Liquidity***

The market problems posed immediate financial system liquidity that were addressed by the Reserve Bank of Australia (RBA). The RBA took early action when problems appeared on 2007 to support financial institution liquidity through changing and broadening the categories of financial instruments that could be accepted as collateral for repurchase agreements. This action was taken in consultation with APRA, which assisted in the selection of the collateral. The expansion of accepted collateral provided banks with additional confidence that they will have central bank funding for important parts of their portfolios in the event that the market is unable to serve their needs, and sent an important signal to investors and other market participants.

The RBA skewed its open market operations towards longer-dated repurchase agreements and those agreements which have collateral provided by bank issued paper. It also substantially raised the level of balances that banks can hold in their Exchange Settlement Accounts.

Apart from the RBA's action there has been increased prudential oversight and market surveillance. APRA, the RBA and the Australian Securities and Investments Commission (ASIC) have increased liaison with market participants to make sure they are close to market developments. Australia's financial regulators have been cooperating particularly closely through this turbulent period and have been keeping the Australian Government closely informed. There has been a high level of exchange of information and coordination, primarily through the Council of Financial Regulators<sup>2</sup>.

### *Prudential Supervision*

The turbulence caused general market uncertainty about the soundness of financial institutions. APRA enhanced its monitoring of bank, building society and credit union (known collectively as authorised deposit-taking institutions - ADIs) liquidity profiles and management, as well as current and planned funding arrangements. This meant more frequent contact, sometimes daily, with major banks to discuss their rolling of funding from various sources and the price and term at which revised funding was obtained. APRA requested from ADIs their funding plans for 2008 and closely analysed them, including for major branches of foreign banks in Australia. It also carefully examined both direct and indirect exposures of ADIs to sub-prime related assets by requesting data on large exposures, watch lists on large exposures and recent provisioning for problem exposures.

APRA kept in frequent contact with the RBA's market operations team to maintain a close understanding of the overall market liquidity situation and to discuss market developments with them. To assist with addressing liquidity issues, APRA allowed a marginally more flexible approach to ADIs holding paper issued by their related securitisation vehicles.

### *Market Integrity*

The share market downturn brought to light concerns with certain market trading practices relating to short selling and stock lending as well as margin lending practices. ASIC and the Australian Securities Exchange (ASX) are addressing these disclosure and transparency concerns. They are examining the arrangements to determine whether current regulatory arrangements are satisfactory.

On the whole the current regulatory system is working well under pressure. All investments have market risks. A key part of the regulatory system is to ensure that investors have full information to make informed investment decisions. On this front, the Government and regulators are closely monitoring issues regarding market integrity. ASIC and ASX have reminded market participants about the need to disclose short sales and substantial holdings, meet continuous disclosure obligations and address false market rumours.

Treasury is closely examining issues around market integrity, in conjunction with ASIC, with a view to fine-tuning the regulatory system as required. The Australian Government will be pursuing legislative changes to address the ambiguity around covered short selling and the adequacy of disclosure. The Treasury is working with ASIC to ascertain the most appropriate form of legislative change to address these issues. The Treasury is discussing interim rule changes with the ASX.

ASIC and the ASX are also reviewing the current list of stock that can be short sold in accordance with the ASX market rules. In response to concerns about settlement risks in relation to stock

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<sup>2</sup> The Council of Financial Regulators consists of the agency heads of the Treasury, the Reserve Bank of Australia, the Australian Prudential Regulation Authority and the Australian Securities and Investments Commission.

lending and short selling, the Treasurer has written to the RBA expressing support for the RBA's review of the risks associated with the settlement of novated and non-novated transactions in relation to stock lending.

### *Credit Rating Agency Review*

The Minister for Superannuation and Corporate Law announced in May 2008 that he had asked the Treasury, working closely with ASIC to review the regulation of credit rating agencies and research houses in Australia.

This review is being conducted in the context of the international concerns with the critical role credit rating agencies (CRAs) have played in the recent market problems. The FSF made a number of recommendations about them which are being worked on by the International Organization of Securities Commissions (IOSCO) and they have been receiving significant scrutiny by the European Commission as well.

The review will look at the FSF recommendations from a domestic perspective and be used to inform Australia's contribution to the work being done by IOSCO. The international dimension of the work on CRAs is described in more detail below.

### *Strengthening Government Bond Market*

The Australian Government took steps in May 2008 to enhance the effective operation of Australia's credit markets by enabling an increase in issuance of Commonwealth Government Securities (CGS) to provide an adequate supply of these securities to meet demand. The existence of an active and efficient bond market along side the banking system strengthens the robustness of Australia's financial system and reduces its vulnerability to adverse shocks.

As part of the Government's action, changes are also being made to the securities lending facility operated by the Australian Office of Financial Management (AOFM) which manages the Australian Government's debt. The facilitating supports the CGS market by allowing market participants to access bonds that are in temporary short supply. This helps smooth operation of the market. Under the new arrangements, the facility will be permitted to accept a wider range of assets as collateral. The change allows the AOFM to accept similar securities to those accepted by the RBA in its market operations. The investment powers are also being widened to allow AOFM to invest in a broader range of assets than under its current mandate.

## **International Regulatory Responses**

The market turbulence has resulted in a considerable amount of analysis and reporting to have been undertaken over the last ten months by national authorities and through international forums and agencies around causes and action that should be taken to remedy present problems and prevent a reoccurrence of a similar situation.

The work of the FSF in collaboration with the IMF are the main international agenda setters on regulatory responses to market turbulence. The rest of the paper notes what they have said and how issues are currently being dealt with. The paper also makes note of the issue of the role of CRAs in the current market problems, which is the most challenging strategic question currently being faced by policy makers.

## **The Financial Stability Forum Recommendations**

The Financial Stability Forum<sup>3</sup> was convened in April 1999 to promote international financial stability through information exchange and international co-operation in financial supervision and surveillance.

The FSF met in Rome in late March 2008. Its members discussed the current challenges in financial markets and their report<sup>4</sup> was delivered to the G-7 Finance Ministers and Central Bank Governors at their meeting in April 2008.

The forum's discussion was developed at two levels. First, the FSF assessed current or short run challenges and responses. The main issues identified as current challenges are the drastic reduction of securitisation operations, the valuation losses that reduce capital positions of financial institutions, and liquidity and credit restrictions due to counterparty concerns. Second, the FSF discussed recommendations to enhance market and institutional resilience going forward.

### *Short Term Recommendations*

The main actions recommended in the short term are:

- Capital replenishment: banks should continue their efforts to replenish capital to compensate losses.
- Disclosure: Adequate disclosure of risk exposures on structured products and poor performing assets is needed.
  - This disclosure is necessary to determine the amount of capital that needs to be replenished and to reduce counterparty concerns that are affecting liquidity in the interbank market.
  - In addition to the current need of disclosure of exposures to structured products, there are other long term transparency regulatory proposals that are detailed below.
  - The FSF has set out a template of leading practice disclosures by large financial institutions and recommends its implementation with the forthcoming mid-year 2008 disclosures.
- Central Bank operations: Central banks should continue to respond flexibly and rapidly to market developments, working in concert if necessary.

### *Long Term Recommendations*

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<sup>3</sup> The FSF brings together senior representatives of 13 countries. Australia is represented by Governor of the Reserve Bank of Australia. Other international institutions represented in the FSF are the IMF, The World Bank, The Bank for International Settlements, the OECD, the International Accounting Standards Board (IASB), the International Organisation of Securities Commissions, the Basel Committee on Banking Supervision (BCBS) and the European Central Bank. The FSF is serviced by a secretariat housed at the Bank for International Settlements in Basel, Switzerland.

<sup>4</sup> *Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience*, April 2008, FSF

The actions recommended in the long term are detailed in the FSF report to the G-7. This report provides a broad agenda to be developed by regulators and standard setters such as IOSCO, International Accounting Standards Board (IASB) and Basel Committee on Banking Supervision (BCBS). This document sets out specific policy recommendations in the following areas:

- Prudential oversight of capital, liquidity and risk management.
- Transparency, disclosure and valuation practices.
- The role and uses of credit ratings.
- Authorities' responsiveness to risks.
- Arrangements to deal with stress in the financial system.

There are 67 individual recommendations made by the FSF, grouped into the five areas identified above. The recommendations are set out in the attachment to this paper.

The recommendations do not form a list of action items for immediate and individual implementation by countries. Some recommendations are more significant than others in policy scope. The large majority of recommendations require either international standard setters to address technical issues to enhance regulatory standards or the financial industry to make changes to market practices. National authorities need to contribute to this international work. Subsequently, international agreed enhancements are then to be adopted by countries into their own regulation.

#### *Central Bank Flexibility*

The FSF has called for central bank operational frameworks to be sufficiently flexible in terms of potential frequency and maturity of operations, available instruments, and the range of counterparties and collateral, to deal with extraordinary situations.

#### *Implementation of Basel II and Prudential Oversight*

The focus of recommendations regarding the strengthening of prudential oversight of capital, liquidity and risk management is the implementation and refinement of the Basel II regulatory capital framework.

The FSF noted that supervision of risk management practices needs to establish strong requirements but be flexible enough to cater for different risk profiles of banks. Banks need to appropriately assess their own capital adequacy based on the risks that emerge over the full credit cycle.

To improve resilience, elements of the Basel II regulatory framework need to be strengthened particularly for supervisory guidelines regarding liquidity management. The current turbulence has demonstrated the importance of liquidity risk management practices and high liquidity buffers in maintaining institutional and systemic resilience in the face of shocks.

#### *Credit Rating Agencies*

The FSF report highlighted the role CRAs play in evaluating and disseminating information on structured credit products, and how many investors have relied heavily on their ratings opinions in making investment decisions. However, recent events have demonstrated how poor credit assessments by CRAs have contributed both to the build-up to, and the unfolding, of the sub-prime crisis.

A more detailed discussion of CRAs is set out below.

### *Crisis Management Arrangements*

Finally, arrangements for dealing with weak banks are detailed. The FSF noted that national arrangements for dealing with weak banks have been tested by recent events and are the subject of review in some countries. It also noted that the nature of the turmoil, the effects of which have been felt in many countries and in many different types of institutions, has emphasised the need to continue to work on crisis cooperation.

### ***G-7 Response to the FSF Report***

In their April communiqué, G-7 Finance Ministers and Central Bank Governors strongly endorsed the FSF report and committed to implementing its recommendations.

G-7 Ministers and Governors identified a number of recommendations for implementation within 100 days and others by the end of 2008. Immediate priorities for implementation within the next 100 days:

- Firms should fully and promptly disclose their risk exposures, write-downs, and fair value estimates for complex and illiquid instruments. The G-7 strongly encouraged financial institutions to make robust risk disclosures in their upcoming mid year reporting consistent with leading disclosure practices as set out in the FSF's report.
- The IASB and other relevant standard setters should initiate urgent action to improve the accounting and disclosure standards for off balance sheet entities and enhance its guidance on fair value accounting, particularly on valuing financial instruments in periods of stress.
- Firms should strengthen their risk management practices, supported by supervisors' oversight, including rigorous stress testing. Firms also should strengthen their capital positions as needed.
- By July 2008, the BCBS should issue revised liquidity risk management guidelines and the IOSCO should revise its code of conduct fundamentals for credit rating agencies.

Recommendations for implementation by the end of 2008:

- Strengthening prudential oversight of capital, liquidity, and risk management: The Basel II capital framework needs timely implementation. The BCBS should raise capital requirements for complex structured credit instruments and off balance sheet vehicles, require additional stress testing, and enhance their monitoring.
- Enhancing transparency and valuation: The BCBS should issue further guidance to enhance the supervisory assessment of banks' valuation processes to strengthen disclosures for off balance sheet entities, securitisation exposures, and liquidity commitments.
- Changing the role and uses of credit ratings: Investors need to improve their due diligence in the use of ratings. Credit rating agencies should take effective action (consistent with IOSCO's revised code of conduct) to address the potential for conflicts of interest in their activities, clearly differentiate the ratings for structured products, improve their disclosure of rating methodologies, and assess the quality of information provided by originators, arrangers, and issuers of structured products.
- Strengthening the authorities' responsiveness to risk: Supervisors and central banks should further strengthen cooperation and exchange of information, including the assessment of

financial stability risks. It is important that an ‘international college of supervisors’ be established for each of the largest global financial institutions. Market authorities also should act cooperatively and swiftly to investigate and penalise fraud, market abuse and manipulation.

- Implementing robust arrangements for dealing with stress in the financial system: Central banks should be able to supply liquidity effectively during financial system stress, and authorities should review and where necessary strengthen their arrangements for dealing with weak and failing banks, domestically and cross border.

The G-7 called for an update from the FSF at the G-8 Finance Ministers’ meeting in Osaka in June and a comprehensive follow-up report by the time of the G-7 Finance Ministers’ meeting in Washington in October 2008.

### ***IMFC Response to the FSF Report***

During the 2008 Spring Meetings in April, the International Monetary and Financial Committee (IMFC) welcomed the recommendations identified in the FSF report and called for their timely implementation. The IMFC communiqué noted that progress on the FSF recommendations, and on strengthening the IMF’s financial surveillance role, will be reviewed at the 2008 Annual Meetings in October 2008.

### ***Progress on Implementing the FSF Recommendations***

The work of international standard setters tasked by the report, such as IOSCO and the BCBS, regarding the G-7’s priority recommendations is on track.

Australia is well positioned in relation to key recommendations, such as implementation of the Basel II framework, which is already in place. Australia is contributing to the work going on amongst the international standard setters, which will flow through to guidance to national authorities, including here in Australia. This international guidance will be used as a reference in considering further measures which should be adopted into national regulation in Australia and other countries.

### **IMF Global Financial Stability Report**

In April the IMF also reported its views on market turbulence issues. It provided its views in Chapters II and III of the April 2008 Global Financial Stability Report<sup>5</sup> on valuation and disclosure and liquidity risk management. These views are summarised below.

#### *Structured Finance: Issues of Valuation and Disclosure*

- The majority of products could usefully be standardised at least to some extent.
  - This should increase transparency and market participants’ understanding of the risks, thus facilitating the development of liquid secondary markets.
- Transparency regarding product characteristics at origination is needed.

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<sup>5</sup> *Global Financial Stability Report - Containing Systemic Risks and Restoring Financial Soundness*, April 2008, International Monetary Fund

- The information should include characteristics of underlying assets, valuation assumptions used, and on their sensitivity to changes (sensitivity analysis of assumptions regarding volatility, default and delinquency, and loss given default under various scenarios).
- The issuer of securitised products should make available the information regarding the underlying assets on a continuous basis.
- Originators that retain risks and rewards in off-balance sheet entities should disclose aggregate information on a timely and regular basis.
- Credit Rating Agencies should use a different scale for structured credit products. Additionally, rating agencies should provide investors with more analytical information regarding potential rating volatility.
- Weaknesses in applying fair value results need to be addressed
  - Most holders adopt fair value for valuing structured products. However, there are situations where the use of fair value may trigger assets sales, margin calls or additional collateral requirements.
  - In times of market downturn, these decisions may generate unnecessary realised losses for the individual firm and simultaneously contribute to a downward spiral of the asset price, thus compounding market illiquidity.
  - Research to deal with this issue should be undertaken. The research should (i) investigate the degree to which decision-making rules based on fair value may compound a crisis, and (ii) identify strategies that could mitigate these adverse effects.
- Further refinement and capital implementation of Basel II would substantially reduce current gaps.
  - As for applying the appropriate risk weights to contingent credit lines, Basel II guidance needs to be strengthened further.
  - Regulatory arbitrage between banks and non-bank financial institutions may remain, as the same risk may be treated differently across regulatory regimes.

### *Liquidity Risk Management*

In Chapter III of the Global Financial Stability Report, the IMF explores the interaction between market and funding liquidity risk and provides recommendations to improve liquidity risk management. Additionally the document also analyses the role of the central bank in providing liquidity.

### *Recommendations to Market Participants on Funding Liquidity Risk*

- Greater transparency is needed regarding bank's liquidity management policies and practices, including liquidity risk appetite, funding sources, liquidity commitments (especially to off-balance sheet entities), maturity mismatches, contingency plan, and assumptions made over deposit withdrawal prospects.
- More severe stress testing of funding liquidity should be adopted, taking into account the possible closure of multiple wholesale markets (both secured and unsecured) and widespread calls on liquidity commitments, taking into account commitments to off-balance sheet

entities. These stress test results and the underlying assumptions should be publicly available for systemically-important firms.

- Cross-border banks should take greater account of multi-currency funding liquidity shocks, taking into consideration the need to manage liquidity mismatches in each operating currency and the potential for stress in the foreign currency swaps markets.
- Bank's reliance on highly structured securities, especially holdings of their own securitised assets, to generate collateral for secured funding have proven problematic. Illiquidity and volatility in these markets have coincided with interbank market disruption resulting in banks facing a correlated liquidity squeeze on both their repurchasable assets and wholesale funding.

#### *Recommendations to Regulators and Supervisory Authorities*

- Raising minimum liquid asset requirements in the form of holding of reliably liquid assets easy to use as a collateral.
- Stricter limits on maturity mismatches in banks' asset/liability structures.
- Tighter rules governing diversification of funding sources and ability to survive a funding market disruption.

The IMF considers that bank supervisors should formulate guidance more along the lines of Pillar 2 (principle-based regulation) of the Basel II framework, rather than initially tightening minimum quantitative requirements for liquid asset holdings.

#### *Recommendations to Monetary Authorities*

- In a crisis central banks should be able to operate with a wide range of counterparties and collateral that provides banks with broad access to liquidity and releases more liquid collateral for collateral for interbank usage. However, central banks should avoid being exposed to excessive credit risk.
- Central banks need to explain what impact of additional emergency liquidity will have on monetary conditions and the circumstances that would permit liquidity withdrawal.
- Coordination with international counterparts on emergency operations, liquidity arrangements for cross-border banking groups, and emergency foreign exchange swaps should be furthered.
  - The case of international securities depository, that would provide international banks with greater flexibility to post collateral across a range of currencies and central banks, could be considered.
- Central banks need to be provided with sufficient information about the liquidity and solvency risk profiles of individual, systematically important institutions.

### **Better Global Oversight of Financial Markets**

Australia is supporting the work of the FSF and IMF in developing policy responses to financial turbulence and agrees with the broad nature of these responses. However, there is a need for strengthening the international cooperation to identify systemic risks to the global financial system and to develop policies to promote its stability. This is a challenging task as it requires changes to the international regulatory framework. The goal of strengthening global cooperation requires a greater level of policy coordination between governments to set the strategic agenda and ensure the coherence of measures developed by various international standard setting bodies.

The FSF is not currently suited to the role of a supervisory organisation. It is a forum for sharing ideas through the bringing together of national and international regulatory, supervisory and standard setting expertise which is extremely valuable. However, its composition means that it tends to have a regulators perspective on the world. This is good for technical analysis of particular issues but does not provide for coherent higher level strategic policy thinking on the global financial system architecture and the market trends and developments and where they will lead financial markets in the future. There is also a need to include systemically important emerging market economies in any efforts to strengthen the global financial system against future crises.

The IMF has set out to strengthen its role in crisis prevention. This requires it to strengthen its expertise on the channels of transmission and feedback between the real and financial economy. This includes identifying macroeconomic threats to stability and encouraging best practices for policy makers, supervisors and regulators. In addition, more monitoring of risks and assessment of vulnerabilities at the country, regional and global levels is desirable.

### **The Role of Credit Rating Agencies**

The recent market turbulence has highlighted the need for policy consideration of the impact of credit ratings on market integrity, prudential regulation and financial system stability.

CRA's play an important role in evaluating and disseminating information on structured credit products, and many investors have relied heavily on their ratings opinions. Poor credit assessments by CRA's contributed both to the build up to and the unfolding of recent events. In particular, CRA's assigned high ratings to complex structured sub-prime debt based on inadequate historical data and in some cases flawed models. As investors realised this, they lost confidence in ratings of securitised products more generally.

One of the important triggers of the current turmoil was the precipitous decline in confidence in ratings of structured credit products. After assigning high ratings to sub-prime related Residential Mortgage Backed Securities and Collateralised Debt Obligations between 2004 and 2007, and thus contributing to the phenomenal growth of sub-prime lending, since mid-2007 CRA's have announced an inordinate number of rapid multi-notch downgrades of these instruments. This has raised questions about the quality of credit ratings with regard to structured products.

One issue that has received attention is whether CRA's' poor ratings performance in structured products might have reflected more intense conflicts of interest in the rating of these than for other products. The CRA's that rate the vast majority of such products rely primarily on an issuer-pays model and the revenues from this rating activity accounted for a fast growing income stream for these CRA's in recent years.

While ratings play a useful role in limiting, monitoring and communicating the credit risks that investors and asset managers take, they do not cover the full range of risks investors face. Credit ratings are assessments of creditworthiness, but not assessments of the level of liquidity, market or rating volatility risk. However, some institutional investors have relied too heavily on ratings in their investment guidelines and choices, in some cases fully substituting ratings for independent risk assessment and due diligence. Some also relied exclusively on ratings for valuation purposes.

The over-reliance on ratings was particularly acute in the case of structured finance products. One important factor is that the analysis of the underlying assets and the correlation risk is quite challenging, and investors in highly-rated products with low risk premia may lack expertise or be tempted to avoid the costs of doing their own analysis. Other factors include the absence of an active secondary market for these products, lack of sufficient historical performance data, and lack of a universally agreed valuation method.

All these factors have contributed to a situation where many investors largely relied on credit ratings to assess the risk of holding structured finance products. Consequently, when the quality of CRAs' ratings became questioned, some investors were left with no independent means of assessing the risk of these products, which added to market illiquidity.

Another concern is that credit ratings are referred to in various regulatory and supervisory frameworks both at the international and at the national level. An example of this are APRA's Prudential Standards for ADIs which were adopted in accordance with the Basel II framework.

Such official recognition in regulation and/or supervisory policies may have played a role in encouraging investors' over-reliance on ratings, by discouraging some investors from paying close attention to what the ratings actually mean.

### ***IOSCO Work on Credit Rating Agencies***

IOSCO is responding to the recommendations of the IMF and the FSF and proposes modifications of the IOSCO Credit Rating Agency Code of Conduct in four areas: quality and integrity of the rating process; independence and avoidance of conflicts of interest; responsibilities to the investing public and issuers; and disclosure and communication with market participants. The proposed modifications are as follows.

#### ***Quality and Integrity of the Rating Process***

A CRA should conduct the rating of structured finance products in an objective manner, periodically revise its methodologies, ensure the use of sufficient information in its ratings or disclose the limitations of information, assure that employees have the appropriate knowledge and experience, establish a new products review by more senior managers, prohibit CRA analysts from making recommendations regarding the design of structured products that the CRA rates, and ensure the adequate allocation of resources to monitor and update its ratings.

#### ***CRA Independence and Avoidance of Conflicts of Interest***

A CRA should establish policies and procedures for reviewing the work of analysts that leave the CRA and join an issuer the CRA rates or has rated, periodically revise its remuneration policies for employees, disclose whether any client makes up more than 10 per cent of its annual revenue, and define what it considers to be an ancillary business.

#### ***CRA Responsibilities to the Investing Public and Issuers***

A CRA should assist investors in understanding what a credit rating is and its limitations, publish quantifiable historical information about the performance of its rating opinions, disclose whether it uses a separate set of rating symbols for rating structured finance products, disclose the methodology in use in determining a rating, and disclose the preliminary ratings requested by a client of potential client if this rating is not finally published.

#### ***Disclosure of the Code of Conduct and Communication with Market Participants***

A CRA should publish in a prominent position on its home webpage links to (1) the CRA's code of conduct; (2) a description of the methodologies it uses; and (3) information about the CRA's historic performance data.

### ***European Commission View on Credit Rating Agencies***

The European Commission has also been examining the role of CRAs and is carrying out consultation on the role of CRAs in structured finance. Following the European Commission's

request to review several aspects of the rating process regarding structured finance instruments, the Committee of European Securities Regulators (CESR) published a consultation paper on the role of CRAs in February 2008.

The consultation paper covered the following areas: transparency of rating processes and methodologies; monitoring of rating performance and the need to act promptly in reviewing structured finance ratings; CRA staff resourcing, including transparency of staff experience and independence; and conflicts of interest.

In May 2008, the CESR made its report<sup>6</sup>. The report called for a new supervisory body to be set up to 'name and shame' CRAs that fail to perform to adequate standards. The CESR also made several recommendations to tighten up the way in which CRAs deal with structured investment products through greater transparency. The European Union's Internal Market Commissioner is not satisfied with the advice. This suggests that the EU is contemplating a new regulatory regime for CRAs which goes further than the self-regulatory approach proposed by the CESR.

## **Summary**

Overall, there is a lot of work being done by authorities around the world on the challenges posed by market turbulence. The key work behind the international agenda on regulatory responses has come from the FSF in collaboration with the IMF. A number of the FSF's recommendations call for international standard setters to address technical issues and identify regulatory enhancements which would then be adopted by countries through their own regulatory regimes.

Internationally, public sector and private sector initiatives are currently underway in areas identified by the FSF. The FSF is seeking to facilitate coordination of these initiatives and oversee their timely implementation, with the object of preserving the advantages of integrated global financial markets and a level playing field across countries. Greater policy coordination between governments in supervising the work of international standard setters is a desirable goal.

Australia is well positioned in relation to key recommendations and is making a significant contribution to the public sector initiatives through international forums to implement the recommendations of the FSF. These actions are in addition to the measures already undertaken by Australian regulators domestically to address liquidity issues. This international guidance will be used as a reference in considering further measures which should be adopted into national regulation in Australia.

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<sup>6</sup> *CESR's Second Report to the European Commission on the compliance of credit rating agencies with the IOSCO Code and The role of credit rating agencies in structured finance*, May 2008, CESR

## Financial Stability Forum Recommendations

Item No.	Issue & Recommendation	FSF Organisational Tasking	FSF Timing
II	<b>Strengthened prudential oversight of capital, liquidity and risk management</b>		
	<b>Capital requirements</b>		
	<i>The Basel II capital framework needs timely implementation. Supervisors will assess the impact of the implementation.</i>		
II. 1	The Basel II capital framework needs timely implementation.	National supervisors	2008 -
II. 2	Supervisors will assess the impact of Basel II implementation on banks' capital levels and will decide whether additional capital buffers are needed.	National supervisors, BCBS	2008 -
	<i>Supervisors will strengthen the Basel II capital treatment of structured credit and securitisation activities.</i>		
II. 3	The BCBS will issue proposals in 2008 to raise capital requirements for certain complex structured credit products such as CDOs of asset-backed securities (ABSs).	BCBS	2008
II. 4	The BCBS and IOSCO will issue proposals in 2008 to introduce additional capital requirements for credit exposures in the banks' and securities firms' trading books.	BCBS, IOSCO	2008
II. 5	The BCBS will issue proposals in 2008 to strengthen the capital treatment for banks' liquidity facilities to off-balance sheet ABCP conduits.	BCBS	2008
	<i>Supervisors will continue to update the risk parameters and other provisions of the Basel II framework as needed.</i>		
II. 6	Supervisors will continue to update the risk parameters and other provisions of the Basel II framework to ensure that its incentives remain adequate, and will rigorously assess banks' compliance with the framework.	BCBS, national supervisors	2008 -
II. 7	Supervisors will assess the cyclical nature of the Basel II framework and take additional measures as appropriate.	BCBS	2009 -
	<i>Authorities should ensure that the capital buffers for monoline insurers and financial guarantors are commensurate with their role in the financial system.</i>		
II. 8	Insurance supervisors should strengthen the regulatory and capital framework for monoline insurers in relation to structured credit.	National supervisors, IAIS	2008 -
	<b>Liquidity management</b>		
	<i>Supervisors will issue for consultation sound practice guidance on the management and supervision of liquidity by July 2008.</i>		
II. 9	The BCBS will issue for consultation sound practice guidance on the management and supervision of liquidity by July 2008.	BCBS	July 2008

Item No.	Issue & Recommendation	FSF Organisational Tasking	FSF Timing
II. 10	National supervisors should closely check banks' implementation of the updated guidance as part of their regular supervision. If banks' implementation of the guidance is inadequate, supervisors will take more prescriptive action to improve practices.	National supervisors	2008 -
II. 11	Supervisors and central banks will examine the scope for additional steps to promote more robust and internationally consistent liquidity approaches for cross-border banks. This will include the scope for more convergence around liquidity supervision as well as central bank liquidity operations.	BCBS, national supervisors, central banks	2008-09
	<b><i>Supervisory oversight of risk management, including of off-balance sheet entities</i></b>		
	<i>Supervisors will use Pillar 2 to strengthen banks' risk management practices, to sharpen banks' control of tail risks and mitigate the build-up of excessive exposures and risk concentrations.</i>		
II. 12	National supervisors will use the flexibility within Basel II to ensure that risk management, capital buffers and estimates of potential credit losses are appropriately forward-looking and take account of uncertainties associated with models, valuations and concentration risks and expected variations through the cycle. National supervisors will report to the BCBS with a view to ensuring a level playing field and the BCBS will share its findings and actions with the FSF.	National supervisors, BCBS	2008-09
II. 13	Supervisors will strengthen guidance relating to the management of firm-wide risks, including concentration risks.	BCBS, national supervisors	2008-09
II. 14	Supervisors will strengthen stress testing guidance for risk management and capital planning purposes.	BCBS, national supervisors	2008-09
II. 15	Supervisory guidance will require banks to manage off-balance sheet exposures appropriately.	BCBS, national supervisors	2008-09
II. 16	Supervisors will issue guidance to strengthen risk management relating to the securitisation business.	BCBS, national supervisors	2008-09
II. 17	Supervisors will strengthen their existing guidance on the management of exposures to leveraged counterparties.	National supervisors	2008-09
	<i>Relevant regulators should strengthen the requirements for institutional investors' processes for investment in structured products.</i>		
II. 18	Regulators of institutional investors should strengthen the requirements or best practices for firms' processes for investment in structured products.	National regulators	2009
	<i>The financial industry should align compensation models with long-term, firm-wide profitability. Regulators and supervisors should work with market participants to mitigate the risks arising from inappropriate incentive structures.</i>		
II. 19	Regulators and supervisors should work with market participants to mitigate the risks arising from remuneration policies.	National regulators, supervisors	2008 -
	<b><i>Operational infrastructure for OTC derivatives</i></b>		
	<i>Market participants should act promptly to ensure that the settlement, legal and operational infrastructure underlying OTC derivatives markets is sound.</i>		

Item No.	Issue & Recommendation	FSF Organisational Tasking	FSF Timing
II. 20	Market participants should amend standard credit derivative trade documentation to provide for cash settlement of obligations stemming from a credit event, in accordance with the terms of the cash settlement protocol that has been developed, but not yet incorporated into standard documentation.	Market participants	2008
II. 21	Market participants should automate trade novations and set rigorous standards for the accuracy and timeliness of trade data submissions and the timeliness of resolutions of trade matching errors for OTC derivatives.	Market participants	2008
II. 22	The financial industry should develop a longer-term plan for a reliable operational infrastructure supporting OTC derivatives.	Financial industry	2008 -
<b>III</b>	<b>Enhancing transparency and valuation</b>		
	<b>Risk disclosures by market participants</b>		
	<i>Financial institutions should strengthen their risk disclosures and supervisors should improve risk disclosure requirements under Pillar 3 of Basel II.</i>		
III. 1	The FSF strongly encourages financial institutions to make robust risk disclosures using the leading disclosure practices summarised in this report, at the time of their upcoming mid-year 2008 reports.	Financial institutions	Mid-2008
III. 2	Going forward, investors, financial industry representatives and auditors should work together to provide risk disclosures that are most relevant to the market conditions at the time of the disclosure.	Financial industry representatives, auditors	2008 -
III. 3	The BCBS will issue by 2009 further guidance to strengthen disclosure requirements under Pillar 3 of Basel II.	BCBS	2009
	<i>Accounting and disclosure standards for off-balance sheet entities</i>		
III. 4	The IASB should improve the accounting and disclosure standards for off-balance sheet vehicles on an accelerated basis and work with other standard setters toward international convergence.	IASB	2008-09
	<b>Valuation</b>		
	<i>International standard setters should enhance accounting, disclosure and audit guidance for valuations. Firms' valuation processes and related supervisory guidance should be enhanced.</i>		
III. 5	The IASB will strengthen its standards to achieve better disclosures about valuations, methodologies and the uncertainty associated with valuations.	IASB	2008-09
III. 6	The IASB will enhance its guidance on valuing financial instruments when markets are no longer active. To this end, it will set up an expert advisory panel in 2008.	IASB	2008-09
III. 7	Financial institutions should establish rigorous valuation processes and make robust valuation disclosures.	Financial institutions	2008
III. 8	The BCBS will issue for consultation guidance to enhance the supervisory assessment of banks' valuation processes and reinforce sound practices in 2008.	BCBS	2008

Item No.	Issue & Recommendation	FSF Organisational Tasking	FSF Timing
III. 9	The International Auditing and Assurance Standards Board (IAASB), major national audit standard setters and relevant regulators should consider the lessons learned during the market turmoil and, where necessary, enhance the guidance for audits of valuations of complex or illiquid financial products and related disclosures.	IAASB, major national audit standard setters, relevant regulators	2008-09
	<b>Transparency in securitisation processes and markets</b>		
	<i>Securities market regulators should work with market participants to expand information on securitised products and their underlying assets.</i>		
III. 10	Originators, arrangers, distributors, managers and CRAs should strengthen transparency at each stage of the securitisation chain, including by enhancing and standardising information on an initial and ongoing basis about the pools of assets underlying structured credit products.	Originators, arrangers, distributors, managers and CRAs	2008
III. 11	Originators and issuers of securitised products should be transparent about the underwriting standards for the underlying assets. They should also make available to investors and CRAs the results of their own due diligence.	Originators, issuers	2008
III. 12	Investors, and their asset managers, should obtain from sponsors and underwriters of structured credit products access to better information about the risk characteristics of the credits, including information about the underlying asset pools, on an initial and ongoing basis.	Investors and their asset managers	2008
III. 13	Securities market regulators will work with market participants to study the scope to set up a comprehensive system for post-trade transparency of the prices and volumes traded in secondary markets for credit instruments.	Securities market regulators, market participants	2008-09
<b>IV</b>	<b>Changes in the role and uses of credit ratings</b>		
	<b>Quality of the rating process</b>		
	<i>CRAs should improve the quality of the rating process and manage conflicts of interest in rating structured products.</i>		
IV. 1	IOSCO will revise its Code of Conduct Fundamentals for Credit Rating Agencies by mid-2008.	IOSCO	Mid-2008
IV. 2	CRAs should quickly revise their codes of conduct to implement the revised IOSCO CRA Code of Conduct Fundamentals. Authorities will monitor, individually or collectively, the implementation of the revised IOSCO Code of Conduct by CRAs, in order to ensure that CRAs quickly translate it into action.	CRAs, authorities	2008 -
IV. 3	CRAs should demonstrate that they have the ability to maintain the quality of their service in the face of rapid expansion of their activities, and allocate adequate resources to both the initial rating and to the rating's regular review.	CRAs	2008 -
	<b>Differentiated ratings and expanded information on structured products</b>		
	<i>CRAs should differentiate ratings on structured finance from those on bonds, and expand the initial and ongoing information provided on the risk characteristics of structured products.</i>		
IV. 4	CRAs should clearly differentiate, either with a different rating scale or with additional symbols, the ratings used for structured products from those for corporate bonds, subject to appropriate notification and comment.	CRAs	2008 -
IV. 5	CRAs should expand the initial and ongoing information that they provide on the risk characteristics of structured products.	CRAs	2008 -

Item No.	Issue & Recommendation	FSF Organisational Tasking	FSF Timing
	<b><i>CRA assessment of underlying data quality</i></b>		
	<i>CRAs should enhance their review of the quality of the data input and of the due diligence performed on underlying assets by originators, arrangers and issuers involved in structured products.</i>		
IV. 6	CRAs should review the quality of the data input and the due diligence performed by originators, arrangers and issuers.	CRAs	2008 -
	<b><i>Uses of ratings by investors and regulators</i></b>		
	<i>Investors should address their over-reliance on ratings. Investor associations should consider developing standards of due diligence and credit analysis for investing in structured products.</i>		
IV. 7	Investors should reconsider how they use credit ratings in their investment guidelines and mandates and for risk management and valuation. Ratings should not replace appropriate risk analysis and management on the part of investors. Investors should conduct risk analysis commensurate with the complexity of the structured product and the materiality of their holding, or refrain from such investments.	Investors	2008 -
	<i>Authorities will review their use of ratings in the regulatory and supervisory framework.</i>		
IV. 8	Authorities should check that the roles that they have assigned to ratings in regulations and supervisory rules are consistent with the objectives of having investors make independent judgment of risks and perform their own due diligence, and that they do not induce uncritical reliance on credit ratings as a substitute for that independent evaluation.	International committees, national authorities	2008 -
<b>V</b>	<b><i>Strengthening the authorities' responsiveness to risks</i></b>		
	<b><i>Translating risk analysis into action</i></b>		
	<i>Supervisors, regulators and central banks – individually and collectively – will take additional steps to more effectively translate their risk analysis into actions that mitigate those risks.</i>		
V. 1	Supervisors should see that they have the requisite resources and expertise to oversee the risks associated with financial innovation and to ensure that firms they supervise have the capacity to understand and manage the risks.	National supervisors	2008 -
V. 2	Supervisors and regulators should formally communicate to firms' boards and senior management at an early stage their concerns about risk exposures and the quality of risk management and the need for firms to take responsive action. Those supervisors who do not already do so should adopt this practice.	National supervisors and regulators	2008 -
V. 3	At the international level, the FSF will give more force to its own risk analysis and recommendations, both directly and through the actions of its members, by initiating and following up action to investigate and mitigate risk.	FSF	2008 -
V. 4	The FSF will establish a mechanism for regular interaction at senior level with private sector participants, including investors and CRAs, for prompting mitigating actions to identified risks and weaknesses.	FSF	2008
	<b><i>Improving information exchange and cooperation among authorities</i></b>		
	<i>Authorities' exchange of information and cooperation in the development of good practices will be improved at national and international levels.</i>		

Item No.	Issue & Recommendation	FSF Organisational Tasking	FSF Timing
V. 5	The use of international colleges of supervisors should be expanded so that, by end-2008, a college exists for each of the largest global financial institutions.	National supervisors	2008
V. 6	Supervisors involved in these colleges should conduct an exercise, by 2009, to draw lessons about good practices.	National supervisors	2009
V. 7	To quicken supervisory responsiveness to developments that have a common effect across a number of institutions, supervisory exchange of information and coordination in the development of best practice benchmarks should be improved at both national and international levels.	National supervisors	2008 -
V. 8	Supervisors and central banks should improve cooperation and the exchange of information including in the assessment of financial stability risks. The exchange of information should be rapid during periods of market strain.	National supervisors, central banks	2008 -
V. 9	To facilitate central bank mitigation of market liquidity strains, large banks will be required to share their liquidity contingency plans with relevant central banks.	National supervisors, central banks, large banks	2008
	<b>Enhancing international bodies' policy work</b>		
	<i>International bodies will enhance the speed, prioritisation and coordination of their policy development work.</i>		
V. 10	International regulatory, supervisory and central bank committees will strengthen their prioritisation of issues and, for difficult to resolve issues, establish mechanisms for escalating them to a senior decision-making level. As part of this effort, they will establish timetables for required action and action plans for addressing delayed or difficult issues.	International committees	2008 -
V. 11	National supervisors will, as part of their regular supervision, take additional steps to check the implementation of guidance issued by international committees.	National supervisors	2008 -
V. 12	The FSF will encourage joint strategic reviews by standard-setting committees to better ensure policy development is coordinated and focused on priorities.	FSF	2008 -
V. 13	The FSF and IMF will intensify their cooperation on financial stability, with each complementing the other's role. As part of this, the IMF will report the findings from its monitoring of financial stability risks to FSF meetings, and in turn will seek to incorporate relevant FSF's conclusions into its own bilateral and multilateral surveillance work.	FSF/IMF	2008 -
<b>VI</b>	<b>Robust arrangements for dealing with stress in the financial system</b>		
	<b>Central bank operations</b>		
	<i>Central bank operational frameworks should be sufficiently flexible in terms of potential frequency and maturity of operations, available instruments, and the range of counterparties and collateral, to deal with extraordinary situations.</i>		
VI. 1	To meet an increased but uncertain demand for reserves, monetary policy operational frameworks should be capable of quickly and flexibly injecting substantial quantities of reserves without running the risk of driving overnight rates substantially below policy targets for significant periods of time.	Central banks	2008
VI. 2	Policy frameworks should include the capability to conduct frequent operations against a wide range of collateral, over a wide range of maturities and with a wide range of counterparties, which should prove especially useful in dealing with extraordinary situations.	Central banks	2008

Item No.	Issue & Recommendation	FSF Organisational Tasking	FSF Timing
VI. 3	To deal with stressed situations, central banks should consider establishing mechanisms designed for meeting frictional funding needs that are less subject to stigma.	Central banks	2008
VI. 4	Central banks should have the capacity to use a variety of instruments when illiquidity of institutions or markets threatens financial stability or the efficacy of monetary policy.	Central banks	2008
VI. 5	To deal with problems of liquidity in foreign currency, central banks should consider establishing standing swap lines among themselves. In addition, central banks should consider allowing in their own liquidity operations the use of collateral across borders and currencies.	Central banks	2008-09
	<b>Arrangements for dealing with weak banks</b>		
	<i>Authorities will clarify and strengthen national and cross-border arrangements for dealing with weak banks.</i>		
VI. 6	Domestically, authorities need to review and, where needed, strengthen legal powers and clarify the division of responsibilities of different national authorities for dealing with weak and failing banks.	National supervisors, central banks, governments	2008-09
VI. 7	Internationally, authorities should accelerate work to share information on national arrangements for dealing with problem banks and catalogue cross-border issues, and then decide how to address the identified challenges.	National authorities, BCBS	2008
	<i>Authorities will review and, where necessary, strengthen deposit insurance arrangements.</i>		
VI. 8	Authorities should agree a set of international principles for deposit insurance systems.	National authorities	2008-09
VI. 9	National deposit insurance arrangements should be reviewed against these agreed international principles, and authorities should strengthen arrangements where needed.	National authorities	2008-09
	<i>Authorities will strengthen cross-border cooperation in crisis management.</i>		
VI. 10	For the largest cross-border financial firms, the most directly involved supervisors and central banks should establish a small group to address specific cross-border crisis management planning issues. It should hold its first meeting before end-2008.	Relevant central banks and national supervisors	2008
VI. 11	Authorities should share international experiences and lessons about crisis management. These experiences should be used as the basis to extract some good practices of crisis management that are of wide international relevance.	National supervisors, central banks	2008-09

**Table Abbreviations:**

AASB – Australian Accounting Standards Board  
ADI – Authorised Deposit-Taking Institution  
APRA – Australian Prudential Regulation Authority  
ASIC – Australian Securities and Investments Commission  
AUASB – Auditing and Assurance Standards Board  
BCBS – Basel Committee on Banking Supervision  
CRA – Credit Rating Agencies  
FCS – Financial Claims Scheme  
FRC – Financial Reporting Council  
FSAP – Financial Sector Assessment Program  
FSF- Financial Stability Forum  
IAASB – International Auditing and Assurance Standards Board  
IASB – International Accounting Standards Board  
IOSCO – International Organisation of Securities Commissions  
MIS – Managed Investment Scheme  
OTC – Over-the Counter  
RBA – Reserve Bank of Australia