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Systemic Risk

Financial Stability Forum Issues Report on Enhancing Market and Institutional Resilience

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At an April 11, 2008 meeting in Washington, DC, finance ministers and central bank governors of the Group of Seven industrialized countries (G-7) formally adopted a reform package proposed by the Financial Stability Forum (FSF) for calming the turmoil in international financial markets. Chaired by Mario Draghi, Governor of the Bank of Italy, the FSF is an international organization of regulators and supervisors organized to promote financial stability, improve market functioning and reduce systemic risk. In October 2007, G-7 economic heads asked the FSF to examine the causes of the current turmoil and set out recommendations that would prevent a future similar crisis.

FSF Report

A few days earlier, the FSF had presented to the G-7 a 75-page report of the FSF's Working Group on Market and Institutional Resilience. That report outlined recommendations for stabilizing the international financial markets. On Friday, the G-7 issued a joint statement strongly endorsing the report and committing to implementing its recommendations. "Rapid implementation of the FSF report," the G-7 said in the joint statement, "will not only enhance the resilience of the global financial system for the longer term but should help to support confidence and improve the functioning of the markets."

The FSF report recommended reforms in institutional practice in several broad areas, including the following:

- increased oversight of capital, liquidity and risk management;
- enhanced transparency and evaluation;
- changes in the role and use of credit ratings;
- strengthening authorities' responsiveness to risk; and
- enhancing responsiveness of central banks to stress in the financial system.

"Recommendation" – A "Gentle Word"

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FSF chair Draghi characterized the term "recommendation" a "gentle word" to describe the report's contents. "In fact," he said, "some of these recommendations are actually policy decisions." Underscoring this point, the G-7 in their joint statement identified four recommendations that should be implemented within the next 100 days:

- market participants to robustly disclose risk;
- International Accounting Standards Board (IASB) and other standard setters to improve accounting and disclosure standards for off-balance sheet entities and to enhance guidance on fair value accounting, particularly for financial instruments in periods of stress;
- market participants to strengthen risk management practices, supported by market supervisors, including rigorous stress testing, and to strengthen their capital positions as needed; and
- by July 2008, the Basel Committee to issue revised liquidity risk management guidelines and the International Organization of Securities Commissions (IOSCO) to revise its code of conduct fundamentals for credit rating agencies.

In view of these recommendations, the aspects of the FSF report most likely to impact hedge funds and their managers include (1) the recommended increased oversight of capital, liquidity and risk management and (2) the demand for enhanced transparency in valuation.

Increased Oversight of Capital, Liquidity and Risk Management

The FSF recommended that the Basel II Accord (2004) be used, with a few improvements to strengthen resiliency, as the framework for incentivizing and monitoring the process by which banks and securities firms address the structural weaknesses highlighted by the current turmoil. The FSF also identified the implementation of Basel II by national governments as a priority. Basel II is an international accord dealing with the capital requirements for banking institutions negotiated by the Basel Committee on Banking Supervision (BCBS), a group of representatives from central banks and banking supervisory authorities from major economies. As part of the FSF's reform package, the BCBS committed to taking several further steps.

Capitalization. The BCBS committed to issuing specific proposals in 2008 to increase Basel II capital requirements for certain complex structured credit products. The BCBS and IOSCO will introduce additional capital charges for default and event risk in the trading books of banks and securities firm. The BCBS will issue proposals in 2008 to strengthen the capital treatment for banks' liquidity facilities to off-balance sheet ABCP conduits.

Liquidity. The BCBS promised to issue guidance by July 2008 for the supervision and management of liquidity risks, including guidance on identifying and measuring the full range of liquidity risks, including contingent liquidity risk associated with off-balance sheet vehicles, the use of stress tests, the role of supervisors, the management of intra-day liquidity risks arising from payment and settlement obligations both domestically and across borders, the management of foreign currency liquidity risk and cross-border flows and the role of disclosure and market discipline in improving liquidity risk management practices. The FSF advised national supervisors to closely check implementation of the updated guidance as part of their regular supervision and take measures if implementation is inadequate.

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Risk Management. The BCBS and individual oversight institutions will issue guidance over the course of 2008 and 2009 on risk management, including strengthening guidance relating to the management of firm-wide risks, including concentration risks, strengthening oversight of banks' stress testing practices for risk management and capital planning purposes, requiring banks to manage off-balance sheet exposures appropriately, improving risk management relating to the securitization business, improving existing guidance on the management of exposures to leveraged counterparties, strengthening the requirements or best practices for firms' processes for investment in structured products and mitigating the risks arising from remuneration policies.

OTC Derivatives. Supervisors plan to encourage market participants take steps to ensure that the settlement, legal and operational infrastructure for OTC derivatives is sound. 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 recently-developed cash settlement protocol. Trade novations should be automated, with rigorous standards for the accuracy and timeliness of trade data submissions and the timeliness of resolutions of trade matching errors. A longer-term plan for reliable OTC operational infrastructure should be developed.

Enhancing Transparency and Valuation

The FSF report calls for dramatic increases in the level of transparency to be made available by market participants to supervisors, especially in the area of risk disclosures.

Risk disclosures by market participants. The FSF report calls for robust disclosures by mid-2008 of market participants' risk exposures, and G-7 heads endorsed this timetable. Going forward, investors, financial industry representatives and auditors should develop principles of useful disclosures, and should meet semi-annually to discuss the key systemic risks. The BCBS intends to issue by 2009 further guidance to strengthen disclosure requirements under Basel II for securitization exposures, sponsorship of off-balance sheet vehicles, banks' liquidity commitments to ABCP conduits and valuations.

Accounting and disclosure standards for off-balance sheet entities. The FSF recommended that the IASB quickly improve accounting and disclosure standards for off-balance sheet vehicles and work with other standard setters toward international convergence.

Valuation. The FSF recommended that international standard setters enhance accounting, disclosure and audit guidance for valuations. Market participants' internal valuation processes and related supervisory guidance should be enhanced. The IASB intends to strengthen standards relating to disclosures of valuations, methodologies and the uncertainty associated with valuations. The IASB intends to set up an expert advisory panel in 2008 to enhance its guidance on valuing financial instruments in illiquid markets. Financial institutions should create rigorous valuations processes and make robust valuation disclosures.

Transparency in securitisation processes and markets. The FSF report called on market participants and securities regulators to expand the information provided about securitized products and their underlying assets. Originators, arrangers, distributors, managers and credit rating agencies should improve transparency at each stage of the securitization chain, including by enhancing and standardizing information on an initial and ongoing basis about the pools of assets underlying structured credit products. Investors and asset managers should, in the FSF's view, be responsible for obtaining from sponsors and underwriters of structured credit products

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access to better information about the risk characteristics of the credits, including information about the underlying asset pools. The FSF called for more transparency about the underwriting standards for the underlying assets of securitized products, and suggested that securities market regulators and participants work together to set up a comprehensive system for post-trade transparency in credit prices and volumes.

Enhanced Disclosures

The FSF report indicated that if its recommendations become policy, market participants may face enhanced disclosure obligations. Specifically, the FSF indicated that its recommendations could require the following categories of disclosure with respect to the listed assets classes or exposure types:

Special Purpose Entities (SPEs)

- size of SPE versus firm's total exposure;
- activities of SPE;
- reason for financial statement consolidation (if applicable);
- nature of exposure (sponsor, liquidity and/or credit enhancement provider);
- collateral type;
- geographic distribution of collateral;
- average maturities of collateral; and
- credit ratings of underlying collateral.

Other Subprime and Alt-A Exposure

- details on whole loans, residential mortgage-backed securities and derivatives;
- detail on credit quality (e.g., credit rating, loan-to-value ratios, performance measures);
- breakdown of subprime mortgage exposure by vintage; and
- sensitivity of valuation to changes in key assumptions and inputs.

Collateralized Debt Obligations

- size of CDOs versus firm's total exposure;
- breakdown of CDOs - type, tranche, rating, etc.;
- breakdown of collateral by type;
- breakdown of subprime mortgage exposure by vintage;
- hedges, including exposures to monolines, other counterparties;
- creditworthiness of hedge counterparties;
- credit valuation adjustments for specific counterparties; and
- sensitivity of valuation to changes in key assumptions and inputs.

Commercial Mortgage-Backed Securities

- breakdown of collateral by industry;
- breakdown of collateral by geography; and
- change in exposure from the prior period, including sales and write-downs.

Leveraged Finance

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- Funded exposure and unfunded commitments;
- change in exposure from prior period(s), including sales and write-downs;
- distribution of exposure by industry; and
- distribution of exposure by geography.

Credit Rating Agencies

The FSF report also recommends that credit rating agencies (CRAs) implement the IOSCO Code of Conduct Fundamentals for CRAs to manage conflicts of interests in rating structured products and improve the quality of the rating process. The FSF also recommends that CRAs differentiate ratings on structured credit products from those on bonds, and expand the information they provide with respect to structured credit products. Regulators will review the role of ratings in regulations and prudential frameworks.

The FSF report also offered a variety of ways that authorities and central bankers could better respond to stress in the financial system, including the creation by the end of 2008 of a “college of supervisors” for each of the largest global financial institutions.

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