15 October 2007

FSF Working Group on Market and Institutional Resilience

Preliminary Report to the G7 Finance Ministers and Central Bank Governors

I. The recent market turmoil

Since mid-June, financial markets worldwide have experienced protracted turbulence, characterised by a pullback in risk-taking, risk repricing and a drying up of liquidity. Difficulties in the US subprime mortgage market and in associated structured products set off the turbulence, but a wide range of markets and institutions have since been affected, notably markets for structured credit products more generally, leveraged loan markets, as well as commercial paper and interbank funding markets.

The turbulence spread through several reinforcing channels. These include valuation uncertainties and rating downgrades of mortgage-backed assets; a loss of confidence about ratings and valuations of other structured credit instruments; the erosion of funding for many asset-backed commercial paper conduits and other vehicles holding these instruments; the possibility that commercial banks would need to supply that funding (for reputational if not also contractual reasons) and their consequent marshalling of liquidity; and concerns about the impact of the actual and potential growth in balance sheets on bank capital ratios.

In recent weeks, liquidity in international markets has improved. Risk premia generally have fallen somewhat, and markets have started to differentiate more across instruments and institutions. But some markets, including the interbank, asset-backed commercial paper and some US secondary mortgage markets, are not working properly and the system remains vulnerable to further shocks.

While the disruption to the functioning of credit and money markets and potential risks for the real economy have been significant, it is worth noting that other components of the financial system have continued to function well. This is the case for the financial market infrastructure, including for the payment and settlement system. Also, to date, the hedge fund sector *per se* has not been as major a factor in the systemic problems as some might have expected. Furthermore, in comparison with previous episodes of increased global risk aversion, the capital cushions of major financial institutions thus far have held up well and emerging market economies have remained largely unaffected. These encouraging aspects are signs that efforts by the private and public sector to strengthen risk management practices and resilience have been beneficial in reducing the severity of the market turmoil.

II. Response

It is too early to draw conclusive lessons from the recent events. Nevertheless, the episode has pointed to a number of weaknesses in financial markets – some which were apparent beforehand and others which were not. Many of the issues that have arisen, notably in relation to the structured finance markets, will need to be addressed by market participants. Authorities will need to monitor and reinforce these efforts and identify areas where additional discipline is required to make markets more resilient.

Market participants have already taken some steps and are considering others to rebuild confidence in the structured finance market. These efforts include taking measures to obtain the data and analytical resources necessary to strengthen valuation approaches for structured finance products, enhancing disclosures about own risk exposures, and collaborative efforts to put the funding of structured investment vehicles on a more secure footing. Industry associations are working on sounder underpinnings for these markets. Credit rating agencies have acknowledged the need to review the information they receive from originators and they provide to investors in structured credit products. More broadly, private sector groups are working to enhance risk management and disclosure practices of hedge fund managers. We will closely monitor the progress of these efforts and the extent to which they result in changes in practices.

The scale of the turbulence has raised broad concerns that require careful consideration by financial policymakers nationally and internationally. Following a request by the G7 Treasury Deputies, the FSF has established a Working Group comprising national authorities, the chairs of international supervisory, regulatory and central bank bodies and the relevant international institutions as members.[1] The Group recently met in London and discussed its work plan and terms of reference. These are described below.

The Working Group has already started its work and will:

- develop a thorough diagnosis of the causes of recent events;
- identify the weaknesses that merit attention from policymakers; and
- recommend actions needed to enhance market discipline and institutional resilience.

The work of the international supervisory, regulatory and central bank committees will play an important role in the Group's work. The Group will facilitate co-ordination of workstreams and timelines across these bodies, ensure that any gaps in the work underway are addressed, and serve as a vehicle for reporting so that a coherent international picture of the official response can be conveyed. The Group will engage additional expertise, including private sector entities and organisations, as appropriate.

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[1] The Basel Committee on Banking Supervision (BCBS), the International Organization of Securities Commissions (IOSCO), the Committee on the Global Financial System (CGFS), the Committee on Payment and Settlement Systems (CPSS), the Joint Forum, the International Accounting Standards Board (IASB), the BIS, the ECB and the IMF are the international organisations that are members of the Working Group in addition to national authorities.

Among the areas that the Group will consider are risk management practices; valuation, risk disclosure and accounting; the role of credit rating agencies; and principles of prudential oversight.

- With regard to risk management practices, the turmoil has brought to light interactions between credit, market liquidity and funding liquidity risks that many regulated financial institutions did not anticipate. Among other areas, the Group will examine and draw implications regarding firms' liquidity and capital management practices, including with regard to contingent liquidity commitments and reputational risk, firms' stress-testing practices, and their risk management frameworks for complex products and non-bank counterparties.
- On valuation, risk disclosure and accounting, the recent turmoil has exposed shortcomings in the transparency and valuation of complex products. It has also posed questions about principles and practices for the consolidation of related off-balance sheet entities. The Group will examine where there is a need to promote improved transparency or other practices in these areas.
- Regarding the role of credit rating agencies, issues have been raised about potential conflicts of interest in activities of rating agencies, the role of credit rating agencies in the development of structured finance products and the uses made by investors of ratings of these products.
- Recent events have re-emphasised the benefits of prompt implementation of the Basel II capital guidelines, and implementation should remain the priority. After the transition to Basel II is further along, supervisors will need to consider whether recent events call for some refinements to Basel II. The Group will also consider what lessons to draw for the regulation and supervision of liquidity management and off-balance sheet risk exposures, and will identify any other areas in which supervisory oversight might need to be adapted to strengthen the financial system.

In some cases, work was already underway amongst FSF members and others in the public sector on these issues before the market turmoil. In other cases, new work programs or the acceleration of existing ones will be required.

Although the G7 did not request that the Group examine the following topics, the turmoil has also raised some issues regarding the authorities' capacity to respond to episodes of market turbulence. These relate to the tools and instruments available to central banks and supervisors in times of distress and coordination between them at the national and international level. There are a variety of ongoing initiatives looking at these issues. The Working Group will take stock of these and identify the key issues meriting attention going forward.

In the months ahead, the members of the Working Group will take forward diagnostic work in their areas of responsibility. The Working Group will continue to review and update the issues meriting attention, and set in train additional workstreams as we learn more about these events.

In the early part of next year, the Working Group will begin to consolidate these diagnoses and outline recommendations. The FSF Chair will make an interim report on the progress of the Group's work at your meeting in early February next year. Work to develop recommendations will continue into the spring. The FSF will review a draft report in late March and will deliver its final report in time for your April 2008 meeting.