FINANCIAL STABILITY FORUM

Press release

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Ref no:13/2009
2 April 2009

Financial Stability Forum Issues Recommendations and Principles to Strengthen Financial Systems

The Financial Stability Forum (FSF) issued reports today covering:

- Recommendations for Addressing Procyclicality in the Financial System;
- Principles for Sound Compensation Practices; and
- Principles for Cross-border Cooperation on Crisis Management.

The Forum also published today an update on the implementation of the recommendations contained in the FSF's April 2008 *Report on Enhancing Market and Institutional Resilience*.

These recommendations and principles, and the other work underway since April 2008, support key aspects of the Action Plan adopted by the G20 Leaders at their November 2008 Summit and have fed into the preparation of today's London Summit.

Brief descriptions of the four reports are presented below. The reports, as well as four background papers on procyclicality, are available on the FSF website, www.fsforum.org.

Addressing procyclicality in the financial system

The present crisis has demonstrated the disruptive effects of procyclicality – mutually reinforcing interactions between the financial and real sectors of the economy that tend to amplify business cycle fluctuations and cause or exacerbate financial instability. Addressing procyclicality in the financial system is an essential component of strengthening the macroprudential orientation of regulatory and supervisory frameworks.

The recommendations set out in this report mitigate mechanisms that amplify procyclicality in both good and bad times. They encompass a mix of quantitative/rules-based and discretionary measures that are interrelated and reinforce one another. They will be implemented over time once conditions in financial markets return to normal.

The recommendations are in the following three areas (see Annex 1):

- ***The bank capital framework.*** These recommendations were developed with the Basel Committee on Banking Supervision (BCBS) and are intended to mitigate the risk that the regulatory capital framework amplifies the transmission of shocks between the financial and real sectors. They include the development of countercyclical capital buffers and a supplementary non-risk based measure to contain bank leverage. An integrated package of measures covering the recommendations will be issued for consultation before the end of 2009.

- ***Bank loan loss provisions*****.** These recommendations reflect the view that earlier recognition of loan losses could have dampened cyclical moves in the current crisis, and that earlier identification of and provisioning for credit losses are consistent both with financial statement users' needs for transparency regarding changes in credit trends and with prudential objectives of safety and soundness. Recommended accounting and capital measures seek to achieve these objectives while encouraging sound provisioning practices and enhancing their transparency. The recommended measures result from dialogue among regulators, supervisors and accounting standard setters.
- ***Leverage and valuation*****.** These recommendations, which were developed with the Committee on the Global Financial System (CGFS), are intended to reduce procyclicality that has arisen from the interaction of leverage, funding mismatches and fair value accounting. They call on regulators and supervisors to obtain a clear and comprehensive picture of aggregate leverage and liquidity, and to use quantitative indicators and/or constraints on leverage and margins as macroprudential tools for supervisory purposes. Accounting standard setters are encouraged to improve approaches to valuation and financial instruments, in cooperation with prudential supervisors, so as to dampen adverse dynamics potentially associated with fair value accounting.

The FSF will monitor the implementation of these recommendations and continue to examine aspects of procyclicality in the system.

Principles for Sound Compensation Practices

The Principles require compensation practices in the financial industry to align employees' incentives with the long-term profitability of the firm. The Principles call for effective governance of compensation, and for compensation to be adjusted for all types of risk, to be symmetric with risk outcomes, and to be sensitive to the time horizon of risks. Implementation by firms will be reinforced through supervisory examinations at the national level (see Annex 2).

The Principles are intended to apply to all significant financial institutions but are especially critical for large, systemically important firms. Authorities expect evidence of material progress in the implementation of the Principles by the 2009 remuneration round. Full implementation should proceed as rapidly as possible and be sustained. Authorities, working through the FSF, will ensure coordination and consistency of approaches across jurisdictions.

Principles for Cross-border Cooperation on Crisis Management

Through these Principles, relevant authorities, including supervisory agencies, central banks and finance ministries, commit to cooperate both in making advanced preparations for dealing with financial crises and in managing them (see Annex 3).

The principles also commit national authorities from relevant countries to meet regularly alongside core supervisory colleges to consider together the specific issues and barriers to coordinated action that may arise in handling severe stress at specific firms, to share information where necessary and possible, and to ensure that firms develop adequate contingency plans. The FSF will act as a clearinghouse for experiences in information sharing and contingency planning for the benefit of all its members.

Update on the Implementation of the April 2008 FSF Recommendations

The update on progress in implementing the recommendations of the April 2008 *Report on Enhancing Market and Institutional Resilience* covers actions in five areas: (i) strengthening capital, liquidity and risk management in the financial system; (ii) enhancing transparency and valuation; (iii) changing the role and uses of credit ratings; (iv) strengthening the authorities' responsiveness to risks; and (v) putting in place robust arrangements for dealing with stress in the financial system.

The report summarises progress since October 2008, when the FSF published a follow-up report reviewing progress until then. The FSF notes that implementation progress since October 2008 has been extensive. In particular:

- Banking supervisors have published proposals for improving risk capture under Basel II, especially with regard to credit-related risks in the trading book. They have also published revised capital charges for liquidity commitments to off-balance sheet entities and for the re-securitised instruments.
- The BCBS published in January 2009 the standards for firm-wide risk management that supervisors will assess under Pillar 2 of the capital framework.
- Central counterparty clearing for over-the-counter credit derivatives has been launched in the US and in Europe.
- Consistent guidance has been issued by the International Accounting Standards Board (IASB) and the US Financial Accounting Standards Board (FASB) for fair valuation when markets are illiquid, and for the transfer of assets between valuation categories in rare circumstances. The IASB has also proposed revised standards for the consolidation and disclosure of off-balance sheet entities and related exposures. The IASB finalised in March 2009 an amendment to IFRS 7 setting forth enhancements to required risk and valuation disclosures for financial activities, including for complex financial instruments.
- The 2008 revisions of the International Organization of Securities Commissions (IOSCO) *Code of Conduct Fundamentals for Credit Rating Agencies* have been substantially implemented by several rating agencies including the three largest ones. IOSCO has also developed a model examination module to be used by the authorities that regulate and inspect credit rating agencies.
- Supervisory colleges have been established for most of the financial institutions identified by the FSF and many of them held face-to-face meetings by end-2008. `
- The International Association of Deposit Insurers and the BCBS issued in March a set of *Core Principles for Effective Deposit Insurance Systems*.

Progress in other areas for future work identified in the April 2008 report is documented in the three other reports published today.

Notes to editors

The four publications issued today reflect collaborative work by FSF members, including central banks, supervisory/regulatory authorities, finance ministries, the BCBS, the Bank for International Settlements (BIS), the CGFS, the International Monetary Fund (IMF), IOSCO, the IASB, and the Organisation of Economic Co-operation and Development. Non-members have also been involved in the certain aspects of this work. Insights have been gained, as well, from discussions with experts from the financial industry, analysts, audit firms, standards setters, the public sector and academia.

The FSF brings together national authorities responsible for financial stability in significant international financial centres, international financial institutions, sector-specific international groupings of regulators and supervisors, and committees of central bank experts. It was established by the G7 Finance Ministers and Central Bank Governors in 1999 to promote international financial stability through enhanced information exchange and international cooperation in financial market supervision and surveillance. The FSF decided in March 2009 to expand its membership to all G20 countries, as well as Spain and the European Commission. The FSF is chaired by Mario Draghi, Governor of the Bank of Italy. The FSF Secretariat is based at the BIS in Basel, Switzerland.

For further information on the FSF, its membership and other publications, visit the FSF website at www.fsforum.org.

Attachments:

- Annex 1: Overview of Recommendations on procyclicality
- Annex 2: Principles for Sound Compensation Practices
- Annex 3: Principles for Cross-border Cooperation on Crisis Management

Annex 1: Overview of Recommendations on Procyclicality

1. Capital

1.1. The BCBS should strengthen the regulatory capital framework so that the quality and level of capital in the banking system increase during strong economic conditions and can be drawn down during periods of economic and financial stress.

The BCBS should develop mechanisms by which the quality of the capital base and the buffers above the regulatory minimum are built up during periods of strong earnings growth so that they are available to absorb greater losses in stressful environments.

As part of this process, the BCBS will assess the appropriate balance between discretionary and non-discretionary measures. It will also develop standards for what constitutes a sound bank capital planning framework.

An important basis for such a countercyclical capital buffer is a clear definition of what constitutes high quality capital.

1.2. The BCBS should revise the market risk framework of Basel II to reduce the reliance on cyclical VaR-based capital estimates.

The BCBS should carry out a more fundamental review of the market risk framework, including the use of Value-at-Risk (VaR) estimates as the basis for the minimum capital requirement. A key objective should be to find ways to reduce the reliance on cyclical VaR-based capital estimates, for example by expanding the role of stress testing within the framework.

1.3. The BCBS should supplement the risk-based capital requirement with a simple, non-risk based measure to help contain the build-up of leverage in the banking system and put a floor under the Basel II framework.

This measure should complement the risk-based approach of Basel II and should be transparent and simple to implement; limit the build-up of leverage in the banking system during booms; put a floor under the risk-based measure that becomes binding if firms take on excessive leverage or attempt to arbitrage the risk-based regime; and not produce adverse incentives.

As part of this effort, the BCBS will assess how to address the impact of differences between International Financial Reporting standards (IFRS) and US Generally Accepted Accounting Principles (GAAP), the appropriate treatment of off-balance sheet exposures and guarantees, and the treatment of highly liquid government securities.

1.4. Supervisors should use the BCBS enhanced stress testing practices as a critical part of the Pillar 2 supervisory review process to validate the adequacy of banks' capital buffers above the minimum regulatory capital requirement.

Supervisors should use the sound principles for stress testing presented by the BCBS in January 2009 to assess the adequacy of banks' capital buffers above the regulatory minimum during periods of economic expansion, when financial market, credit and liquidity conditions appear benign, and when bank earnings are high. The BCBS will conduct an assessment of compliance with the principles once they have been finalised and implemented at banks.

1.5. The BCBS should, on a continuing basis, monitor the impact of the Basel II framework and make appropriate adjustments to dampen excessive cyclicality of the minimum capital requirements.

The BCBS is tracking the impact of the Basel II framework on the level and cyclicality of capital requirements through regular data collection.

In parallel, the BCBS should review mechanisms through which known channels of cyclicality in the minimum Pillar 1 capital requirement, such as migrations in credit scores, could be addressed. The BCBS is working to develop concrete proposals to mitigate any excessive impact of ratings migrations on regulatory capital requirements.

1.6. The BCBS should, on a continuing basis, carry out regular assessments of the risk coverage of the capital framework in relation to financial developments and banks' evolving risk profiles and make timely enhancements.

Reflecting the significant capital shortfalls that emerged at a number of banks during the crisis, the risk coverage of the capital framework needs to be improved, and three main areas have been identified: capital requirements for resecuritisations; the standardised capital requirement for short term liquidity lines to asset-backed commercial paper conduits and risk weights for general market disruption lines; and stressed VaR add-on and incremental risk charges to capture default and migration risk for unsecuritised credit products.

More broadly, the BCBS should strengthen the Basel II framework in (i) the treatment of counterparty credit risk under the three pillars of Basel II; and (ii) the role of external ratings.

The BCBS should carry out regular assessments of the need for future enhancements to the framework to ensure that banks' evolving risk profiles are captured in an appropriate manner.

2. Provisioning

2.1. The FASB and IASB should issue a statement that reiterates for relevant regulators, financial institutions and their auditors that existing standards require the use of judgement to determine an incurred loss for provisioning of loan losses.

The FSF determined that the incurred loss approach allows for considerable use of management's expert credit judgement to ensure that loan loss provisions reflect the credit losses inherent in loan portfolios, but banks have not always used this flexibility. Possible sources of the diversity in practice include: historical country practices, management biases, differing legal and tax requirements, influences of regulators and auditor practices. The wide range of practice was not perceived as a difference between US GAAP and IFRS, but rather, different application practices. Based on such a statement by the IASB and FASB, the diligence used by all institutions to incorporate reasonable judgments regarding the impact of factors that are likely to cause loan losses to differ from historical levels may improve practice and help lessen procyclicality while enhancing the consistency of information provided to investors.

2.2. The FASB and IASB should reconsider the incurred loss model by analysing alternative approaches for recognising and measuring loan losses that incorporate a broader range of available credit information. The FSF recommends that the FASB and IASB establish a resource group to provide input on technical issues and complete this project on an expedited basis.

Standards setters should reconsider their current loan loss provisioning requirements and related disclosures on an expedited basis, including by analysing fair value, expected loss and dynamic provisioning approaches.

2.3. The BCBS should undertake a review of Basel II to reduce or eliminate disincentives for establishing appropriate provisions for loan losses.

Certain features of the Basel II framework are potentially significant disincentives for improved provisioning practices. For example, the 1.25 percentage points and the 60 basis points constraints on the amounts of reserves that may be added to capital under the standardised and internal ratings-based approaches, respectively, may create a disincentive for banks whose level of provisions approach those thresholds.

2.4. The BCBS should undertake a review of Basel II to assess the adequacy of disclosure of loan loss provisioning under Pillar 3.

The BCBS should review and enhance the Pillar 3 disclosures about loan loss provisioning practices and related credit risk and credit losses in loan portfolios to improve the transparency of provisioning practices.

3. Valuation and leverage

3.1. Authorities should use quantitative indicators and/or constraints on leverage and margins as macroprudential tools for supervisory purposes.

3.1.1 Authorities should use quantitative indicators of leverage as guides for policy, both at the institution-specific and at the macroprudential (system-wide) level. On leverage ratios for banks, work by the BCBS to supplement the risk based capital requirement with a simple, non-risk based measure is welcome (see Recommendation 1.3).

A leverage ratio should be used as a vulnerability indicator and an instrument for supervisory and macroprudential policy. At the sectoral level, leverage ratios should be computed by national authorities for the main types of financial institutions to the extent they are of systemic importance.

3.1.2 Authorities should review enforcing minimum initial margins and haircuts for OTC derivatives and securities financing transactions.

Enforcing minimum initial margins for over-the-counter (OTC) derivatives and minimum haircuts or margins for securities financing transactions will reduce leverage in position taking, while requiring margins or haircuts to be relatively stable over the cycle will reduce the tendency for margining and collateral practices to create adverse feedback effects at times of market stress.

3.2. The BCBS and the CGFS should launch a joint research program to measure funding and liquidity risk attached to maturity transformation, enabling the pricing of liquidity risk in the financial system.

The BCBS and the CGFS should develop a research effort to address funding and liquidity risk, starting in 2009. A key component of this research agenda will be to define robust measures of funding and liquidity risk, which could assist assessments and pricing of liquidity risk by the private sector. Stress tests to gauge the probability and magnitude of a liquidity crisis in different market environments will be considered in this light.

3.3. Based on the conclusions of the above research program, the BIS and IMF could make available to authorities information on leverage and on maturity mismatches on a system-wide basis.

Following the completion of the research project under Recommendation 3.2, the FSF recommends that, on the basis of its findings, information be collected on leverage and maturity mismatches, on a coordinated international basis, including from off-balance sheet vehicles and money market funds. The BIS and IMF could jointly develop the conceptual framework for the data collection. Data could be collected by the BIS or the IMF.

3.4. Accounting standard setters and prudential supervisors should examine the use of valuation reserves or adjustments for fair valued financial instruments when data or modelling needed to support their valuation is weak.

Standard setters and supervisors should explore whether firms should be required to hold valuation reserves or to otherwise adjust valuations to avoid overstatement of income when significant uncertainty about valuation exists. For financial instruments that are not actively traded, insufficient market depth or reliance on valuation models using unobservable inputs that are difficult to verify may create considerable valuation uncertainty.

One solution could be to partially de-link the valuation process (in mark-to-market) from certain aspects of income and profit recognition when significant uncertainty exists. The size of the reserve or adjustment could be based on the degree of uncertainty created by the weakness in the data or underlying modelling approach. Increases and decreases in the reserve or adjustment should be fully transparent.

3.5. Accounting standard setters and prudential supervisors should examine possible changes to relevant standards to dampen adverse dynamics potentially associated with fair value accounting. Possible ways to reduce this potential impact include the following:

- ***Enhancing the accounting model so that the use of fair value accounting is carefully examined for financial instruments of credit intermediaries.***
- ***Transfers between financial asset categories.***
- ***Simplifying hedge accounting requirements.***

These efforts from the accounting standard setters should be undertaken in cooperation with prudential supervisors, including the BCBS. The BCBS should consider the implications of standards setters' efforts on capital measures.

Annex 2: Principles for Sound Compensation Practices

1. Effective governance of compensation

The board of directors of major financial firms should exercise good stewardship of their firms' compensation practices and ensure that compensation works in harmony with other practices to implement balanced risk postures. The Principles need to become ingrained over time into the culture of the entire organisation.

1. **The firm's board of directors must actively oversee the compensation system's design and operation.** The compensation system should not be primarily controlled by the chief executive officer and management team. Relevant board members and employees must have independence and expertise in risk management and compensation.

2. **The firm's board of directors must monitor and review the compensation system to ensure the system operates as intended.** The compensation system should include controls. The practical operation of the system should be regularly reviewed for compliance with design policies and procedures. Compensation outcomes, risk measurements, and risk outcomes should be regularly reviewed for consistency with intentions.

3. **Staff engaged in financial and risk control must be independent, have appropriate authority, and be compensated in a manner that is independent of the business areas they oversee and commensurate with their key role in the firm.** Effective independence and appropriate authority of such staff are necessary to preserve the integrity of financial and risk management's influence on incentive compensation.

2. Effective alignment of compensation with prudent risk taking

An employee's compensation should take account of the risks that the employee takes on behalf of the firm. Compensation should take into consideration prospective risks and risk outcomes that are already realised.

4. **Compensation must be adjusted for all types of risk.** Two employees who generate the same short-run profit but take different amounts of risk on behalf of their firm should not be treated the same by the compensation system. In general, both quantitative measures and human judgment should play a role in determining risk adjustments. Risk adjustments should account for all types of risk, including difficult-to-measure risks such as liquidity risk, reputation risk and cost of capital.

5. **Compensation outcomes must be symmetric with risk outcomes.** Compensation systems should link the size of the bonus pool to the overall performance of the firm. Employees' incentive payments should be linked to the contribution of the individual and business to such performance. Bonuses should diminish or disappear in the event of poor firm, divisional or business unit performance.

6. **Compensation payout schedules must be sensitive to the time horizon of risks.** Profits and losses of different activities of a financial firm are realized over different periods of time. Variable compensation payments should be deferred accordingly. Payments should not be finalized over short periods where risks are realized over long

periods. Management should question payouts for income that cannot be realized or whose likelihood of realisation remains uncertain at the time of payout.

7. **The mix of cash, equity and other forms of compensation must be consistent with risk alignment.** The mix will vary depending on the employee's position and role. The firm should be able to explain the rationale for its mix.

3. Effective supervisory oversight and engagement by stakeholders

Firms should demonstrate to the satisfaction of their regulators and other stakeholders that their compensation policies are sound. As with other aspects of risk management and governance, supervisors should take rigorous action when deficiencies are discovered.

8. **Supervisory review of compensation practices must be rigorous and sustained, and deficiencies must be addressed promptly with supervisory action.** Supervisors should include compensation practices in their risk assessment of firms, and firms should work constructively with supervisors to ensure their practices conform with the Principles. Regulations and supervisory practices will naturally differ across jurisdictions and potentially among authorities within a country. Nevertheless, all supervisors should strive for effective review and intervention. National authorities, working through the FSF, will ensure even application across domestic financial institutions and jurisdictions.

9. **Firms must disclose clear, comprehensive and timely information about their compensation practices to facilitate constructive engagement by all stakeholders.** Stakeholders need to be able to evaluate the quality of support for the firm's strategy and risk posture. Appropriate disclosure related to risk management and other control systems will enable a firm's counterparties to make informed decisions about their business relations with the firm. Supervisors should have access to all information they need to evaluate the conformance of practice to the Principles.

Annex 3: Principles for Cross-border Cooperation on Crisis Management

1. The objective of financial crisis management is to seek to prevent serious domestic or international financial instability that would have an adverse impact on the real economy. In so doing, authorities will be mindful of the impact interventions may have on the public purse and will, as far as possible:

   - maintain incentives for financial institutions to behave prudently,
   - promote private sector solutions and use public sector interventions only when this is necessary to preserve financial stability, and
   - maintain a level competitive international playing field, in the spirit of the Basel Accord.

2. While financial crisis management remains a domestic competence, the growing interactions between national financial systems require international cooperation by authorities. Home authorities should lead work with the key host authorities to look at the practical barriers to achieving coordinated action in the event of a financial crisis involving specific firms, for every cross-border bank identified by the FSF as having or going to have a core supervisory college. Some of these barriers will be common to more than one firm, and these principles suggest common support tools. Home authorities of other important banks and other financial firms that have systemic implications in several countries may also wish to coordinate the development of crisis management arrangements around those firms.

In preparing for financial crises, authorities will:

3. Develop common support tools for managing a cross-border financial crisis, including: these principles; a key data list; a common language for assessing systemic implications (drawing on those developed by the EU and by national authorities); a document that authorities can draw on when considering together the specific issues that may arise in handling severe stress at specific firms; and an experience library, which pools key lessons from different crises.

4. Meet at least annually to consider together the specific issues and barriers to coordinated action that may arise in handling severe stress at specific firms. Home supervisors will coordinate this process, which will directly involve the relevant authorities (including supervisors, central banks, finance ministries) in countries represented on a cross-border bank's core supervisory college. This process will be done for every bank with an FSF core supervisory college, but authorities may also cooperate around other specific cross-border firms as appropriate.

5. Home authorities will work to ensure that all countries in which the firm has systemic importance are kept informed of the arrangements for crisis management developed by the core college country authorities (because all countries in which a bank has operations are not represented on core colleges).

6. Share, at minimum, the following information, where permitted by legal frameworks and confidentiality issues:

   - The firm's group structure, including any legal, financial and operational intragroup dependencies, for example arising from the centralisation of liquidity or risk management,

- The interlinkages between the firm and financial system (e.g., in markets, infrastructures) in each jurisdiction in which it operates,
- The firm's contingency funding arrangements,
- Potential impediments to a coordinated solution stemming from the legal frameworks and bank resolution procedures of the countries in which the firm operates.

7. Ensure that firms are capable of supplying in a timely fashion the information that may be required by the authorities in managing a financial crisis.
8. Strongly encourage firms to maintain contingency plans and procedures for use in a wind-down situation (e.g., factsheets that could easily be used by insolvency practitioners), and regularly review them to ensure that they remain accurate and adequate.
9. Ensure that firms maintain robust, up to date, funding plans that are practical to use in stressed market scenarios, including where large amounts of foreign currency are required. When reviewing firms' plans, authorities will together consider the presumptions made in the plans regarding possible national authority responses (e.g., ring-fencing).
10. Seek to remove any practical barriers to efficient, internationally coordinated resolutions identified when developing contingency plans, working together where necessary and, where they reveal issues that may have broader implications for other firms in general, refer them to the FSF and other relevant international committee(s) (e.g. BCBS, IOSCO, CPSS, IAIS etc).

In managing a financial crisis, authorities will:

11. Strive to find internationally coordinated solutions that take account of the impact of the crisis on the financial systems and real economies of other countries, drawing on information, arrangements and plans developed ex-ante. These coordinated solutions will most likely be mainly driven by groups of authorities of the most directly involved countries.
12. Share national assessments of systemic implications, using the agreed framework.
13. Share information as freely as practicable with relevant authorities from an early stage in a way that does not materially compromise the prospect of a successful resolution and subject to the application of rules on confidentiality.
14. If a fully coordinated solution is not possible, discuss as promptly as possible national measures with other relevant authorities.
15. For purposes of clarity and coordination, share their plans for public communication with the appropriate authorities from other affected jurisdictions.

These principles are based in part on the recommendations in the FSF, BCBS, IOSCO and G10's Joint Task Force Report (2001) on Winding Down an LCFI, and EU principles for financial crisis management.