# Statement by Mario Draghi

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The Financial Stability Forum (FSF) presented yesterday its Report on Enhancing Market and Institutional Resilience to the G7 Finance Ministers and central bank Governors. The report identifies causes and weaknesses that have contributed to the turbulence in the financial system and makes recommendations to address them. The key recommendations and plans for overseeing implementation are outlined below, following a summary of the conclusions from the FSF's discussion at its Rome meeting on 28-29 March 2008 of current challenges in financial markets and the steps that are being taken to address them.

### Financial system risks and responses

The financial system faces a number of significant near-term challenges. With many securitisation markets effectively closed, assets are accumulating on bank balance sheets. Together with valuation losses on mortgages and other assets, this is straining capital positions and contributing to tightening credit conditions. Hoarding of liquidity and counterparty concerns are leading to a shortening of the maturity of banks' funding profiles, causing severe strains in interbank and other lending markets.

While the necessary deleveraging has been ongoing since last summer, the process is being complicated by the lack of transparency and valuation difficulties for some credit instruments. Financial institutions should continue enhancing their disclosures of risk exposures and refining valuation judgments concerning structured credit activities and poorly performing assets on and off the balance sheet. Banks, securities firms and financial guarantors have made progress in replenishing capital levels and should continue to do so where necessary. The raising of capital and the repairing of credit markets will facilitate balance-sheet management by financial institutions and help to counteract the potential cycle of financial market and economic weakness.

National authorities have taken a variety of exceptional steps to facilitate adjustment and to dampen the impact on the real economy. Authorities in the main financial centres are in continuous contact and closely monitoring developments. Supervisors are working with firms so that risks in current market circumstances are effectively identified and appropriately managed. Central banks have provided liquidity to address market pressures, both individually and in concert, and will continue to do so as long as needed. Authorities will also act cooperatively and swiftly to investigate and penalise market abuse or manipulation.

While national authorities may continue to consider short-term policy responses should conditions warrant it, to restore confidence in the soundness of markets and institutions it is essential that we take further steps now to enhance the resilience of the global system.

### Report on enhancing market and institutional resilience

The findings and recommendations in the FSF's report are the product of an intensive and collaborative effort of the main international bodies and national authorities in key financial centres. Insights have been gained, as well, from private sector market participants. The report

makes concrete, operational recommendations and sets out timetables for their implementation. Among the key recommendations[1] are the following:

***Strengthened prudential oversight of capital, liquidity and risk management***

Basel II provides the appropriate framework for supervisors to incentivise and monitor the process by banks and securities firms to address the weaknesses that the turmoil has revealed. Its implementation should proceed with priority. But, to improve resilience, elements of Basel II need to be strengthened. A fundamental review of supervisory liquidity guidelines is also taking place.

It is especially important to strengthen the prudential framework for securitisation and off-balance sheet activities. Initiatives are also required to make the operational infrastructure for over-the-counter (OTC) derivatives more robust.

*Capital requirements*

Supervisors, working through the Basel Committee, will enhance the Basel II capital treatment of structured credit and off-balance sheet activities.

- The Basel Committee will issue proposals in 2008 to:
  - raise capital requirements for certain complex structured credit products such as collateralized debt obligations of asset-backed securities;
  - introduce, together with IOSCO, additional capital requirements for credit exposures in the banks' and securities firms' trading books; and
  - strengthen the capital treatment for banks' liquidity facilities to off-balance sheet asset-backed commercial paper (ABCP) conduits.
- Supervisors will assess the impact of Basel II implementation on banks' capital levels and will decide whether additional capital buffers are needed.
- Supervisors will continue to update the risk parameters and other provisions of Basel II and will rigorously assess banks' compliance with the framework. They will assess the cyclicality of the Basel II framework.
- Insurance supervisors should strengthen the regulatory and capital framework for monoline insurers in relation to structured credit.

*Liquidity Management*

The turmoil demonstrated the central importance that effective liquidity risk management practices and high liquidity buffers play in maintaining institutional and systemic resilience in the face of shocks.

- The Basel Committee will issue for consultation sound practice guidance on the management and supervision of liquidity by July 2008. It will cover the following areas:
  - the identification and measurement of the full range of liquidity risks, including contingent liquidity risk associated with off-balance sheet vehicles;
  - stress tests, including greater emphasis on market-wide stresses and the linkage of stress tests to contingency funding plans;
  - the role of supervisors, including communication and cooperation between supervisors, in strengthening liquidity risk management practices;

[1] This is an informal summary; the full text of the complete set of recommendations is in the report.

  - the management of intra-day liquidity risks arising from payment and settlement obligations both domestically and across borders;
  - cross-border flows and the management of foreign currency liquidity risk; and
  - the role of disclosure and market discipline in promoting improved liquidity risk management practices.

- 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.
- 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.

*Supervisory oversight of risk management, including of off-balance sheet entities*

Firms' boards and senior management must strengthen risk management practices according to the lessons they have learned from the turmoil. Supervisors for their part will act to monitor the progress of banks and securities firms in strengthening risk management and capital planning practices.

- 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.

The Basel Committee will issue further guidance for supervisory review over the course of 2008 and 2009 in a number of areas, as described below.

- To strengthen guidance relating to the management of firm-wide risks, including concentration risks.
- To strengthen stress testing guidance for risk management and capital planning purposes.
- To require banks to manage off-balance sheet exposures appropriately.
- To strengthen risk management relating to the securitisation business.
- To strengthen their existing guidance on the management of exposures to leveraged counterparties.

Individual jurisdictions will also issue strengthened guidance on these issues.

*Operational infrastructure for OTC derivatives*

Market participants should act promptly to ensure that the settlement, legal and operational infrastructure underlying OTC derivatives markets is sound.

- Market participants should amend standard credit derivative trade documentation in accordance with the terms of the cash settlement protocol that has been developed, but not yet incorporated into standard documentation.
- 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.
- The financial industry should develop a longer-term plan for a reliable operational infrastructure supporting OTC derivatives.

***Enhancing transparency and valuation***

This period of market turmoil and illiquidity has highlighted the importance to market confidence of reliable valuations and useful disclosures of the risks associated with structured credit products and off-balance sheet entities.

*Risk disclosure by market participants*

Enhanced disclosures by financial firms of more meaningful and consistent quantitative and qualitative information about risk exposures, valuations, off-balance sheet entities and related policies are important to restore market confidence.

- 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.[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.
- The BCBS will issue by 2009 further guidance to strengthen disclosure requirements under Pillar 3 of Basel II for securitisation exposures, sponsorship of off-balance sheet vehicles, liquidity commitments to ABCP conduits, and valuations.

*Accounting and disclosure standards for off-balance sheet vehicles*

The build-up and subsequent revelation of significant off-balance sheet exposures has highlighted the need for clarity about the treatment of off-balance sheet entities and about the risks they pose to financial institutions.

- 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.

*Valuation*

Potential weaknesses in valuation practices and disclosures, and the difficulties associated with fair valuation in circumstances in which markets become unavailable, have become apparent from the turmoil. International standard setters should enhance accounting, disclosure and audit guidance for valuations. Firms' valuation processes and related supervisory guidance should be enhanced. To address these issues:

- The IASB will strengthen its standards to achieve better disclosures about valuations, methodologies and the uncertainty associated with valuations.
- 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.
- Financial institutions should establish rigorous valuation processes and make robust valuation disclosures, including disclosure of valuation methodologies and the uncertainty associated with valuations.
- The Basel Committee will issue for consultation guidance to enhance the supervisory assessment of banks' valuation processes and reinforce sound practices in 2008.
- The International Auditing and Assurance Standards Board (IAASB), major national audit standard setters and relevant regulators should consider the lessons learned

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[2] In its report to the FSF, the Senior Supervisors Group analysed year-end 2007 disclosures by a sample of large internationally-oriented banks and securities firms. The report "Leading-Practice Disclosures for Selected Exposures", April 2008, can be obtained at the following website: http://www.newyorkfed.org/newsevents/news/banking/2008/SSG_Leading_Practice_Disclosures.pdf

during the market turmoil and, where necessary, enhance the guidance for audits of valuations of complex or illiquid financial products and related disclosures.

*Transparency in securitisation processes and markets*

Market practices regarding initial and ongoing disclosures relating to structured products, both in public and private markets, will need to improve in the light of recent events. Securities market regulators will work with market participants to this end. IOSCO will assess the progress made by end-2008.

- 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.

***Changes in the role and uses of credit ratings***

Credit rating agencies (CRAs) 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 CRAs contributed both to the build up to and the unfolding of recent events. CRAs have undertaken a series of actions to draw lessons for their internal governance and operational practices. The steps are welcome but more is needed.

*Quality of the rating process*

CRAs should improve the quality of the rating process and manage conflicts of interest in rating structured products. To this end:

- IOSCO will revise its Code of Conduct Fundamentals for Credit Rating Agencies by mid-2008.
- 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.

*Differentiated ratings and expanded information on structured products*

Structured products have different credit risk properties from traditional corporate debt ratings.

- 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 should expand the initial and ongoing information that they provide on the risk characteristics of structured products.

*CRA assessment of underlying data quality*

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. CRAs should:

- require underwriters to provide representations about the level and scope of due diligence that they have performed on the underlying assets;
- adopt reasonable measures to ensure that the information they use is of sufficient quality to support a credible rating;
- establish an independent function to review the feasibility of providing a credit rating for new products materially different from those currently rated;

- refrain from rating a security where the complexity or structure of a new type of structured products or the lack of robust data about underlying assets raise serious questions as to whether CRAs can determine a credit rating;
- disclose what qualitative reviews they perform on originators' underwriting standards; and
- take into account the information on the portion of underlying assets held by originators when rating securitised products.

*Use of ratings by investors and regulators*

Enhanced disclosure by CRAs is useful only if investors make appropriate use of the information for their due diligence and risk management. Investors should address their over-reliance on ratings.

- 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.

Credit ratings are referred to in various regulatory and supervisory frameworks both at international and national level.

- 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.

***Strengthening authorities' responsiveness to risk***

Some of the weaknesses that have come to light were known or suspected within the community of financial authorities before the turmoil began. Much work was underway at international levels that – if already implemented – might have tempered the scale of the problems experienced. However, international processes for agreeing and implementing regulatory and supervisory responses have in some cases been too slow given the pace of innovation in financial markets.

*Translating risk analysis into action*

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.

- 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.
- 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.

*Improving information exchange and cooperation among authorities*

Authorities' exchange of information and cooperation in the development of good practices will be improved at national and international levels.

- 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. Supervisors involved in these colleges should conduct an exercise, by 2009, to draw lessons about good practices in operating colleges.

- Supervisory exchange of information and coordination in the development of best practice benchmarks should be improved at both national and international levels.
- 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.
- To facilitate central bank mitigation of market liquidity strains, large banks will be required to share their liquidity contingency plans with relevant central banks.

*Enhancing international bodies' policy work*

International bodies will enhance the speed, prioritisation and coordination of their policy development work.

- 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.
- National supervisors will, as part of their regular supervision, take additional steps to check the implementation of guidance issued by international committees.
- The FSF will encourage joint strategic reviews by standard-setting committees to better ensure policy development is coordinated and focused on priorities.
- 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.

***Robust arrangements for dealing with stress in the financial system***

*Central bank operations*

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. Overall, central banks' responses to the liquidity tensions caused by the financial market turmoil have been reasonably effective at relieving pressures in interbank funding markets. They could not, and were not intended to, address the underlying causes of the problems, which lay well beyond the scope of central banks' reserve-providing operations. Nevertheless, the experience offers some lessons that could lead in some cases to a revision of central bank operational objectives and policy instruments.

- 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.
- 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 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.
- To deal with stressed situations, central banks should consider establishing mechanisms designed for meeting frictional funding needs that are less subject to stigma.

- 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.

*Arrangements for dealing with weak banks*

National arrangements for dealing with weak banks have been tested by recent events and are the subject of review in some countries. 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.

- 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.
- Internationally, authorities should accelerate work to share information on national arrangements for dealing with problem banks and catalogue cross-border issues, and then to decide how to address the identified challenges.
- Authorities should agree a set of international principles for deposit insurance systems. National deposit insurance arrangements should be reviewed against these agreed international principles, and authorities should strengthen arrangements where needed.
- 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.
- 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.

## Hedge fund industry

In its 2007 report on highly leveraged institutions the FSF called on the hedge fund industry to review and enhance sound practice benchmarks. In response, best practice standards have been developed by the UK-based Hedge Fund Working Group, and are to be released shortly by a similar US-based group. The FSF will review regular reports on the adoption of the standards by the hedge fund industry and how well these standards are meeting the objectives of increasing transparency and improving risk management practices.