1. G20 Working Group Issues: Reform and Rules

This section assesses and gives recommendations for G20 Working Group I: 'Enhancing Sound Regulation and Strengthening Transparency' and Group II: 'Reinforcing International Cooperation and Promoting Integrity in Financial Markets'

Executive Summary

Barbara Ridpath

The interconnectedness of the world's financial system and the interdependence of its players have become evident in the first clear crisis of globalization. The critical question this raises is whether we have a credible infrastructure for such a globally integrated financial system, and if we do not, what is needed to establish such an infrastructure. The submissions in this section pick up several, but by no means all, the areas in which work is needed if we are to come out of this financial crisis with a sounder, more robust financial architecture.

The contributions vary distinctly between those submitted for the US-based working group and those prepared for the London-based seminar, with the former having a strong focus on the US financial system. This is natural given the size of the US economy and the fragmentation of its regulatory structures. The US financial system is both large enough to consider its issues in isolation, and too large and important to do so without affecting the likelihood of effective solutions on an international basis. US policy-makers and legislators will have to ensure they focus sufficiently on improvements in the global financial and regulatory architecture as well as their domestic institutions for the forthcoming G20 meetings to produce lasting value in this crisis.

Just as active US participation is a precondition for success, so too is an understanding of what policy-makers are trying to achieve with financial regulation. There is still enormous work to be done on causality and lessons from the crisis, but it is worth taking the time to understand these, and to agree the objectives and purpose of regulation before anyone sets out to change it. Without such consensus, whatever is decided will be not be implemented effectively among the signatories, as each will interpret the new regulations in a way that suits its own purpose. In addition, it is important to recognize that no regulation or regulatory system is going to prevent another crisis. At best, this work can prevent the same type of crisis from recurring, or improve the early warning signals for the next one.

The third and perhaps most difficult precondition is that those attending the G20 meetings in London in April must try to put aside national interests to arrive at a regulatory and supervisory structure that aligns with the actual shape of the financial industry. While some still non-existent form of international regulation for major institutions may or may not be an improvement on the current domestic supervisors, it is clear that for the key institutions (many of which earn well over half their income outside their home markets), existing domestic supervision no longer fits their business model or geographic reach. The corollary to this is that any deposit guarantee system for these institutions, and any legal framework for bank rescue or insolvency, would also need to be cross-border – a very difficult concept indeed.

Subjects that the authors in these two working groups were asked to address elicited a wide variety of views and recommendations. While consensus was not reached on all issues, ideas coalesced around several key themes. The recommendations for which there was broad agreement are divided between those that can be implemented in the near term, and those that are either more 'architectural' in nature, or require further study. The latter are of no less importance, and should be added to future agendas. The individual submissions contain a wealth of further ideas that are worthy of study.

Bold Action for the G20 Summit

Douglas Rediker

With the London Summit rapidly approaching, I urge participants to take bold steps to address the fundamental structural issues in global finance that have, in part at least, led to the current economic crisis. I recognize that there remains a debate between those who believe that the current economic environment compels a dramatic rethink of the foundations, systems and structures upon which the global economy operates, and those who believe that such sweeping reforms are both unnecessary and politically impossible. In short, there are those who seek to begin the process of crafting a 'new Bretton Woods' and those who seek to ban the use of that phrase altogether.

I fall into the former camp.

The global financial sector is in need of structural reform. I believe that the current economic crisis provides an opportunity to reshape the global financial system in ways that more accurately reflect the global nature and risks inherent in 21st-century banking, finance and capital flows. The leaders at the London Summit should collectively announce one or more bold steps to demonstrate that this will not be an exercise in 'kicking the can down the road' but rather a recognition both of what is at stake and that now is the time to frame a global collective response.

Participants at the London summit are widely representative. Given the unofficial nature of the London Summit and the G20 – a group with no formal voting rules, enforcement power or vetoes – the gathering represents a true 'free market' where there is competition for ideas, creativity and leadership. It provides the perfect opportunity for a 21st-century successor to the intellectual and creative leadership of John Maynard Keynes to emerge.

To be successful, it is imperative that the United States play an active leadership role at the London Summit. The US has a unique role. It is the world's largest economy and the incumbent provider of global economic stability and ballast – through the size of its market and the reserve currency status of the US dollar, and as the world's leading financial centre and capital market. The failure of the US to assume a leadership role, especially with the presence of President Obama, would undoubtedly be seen as an opportunity missed.

Thus far, publicly at least, the most innovative and bold structural proposals have come from Europe, where a recent report by the High Level Group on Financial Supervision in the EU, under the direction of Jacques de Larosière, contains some very worthy, realistic and detailed recommendations. Unofficial groups, such as the G30 Financial Reform Working Group chaired by Paul Volcker, have similarly issued reports which I urge summit participants to review carefully and consider seriously. While I will not take up space here to repeat the specific recommendations of these two reports, I point to them as examples of the type of thinking that should be in evidence at the London Summit. In particular, I note the EU recommendation for the creation of a European Systemic Risk Council. The proposal is important because it seeks to address the systemic nature of risk, which underpins the existing financial system, and also because of its inherent inconsistency – which, in this instance, I consider a virtue. It is inconsistent because if the risk is systemic, then, by definition, it cannot be limited to Europe but must in fact encompass the global 'system'. That is a virtue, because it is a proposal which can be scaled to include a commitment by all London Summit participants – not just those who are members of the EU.

I urge participants to expand the possibilities for cross-border, global structural initiatives to address a crisis, the scale of which is already beyond anything considered possible only months ago. Failure to do so may well be seen in the future as a failure of imagination.

While not attempting to put forward comprehensive recommendations for such bold reforms, I would nevertheless like to propose certain areas for consideration.

I believe that Summit participants should embrace a deeper exploration of how 'risk' is integrated into the global financial system. Risk is the cornerstone of our financial system, but how it is treated is one of the most misunderstood aspects of what is at the very core of needed reforms.

As governments play an increasingly large role in the global financial system, it is imperative that those proposing reforms consider the enormous differences between those who approach risk as lawyers, politicians and policy-makers – for whom, in general, risk is something to be avoided and/or mitigated – and those in the financial sector, for whom it is something to be valued and managed. That distinction is of enormous consequence. Any proposals to reform the global financial system must take into account these fundamentally different approaches to risk.

This may ultimately result in a bifurcated financial system in which the more risk-averse are drawn to a more traditional banking model, and where the systemic nature of the banking sector makes it worthy of government intervention and taxpayer support. Those entities that seek to take on more sophisticated financial-sector activities, wherein risk is valued and managed, would be excluded from the banking sector and would fall into a non-bank financial services sector. As proposed in the G30 report and elsewhere, there are a number of different proposals to ensure that this sector is regulated on a globally coordinated basis to ensure that innovation is not destroyed but systemic threats are kept under control. These proposals need to be considered in great detail.

A further observation is that, to be truly effective, supervision of the global financial system requires not only coordinated supervision but coordinated enforcement. The global nature of capital flows and the risk of regulatory arbitrage require that specific and enforceable sanctions are coordinated on a global basis. This is not a call for a 'super-regulator', but it is a call for individual countries to recognize that sophisticated financial professionals are paid to execute transactions to create revenue and profit from the opportunities that such arbitrage presents. To expect the individuals or the firms that employ them to do otherwise is to misunderstand their fundamental job description.

I recommend consideration of the recognition that those who engage in the provision of banking services are acting in a capacity that is crucial to the successful functioning of national and international society.

It is for this reason that governments around the world have been compelled to provide enormous amounts of capital and other support to the banking sector in the recent turmoil and trauma. In this regard, it should not be unrealistic to expect those who provide these crucial services to be individually licensed (not just regulated) to do so – as is the case with lawyers, doctors and other professional service providers. As part of this reconsideration of the role of financial professionals, I recommend consideration of a code of professional responsibility for those engaged in certain banking and financial activities.

As the system is currently constituted, the responsibility for risk management rests primarily with the institution, not the individual. When combined with individual incentive structures that virtually invite risk-taking beyond what might be considered prudent for the institution or, ultimately, the financial system as a whole, the structure provides limited personal responsibility with enormous potential reward. Executive compensation caps do not fully address this.

While I strongly support much needed reforms to existing incentive and compensation structures, I further recommend the adoption of a set of basic, but binding, professional guidelines with which individual financial services professionals' behaviour should comply. This would at least begin to address a fundamental structural weakness in the current financial system, which is riddled with inherent conflicts. Unless we change the individual's responsibilities as well as incentives, the reforms necessary to the financial system may well fail to address fundamental issues.[1]

The global economic climate has deteriorated significantly since the November 2008 G20 summit. The issues

1. Unless the regulation, incentives and responsibilities of the financial services industry are changed, then even a return to economic growth and a restored housing sector will not fundamentally address the causes of the current crisis. Financial professionals are paid enormous sums to structure, sell and trade complex financial products. The fact that housing was the underlying asset upon which many of these structures were based does not mean that a similar bubble could not occur with another underlying asset. Clearly the size of the housing market made this crisis worse than it might otherwise have been, but fixing housing will not fix the financial system. Had it not been housing, it could have been consumer debt, credit cards or possibly something else that would have been ripe to serve as the underlying asset around which an unregulated culture of derivatives and securitized products would have been created.

become more serious by the day. I fully recognize how difficult these issues are and further how complicated it is to coordinate even a simple meeting of world leaders – much less one as crucial (and large) as the London Summit. An enormous task has been set before the countries that will be participating and leading the effort. But it is precisely because the global economic crisis has become so severe that bold action is required. Countries must seek to find common ground.

Given the magnitude and scale of the issues now confronting summit participants, those officials tasked with its preparation should not feel bound to adhere strictly to the agenda and working groups created four months ago. Those seeking to take an active leadership role in solving this crisis, in particular the United States, should consider bold steps and proposed revisions to that agenda to more comprehensively reflect the current global economic crisis.

Now is not the time for caution, but rather the time for bold assertion of leadership, ideally by the United States, but hopefully with the collective support of the global community. There is much at stake.

The G20 Agenda: Financial Standards and Regulation

Nicolas Véron

Representing about two-thirds of the world's population, four-fifths of world trade, and nine-tenths of world GDP or market capitalization, the G20 is strong on legitimacy.[1] But the very diversity of its constituent countries means it cannot act as an executive body, something that even the smaller and more homogeneous G7 always struggled to be. Thus the G20 cannot aim at running global financial regulation itself. Nor can it realistically empower one single institution, whether the International Monetary Fund, Financial Stability Forum (FSF) or any other, to play an overall coordinating role, as preparations for the November summit made quite clear. Rather, the G20 should rely on specialized global institutions for tackling individual challenges for which national or regional responses are insufficient.

In such an approach, the role of the G20 in economic and financial regulation will be to endorse and empower such institutions, which include the FSF, the Basel Committee on Banking Supervision (BCBS), and the International Accounting Standards Board (IASB), as well as global treaty-based organizations such as the IMF or World Trade Organization; to ensure these institutions' governance makes them legitimate enough to be effective; to foster initiatives to fill gaps in the extant regulatory landscape; and to help the resolution of differences in cases of overlapping or conflicting mandates. This is consistent with the inherently political and non-specialized nature of the G20, now that its meetings are conducted at the level of heads of state and of government.

The following remarks are focused on three specific issues within the scope of the current G20 working groups on 'enhancing sound regulation and strengthening transparency' and 'reinforcing international cooperation and promoting integrity in financial markets'.

Prudential standards

The Basel II capital accord is widely recognized as a marked improvement on pre-existing arrangements. It cannot be blamed for a crisis that originated before its implementation. However, several tenets of Basel 2 – including its reliance on banks' internal risk measurements and on credit ratings, or its risk-weighting of property-based financial instruments – have been called into question by the early lessons from the crisis, and will require revision. Moreover, the crisis has underlined the importance of multi-year financial cycles and has exposed the potential procyclical effect of capital regulation. Thus the setting of prudential standards will be under the spotlight in the years to come.

This will inevitably lead to questioning the governance and due process of standard-setting within the BCBS. The committee currently includes 13 countries: Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Spain, Sweden, Switzerland, the United Kingdom and the United States. The absence of China from this list has become an anomaly since large Chinese banks have risen to the top ranks globally, and if China is included there may be pressure to include other large emerging countries too.[2] Separately, the standard-setting process has been criticized in retrospect as having been somewhat captured by the global banking industry, raising questions as to the

1. It is assumed here that the G20 format remains the reference for regular high-level gatherings on economic and financial issues – even if more participants, including countries such as Spain and the Netherlands and international organizations, are invited to the meetings.
2. As of 31 December 2008, three of the world's top five banks by market capitalization, including both the first and the second, were Chinese (Industrial and Commercial Bank of China, China Construction Bank and Bank of China); the other two were JP Morgan Chase and HSBC. Source: FT Global 500 ranking.

autonomy and guiding principles of this process, in order to ensure greater effectiveness.

As regards the substance of the changes to be brought about, the G20 should avoid being too prescriptive. The aim of reducing procyclicality is widely shared, and many voices have called for the introduction of a version of 'dynamic provisioning' such as has long been practised in the Spanish banking industry. However, dynamic provisioning in a global prudential framework is fraught with challenges and there is no guarantee of finding satisfactory responses. The G20 should not prejudge which technical choice will be most appropriate.

Accounting standards

Since the G20 meeting of 15 November 2008, the International Accounting Standards Committee Foundation (IASCF) – the private-sector foundation that appoints, finances and oversees the IASB – has adopted a reform of its governance framework to submit itself to a 'Monitoring Board' that includes representatives from the US Securities and Exchange Commission, European Commission, Japanese Financial Services Agency and International Organization of Securities Commissions (IOSCO).

This significant change is unlikely to resolve all questions raised by the IASB's governance.[3] Especially intriguing in the context of transition from G7/G8 to G20 is the limited representation it gives to large emerging economies, above all China, which will only be represented in the Monitoring Board through the (rotating) chair of IOSCO's Emerging Markets Committee. Equally problematic in the long run is the absence of representation of the global community of users of financial information, primarily investors: it should not necessarily be assumed that the Monitoring Board's members can represent them properly. However, none of these issues is urgent, and in April 2009 the G20 should probably limit itself to taking note of the creation of the Monitoring Board, if, as is currently expected, it has been created by that time.[4]

More topically, the G20 may take stock on the status of worldwide adoption of International Financial Reporting Standards (IFRS – the standards set by the IASB) in the context of a new US administration. Mary Schapiro, the new Chair of the Securities and Exchange Commission (SEC), has signalled a more cautious approach to IFRS adoption in the US than her predecessor. There is now a distinct possibility that even if adoption of IFRS remains a long-term goal, it may not happen in the United States within the next five years at least. This is not necessarily a problem, but would warrant a discussion at the level of the G20.

Controversies on the role of so-called 'fair-value accounting' in the crisis are likely to abate somewhat compared with the November 2008 summit, given both the IASB's initiative to create a global working group of respected individuals on this matter, and an SEC report issued in December that found no evidence of a significant negative impact of fair-value accounting.[5]

The consistency of implementation and enforcement of IFRS in jurisdictions that have adopted them may also merit the attention of the G20. Such cross-border consistency is not a given even within the European Union. The IASB is not responsible for the way its standards are implemented, and thus the question of whether there should be a form of global monitoring remains open for the moment.

Supervision of intermediaries

On the vexed question of how to oversee large and complex cross-border financial institutions, the G20 pledged in November 2008 to create or strengthen supervisory 'colleges', which bring together national supervisory authorities with jurisdiction over a specific international financial firm under the coordinating authority of (generally) the home-country supervisor. The EU has also planned to give a formal status to such colleges in the forthcoming revisions of its own capital requirements

3. Nicolas Véron, 'Fuzzy oversight will not solve standards issue', *Financial Times*, 5 February 2009.
4. At the date of writing, not all proposed members of the Monitoring Board had yet signed its charter and memorandum of understanding.
5. Securities and Exchange Commission, *Report and Recommendations Pursuant to Section 133 of the Emergency Economic Stabilization Act of 2008: Study on Mark-To-Market Accounting*, 30 December 2008.

directive (for banks) and the 'Solvency 2 directive' (for insurance companies).

Unfortunately, colleges are not likely to solve the trickiest challenges posed by cross-border banks. Either they give binding authority to the coordinating supervisor or to the entire college by majority vote, which amounts to the transnational or supranational delegation of sovereignty they were designed to eschew; or they remain mere coordinating devices, useful in allowing exchanges of information and best practices (this already exists to large extent) but not bringing effective global supervision. In fact, there can be no institutional response to this challenge at the global level because, as specifically reaffirmed in the November 2008 G20 declaration, banking supervision remains a national prerogative. The same applies to non-banking financial institutions such as investment banks or hedge funds, if these are to be brought into the fold of direct and formal financial supervision.

Beyond financial institutions, however, more integrated oversight may be envisaged for some intermediaries that are difficult to regulate or supervise at a national or even regional level because of their systemic importance and degree of global cross-border integration. This is especially the case for rating agencies, which now seem bound to be formally regulated not only in the US (as has been the case, to some extent, since the 1970s) but also in the EU and probably in other jurisdictions as well. The draft legislation initially introduced in the EU illustrates the risk of regulation resulting in raised protectionist barriers or in an extension of regulatory powers on a politically unsustainable extraterritorial basis. Unlike banks, rating agencies (and perhaps also the largest audit networks) are players for which a global supervisor may be considered by the G20 – a more sustainable scenario than less integrated alternatives.

Practical Proposals for Regulatory Reform

John Eatwell

In April 2008 the G7 finance ministers, worried about growing financial turbulence, endorsed the approach to regulatory reform presented to them in a report from an eminent group assembled under the auspices of the Financial Stability Forum and including the Chairman of the UK's Financial Services Authority, the President of the Federal Reserve Bank of New York, and the Chairman of the US Securities and Exchange Commission.[1] The report began with an honest recognition of past failure: 'A striking aspect of the turmoil has been the extent of risk management weaknesses and failings at regulated and sophisticated firms.' There followed a series of detailed recommendations, the essence of which was embodied in three core themes: greater transparency, greater disclosure and stricter risk management by firms. In other words, *nothing new*. The committee was repeating the tired trinity that has defined financial regulation for the past three decades. The trinity failed, and without a new approach the regulators will fail again.

That failure had two closely related origins: regulation failed to keep up with the institutional changes that in 30 years have transformed financial markets; and the regulators accepted that firms had the technical skills, expressed in their mathematical models, to manage risk better than the regulator could.

Thirty years ago most loans to businesses and to individuals were made by banks, or specialist institutions such as building societies. The deregulatory fervour of the 1980s changed all that. Credit markets became 'disintermediated'; instead of banks acting as intermediaries between savers and borrowers, the markets took over. A significant proportion of borrowing (though still less than half) is now packaged into securities that are sliced and sold through a myriad of financial intermediaries. Investment banks, such as Lehman Brothers, Merrill Lynch, Goldman Sachs, Barclays Capital and RBS, were at the centre of this process, taking on massive amounts of debt relative to their capital base (becoming highly leveraged) in order to deal profitably in the complex web of markets. Guiding their operations were the statistical models that purported to measure the risk of their operations against patterns of past market behaviour. The firms claimed that they could manage risky markets, *and the regulators swallowed that claim*.[2] Faith in transparency, disclosure and risk management by firms is at the heart of financial regulation today. While many of the investment banks have disappeared, the same philosophy persists. Yet at the same time it is generally accepted that a core purpose of financial regulation is to mitigate *systemic* risks, such as a general loss of liquidity. Such risks are externalities; their cost to the economy as a whole is greater than the cost to a firm whose actions are creating the risk, and greater than the risk exposure of the firm as assessed by its risk models. In the face of *systemic* market failures even the most transparent market is inefficient and risk is mispriced, with consequences that are all too evident today. So what can be done to tackle 'systemic' risks?

First, regulators must base their approach on the system as a whole. For example, while financial firms are encouraged by supervisors to conduct thousands of stress tests on their risk models, few are conducted by the regulator on a systemic scale. If it is possible to have

1. 'Enhancing market and institutional resilience', April 2008, and 'Follow up on implementation', October 2008, Financial Stability Forum, Basel (www.fsforum.org).
2. 'Those of us who have looked to the self-interest of lending institutions to protect shareholders' equity, myself included, are in a state of shocked disbelief. … This modern risk-management paradigm held sway for decades. The whole intellectual edifice, however, collapsed in the summer of last year.' Alan Greenspan, evidence to US House of Representatives, 23 October 2008.

systemic stress tests on the impact of Y2K, or of avian flu, why not on liquidity? The regulator should conduct tests of scenarios most likely to produce systemic stress – such as a 40 per cent drop in house prices. The information gleaned in this exercise should feed into regulatory measures that are likely to be quite different from those suggested by the risk management of an individual firm. After all, banks end up concentrating their resources in places where their *individual* risk management systems tell them, erroneously, they are safe.

Analytically, a major unresolved question is whether it is possible to build systemic risk models 'from the bottom up', i.e. at the level of the firm but recognizing the presence of externalities and of strategic behaviour. I believe that for all practical purposes it is not possible to model financial externalities in this way, because financial externalities are predominantly macro-economic (the general state of confidence/uncertainty) and are transmitted macro-economically (the general levels of interest rates, the exchange rate, and so on). Hence, micro-risk management by individual firms should be combined with macro-risk modelling by the regulators, with consequent macro-prudential regulatory interventions based on macro-risk assessment.[3] However, as noted below, *international* macro-prudential regulation poses a number of difficult issues.

Second, as an important component of macro-risk management, financial institutions must be required to undertake procyclical provisioning, raising their reserves in good times and using those reserves as a cushion in bad times. The rules determining these reserves would be quite different from those governing the regulatory capital that financial institutions are required to hold today. That capital is a charge, not a buffer. Since the firm must hold a certain capital reserve to be allowed to operate, it cannot use that reserve to tide it over in bad times. The provisioning requirements should be based on the health of the economy as a whole, so capturing systemic strength and weakness. A policy with some of these characteristics has been pursued in Spain where, despite the massive property crisis, the banks have so far remained strong. Astonishingly, it has been proposed that the Spanish system should be dismantled because it is not in accord with international financial accounting standards.

Third, to secure effective macro-risk management, financial regulation must escape from its present focus on the nature of institutions – commercial banks are regulated differently from investment banks; hedge funds are not regulated at all – and concentrate instead on function. Major macro-risk stems from the liability side of the balance sheet. Targeting regulation on highly leveraged financial institutions, whatever their formal legal status, would be an important step in this direction. Many years ago the only significant highly leveraged institutions were commercial banks. Today, leverage is a characteristic of firms throughout the financial system, whether they are deposit-taking banks, investment banks, hedge funds, mutual funds, private equity firms or insurance companies. It is this leverage that threatens market gridlock in a disintermediated financial system.[4] Regulation must switch from an institutionally defined approach to a functionally defined approach as a vital component of systemic regulation.

Fourth, it would also be useful to distinguish short-term-funded leverage from arrangements with longer-term funding. Consider, for example, the current debate over the impact of mark-to-market accounting. From a risk management perspective, the problem with the current value accounting rules is that the focus is on the asset: its perceived liquidity and the intention of the asset holder to hold it to maturity or to trade it. We have seen how asset liquidity and holder intentions can change rapidly in a crisis, leading to an increasingly artificial view of value and solvency. It would be far better to focus on the *funding* liquidity of the asset. Where assets are funded with short-term liabilities, then whatever the perceived liquidity or intentions of the asset owners, it is

3. The need for macro-prudential regulation is a theme of the lecture given by Adair Turner on 21 January 2009, 'The Financial Crisis and the Future of Financial Regulation', www.fsa.gov.uk/pages/Library/Communication/Speeches/2009/0121_at.shtml, and of the draft report by Markus Brunnermeier, Andrew Crockett, Charles Goodhart, Martin Hellwig, Avinash Persaud and Hyun Shin, *The Fundamental Principles of Financial Regulation*, Geneva Report on the World Economy 11, CEPR, London, 6 January 2009.
4. There is no such thing as safe leverage. It's simply that some is safer than others.

appropriate to mark the value of that asset to market in case funding dries up and the assets need to be sold tomorrow. But where assets are funded with or set against long-term liabilities, as is typically the case with a young pension fund, then marking asset values to market is not appropriate and can lead to an artificial view of risk and investment decisions based on a risk that is not important to the holder. Indeed, an incentive to match assets and liabilities would remove much of the sting from mark-to-market accounting.

Fifth, the systemic risks inherent in the misuse of the credit derivatives markets should be addressed by developing common standards and effective clearing.[5] The prevalence of custom-made over-the-counter (OTC) contracts greatly increases the complexity of the market in credit default swaps, a complexity yet further increased by the practice of writing derivatives on derivatives. (Note that the problem is *complexity*, not *transparency*. Typically a derivative product is fully documented. The problem is that so many products are so complex that total transparency does not result in understanding.) The introduction of standardized contracts would reduce complexity and greatly facilitate the establishment of a clearing mechanism. There are around $55 trillion of credit default swap contracts outstanding today, but once back-to-back contracts have been netted out the remaining risk is less than 10 per cent of that number. Establishing a clear distinction between regulation of standardized contracts that are readily understood and relatively easily netted (requiring an effective settlement mechanism too) and complex OTC contracts would greatly reduce the downside systemic risk. The development of market-traded instruments would be encouraged if commercial banks were not permitted to deal in OTC contracts.

Sixth, given that a detailed knowledge of the operation and structure of firms and markets is essential to the effective management of systemic risk, it must be recognized that that knowledge is spread between different regulators, whether between the Financial Services Authority (FSA) and the Bank of England as in the UK, or between the large collection of regulators in the US. There is a need for all regulators to understand the interaction of market structures, and to be sensitive to the relationship between those structures and systemic risk. Why not create in the US a new overarching Federal Regulatory Commission, the membership of which spans all relevant regulators, who would thus be jointly and severally responsible for financial stability? In the UK the FSA and the Bank of England should create a common Financial Stability Committee, guiding the joint responsibility of the two institutions for systemic risk. Such structures would have the dual advantage of informing stability analysis with the actual operations of disintermediated markets, and ensuring that systemic risk became a basic tenet of the operational philosophy of all regulators. These overarching committees should be backed by well-resourced research departments. As the experience of the past year has shown, it was only the lowly research teams that spotted the dangers of sub-prime mortgages. They were ignored. They now need a voice at the top table.

Finally, effective regulation requires that the domain of the regulator be that of the market being regulated. In today's liberal financial markets, this means that effective regulation must be international.[6] The G20 will need to construct an operational counterpart to the Financial Stability Forum that can monitor, coordinate and if necessary enforce measures in individual jurisdictions. It has been suggested that the International Monetary Fund, as an existing treaty organization, could fulfil this role. I am not convinced this would be the best approach, since what is needed is an organization that has a new sort of relationship with the authorities in systemically relevant countries. However, it may be necessary to fall back on the IMF if the consensual approach of the Basel committees is deemed inadequate, and the complexities of creating a new treaty organization prove excessive. Perhaps a new organization embedded within the IMF is the answer.

5. To be fair, this was also in the Financial Stability Forum reports cited in note 1 above.
6. The case for an international regulator is made in John Eatwell and Lance Taylor, *Global Finance at Risk: The Case for International Regulation* (New York: The New Press, 2000).

But even if the institutional problem is solved, the extension of macro-prudential regulation to international markets, and especially to internationally active firms, poses a major problem. If the economic (and financial) cycles of the major economies are not highly correlated, then 'dampening' actions in one jurisdiction may be offset by 'expansionary' actions in another, encouraging potentially destabilizing 'macro-prudential regulatory arbitrage'! The answer to this dilemma probably has to be a pragmatic one: if cycles are not correlated, potential problems are less severe than they otherwise might be. And in so far as macro-prudential regulation has a dampening effect in booms and an expansionary effect in slumps, the overall international position is not likely to be destabilizing – just so long as everyone sticks to the rules.

Financial Regulation: Three Steps We Can Take Now

Robert Rosenkranz

An international, cooperative approach to financial regulation in the aftermath of the crisis might usefully focus on three initiatives. First, rating agencies have become the *de facto* allocators of capital, because regulators have put the power of law behind their judgments. Poor judgments about structured securities resulted in misallocations of credit to house finance and an ensuing house-price bubble, the root cause of the current crisis. Rating agencies should be written out of our laws, and the capital rules applicable to financial institutions should rely instead on market spreads rather than ratings to assess risk.

Second, credit default swaps (CDS) were, at their peak, a $60 trillion market, dwarfing the $6 trillion of US corporate debt outstanding. CDS serve a useful economic function, but they created the potential for contagion among leading financial institutions. We should mandate that CDS trading take place on regulated exchanges, with standard margin provisions, transparent price and volume data, safeguards against manipulation, and a centralized clearing mechanism.

Third, Generally Accepted Accounting Principles (GAAP) have become highly procyclical in the past decade, particularly with the emergence of such concepts as 'fair value' accounting and mandated losses on 'other than temporary' impairments. Both US GAAP and International Accounting Standards are formulated by boards, staffed by accountants, whose goal is to maximize the utility of accounting statements to their users. They generally lack the training or expertise to consider the larger implications of accounting principles for the functioning of financial firms and markets, and the broader economy, as they move through inevitable cycles of expansion and contraction. We should take a lesson from the US insurance industry, and establish regulatory accounting principles (RAP) for banks, insurance companies and other regulated financial firms. RAP, rather than GAAP, should determine capital adequacy.

These three problems have interacted in a particularly toxic way in the current crisis. The AIG saga is an interesting case study. AIG assumed credit risk on too many highly rated securities whose risks they misjudged, in part because regulatory capital requirements pushed them in that direction. When the risks began to emerge and liquidity in credit markets dried up, market snapshots drove reductions in equity and earnings. AIG's CDS exposures were huge, in part because they were not exchange-traded and hence had no associated margin requirements. AIG's counterparties were thus at risk, but were satisfied as long as AIG held an AAA rating. The emerging mark-to-market losses jeopardized that rating, leading to cash demands from CDS counterparties that AIG could not fund. The systemic risks were such that government intervention was needed.

Elements of the same story apply to most of the major financial institutions presenting systemic risk. The initiatives suggested here will not fix the current crisis, but they do address root causes and should substantially mitigate the chances of a recurrence.

Rating agencies

The ratings agencies have been widely criticized for their role in the financial crisis. It is said that they wrongly assessed the risks on trillions of dollars backed by residential mortgages. And indeed they did. But the real problem was not the erroneous ratings *per se* (everyone misgauges risk and the ordinary mortals in ratings agencies are no exception), but the fact that these erroneous ratings were incorporated into law. The capital requirements for US financial institutions are highly sensitive to the ratings of the bonds they hold. Money market funds are typically barred altogether from investments rated lower than AAA. The Bank for International Settlements (BIS) also uses ratings to drive capital requirements, so the rating agencies have the same role in global capital markets. This regulatory approach creates a massive incentive to group and slice assets in ways that maximize not their fundamental soundness but their rating.

Indeed, that is the principal *raison d'être* of the $6 trillion structured finance industry. Sub-prime mortgages (and all manner of other risky loans) held directly by financial institutions are questionable assets with high associated capital charges. Each one alone would deserve a 'junk' rating. Structured finance simply piles such risky assets in bundles and slices the bundles into tranches. The rating agencies deemed some 85 per cent of the tranches, by value, AAA credits, and nearly 99 per cent investment grade, thus turning dross into gold by a sort of ratings alchemy.

This ratings alchemy created enormous demand for dross, in this case dodgy mortgages. Credit was extended to countless dubiously qualified purchasers of homes, which in turn drove dramatic increases in house prices. The housing bubble has now burst, with average house prices in America down some 20–25 per cent from the peak. This led to the current crisis, which is potentially the most severe economic downturn since the Great Depression.

President Barack Obama and the US Congress should write ratings agencies out of the law forthwith, as should the BIS. The market is a far better judge of risk and value than any individual analyst, team, or firm. The amount of capital required to hold a fixed-income security should be determined not by a rating but by its yield, expressed as a spread over treasuries. The higher the spread, the riskier the market has determined the asset to be, and the more capital should be required to hold it. Similarly, financial institutions should be required to set aside a percentage of their interest income every year as reserves for credit losses; the higher the spread, the higher the reserve percentage. Should spreads widen, the share of the return set aside for reserves should increase, thus gradually increasing reserves commensurate with the market's perception of increased risk.

Credit default swaps

A credit default swap passes the risk of a default by a corporate borrower from one party to the swap to the other. Total CDS outstanding at the peak were roughly $62 trillion, twelve times the amount of actually outstanding corporate debt. Thus a corporation defaulting on $5 billion in debt triggers payments on CDS contracts of more than $60 billion. Obviously any market this big can destabilize the system. Yet there is not even the most rudimentary regulatory framework for transparency: no data on volume, no data on transacted prices, no central marketplace, no calculation of net outstanding positions, no capital requirements for market participants, no official mechanism for settlements, and no restraints on manipulation. CDS are an inventive and useful element in a free-market economy, but they entail the risk that the failure of a major financial institution such as AIG can cause a contagion affecting all the other major players.

CDS also make it very easy to speculate against individual debt issuers. Bearish investors are essentially unconstrained in driving spreads up by effectively selling short the credits of individual issuers. For financial institutions, this can easily become a self-fulfilling prophecy, as the higher spreads drive their costs of capital up and their earnings down, in a vicious cycle terminating with a 'run' in which their liabilities cannot be rolled over at any price.

Another feature of the over-the-counter CDS market is that margin requirements are not driven by daily price changes but by the ratings of the counterparties. Ratings downgrades thus become highly destabilizing events – self-fulfilling prophecies themselves – as we saw in the case of AIG.

All of these concerns can be effectively mitigated by normal exchange trading arrangements. As is the case in commodities and futures exchanges, all participants would have initial and maintenance margin requirements, thus limiting counterparty risk to a single day's trading. A central clearing mechanism would also minimize counterparty risk and hence the danger of contagion if a single major participant fails. The ratings of market participants would be irrelevant. Prices, volumes and open interest would be reported, bringing transparency both to the market as a whole and to the regulators.

Rules against manipulation are also critical. Those who purchase CDS on bonds they own are hedging their risk; those who purchase CDS on bonds they do not own are seeking a speculative profit in the event of default. Speculators should have substantially higher margin requirements than hedgers, and should be subject to the equivalent of a down-tick rule for stocks, which requires that short sales be executed at prices equal to or higher than the previous trades. This would reduce their ability to trigger the very defaults they seek to profit from.

GAAP accounting

In prior credit and interest rate cycles, major financial institutions were often insolvent in the sense that they could not liquidate their assets for more than the face value of their liabilities. This state of affairs was disquieting, of course, but as long as the institutions could operate as going concerns and roll their liabilities over in the ordinary course of business, disquiet did not breed disaster. There was no 'run on the bank' forcing the sale of assets at distressed prices at cyclical lows. Indeed few, if any, financial institutions could survive a 'run on the bank' at any time. That is why we have the Federal Deposit Insurance Corporation (FDIC), the Securities Investor Protection Corporation (SIPC), and state guarantee funds to insure the obligations of banks, brokerage firms, and insurance companies respectively. These institutions protect the customers of failed financial enterprises, but far more importantly they prevent concerns about their solvency from becoming self-fulfilling prophecies.

'Fair value' or mark-to-market accounting does the opposite. At the time of greatest fear in the markets (and cycles of greed and fear in markets have been with us since Babylonian times) a handful of the weakest holders of assets may sell in panic, or be forced to sell by their creditors, into highly illiquid markets. The 'market prices' thus established are then used by the accountants, either directly or as an input into a 'fair value' process, to value similar assets held by financial institutions generally. Consider that in December 2008, the average of the top 100 bank loans were selling at 65 cents on the dollar, implying that the holders had lost 35 cents. A quite draconian estimate of ultimate credit losses on these loans is 8–12 per cent (20–30 per cent defaults, with 60–70 per cent recoveries). Credit losses of that magnitude will be a strain for banks, hurting earnings and weakening capital positions for several years. But only the weakest banks will be unable to cope. What 'fair value' accounting does is not to recognize 8 or 12 cents of losses over a period of several years, but to recognize 35 cents of losses as an immediate reduction in equity. There follows a determination, driven by the imprecise language in the accounting pronouncements, as to whether such losses are 'temporary' or 'other than temporary'. If losses are deemed 'other than temporary' they are treated as if the securities had been sold at a loss for purposes of both stating income and calculating statutory capital. This accounting principle is why so many major financial institutions appear weaker now than they did in previous cycles. The appearance of weakness becomes a self-fulfilling prophecy, generating pressures to shrink lending, to delever balance sheets, and to raise capital on terrible terms. Financial cycles are like motion pictures, with scary bits followed by happy endings. The quarterly marks are like snapshots, taken at the most unflattering moments. When the snapshots dominate, there may be no happy endings. I am not suggesting that such snapshots be torn up – simply that they belong in footnotes to financial statements, to be considered as the users see fit, rather than as prime drivers of the balance sheets and income statement.

Accounting principles are formulated, both in the US and internationally, by accounting standards boards, generally staffed by members of the accounting profession. They view their role as maximizing the utility of financial statements to the user. They do not systematically consider the larger implications of accounting principles on the functioning of markets or the broader economy, nor are they equipped by training or expertise to do so. When the authorities bring these considerations to bear, the Financial Accounting Standards Board (FASB) is often resistant. Recently, in the Emergency Economic Stabilization Act (EESA) legislation, Congress recognized the problem and authorized the Securities and Exchange Commission to suspend mark-to-market accounting. The SEC demurred, but did urge more flexible application of the existing rules. The FASB responded grudgingly, with some modest changes, which the pricing groups within the 'big four' accounting firms[1] watered down even further in practice. Thus it is hard to imagine that accounting standards established under current mechanisms can ever serve larger policy and strategic goals adequately.

Congress has already given the SEC authority to suspend mark-to-market accounting, and the International Accounting Standards Board has made some movement in that direction. The US should go further and lead a co-ordinated suspension of this rule. By doing so, it would buy, at very low cost, some badly needed breathing room for the financial sector. There is a risk that a suspension of mark-to-market rules will be perceived as a denial of reality. That risk should be mitigated by a far more rigorous set of standards to gauge reserves for credit losses, and to verify their adequacy. The property and casualty insurance industry is a good model: it routinely establishes reserves for unknown future events. Those reserves must pass muster with professionally certified internal actuaries, with external independent actuaries, with the actuarial departments of independent audit firms, and with state insurance regulators. This approach – a focus on the adequacy of reserves for ultimate losses on assets, rather on than their price in a chaotic and illiquid market – treats financial institutions like going concerns and helps ensure that they remain so.

1. PricewaterhouseCoopers, Deloitte Touche, Ernst & Young and KPMG.

Principles for Financial Supervision Reform

Robert Nichols

The G20 meets in London at a time of unprecedented challenge, and its decisions and subsequent actions will have long-lasting implications for its member nations and, indeed, the world.

Among the challenges the G20 must take up as part of its efforts to address the global economic downturn is reform and modernization of financial supervision – both at the national level and with the aim of improving cross-border cooperation. Financial markets are global and so are financial crises. The current crisis is complex in nature and origins. Sorting out how it happened and ensuring it never happens again are complicated tasks that require time and careful thought. It is already widely acknowledged, however, that outdated supervisory frameworks helped create the opportunity for the crisis.

As part of the broader reform effort, in recent months the Financial Services Forum (FSF)[1] has been working to develop principles that it believes should define the parameters of meaningful reform and modernization of financial supervision in the United States. The current framework is a Depression-era patchwork of regulatory fiefdoms with overlapping jurisdictions, varying statutory responsibilities and powers, and often inconsistent supervisory postures, priorities and methodologies. These circumstances have led to regulatory arbitrage and inefficiency. Unfortunately the balkanized nature of the current framework undermines regulators' ability to ensure institutional and systemic safety and soundness.

The United States needs a 21st-century supervisory framework that ensures the safety and soundness of all financial institutions and the financial system as a whole; that protects the varied interests of depositors, savers, investors and policy-holders; and that is responsive to the activities, innovations and risks of the world's most dynamic capital marketplace.

Forum principles of financial supervision reform

Ensure the stability of the US financial system and the safety and soundness of all financial institutions operating in the US. 'All financial institutions' would include conventional financial institutions as well as non-conventional (i.e., hedge funds, private equity firms) that pose systemic risk. A systemic supervisor should be established to oversee the financial system in totality, ensure comprehensive oversight of all financial institutions, and provide a mechanism for greater regulatory cooperation and consistency – all of which would serve to ensure systemic stability and the safety and soundness of all financial institutions.

Protect the legitimate interests of varied financial institution stakeholders including depositors, customers, investors and policy-holders, while being mindful of the cost to taxpayers and intergenerational debt burdens. The interests of depositors, customers, investors and policy-holders can vary and their protection may require a degree of regulatory specialization.

Make regulatory oversight more accountable, effective, responsive and efficient through material supervisory rationalization and the elimination of unnecessary supervisory overlap and duplication. Supervisory overlap and

1. The Financial Services Forum is a non-partisan financial and economic policy organization comprised of the chief executive officers of 17 of the largest and most diversified financial services institutions doing business in the United States. The purpose of the Forum is to pursue policies that encourage savings and investment, promote an open and competitive global marketplace, and ensure the opportunity of people everywhere to participate fully and productively in the 21st-century global economy.

duplication have led to confusion, regulatory arbitrage, structural imbalances, inefficiency and waste, as well as undermining regulators' ability to ensure institutional and systemic safety and soundness. Howell Jackson of Harvard Law School has estimated that gross financial regulatory costs to US taxpayers – even after adjusting for differences in GDP – are more than six times greater than in the United Kingdom. Other industry experts have estimated that regulatory costs to American financial institutions are fifteen times higher than in the United Kingdom. No doubt most of this burden is the result of substantial supervisory overlap and duplication.

Ensure that all financial institutions are subject to comprehensive oversight (i.e. covering all aspects of a firm's varied businesses and the associated risks). It is widely acknowledged best practice that all financial institutions – particularly large and complex financial conglomerates – should be subject to 'comprehensive consolidated supervision', whereby some supervisor, either directly or relying on functional regulators for subsidiary-specific information, understands and is familiar with the details of all business activities and the associated risks of a financial enterprise.

Ensure that any federal oversight of financial institutions takes into account the varied nature of the business operations of each type of financial institution and that the expertise needed to provide effective oversight is present. Notwithstanding tremendous convergence in recent decades of previously distinct financial sectors and the products and instruments they develop, market, and deal in, sufficient sectoral differences remain that warrant an appropriate degree of regulatory specialization and expertise.

Ensure 'umbrella' or 'systemic' oversight of the financial system as a whole, and improve supervisory cooperation, consistency and transparency among financial institution regulatory authorities. Regulatory inconsistencies across industry sectors, insufficient regulatory cooperation and a stovepiped regulatory structure – no authority looking at the big pictures – all contributed to the current crisis. A more seamless, consistent and holistic approach to supervision is necessary to ensure systemic stability and the safety and soundness of all financial entities.

Ensure a 'level playing field' – institutions developing, marketing and dealing in similar products and services entailing similar risks should be subject to similar supervisory oversight. Recent decades have witnessed tremendous convergence in the activities, products, instruments and associated risks of previously distinct sectors of the financial marketplace. Differences in regulatory treatment cause confusion, introduce structural distortions and encourage regulatory arbitrage – all of which undermines safety and soundness.

Improve financial market transparency by requiring greater disclosure of more reliable and relevant financial information by all financial institutions to market participants. Markets run on information – more reliable and relevant information improves pricing and market performance, minimizing distortions that can lead to crisis. Among the many goals of enhanced regulatory cooperation, greater disclosure and transparency should be a top priority.

Enhance cross-border supervisory cooperation and the harmonization of regulatory methodologies and requirements internationally. While sovereign states and national jurisdictions still matter, financial markets are global and so are financial crises. Harmonization of international supervisory and accounting standards, greater information-sharing, and more frequent and robust cross-border cooperation will greatly enhance the effective and efficient functioning of global capital markets, as well as official crisis response efforts.

Integrate rules-based regulation with overarching principles of prudential supervision. Much of the discussion regarding 'rules-based' vs 'principles-based' supervision is erroneous and misleading – as if policy-makers must choose between the two approaches. Overarching principles are critical to effective, well-reasoned supervision, as are rules for implementing those principles. Proper integration of principles and rules should be the objective.

Change can be difficult and can cause significant anxiety – even when virtually everyone agrees it is necessary and overdue. But reform and modernization of US financial supervision is possible and desirable. For decades the US financial system has remained the world's leader despite the costs, burdens and deficiencies of an outdated supervisory framework. The United States can no longer afford such a significant competitive drag and threat to safety and soundness.

By preserving the diffusion of regulatory power while achieving significant rationalization and a much more efficient, consistent and comprehensive supervisory framework, the Forum's principles for supervisory reform and modernization strike the balance between the strengths of the current framework and badly needed, long-overdue reform. As a result, the safety and soundness, and the competitiveness, of the US financial system (and thus the global capital markets) would be greatly enhanced – and investors and depositors would have the protection and peace of mind they deserve.

Toward a Global Regulatory Framework for Credit Ratings

Standard & Poor's[1]

Overview and summary

Our financial markets have changed radically in recent years, becoming more global, complex and interdependent. Clearly, laws and regulations have to change as well, and world leaders are making good progress toward creating a new global financial architecture. The need for change includes the regulatory framework for credit rating agencies in the US, Europe, Asia and the rest of the world. Rating agencies play an important role in the market's analysis of the creditworthiness of issuers and financial instruments. Investors also use rating opinions as a tool in making investment decisions – although it is important for investors to realize that ratings are only one tool, and they should not be used as a substitute for independent investment analysis.

For its part, Standard & Poor's Ratings Services (S&P) is reflecting on what more should be done in the future. It is clear that a number of the assumptions credit rating agencies used between 2005 and 2007 in rating structured finance bonds backed by sub-prime mortgages have not held up. One unforeseen development was the extreme nationwide collapse in the US housing market. Rating agencies and others, including banks, insurance companies, regulators and policy-makers, did not anticipate the full extent of what has become a global recession, fuelled by the implosion of the unregulated derivatives market, loose monetary policy, excessive liquidity and record levels of institutional and personal debt.

Going forward, it is important to the restoration of confidence in the markets that all market participants take stock of what has happened and adopt workable solutions. At S&P, we have been actively applying lessons from the current crisis to adopt a number of constructive measures. We will continue to do so. We also believe regulation can play an important role in this process, and we welcome proposals that would, on a globally consistent basis, increase transparency and preserve the analytical independence of rating agencies' opinions and analytical processes. This paper is offered in a spirit of cooperation and openness to promote independent, credible ratings, and to foster investor confidence in the capital markets.

This paper provides S&P's recommendations for what regulations should accomplish generally, as well as specific recommendations that should be instituted globally for credit rating agencies, keeping in mind the necessity of restoring investor confidence and ensuring a fair playing field for investors. It also considers the current use of ratings in regulations and investment guidelines.

The goals of regulation generally

The current financial crisis has prompted a number of questions about both the regulation of credit rating agencies and the financial regulatory system in general. In large part, the current regulatory structure reflects the fragmented state of the markets from nearly 70 years ago, when banks, securities firms and insurance companies engaged in distinctly different activities. Today, many of the products and services offered by these financial firms have converged, yet the entities that regulate them and the rules under which they operate remain largely distinct. Regulators find that their jurisdiction does not match the

1. This paper was presented by Rita Bolger at the ACUS–CH workshop on 2 March 2009. It has been published as a White Paper by Standard & Poor's – http://www2.standardandpoors.com/spf/pdf/media/GlobalRegReport.pdf.

activities of the entities they are regulating. At the same time, new, unregulated players have entered the scene, and products have been developed that fall outside the existing regulatory process. These developments suggest the need for reform of our financial regulatory architecture. Entities that have been unregulated may require regulation, and some regulatory bodies may require their mandate to be widened to reflect changes in the activities of the entities they regulate. Recent US Government Accountability Office and G30 group reports call for clearly defined regulatory goals that are global, system-wide and comprehensive, addressing all roles and processes and taking a flexible approach.

S&P believes any new regulatory architecture should focus on the following goals with regard to credit rating agencies and others:

- Safety and soundness of financial markets;
- Business conduct based on transparency and fair dealing;
- Efficiency and cost-effectiveness by aligning responsibilities among different participants across the marketplace;
- Consistency of regulation across similar businesses;
- Internationally consistent standards and coordinated enforcement;
- Adaptability to accommodate future innovations and changes in market structure;
- Flexibility to foster fair competition to benefit investors;
- Promotion of credit ratings that are analytically sound, independent, and unbiased; and
- Promotion of competition among rating agencies and differing views on creditworthiness.

The general goals of regulation of credit rating agencies

S&P believes that well-crafted regulation of credit rating agencies can serve to meet the goals of regulation as described above. It can also serve to enhance the ratings process and restore investor confidence by facilitating consistent application of practical and flexible standards. While regulation should avoid dictating how a rating agency should go about performing its analysis, ultimately a well-functioning ratings process offers benefits for the economy as a whole by contributing to greater investor confidence.

In order to address areas where investors and policymakers have identified gaps and key issues in the current regulatory regime for credit rating agencies, we have highlighted below the significant investor concerns and expectations we have heard and how regulation might enhance the process.

1. Independently derived, credible, and unconflicted credit ratings. Appropriate regulation that addresses the effective management of potential conflicts of interest can only benefit the marketplace. This is an area where regulation can be particularly helpful by requiring policies and procedures to address potential conflicts of interest at the institutional and staff levels, including a code of ethics that requires disclosure of potential conflicts, how they are managed, with oversight of the code's effective application for all rating agency business models. Regulations could also prohibit activities that are clearly anticompetitive.

2. Transparency regarding issuer and rating agency communication. Market participants want to know about the interaction between issuers and analysts during the rating process, particularly where issuers request a structured finance rating.

3. The meaning and use of ratings should be clear, including the level of risk inherent in the rating. Rating agencies that are transparent about the meaning and limitations of their ratings – for example, clarifying that credit ratings do not address the suitability of a security for any individual investor – are of use to the market. Regulation that requires rating firms to provide publicly detailed explanations about the nature of their opinions and pertinent information used in the rating process would enhance investor knowledge, as would regulation that encourages rating agencies to commit to ongoing investor education.

4. Consistency and comparability of ratings across asset classes and geographies – accountability for ratings

quality. Regulation that requires rating agencies to publicly disclose their ratings performance statistics would aid market participants in assessing ratings quality. Rating agencies can be subject to appropriate and proportionate penalties in cases of proven breaches of regulatory requirements.

5. Transparency and soundness of credit rating analysis. Regulation that requires robust disclosure of the ratings process, including criteria and methodologies for assigning and updating ratings, would give investors critical information they need to make informed decisions, to compare ratings, and to form their own opinions on the soundness of an agency's analytics. A similar result could be achieved through regulation that requires identification of the models and underlying assumptions used in a rating agency's analysis. There is a particular need to identify such models and assumptions in structured finance. In addition, regulation that requires agencies to publicize their ratings performance statistics and allows for comparison across geographies, certain asset classes and with competitors, would inform independent investor analysis. Rating agencies could add to this informational process by making personnel available to explain their methodologies to users.

6. Clear and consistent applications of policies to lessen 'surprises' when and if ratings are changed. Rating agencies that use 'warning signals' whenever possible – such as S&P's CreditWatch and Outlook signifiers – to signal to the marketplace potential future rating changes are important to investors. However, rating users need to understand that ratings can change suddenly based on market- or industry-specific events. This possibility is a reason why regulators might carefully reconsider using ratings exclusively in their regulations.

7. Ratings on new and different securities should be differentiated. The current financial crisis has highlighted the need for markets to better understand the meaning of ratings on new and complex securities, including structured finance ratings, and how they differ from traditional ratings. Regulation could play a role in making those differences transparent.

8. Availability of information, particularly for structured finance ratings. Rating agencies that utilize the issuer-pays model receive confidential information from issuers and others throughout the rating and surveillance process. Regulation that requires agencies to follow policies and procedures to avoid the disclosure and misuse of confidential information would be consistent with the spirit of current securities regulation. Where markets and regulators believe the confidential information should be made available to a rating agency's competitors or to others, regulation should require issuers and others responsible for the quality of that data to make this information widely available.

9. Confirm that rating agencies are following through on their commitments. Regulation that provides for regulatory authorities to check agencies' compliance with their processes and policies through robust, periodic inspections would be beneficial to promoting ratings quality. However, regulators must protect analytical independence by avoiding rules and examination processes that impact on the substance of rating opinions and an agency's analytics.

10. Competitive market for ratings with more and varying views on credit quality from qualified providers. Ratings based on a high degree of integrity and intellectual rigour benefit the marketplace, and formal registration of credit rating agencies and promotion of increased industry competition should help in this area. A registration regime that follows globally consistent standards can serve as a model. Regulators that are transparent about the criteria they use in accepting applications, including the need for sufficient analytical and financial resources, would act as a uniting force in establishing a global regulatory framework. Regulation that requires disclosure about staffing, number of ratings issued, and training requirements would allow regulators to make more informed decisions regarding the adequacy of an agency's resources. Regulators could also increase their ability to evaluate agencies by analysing financial information from agencies provided to regulators on a confidential basis. Regulators should be careful, however, not to attempt to supplant their own judgments about ratings analysis for those of independent rating agencies. Evaluations as to the quality of ratings and ratings processes should ultimately be left to the market.

Specific recommendations for an international regulatory framework for credit rating agencies

Credit rating agencies conduct business in numerous countries across the globe. A regulatory framework that provides consistent standards across jurisdictions can promote the soundness of international, as well as domestic, business.

One potential model for an international regulatory approach is the IOSCO Code of Conduct, recently updated in May 2008. For example, in the US, credit rating agencies are subject to the Credit Rating Agency Reform Act of 2006, which sets standards that to a significant degree mirror those established under the IOSCO Code of Conduct.

Regulators in Europe, Japan and Australia are actively reviewing formal oversight of rating agencies. Regulators in any country should take care before seeking to exceed existing standards given the effect such an approach could have on rating agencies operating in multiple jurisdictions. These agencies may face conflicting rules that could ultimately harm ratings consistency owing to country- or region-specific requirements.

A sound regulatory framework for rating agencies globally should have the following components:

Registration. One feature of a globally workable regulatory regime would be to have rating agencies register in the jurisdiction of their principal place of business and only allow registration of those that have in place standards to promote ratings integrity. From its home jurisdiction, a rating agency could be recognized to do business in other jurisdictions pursuant to a notice filing with the local regulator. This 'passport' would allow for a streamlined and consistent regulatory approach across all the jurisdictions in which the credit rating agency conducts business. Regulators could consider limiting regulation to agencies whose ratings are used in local laws or regulations.

Performance measurement. Another feature would be to require registered rating agencies to publicly issue performance measurement statistics over the short, medium, and long term, and across asset classes and geographies.

Disclosure of rating methodologies. Registered credit rating agencies could also be required to make robust disclosures regarding the analytical bases of their ratings opinions, the type of information used to arrive at ratings, and their internal standards for promoting consistency and for monitoring and updating ratings. With greater transparency of credit rating agency methodologies, investors would be in a better position to assess the opinions.

Control over non-public information and disclosure of underlying data. By having access to non-public information, rating agencies are in a position to provide more informed analysis, thus potentially enhancing the quality of the ratings they provide. Accordingly, any regulatory regime for credit rating agencies should ensure that agencies have policies and procedures requiring their employees to treat non-public information confidentially. Regulators should understand that, if such information is disclosed to a rating agency, including to rate a structured finance product, the responsibility for the quality of the information provided and the disclosure to the marketplace in a broad and fair manner rests with the issuer and the underwriter. Regulators should consider whether compulsory disclosure by issuers and underwriters of confidential information would be more efficient and beneficial to the marketplace. Such rules would allow competing agencies and sophisticated market participants to evaluate in greater detail the analysis and assumptions of the rating agency.

Organizational transparency. Registered credit rating agencies should be required to disclose detailed information about their organization's structure, including their resources, their independence from any particular issuer, their ability to train and retain employees, and the independence of commercial from analytical functions. Rating agencies should provide pertinent information about their financial resources to regulators on a confidential basis.

This disclosure will allow regulators to assess the viability of agencies.

Development of code of ethics. Rating agencies should develop and disclose to the public a detailed code of ethics, including a description of how that code will be enforced and how it relates to broader principles such as existing industry or regulatory standards. An independent officer or ombudsman should be established to communicate with the public regarding concerns that might arise about the code's enforcement.

Elimination of potential conflicts of interest. A regulatory regime must include robust standards for analyst and employee independence and the procedures for mitigating potential conflicts of interest in the ratings process. Regulation should require disclosure of such conflicts and prohibit analysts from performing commercial activities and providing consulting or advisory services to entities they rate. In this regard, regulation should require disclosure of the guidelines for analyst and issuer interaction. Regulation should prohibit analysts from being compensated based on the fees paid by the entities they directly rate.

Prohibitions on anti-competitive activity. A regulatory regime should prohibit unfair, abusive or coercive activity. Certain activities should be prohibited outright, such as threatening an issuer with an unfavourable rating or threatening to withdraw an existing rating unless the rating agency is paid to rate an issue.

Transparency of models. A regulatory regime should require policies and procedures on the use and transparency of models, assumptions and how agencies check their effectiveness, including through the use of third parties.

Accessibility. A regulatory regime should require a mechanism for ratings users to raise questions about methodologies and should require registered credit rating agencies to have in place personnel to answer these questions.

Effective oversight. A regulatory regime should provide for effective oversight of registered agencies' compliance with their policies and procedures through robust, periodic inspections. Such oversight must avoid interfering in the analytical process and methodologies, and not second-guess rating opinions. External interference in ratings analytics undermines investor confidence in the independence of the rating opinion and heightens moral hazard in influencing a rating outcome.

Analytical independence. Regulators must preserve the analytical independence of rating agencies' opinions, analytical processes and methodologies. This independence is critical to restoring confidence in credit ratings and fostering innovation in financial services.

Accountability. A regulatory regime should hold registered rating agencies accountable for established breaches of the regulations without undermining analytical independence. Sanctions may include penalties proportionate to the nature and seriousness of any breach, suspending or removing an agency's registration, and disallowing the continued use of that agency's ratings for regulatory purposes.

International consistency. Regulatory regimes globally must be consistent in applying standards. Regulators should coordinate in exercising oversight of rating agencies subject to regulation beyond their own borders. This will avoid inconsistent rules and inconsistent handling of infractions that would create uncertainty for analysts and users of ratings. Regulators should commit to sharing information, subject to confidentiality undertakings.

Meaning of ratings. Rating agencies should clearly explain the meaning of their credit ratings and what elements they do not address: for example, suitability of investments for any particular investor.

Differentiate new and complex ratings. A regulatory regime could require that new and complex ratings, including structured finance products, be differentiated in some manner to put investors on notice that potential volatility or the types of underlying assets/data for rating structured products may be distinguishable from factors affecting corporate and municipal ratings.

Use of ratings in regulations

The use of ratings in regulations and investment guidelines has been debated in global markets. We believe that if regulators and policy-makers choose to incorporate ratings in their rules as benchmarks to measure creditworthiness, then the use of additional benchmarks may also be warranted. There may be additional appropriate benchmarks for market participants to choose from – whether in regulations, investment guidelines, or private agreements – that would protect against 'credit cliffs', namely situations when rating downgrades can occur quickly and without forewarning. Where regulations mandate minimum rating levels, credit cliffs can cause market disruption and significantly impair the liquidity of downgraded securities.

Regulation of other market participants

Ratings play only one role, among many, in the investment decision-making process. Others, such as auditors, play a unique role that rating agencies should not be expected to play because that would add unnecessary costs and inefficiencies to the system. Regulation should address the role of various market participants such as mortgage lenders and originators in addition to the role of rating agencies.

Conclusion

This is a broad outline of a general approach to regulation of credit rating agencies and offers some specific suggestions for an international regulatory approach for credit rating agencies. It provides a framework for addressing the regulatory challenges of a global, fast-paced, rapidly changing market in which new financial instruments, products, markets and participants are constantly emerging, the status quo is constantly changing, and market participants have little time to assess the impact of any change. An agreement in principle on this type of framework would open the path for further work aimed at developing more specific provisions.

But no aspect of the marketplace can be reviewed or regulated in isolation. Regulators and lawmakers should also review their regulatory regimes for all market participants. The current global financial crisis calls for a full and transparent review. No doubt the structure put in place in the coming months will set the foundation for oversight of a broad array of financial market participants for years to come. S&P looks forward to assisting regulators and policy-makers in crafting fair, effective and transparent regulation that will serve our global markets going forward.