

## V. Strengthening the authorities' responsiveness to risks

Some of the weaknesses that have come to light were known or suspected within the community of financial authorities before the turmoil began. Indeed, 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. Where international guidance to firms has been agreed, national regulators and supervisors have not always followed up with firms to check that they have implemented the guidance. Where authorities have expressed concerns about risks to markets or to individual institutions, they have not always been successful in changing behaviour. Authorities need to enhance the prioritisation and coordination of their risk assessments and international policy development work and increase the effectiveness of their communication with markets.

This chapter contains recommendations on:

- Translating risk analysis into action;
- Improving information exchange and cooperation among authorities; and
- Enhancing international bodies' policy work.

### 1. 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.**

**V.1 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.**

The increased complexity of financial products and markets poses greater challenges to the ability of market participants, regulators and supervisors to keep pace with the evolving risks to markets and institutions. Supervisors and regulators need to make sure that the risk management and control framework within financial institutions keeps pace with the changes in instruments, markets and business models, and that firms do not engage in activities without having adequate controls. The skills of risk managers and supervisors will need to be continually updated to keep pace with market changes.

**V.2 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.*

Where supervisors identify concerns about a firm's risk exposures and the quality of risk management, they can best assure that the firm will take prompt, responsive, firm-wide action by raising the concerns early and directly with the firm's board and senior management, rather than solely with risk managers and compliance officers. Supervisors in some jurisdictions already follow this practice, and others should do so.

**V.3 At the international level, the FSF will give more force to its own risk analysis and recommendations, both directly and through the actions of its members, by initiating and following up action to investigate and mitigate risk.**

In the years leading up to the market turmoil, many authorities, including supervisors, regulators and central banks, identified concerns about weaknesses that have now come more fully to light (e.g., about lack of effective credit risk transfer, valuation difficulties in complex products, and weaknesses in the robustness of risk management practices for market and funding liquidity). Nevertheless, they had only limited success in focusing market participants' attention on these issues and on the need to take proactive steps to address them.

**V.4 The FSF will establish a mechanism for regular interaction at senior level with private sector participants, including investors and CRAs, for prompting mitigating actions to identified risks and weaknesses.**

An enhanced dialogue of this sort between the authorities within the FSF and the financial industry would enable market participants to raise with the FSF issues of market weakness and other important regulatory issues that warrant attention, and of how to best stimulate actions by the private sector to address the identified weaknesses.

## 2. 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.**

Supervisory exchange of information and cooperation in addressing cross-border issues should continue to be improved. Much work has taken place in recent years among supervisors in those areas. Some of the most concrete and formal examples of this work involve regional initiatives, such as in the European Union. Work to further improve international cooperation should continue and be further enhanced. Some specific examples are as follows.

**V.5 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.**

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Cross-border communication between supervisors of the various units of each large global financial institution has worked fairly well in the period leading up to, and during, the market turmoil. Nevertheless, the global ramifications of the turmoil, the further illustration that it has given of the importance of firm-wide risk management, and more specifically the difficulties over cross-border liquidity management have further emphasised the importance of systematic cross-border supervisory cooperation.

Supervisors should build on existing examples of supervisory colleges, both in the Basel II framework and in regional arrangements such as the EU, to establish an international college of the most relevant supervisors for each of the largest global financial institutions by end-2008. The purpose of the colleges would be to enhance cooperation on ongoing supervisory issues. The design and membership of each college would need to be tailored to the institution that it oversees in order to ensure that the college is able to operate in an effective and flexible fashion. Colleges should hold their first meetings by December 2008 to exchange information and assessments and, as appropriate, to cooperate in supervision.

***V.6 Supervisors involved in these colleges should conduct an exercise, by 2009, to draw lessons about good practices.***

The most appropriate format for each international college of supervisors and priorities for issues to be addressed will vary according to the organisational form and activities of the particular financial institution. At the same time, it would be valuable to derive common lessons about good practices in operating colleges. Supervisors should therefore undertake an exercise, by 2009, to draw lessons from the experiences of colleges up to that point.

***V.7 To quicken supervisory responsiveness to developments that have a common effect across a number of institutions, supervisory exchange of information and coordination in the development of best practice benchmarks should be improved at both national and international levels.***

Supervisors, both nationally and internationally, will seek further opportunities to compare risk management practices across firms, draw lessons and develop benchmarks to improve those practices. The recent study by the Senior Supervisors Group of risk management practices of major financial institutions during the market turmoil provides an example of the way supervisors can flexibly organise themselves to address in a timely way issues having a common effect across a number of institutions and to draw common lessons.

***V.8 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.***

An important feature of the current market turmoil has been the interaction of market concerns about the health of individual financial institutions with strains in market functioning, including dislocations in money markets. Communication and cooperation

among supervisors and central banks has worked reasonably well, including across borders. Nevertheless, the episode has provided a reminder that such arrangements need to be kept under review, to ensure that they remain robust both in normal times and during periods of market strain, and that they evolve to meet changing requirements as markets themselves change.

The supervision of individual institutions should be complemented by information on the results of central banks' assessments of the stability of the broader financial system, and conversely the central bank assessments should be complemented by information from the supervisory assessments of individual institutions.

**V.9 To facilitate central bank mitigation of market liquidity strains, large banks will be required to share their liquidity contingency plans with relevant central banks.**

Rapid availability of information at the relevant authorities is especially important at times of market strain. This involves both arrangements for prompt sharing of information once strains emerge, and also advance sharing of information that would be relevant. One such example is the need for large banks to share their liquidity contingency plans not only with their supervisors but with relevant central banks. Sharing of such information would enable central banks to base their money market operations on a better understanding of the implications of market strains for banks' liquidity needs.

### **3. Enhancing international bodies' policy work**

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

**V.10 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. As part of this effort, they will establish timetables for required action and action plans for addressing delayed or difficult issues.**

The speed of innovation and increasing globalisation pose challenges for authorities in responding in a rapid and internationally coordinated fashion. The turmoil has involved a number of instruments and markets which grew very rapidly in volume and complexity in recent years and which had systemic effects that crossed national and sectoral boundaries.

International regulatory, supervisory and central bank committees need to remain flexible and responsive in their prioritisation of issues, and ready to find rapid solutions to issues that are proving difficult to resolve by their regular channels. As part of their response to the current turmoil, these committees have demonstrated their willingness to accelerate their work timetables where needed. Member bodies of these committees need to ensure

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that their senior managements are made aware at an early stage of issues of potential systemic importance that may in due course require resolution at a senior level.

***V.11 National supervisors will, as part of their regular supervision, take additional steps to check the implementation of guidance issued by international committees.***

International committees' standards and guidance to firms will only be successful in mitigating risks if firms implement them. National supervisors will more closely check the implementation of international guidance to firms, consistent with their own statutory mandates. An early opportunity for supervisors to take such action will be in the follow-up to the forthcoming strengthened liquidity guidance by the BCBS.

***V.12 The FSF will encourage joint strategic reviews by standard-setting committees to better ensure policy development is coordinated and focused on priorities.***

International standards play an important role in shaping a resilient integrated financial system on a level playing field. As the system integrates and becomes more market based, interdependencies across standard-setting areas increase. To facilitate the coordination of policy development and its focus on priorities, the FSF will encourage joint strategic reviews by standard-setting bodies of their priorities, thereby aiming to ensure that gaps are filled and duplication avoided. The BIS will actively support the FSF in this work.

***V.13 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.***

The FSF and IMF have cooperated closely on financial stability work ever since the FSF was formed. The IMF, in its role as a member of the FSF, participates fully in FSF activities. The FSF Chairman regularly reports to the International Monetary and Financial Committee of the IMF. The FSF and IMF have worked together on many different projects, in particular with respect to the joint IMF/World Bank assessment of countries' compliance with the 12 key standards and codes that the FSF has designated as deserving priority implementation.

The global nature of the recent turmoil has emphasised the need for cross-border cooperation between authorities and, as part of that, the FSF and IMF are exploring ways to intensify their cooperation. As one example of this, the IMF will send to the FSF a note describing their assessment of key risks to global financial stability ahead of each semi-annual FSF meeting. This will supplement the existing analysis of risks taking place within the FSF. The IMF will in turn draw lessons from FSF meetings for issues to focus on in its bilateral and multilateral surveillance work.