G20 Working Group 1
Enhancing Sound Regulation and Strengthening Transparency

Final Report

March 25, 2009

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1. Executive Summary and Recommendations

G20 Leaders tasked the Working Group on Enhancing Sound Regulation and Strengthening Transparency (Working Group 1) with reviewing work underway and making recommendations that will strengthen international regulatory standards, enhance transparency in global financial markets and ensure all financial markets, products and participants are appropriately regulated or subject to oversight, depending on their circumstances.

The recommendations contained in this Report are a response to the causes of the current crisis, and are intended to prevent future ones from occurring. They are consistent with the recognition that robust regulation in each country, based on effective global standards, is vital to future financial stability.

The first line of defence in preventing instability in the financial system is sound regulation and recent events have clearly demonstrated that regulatory failures in some jurisdictions fuelled the current crisis. The regulatory framework needs strengthening, and it is essential to get micro-prudential regulation right in order to promote financial institutions that are sound and that manage risks appropriately.

But what has also become clear most recently is that this is a systemic crisis which has at its root the build-up of systemic vulnerabilities arising from excess liquidity, leverage, risk-taking and systemic concentrations across the financial system. History shows that, while each financial crisis is different, a shared feature is that they are preceded by a period of excess risk-taking, strong credit growth and asset price increases in various markets. The current crisis highlights the extraordinary financial and social costs of failures in the financial system.

As directed by the Leaders Declaration and the G20 Troika, an important focus of Working Group 1 has been to strengthen microprudential policy while supplementing it with a greater emphasis on a system-wide approach to regulation in order to better mitigate the build-up of systemic risks.

To achieve these objectives, this report contains recommendations in the following areas:

- A System-wide Approach to Financial Regulation
- Scope of Regulation
- Oversight of Credit Rating Agencies
- Private Pools of Capital
- Transparent Assessment of Regulatory Regimes
- Procyclicality
- Capital
- Liquidity
- Infrastructure for OTC Derivatives

- Compensation Schemes and Risk Management
- Accounting Standards
- Transparency
- Enforcement
- Technical Assistance and Capacity Building in Emerging Market Economies

The Report sets out 25 recommendations for Leaders that the Working Group strongly believes will support the vital role of the financial system in promoting economic growth while, at the same time, reducing the likelihood of a similar crisis in the future and mitigating the consequences of future periods of financial stress.

The key overarching recommendations of Working Group 1 can be summarized in five broad points.

1. As a supplement to sound micro-prudential and market integrity regulation, national financial regulatory frameworks should be reinforced with a macro-prudential overlay that promotes a system-wide approach to financial regulation and oversight and mitigates the build-up of excess risks across the system. In most jurisdictions, this will require improved coordination mechanisms between various financial authorities, mandates for all financial authorities to take account of financial system stability, and effective tools to address systemic risks. It will also require an effective global table to bring together national financial authorities to jointly assess systemic risks across the global financial system and coordinate policy responses.

2. The scope of regulation and oversight should be expanded to include all systemically important institutions, markets and instruments. This will require enhanced information for financial authorities on all material financial institutions and markets, including private pools of capital. Large complex financial institutions require particularly robust oversight given their size and global reach. The regulatory and oversight framework should strive to treat similar institutions and activities consistently, with greater emphasis on functions and activities and less emphasis on legal status.

3. Once conditions in the financial system have recovered, international standards for capital and liquidity buffers should be enhanced, and the build-up of capital buffers and provisions in good times should be encouraged so that capital can absorb losses and be drawn down in difficult times.

4. Through the expanded Financial Stability Forum, the International Monetary Fund and the international standard setters, international standards, including those for macro-prudential regulation, the scope of

regulation, capital adequacy and liquidity buffers, should be coordinated to ensure a common and coherent international framework, which national financial authorities should apply in their countries consistent with national circumstances. The financial regulatory and oversight frameworks and their implementation in all G-20 countries should be reviewed periodically, validated internationally and made public.

5. Sound micro-prudential and market-conduct regulation supplemented with an effective macro-prudential framework requires enhancements to a range of supporting policies and infrastructure, including: compensation practices that promote prudent risk taking in line with principles developed by the FSF; the greater standardization of derivatives contracts and the use of risk-proofed central counterparties; improved accounting standards that better recognize loan-loss provisions and dampen adverse dynamics associated with fair-value accounting; effective enforcement of regulation that is coordinated internationally including the enforcement of the adherence of credit rating agencies to the substance of the IOSCO code of conduct; and national authorities and international standard setters working together and assisting each other in strengthening financial regulatory and oversight frameworks and their implementation across the G-20 and beyond.

Underlying Causes of the Market Turmoil:

The turmoil which began to unfold during the Summer of 2007 was, in part, a consequence of an extended period of low real interest rates around the world, supported by an expansionary monetary policy, large current account imbalances, robust global growth and limited volatility in economic conditions. This benign environment caused investors to extend their search for yield further out the credit quality curve, leading to overly optimistic assessments and lack of due diligence in assessing credit risk.

In response to the increased demand for credit instruments offering higher yield, the financial system developed new structures and created new instruments, some with embedded leverage. Many of these instruments were opaque and masked the extent of leverage and interconnectedness of risk, which appeared to be globally dispersed across a wide range of institutions and markets. Much of the due diligence in examining these innovations was outsourced to credit rating agencies.

The trading of innovative over-the-counter financial products, particularly those aimed at transferring credit risk, notably credit default swaps and collateralized debt obligations, expanded very rapidly. Financial institutions failed to properly manage and monitor risks to liquidity in the event that these markets froze.

At the same time, regulated banks and financial institutions supported the acceleration of financial innovation and the push towards more unregulated pools of capital by establishing off-balance sheet and structured investment vehicles. These unregulated investment vehicles, created in response to features of the regulatory and accounting framework, often financed their operations without minimum capital buffers or adequate liquidity plans. In addition, the risks they were exposed to, including maturity mismatches, were often misunderstood.

Risk management within institutions and the expertise of regulators did not keep pace with these innovations. Financial sector compensation schemes based on short-term returns, without consideration of the attendant risks, reinforced the momentum for risk taking.

Eventually the increase in asset prices could not be sustained. Delinquencies translated into price decreases on U.S. sub-prime mortgage-backed securities, which in turn produced losses for investors and led to margin calls for leveraged sub-prime asset holders. As the market turmoil spread across a wide range of markets for structured and securitized products, increased risk aversion, reduced liquidity, and concerns about the soundness of major financial institutions fed on each other. Many institutions experienced significant balance sheet pressures, which led to a tightening of lending standards with adverse effects on real economic growth.

In hindsight, policymakers, regulators and supervisors in some advanced countries did not act to stem excessive risk-taking or to take into account the interconnectedness of the activities of regulated and non-regulated institutions and markets. This was due in part to fragmented regulatory structures and legal constraints on information sharing. Further, uncertainties concerning exposures to, and the valuation of, structured products and the difficulty of valuing financial instruments when markets are under stress may have exacerbated the turmoil.

Identified Weaknesses:

Some of the more salient weaknesses identified as drivers of the current turmoil include:

Weaknesses in Underwriting Standards: The credit quality of loans granted with the intention of transferring them to other entities through the securitization process was not adequately assessed.

Lack of Oversight of Systemic Risks: While the build-up of leverage and the underpricing of credit risk were recognized in advance of the turmoil, their extent was under-appreciated and there was no coordinated approach to assess the implications of these systemic risks and policy options to address them. There was also insufficient recognition of the interconnectedness of risks within both regulated and unregulated markets.

Lack of Oversight of Unregulated Pools of Capital: Unregulated and lightly regulated pools of capital, such as hedge funds, private equity funds, and a number of the banks' off-balance sheet securitization vehicles, grew rapidly in importance during the period preceding the crisis. Regulatory arbitrage pushed risks outside the regulatory framework and, in many jurisdictions, oversight of these markets and entities consisted to a large extent of indirect oversight through the supervision of counterparties and market discipline.

Weak performance by Credit Rating Agencies: There was an over-reliance on credit rating agencies and shortcomings in rating models and methodologies, as well as insufficient attention to conflicts of interest in the rating process.

Procyclical Tendencies Fed by Regulatory and Accounting Frameworks: Certain aspects of accounting frameworks and capital regulation tend to enhance the natural tendency of the financial system to amplify business cycles, affecting both the degree of credit expansion in benign conditions and the degree of credit contraction in the downturn.

Shortcomings in Risk Management Practices: A number of the standard risk management tools used by financial firms relied on samples of historical data from short periods and were not suited to estimating the likelihood and the scale of potential losses in the adverse tail of risk distributions for structured credit products. In addition, compensation arrangements often created incentives for excessive risk-taking through insufficient regard to longer-term risks.

Financial Innovation Outpacing Risk Management: There was a significant acceleration of financial innovation in years leading up to the crisis that far outpaced the ability of firms to manage risks and of regulators to effectively monitor them.

Weaknesses in Disclosure: Weaknesses in public disclosures by financial institutions damaged market confidence during the turmoil. Public disclosures by financial institutions did not always make clear the type and magnitude of risks associated with their on- and off-balance sheet exposures.

Weaknesses in Resolution Procedures**:** Existing procedures for resolving troubled institutions have been shown to be inadequate when an institution imposes substantial systemic risks. In addition, national resolution mechanisms have not been effective in some cross-border resolutions.

Lack of Transparency in Various OTC Markets**:** In many cases, investors and other market observers could obtain only minimal information about pricing, trading volume, and aggregate open interest in various products that trade in the OTC markets.

A vision for the future financial system

The financial system will continue to play a vital role to intermediate savings and provide funding to the real sector, thereby supporting economic growth. The Working Group recognises that financial markets will remain global and interconnected, while financial innovation will continue to play an important role to foster economic efficiency. Protectionist moves must be strongly resisted. In order to address the underlying causes and weaknesses identified above, the Working Group envisages the need for a reform of the regulatory framework to avoid the emergence of similar crises and to mitigate the consequence of any future episode of financial stress.

The regulatory framework will need to keep pace with the associated risks in a more rapid and effective manner. Large complex financial institutions will continue to operate in multiple jurisdictions in order to meet the needs of their large global clients, and supervision will need to be better coordinated internationally with a robust global resolution framework. In order to avoid regulatory arbitrage, there is a need for greater consistency in the regulation of similar instruments and of institutions performing similar activities, both within and across borders.

In addition, capital markets will require greater emphasis on reducing counterparty risk and on ensuring that their infrastructure allows them to remain a source of funding during periods of stress.

The post-crisis period will likely be characterized by a financial system with lower levels of leverage, reduced funding mismatches (both in terms of maturity and currency), less exposure to counterparty risk, and greater transparency regarding financial instruments. After credit markets recover from the crisis, it will be important to mitigate the inevitable pressure to expand profits through increased risk-taking. A more developed macro-prudential approach will be an important element in this context.

The type, size, and cross-border exposures of institutions and markets that will emerge from this crisis will likely be considerably different than before. As banks and financial institutions consolidate, policy makers will have to adapt prudential regulation to varying degrees of size and concentration. Similarly, competition policy will play an important role in ensuring healthy competition.

Financial institutions, markets and instruments will therefore continue to evolve in ways which pose challenges for regulation, notwithstanding the retrenchment that is currently underway. Financial institutions, policymakers, supervisors and regulators will all need to become better equipped to manage the interconnectedness of markets, both domestically and globally, the effects of innovation, and the potential for incentives to become misaligned.

Transition to a new regulatory regime:

It will be necessary to consider the appropriate timing for changes in the regulatory framework going forward. Recommendations should promote proportionate regulatory reaction when needed, acknowledging the possible limits of the self-regulation approach in some contexts. For example, while ultimately capital buffers for the system should be enhanced during the economic expansion in order to be drawn down as needed in downturns, changes in the current environment may have negative consequences on the real economy. A considered and comprehensive review of the consequences of reforms and harmonization, coordinated across jurisdictions, is necessary to increase the effective transition to a more stable financial system.

Review of Progress of G20 Action Plan

This Report presents a high level overview of measures taken in response to each item of the Washington Action Plan. A very substantial amount of work has already been achieved and many additional initiatives are underway to enhance the regulatory framework in response to this Action Plan. Overall, this work is proceeding well and in a coordinated fashion.

Milestones of particular importance that are evidence of the exceptional amount of work by national authorities and international bodies include:

A. Measures to address the current crisis

On Transparency:

- Several accounting standard setting bodies published guidance to clarify expectations for the valuation of financial instruments, including complex securities.
- Prudential supervisors in many jurisdictions strongly encouraged their internationally active financial institutions to enhance disclosure by adopting leading risk disclosure practices addressed in a report by the Senior Supervisors Group to the Financial Stability Forum (FSF), and larger financial institutions have responded by disclosing more meaningful qualitative and quantitative information about risk exposures involving complex instruments.
- The Basel Committee for Banking Supervision (BCBS) has published proposals for enhanced disclosures related to securitizations.

B. Measures for the medium/longer term

On Regulatory Regimes:

- The International Organization of Securities Commissions (IOSCO), the International Association of Insurance Supervisors (IAIS) and the BCBS have undertaken initiatives to assess differences in regulation across sectors, identify regulatory gaps, and examine issues related to expanding the scope of regulation.
- IOSCO assessed the implementation by credit rating agencies of its code of conduct, and is currently developing a framework for coordination amongst regulators in monitoring and enforcing compliance. In addition, some jurisdictions are in the process of adopting legally binding rules to regulate and supervise credit rating agencies.

On Procyclicality:

- Working groups formed by the FSF have prepared recommendations to mitigate procyclicality with respect to bank capital, provisioning practices, and valuation and leverage.

On Prudential Oversight:

- The BCBS issued, for consultation, proposals to strengthen the risk capture of the Basel II framework, including enhancements to the capital treatment of securitizations, off-balance sheet exposures, and trading book activities. These measures form part of a comprehensive strategy to strengthen the regulation, supervision and risk management of internationally active banks in order to address weaknesses revealed by the crisis. This strategy also includes work in progress to enhance the consistency and quality of capital and to mitigate procyclicality.
- An international group of prudential supervisors and national authorities is working with the industry to strengthen the infrastructure for over-the-counter (OTC) credit derivatives, with the top priorities being the implementation of central counterparty clearing for credit default swaps (CDS). One central counterparty was launched in late 2008 in the European Union, and more are expected to begin operating in 2009 in the United States and in the European Union.

On Compensation Schemes and Risk Management:

- A Working Group of the FSF has developed sound practice principles for compensation schemes.
- The BCBS and national prudential supervisors issued guidance to enhance practices in a number of risk management areas, including stress testing, risk concentrations, off-balance sheet exposures, valuation and liquidity risk.

On Transparency:

- The International Accounting Standards Board (IASB) and the U.S. Financial Accounting Standards Board (FASB) have established an advisory group comprised of senior leaders with broad international experience in financial markets to advise the Boards in considering accounting issues emerging from the global crisis. Furthermore, the Trustees of the International Accounting Standards Committee Foundation (IASCF) approved in mid-January the establishment of a formal link to a newly created external Monitoring Board composed of public authorities. They also approved the expansion of the IASB membership to 16 members and provided additional guidelines regarding their geographic diversity.

Recommendations to Leaders by the Working Group

The objective of the recommendations for further reform made by the Working Group is to build a financial system that will support growth and rising living standards across the globe, while reducing the risk of financial instability. Financial crises have very large social costs. At the same time, there are large social benefits to all from a dynamic and efficient financial system that transforms savings into productive investments, and helps households and businesses manage risk. The regulatory framework needs to maximize stability and efficiency while ensuring an appropriate balance where there are trade-offs.

The following is a summary of the recommendations for further action put forward by the Working Group. By charting a clear direction and a timeline, this package of recommendations has the potential to provide the sense of clarity and the increased confidence the financial system requires in the short run, and increased efficiency and stability going forward.

The Report identifies bodies that could be tasked with implementing and monitoring progress against these recommendations as well as implementation timelines. In many cases, the responsibility for monitoring implementation has been placed on the International Monetary Fund (IMF) and the World Bank (WB), through the Financial Sector Assessment Program (FSAP) and Article IV. To support these new responsibilities, these institutions may need to modify their instruments and tools, including by adapting the scope of assessments to make them more targeted. They should also accord due priority to this monitoring in their assessment schedule, and the IMF and the World Bank could explore using other bilateral or multilateral instruments to support these objectives.

Summary of Recommendations:

System-wide Approach to Financial Regulation

***Recommendation 1*: As a supplement to their core mandate, the mandates of all national financial regulators, central banks, and oversight authorities, and of all international financial bodies and standard setters (IASB, BCBS, IAIS and IOSCO) should take account of financial system stability.**

- **Responsibility:** Finance Ministries, national financial regulators and oversight authorities, central banks, IOSCO, IAIS, BCBS, IASB and other accounting standards setters, expanded FSF, IMF
- **Timeline**: To be completed within 2 years
- **Monitoring:** Compliance by national authorities to be monitored by IMF-WB (through FSAP and Article IV), compliance by international bodies to be monitored by expanded FSF

***Recommendation 2*: Within each country, there should be an effective mechanism for appropriate domestic financial sector authorities to jointly assess the systemic risks across the financial system and to co-ordinate the domestic policy response to limit the build-up in systemic risk. The structure of this coordinating mechanism should be transparent, with clear assignments of roles, responsibilities and accountability for each authority.**

- **Responsibility**: Finance Ministries, financial regulators and supervisors, central banks, in cooperation with other relevant bodies, including policy authorities for housing finance and accounting standard setters, as appropriate
- **Timeline**: To be completed within 2 years
- **Monitoring:** IMF-WB (through FSAP and Article IV)

***Recommendation 3*: Financial sector authorities should have suitable macroprudential tools to address systemic vulnerabilities. Measures that are simple to understand and to implement would be preferable to more complex ones, and tools that rely on pre-specified limits or rules are attractive. However, rules need to be complemented with the informed judgement of financial sector authorities based on their joint assessment of the risks across the financial system.**

In order to achieve consistency globally, international bodies and standard setters – such as the expanded FSF, IOSCO, the IAIS, the BCBS, the BIS and others (*e.g.*, IASB, CGFS) – will develop such tools and provide national authorities, which are responsible for their implementation, with options. Potential macroprudential tools that should be explored further could include:

a. **Complementing risk-based capital measures with simpler indicators aimed to measure the build-up of leverage, with enhanced sensitivity to off-balance sheet exposures;**

b. Capital requirements that adjust over the financial cycle;

c. Loan-loss provisioning standards that incorporate all available credit information;

d. The use of longer historical samples to assess risk and margin requirements; and

e. Greater focus on loan-to-value ratios for mortgages.

- **Responsibility**: National authorities, expanded FSF, IOSCO, IAIS, BCBS, BIS, IASB, CGFS
- **Timeline for tool development**: Expanded FSF to provide an annual report on the suite of tools under development by its members, with an Interim Report in Fall 2009.
- **Timeline for tool implementation**: On an ongoing basis
- **Monitoring**: Development of tools to be monitored by G20, as well as expanded FSF, and their implementation by the IMF-WB (through FSAP and Article IV)

***Recommendation 4*: The expanded FSF, together with the IMF, should create an effective mechanism for key financial authorities in each country to regularly come together around an international table to jointly assess the systemic risks across the global financial system and to coordinate policy responses.**

- **Responsibility**: Expanded FSF, IMF, Finance Ministries, national financial regulators and oversight authorities, central banks
- **Timeline**: Fully implemented within 2 years, with initial system in place by the Fall 2009 FSF meetings
- **Monitoring**: G20

Scope of Regulation

***Recommendation 5*: All systemically important financial institutions, markets and instruments should be subject to an appropriate degree of regulation and oversight, consistently applied and proportionate to their local and global systemic importance. Consideration has to be given to the potential systemic risk of a cluster of financial institutions which are not systemically important on their own. Non-systemically important financial institutions, markets and instruments could also be subject to some form of registration requirement or oversight, depending on the type and degree of risk posed, for example for the integrity or efficiency of markets.**

In order to determine the appropriate degree of regulation or oversight, national authorities should determine appropriate mechanisms for gathering relevant information on all material financial institutions, markets and instruments. This information will allow national authorities to assess the potential for their failure or severe stress to contribute to systemic risk,

either on their own, as part of a cluster, or through linkages with other segments of the financial system. Information on systemic risk should be monitored through a globally coordinated mechanism.

National authorities should have the authority to expand the perimeter of regulation in a timely way, recognizing that it may vary across countries and through time. They should do so in close coordination with appropriate global fora and standard-setters in order to achieve as much consistency as possible across jurisdictions.

- **Responsibility:** National authorities, central banks, IOSCO, IAIS and BCBS, with recommendations from the expanded FSF and the IMF
- **Timeline:** Two stages: process to obtain information underway in Fall 2009, with system in place within 2 years
- **Monitoring:** Expanded FSF to ensure a consistent approach to the perimeter of regulation, and the information collection framework to be monitored by IMF-WB (through FSAP and Article IV)

***Recommendation 6*: The systemic importance of financial institutions, markets and instruments depends on a wide range of factors, including their size, leverage, interconnectedness, as well as funding mismatches. The IMF, in consultation with the BIS and the expanded FSF and other bodies, should jointly develop a common international framework and guidelines to help national authorities assess whether a financial institution, market or an instrument is systemically important as consistently as possible across jurisdictions.**

This framework should strive to treat similar activities more similarly for regulatory or oversight purposes regardless of the legal form of the institution, so as to avoid regulatory arbitrage.

- **Responsibility:** IMF, BIS, expanded FSF
- **Timeline:** Fall 2009
- **Monitoring:** G20

***Recommendation 7*: Large complex financial institutions require particularly robust oversight given their systemic importance, which arises in part from their size and interconnectedness (or correlation) with other institutions, and from their influence on markets.**

- **Responsibility:** Prudential supervisors, with recommendations from the expanded FSF
- **Timeline:** Ongoing
- **Monitoring:** Expanded FSF

***Recommendation 8*: The boundaries of the regulatory framework should be reviewed periodically within national jurisdictions, in light of financial innovation and broader trends in the financial system. International bodies will promote good practice and consistent approaches in this area.**

- **Responsibility:** Prudential supervisors, central banks, and securities regulators, with guidance from the expanded FSF and the IMF
- **Timeline:** Ongoing
- **Monitoring:** Expanded FSF

Oversight of Credit Rating Agencies

***Recommendation 9*: All credit rating agencies whose ratings are used for regulatory purposes should be subject to a regulatory oversight regime that includes registration and that requires compliance with the substance of the IOSCO Code of Conduct Fundamentals. National authorities should obtain the authority to enforce compliance and require changes to a rating agency's practices and procedures for managing conflicts of interest and for assuring the transparency and quality of the rating process. Given the global scope of some credit rating agencies, the oversight framework should be consistent across jurisdictions with appropriate sharing of information between national authorities responsible for the oversight of credit rating agencies.**

- **Responsibility**: National authorities
- **Timeline**: To be completed within 2 years
- **Monitoring:** by IOSCO and IMF-WB (through FSAP and Article IV)

Private Pools of Capital

***Recommendation 10*: Private pools of capital, including hedge funds, can be a source of risk owing to their combined size in the market, their use of leverage and maturity mismatches, and their connectedness with other parts of the financial system. They or their managers should therefore be required to register with financial authorities and disclose appropriate information to assess the risks they pose.**

- **Responsibility**: National authorities
- **Timeline**: To be implemented within 2 years
- **Monitoring:** Expanded FSF

Transparent Assessment of Regulatory Regimes

***Recommendation 11*: All G20 members should commit to undertake a Financial Sector Assessment Program (FSAP) report and to publish its conclusions. National authorities may also periodically undertake a self-assessment of their regulatory frameworks based on internationally agreed methodologies and tools.**

To improve the FSAP process, the basis upon which countries are assessed should be expanded to encompass macroprudential oversight,

the scope of regulation, and supervisory oversight of the influence of the structure of compensation schemes at financial institutions on risk taking.

- **Responsibility**: Finance Ministries, IMF/WB
- **Timeline**: G20 countries that have not undertaken an FSAP should immediately commit to do so, in consultation with the IMF/WB; Countries with systemically important financial systems should be subject to a self-assessment every 5 years, and FSAP Updates in consultation with IMF/WB
- **Monitoring:** IMF/WB

Procyclicality

***Recommendation 12*: The FSF and other bodies, particularly the BCBS, should develop and implement supervisory and regulatory approaches to mitigate procyclicality in the financial system by promoting the build-up of capital buffers during the economic expansion and by dampening the adverse interaction between fair valuation, leverage and maturity mismatches in times of stress.**

- **Responsibility**: FSF and member bodies, BCBS, CGFS
- **Timeline for development**: Strategic plan Fall 2009, with further progress reported by year end
- **Timeline for implementation**: As appropriate, with discussion with sector and coordination by the expanded FSF
- **Monitoring:** Expanded FSF

***Recommendation 13*: Accounting standard setters should strengthen accounting recognition of loan loss provisions by considering alternative approaches for recognizing and measuring loan losses that incorporate a broader range of available credit information. They should also examine changes to relevant standards to dampen adverse dynamics associated with fair value accounting, including improvements to valuations when data or modelling is weak. Accounting standards setters and prudential supervisors should work together to identify solutions that are consistent with the complementary objectives of promoting the stability of the financial sector and of providing transparency of economic results in financial reports.**

- **Responsibility**: Accounting standards setters, BCBS
- **Timeline for development**: Strategic plan Fall 2009
- **Timeline for implementation**: As appropriate, with discussion with sector and coordination by the expanded FSF
- **Monitoring:** Expanded FSF

Capital

***Recommendation 14*: Capital should serve as an effective buffer to absorb losses over the cycle, so as to protect both the solvency of financial institutions in the event of losses, and their ability to lend.**

In the near term, capital buffers above required minimums should be allowed to decline in response to deteriorating economic conditions and credit quality, and urgent consideration should be given to measures that would facilitate access to additional private sector capital in the downturn.

Once conditions in the financial system have recovered, the adequacy of the international standard for the minimum level of capital for banks should be reviewed and the quality and global consistency of capital should be enhanced. In addition, capital buffers above minimum requirements and loan-loss provisions should be built up in good times in order to enhance the ability of regulated financial institutions to withstand large shocks.

In this context, the BCBS should develop standards to promote the build-up of capital buffers in good times that can be drawn down in periods of stress. The BCBS should also complement risk-based capital measures with simpler indicators to monitor the build-up of leverage.

The international standard for the minimum level of capital should remain unchanged until the financial system has recovered.

- **Responsibility**: BCBS
- **Timeline**: The review of international standards related to capital buffers and the quality and consistency of capital will be discussed at periodic BCBS meetings and the transition will be completed as appropriate, in consultation with the industry and with coordination by the expanded FSF.
- **Monitoring**: Expanded FSF

***Recommendation 15*: G20 Leaders should support the progressive adoption of the Basel II capital framework, which will continue to be improved on an ongoing basis, across the G20.**

- **Responsibility**: Prudential supervisors, BCBS
- **Timeline**: The transition to Basel II is to be completed as appropriate, in consultation with the industry and with coordination by the expanded FSF
- **Monitoring**: IMF-WB (through FSAP and Article IV), BCBS

Liquidity

***Recommendation 16*: Prudential supervisors and central banks should deliver a global framework for promoting stronger liquidity buffers at banks, including cross-border institutions, to ensure that they can withstand prolonged periods of market and funding liquidity stress.**

In addition, the BCBS should enhance tools, metrics and benchmarks that supervisors can use to assess the resilience of banks' liquidity cushions and constrain any weakening in liquidity maturity profiles, diversity of funding sources, and stress testing practices.

- **Responsibility**: Prudential supervisors, central banks, BCBS
- **Timeline**: To be completed within 2 years
- **Monitoring:** Expanded FSF

Infrastructure for OTC Derivatives

***Recommendation 17*: Financial institutions should continue to strengthen the infrastructure supporting OTC derivatives markets. In the case of credit derivatives, this includes standardizing contracts to facilitate their clearing through a central counterparty. National authorities should enhance incentives as needed for the use of central counterparties to clear OTC credit derivatives.**

- **Responsibility**: Financial institutions, prudential supervisors and other authorities, central banks
- **Timeline**: To be completed within two years; Industry to prepare an action plan on standardization in the Fall 2009
- **Monitoring**: Prudential supervisors and expanded FSF

***Recommendation 18*: Central counterparties should be subject to transparent and effective oversight by prudential supervisors and other relevant authorities, including central banks, and meet high standards in terms of risk management, operational arrangements, default procedures, fair access and transparency. The CPSS and IOSCO should review their experiences in applying their recommendations for central counterparties to derivatives.**

- **Responsibility**: Prudential supervisors, central banks, CPSS, IOSCO
- **Timeline**: To be completed within 2 years
- **Monitoring:** Expanded FSF

<u>Compensation Schemes and Risk Management</u>

***<u>Recommendation 19</u>*: Large financial institutions should ensure that their compensation frameworks are consistent with their long-term goals and with prudent risk-taking. As such, the Boards of Directors of financial institutions should set clear lines of responsibility and accountability throughout their organizations to ensure that the design and operation of its remuneration system supports the firm's goals, including its overall risk tolerance. Shareholders may have a role in this process. Boards should also ensure there are appropriate mechanisms for monitoring remuneration schemes.**

- **Responsibility**: Boards of Directors of financial institutions
- **Timeline**: Fall 2009
- **Monitoring:** Prudential supervisors or other relevant national authorities

***<u>Recommendation 20</u>*: In order to promote incentives for prudent risk taking, each financial institution must review its compensation framework to ensure it follows sound practice principles developed by the FSF. These include the need for remuneration systems to provide incentives consistent with the firm's long-term goals, to be adjusted for the risk taken by employees, and for the variable components of compensation to vary symmetrically according to performance.**

- **Responsibility**: Financial institutions
- **Timeline**: Fall 2009
- **Monitoring:** Prudential supervisors or other relevant national authorities

***<u>Recommendation 21</u>*: Prudential supervisors should enhance their oversight of compensation schemes by taking the design of remuneration systems into account when assessing risk management practices. The BCBS should more explicitly integrate this dimension in its guidance for the assessment of risk management practices by national prudential supervisors.**

- **Responsibility**: Prudential supervisors, BCBS
- **Timeline**: Fall 2009
- **Monitoring:** Expanded FSF

<u>Transparency</u>

***<u>Recommendation 22</u>*: Accounting standard setters should accelerate efforts to reduce the complexity of accounting standards for financial instruments and enhance presentation standards to allow the users of financial statements to better assess the uncertainty surrounding the valuation of financial instruments.**

- **Responsibility**: Accounting standard setters
- **Timeline**: Fall 2009
- **Monitoring:** Expanded FSF

***Recommendation 23*: The IASB should enhance its efforts to facilitate the global convergence towards a single set of high-quality accounting standards by sharing the experience of countries that have completed this process and by providing technical assistance.**

- **Responsibility**: IASB
- **Timeline**: Fall 2009
- **Monitoring**: Expanded FSF

Enforcement

***Recommendation 24*: The effective enforcement of regulation should be a priority of all financial regulators. As such, national financial regulators and oversight authorities should ensure the effectiveness of their enforcement activities and that appropriate resources are available for monitoring the application of regulation and for prosecuting offenders. The enforcement function should be independent from other activities or from external influences.**

- **Responsibility**: Prudential supervisors and other authorities
- **Timeline**: To be completed within 2 years
- **Monitoring**: IMF-WB (through FSAP and Article IV)

Technical Assistance and Capacity Building in Emerging Market Economies

***Recommendation 25*: Recognizing that the degree of development of financial systems varies considerably across the G20, national authorities should commit to assist each other in enhancing their capacity to strengthen regulatory frameworks. In addition, IOSCO, the IAIS and the BCBS should have the appropriate capacity to provide technical assistance. The needs of emerging market economies deserve particular consideration.**

- **Responsibility**: Finance Ministries, prudential supervisors and other authorities, IOSCO, IAIS, BCBS
- **Timeline**: Ongoing
- **Monitoring**: IMF-WB (through FSAP and Article IV)

2. Introduction

The Working Group was tasked with reviewing work underway in member countries and in international bodies, and with making recommendations that will enhance transparency in global financial markets, strengthen international regulatory standards, and ensure that all financial markets, products and participants are regulated or subject to oversight, as appropriate to their circumstances.

The mandate of the Working Group was not to make detailed technical recommendations, but to provide direction for policy measures to be pursued further by appropriate authorities and to provide a set of recommendations for timely, coordinated policy action.

Given the breadth of its mandate, the Working Group has identified some priorities to focus on, which are reflected in the recommendations for further reform presented throughout this report. Members were surveyed to obtain their views on these priority areas and to gather information on measures taken to implement the Washington Action Plan. The Working Group worked through regular conference calls, combined with one face-to-face meeting.

As mandated in the Leaders' Declaration, the Working Group relies to a large extent on existing work streams underway. International bodies conducting this work – the Financial Stability Forum, the International Organization of Securities Commissions, the Basel Committee for Banking Supervision, the International Association of Insurance Supervisors, the International Accounting Standards Board, the International Monetary Fund and the World Bank – all were represented on the Working Group, and their participation has been of tremendous value.

This Report is structured around the areas for reform identified in the Washington G20 Leaders' Action Plan. It provides some context on the need for reform in these areas, summarizes progress to date against items from the Washington Action Plan to address these shortcomings, and makes recommendations for further action and reform. The Working Group also makes some recommendations that go beyond the Washington Action Plan.

The report begins by developing an overarching theme that combines many of the specific action items included in the Washington Action Plan. This overarching theme is the need to supplement microprudential regulation with a more system-wide macroprudential approach which is designed to identify and mitigate the build-up of systemic vulnerabilities arising from excess liquidity, leverage, risk-taking and systemic concentrations across the financial system.

3. System-wide Approach to Financial Sector Regulation

It is fundamental that regulators and standard setters strive to achieve a prudential regulatory framework that protects the stability of financial institutions. Regulatory and supervisory weaknesses, such as those with respect to underwriting standards in the U.S. mortgage market, helped exacerbate the current crisis. It is essential that prudential regulation at the firm level be strengthened and that competent national regulators provide a first line of defense in preventing instability in the financial system.

However, a fundamental lesson from the current crisis is that effective supervision at the individual firm level, while necessary, is not sufficient to safeguard the soundness of the financial system as a whole. This is also the lesson of a long history of systemic financial failures. While each financial crisis is different, the crises over history generally share some key common elements including excessive risk taking, rapid credit growth and rising leverage. This points to the need for regulators, supervisors, and central bankers to supplement strong microprudential regulation with a macroprudential overlay to more effectively monitor and address the build-up of risks arising from excess liquidity, leverage, risk-taking and systemic concentrations that have the potential to cause financial instability.

Since the risk of distress to the financial system as a whole is not simply the sum of the risk to its individual components, the impact of the collective behaviour of economic agents on aggregate risk needs to be taken into account explicitly. To illustrate, take the example of a bank's leverage during an economic expansion. It may be individually appropriate for banks to take more risk during benign economic times, for example by increasing lending. However, when this behaviour is widespread, the overall leverage of the banking sector may create the potential for financial instability. Microprudential and macroprudential authorities may view this situation differently. The increased leverage may not be viewed as a concern from a microprudential perspective if it is supported by appropriate safeguards at the institution level, for example by sufficient capital buffers. However, even if these safeguards are considered appropriate for an individual institution, a macroprudential regulator may nonetheless be concerned by the potential for a systemic imbalance arising from a widespread increase in the overall leverage of the banking sector. As another example, the behaviour of individual institutions in markets as conditioned by capital requirements for their trading book, internal risk management practices, and rules and practices regarding margin requirements can lead to procyclicality in financial market prices.

A challenge for policymakers is to achieve the appropriate balance between the complementary microprudential and macroprudential approaches to financial sector oversight. Traditional microprudential objectives still need to be vigorously pursued in order to preserve financial stability, since incidents of financial stress are likely to be less frequent - and the associated costs reduced – if individual institutions are well managed, if markets function efficiently, and if the infrastructure supporting the financial system is strong.

The ability of authorities to address systemic risk needs to be considerably enhanced. A number of policy institutions, for example central banks, have enhanced their analysis of systemic risks in recent years - many of the systemic vulnerabilities that caused or enhanced the current turmoil had in fact been identified – but policy mechanisms to effectively translate these analyses into policy action are lacking.

The objective of enhancing the macroprudential orientation of the regulatory framework guides a broad range of issues addressed in this Report. This objective responds to the G20 Leaders' principle of making regulatory regimes more effective over the cycle and is related to many of the issues raised by Leaders in the Washington Action Plan, including certain aspects of compensation schemes at financial institutions, of margin requirements and risk management practices focused on Value-at-Risk calculations based on short historical samples, of the capital adequacy framework, and of valuation and loan-loss provisioning practices. In addition, there is a need to redefine the scope of the regulatory framework in order to establish appropriate oversight for the institutions and markets that may be the source of systemic risk. Risk management also needs to be enhanced to better evaluate vulnerabilities arising from low-frequency, system-wide risks, and to better mitigate these risks.

The Working Group views a commitment towards improving financial sector policy so that it can effectively mitigate the build-up of systemic risk to be of the highest priority. Resources must be committed to develop an overarching framework for addressing these issues. Building such a framework will involve reviewing the mandates of authorities, establishing national and international coordination mechanisms, and enhancing the tools of authorities to effectively address systemic concerns. There remains considerable uncertainty about how best to mitigate systemic risks, how to assess these risks as they arise, and how to respond. But it is essential that we move forward even if we do not yet have all the answers. Thirty years ago, when monetary policy began to focus on price stability, there was considerable uncertainty about how to implement this objective, and how to assess the determinants of inflation. Yet, the focus of monetary policy on price stability accelerated the development of effective inflation control frameworks, and has resulted in considerable success in keeping inflation low with important economic and social benefits.

The Working Group recommends that the mandate of all national financial regulators and oversight authorities and of all international financial bodies take account of financial system stability, as a complement to their core mandates. Financial sector authorities need to address systemic risks, and they need to consider the implications of their policies and standards for the stability of the financial system. In the case of accounting standard setting bodies, this implies that they will work towards ensuring that accounting standards will not affect the economic cycle, while balancing this goal with the primary objective of financial statements to provide objective, timely and accurate information on the economic situation of an entity.

Policymakers will need to address issues of coordination and cooperation, both at the domestic and international level. In addition, the relevant authorities must ensure they have instruments at their disposal to limit the buildup of imbalances with the potential to contribute to financial instability. Such policy tools will be developed with assistance of the financial standard setters, such as IOSCO, the IAIS and the BCBS. Global standards should be minimum best practices and national authorities would have the right to impose higher standards appropriate to their own circumstances.

The analysis of these instruments prior to their implementation should be conducted in a comprehensive fashion, taking into account the interaction between the various instruments considered. There may also be need for a review of governance of each authority, given the potential pressure for discretion in application of these tools at various points over the business cycle. The recommendations of the G20 Working Group on Reinforcing International Cooperation and Promoting Integrity in Financial Markers (Working Group 2), for example with respect to early warning exercises, and of the G20 Working Group on Reforming the IMF (Working Group 3), should support these expanded roles for the international bodies.

As an overarching framework to approach the Washington Action Plan, the Working Group recommends the following:

***Recommendation 1*: As a supplement to their core mandate, the mandates of all national financial regulators, central banks, and oversight authorities, and of all international financial bodies and standard setters (IASB, BCBS, IAIS and IOSCO) should take account of financial system stability.**

- **Responsibility:** Finance Ministries, national financial regulators and oversight authorities, central banks, IOSCO, IAIS, BCBS, IASB and other accounting standards setters, expanded FSF, IMF
- **Timeline**: To be completed within 2 years
- **Monitoring:** Compliance by national authorities to be monitored by IMF-WB (through FSAP and Article IV), compliance by international bodies to be monitored by expanded FSF

***Recommendation 2*: Within each country, there should be an effective mechanism for appropriate domestic financial sector authorities to jointly assess the systemic risks across the financial system and to co-ordinate the domestic policy response to limit the build-up in systemic risk. The structure of this coordinating mechanism should be transparent, with clear assignments of roles, responsibilities and accountability for each authority.**

- **Responsibility**: Finance Ministries, financial regulators and supervisors, central banks, in cooperation with other relevant bodies, including policy authorities for housing finance and accounting standard setters, as appropriate

- **Timeline**: To be completed within 2 years
- **Monitoring:** IMF-WB (through FSAP and Article IV)

<u>Recommendation 3</u>**: Financial sector authorities should have suitable macroprudential tools to address systemic vulnerabilities. Measures that are simple to understand and to implement would be preferable to more complex ones, and tools that rely on pre-specified limits or rules are attractive. However, rules need to be complemented with the informed judgement of financial sector authorities based on their joint assessment of the risks across the financial system.**

In order to achieve consistency globally, international bodies and standard setters – such as the expanded FSF, IOSCO, the IAIS, the BCBS, the BIS and others (*e.g.*, IASB, CGFS) – will develop such tools and provide national authorities, which are responsible for their implementation, with options. Potential macroprudential tools that should be explored further could include:

a. Complementing risk-based capital measures with simpler indicators aimed to measure the build-up of leverage, with enhanced sensitivity to off-balance sheet exposures;
b. Capital requirements that adjust over the financial cycle;
c. Loan-loss provisioning standards that incorporate all available credit information;
d. The use of longer historical samples to assess risk and margin requirements; and
e. Greater focus on loan-to-value ratios for mortgages.

- **Responsibility**: National authorities, expanded FSF, IOSCO, IAIS, BCBS, BIS, IASB, CGFS
- **Timeline for tool development**: Expanded FSF to provide an annual report on the suite of tools under development by its members, with an Interim Report in Fall 2009.
- **Timeline for tool implementation**: On an ongoing basis
- **Monitoring**: Development of tools to be monitored by G20, as well as expanded FSF, and their implementation by the IMF-WB (through FSAP and Article IV)

<u>Recommendation 4</u>**: The expanded FSF, together with the IMF, should create an effective mechanism for key financial authorities in each country to regularly come together around an international table to jointly assess the systemic risks across the global financial system and to coordinate policy responses.**

- **Responsibility**: Expanded FSF, IMF, Finance Ministries, national financial regulators and oversight authorities, central banks
- **Timeline**: Fully implemented within 2 years, with initial system in place by

the Fall 2009 FSF meetings
- **Monitoring**: G20

4. Washington Action Plan

The structure of the financial system has changed over time, with new types of institutions emerging and with distinctions between different types of players becoming more blurred as their activities converged. New types of complex financial instruments - sometimes with embedded leverage and a lack of transparency about their structure and the drivers of their performance - have also emerged. Although these developments may have come about as a result of innovations aimed at improving the efficiency of the financial system, they have also created opportunities for increasing leverage and for shifting risks among players in highly opaque ways.

In order to support innovation, and because the link to depositor protection was limited, policymakers have traditionally relied on market discipline to promote integrity in this segment of the financial system. Innovative institutions and markets were thus often lightly regulated or unregulated. One of the lessons of the current crisis is that market discipline did not adequately fulfill its intended role during the last economic cycle as risk exposures of regulated financial institutions and of the shadow banking system, as well as the complexity of the financial system and its opaqueness to both regulators and market participants ultimately proved destabilizing.

4.1 Regulatory Regimes

4.1.1 The Scope of Regulation

The contribution to the current crisis of certain financial institutions, markets and innovative instruments that were either unregulated or lightly regulated has highlighted the need for financial sector policymakers to redefine the perimeter of the regulatory framework. Examples of such institutions and instruments include mortgage brokers/originators, investment banks, securitization vehicles, credit rating agencies, as well as hedge funds and other private asset pools.

The need for enhancing prudential oversight stems in part from the realization that products and vehicles removed from a bank's balance sheet may still pose risks for this financial institution. Further, systemic failures, once largely confined to large institutions, can result from the interconnectedness between institutions whose individual condition may not pose a systemic risk in itself.

The Working Group views the protection of market integrity and the promotion of efficient capital markets as objectives of great importance for financial sector policy. We note that market integrity is within the purview of Working Group 2 and welcome their efforts to enhance the effectiveness of the regulatory framework in this area. Given our mandate and our objective to achieve a regulatory framework that better addresses system-wide concerns, we will focus our attention on the need to better assess systemic risks and to enhance regulation and oversight for financial institutions, markets and instruments – or types of financial institutions, markets and instruments - with the potential to be systemically important, either on their own or as a group.

Action Item: The appropriate bodies should review the differentiated nature of regulation in the banking, securities, and insurance sectors and provide a report outlining the issue and making recommendations on needed improvements. A review of the scope of financial regulation, with a special emphasis on institutions, instruments, and markets that are currently unregulated, along with ensuring that all systemically-important institutions are appropriately regulated, should also be undertaken. (For action in the medium term)

Process for Taking Forward the Leaders' Action Item

Since the Washington Summit, international bodies have undertaken a number of initiatives to assess differences in regulation across sectors, identify regulatory gaps and examine issues related to expanding the scope of regulation in response to this action item.

1. The Joint Forum, a Working Group of the BCBS, IOSCO and the IAIS, is undertaking a project that addresses the differentiated nature and scope of financial regulation. The main objective of this project is to identify areas where systemic risks may not be fully captured in the current regulatory framework. Special emphasis will be placed on institutions, instruments, and markets that are currently unregulated or lightly regulated. As appropriate, the Joint Forum will leverage off current work from other international bodies in its assessment.
2. An IOSCO Task Force is exploring whether and how to extend key regulatory principles applying to regulated products and markets, in the areas of transparency, market conduct, and market infrastructure, to securitized products and CDS. An interim report will be published in mid-March.
3. An IOSCO Task Force is examining issues surrounding unregulated entities such as hedge funds, including the development of recommendations for mitigating risks associated with their trading and opacity through oversight. An interim report setting forth a range of options will be published in March.
4. The IAIS is elaborating its medium-to long-term strategic focus through examining issues related to the supervision of internationally active insurance groups, macro elements of prudential supervision including contagion effects and the issue of non-regulated entities and regulatory consistency across financial sectors. A report is expected in June 2009.

The FSF will draw from the above work to review regulatory objectives, the instruments of regulation, and to what entities and activities these instruments should apply. This will be discussed at the March FSF Meeting.

Working Group Assessment

Work underway in response to this action item is only a first step towards achieving the Leaders' vision of a financial system in which all systemically important institutions are appropriately overseen.

As a starting point for determining how to assign appropriate oversight, more work is urgently needed to define systemic importance. The IMF and the FSF would be well placed to conduct this work jointly. The recent "Geneva Report" and the G30 report "Financial Reform: A Framework for Financial Stability" are useful starting points. They note that assessments of systemic significance should take into account a wide range of factors, including size, leverage, interconnectedness, and funding mismatches.

The increased integration of markets globally should be taken into account when assessing the systemic importance of any given financial institution, market or instrument given the potential for contagion across borders. Achieving a robust framework for regulating cross-border institutions, including by addressing the roles and responsibilities of authorities in home and host countries, is therefore important. This issue is treated by Working Group 2.

In order to assess appropriate regulatory perimeter, a framework to gather information and assess risk that is pervasive in both its geographical and institutional coverage is necessary. Authorities need the ability to acquire sufficient relevant information on the activities and exposures of all financial institutions, participants and issuers, in order to periodically assess their contribution to systemic risk, either on their own or through linkages with other segments of the financial system. These include, for example, the shadow banking system and hedge funds.

Three key areas for additional data collection by regulators should be considered in order to analyze the potential risks posed and decide whether regulatory action is needed. First, data on the nature of a financial institution's or vehicles activities should be collected - including, in the example of an hedge fund manager, data on the size, investment style, and linkages to systemically important markets of the funds it manages. Second, regulators should develop and monitor common metrics to assess the significant exposures of counterparties on a group-wide basis, including prime brokers for hedge funds, to identify systemic effects. Third, data on the condition of markets such as measures on the volatility, liquidity and size of markets which are deemed to be systemically important and/or vulnerable, should also be collected. It is envisaged that regulators would use a combination of existing information sources, including data collected from key institutions and vehicles. Consideration of what regulatory, registration or oversight framework would best enable this information collection and subsequent action would be determined by financial regulators at the home and host country level.

After identifying financial institutions, markets or instruments presenting risks that regulators wish to address, this could then be achieved over time as appropriate, whether by direct or indirect regulation, depending on the nature of the risk and/or the intensity of oversight that is desired. While we focus on the need for appropriate regulation and oversight for systemically important institutions, markets and instruments, the Working Group also supports an appropriate oversight and regulation framework for those that are not systemically important, for example for addressing concerns related to the integrity or the efficiency of markets.

Attention should be given to limiting negative spillovers to other parts of the financial system in the event of severe stress or failure, for example by enhancing counterparty risk management and by developing effective resolution regimes. In order to cope with the changes in the structure of the financial system over time, and recognizing that the determinants of systemic risk may vary over time and across countries, regulators need to have the ability to assign regulatory requirements within their jurisdictions, and they need to periodically review the perimeter of regulation to ensure that all parts of the system that could pose systemic risk have appropriate prudential requirements and resolution regimes.

Particular consideration should be given to the potential for the shadow banking system and for leveraged institutions such as hedge funds to contribute to systemic risk. We note that leverage may arise both directly through formal debt (*e.g.*, bonds, credit lines, IOUs) and indirectly through implicit borrowing due to certain derivatives transactions. Anecdotal evidence suggests that this indirect leverage is particularly important for hedge funds, and it should be taken into account when assessing their systemic importance. A clear implication of broadening information requirements is that hedge funds or their managers will need to register and provide authorities with the relevant information they require to asses the need for regulating them. Oversight and regulation will then be enhanced as appropriate, depending on risks revealed by the analysis of the information obtained. Oversight for hedge funds is discussed further in section 4.1.3.

In addition to traditional prudential tools such as capital buffers or risk management guidelines, prudential oversight for systemically important financial institutions could be enhanced either by restricting some of their activities that may present particularly high risks or conflicts of interest, or by assigning appropriate capital charges to reflect non-core activities. Examples of measures restricting activities for banking institutions are given in the G30 Report. They include disallowing the sponsorship or the management of private pools of capital in which the bank's own funds are commingled with that of clients, imposing strict capital and liquidity requirements for large proprietary trading, and retaining a meaningful part of credit risk when packaging and selling structured products. Another option includes increasing the costs of dealing in certain non-standard activities, perhaps through appropriate capital charges, so that financial institutions will be able to determine whether the cost of accommodating innovation merits the change.

Because of practical implementation issues, legal structures and jurisdictional limits will necessarily play an important role in the development of any supervisory model. However, given the convergence in the activities conducted by different types of financial institutions, achieving greater consistency in the regulatory principles that would apply to similar markets and institutions performing similar activities, both within and across borders, would be desirable in order to reduce the scope for regulatory arbitrage. The Working Group recommends that the expanded FSF conduct an analysis of the regulatory perimeter to examine practical issues related to putting greater emphasis on functions and activities and less emphasis on legal status.

The minimum degree of oversight applicable to the entire financial system has been an area of considerable discussion within the Working Group. The majority of Working Group members consider that some form of disclosure requirements for material entities or markets are an appropriate minimum standard, with authorities in each jurisdiction assessing risks posed by financial institutions, markets and instruments and increasing the degree of oversight and regulation according to their risk. However, some Working Group members would prefer a global standard for regulation and oversight applicable to all financial institutions, markets and instruments.

***Recommendation 5*: All systemically important financial institutions, markets and instruments should be subject to an appropriate degree of regulation and oversight, consistently applied and proportionate to their local and global systemic importance. Consideration has to be given to the potential systemic risk of a cluster of financial institutions which are not systemically important on their own. Non-systemically important financial institutions, markets and instruments could also be subject to some form of registration requirement or oversight, depending on the type and degree of risk posed, for example for the integrity or efficiency of markets.**

In order to determine the appropriate degree of regulation or oversight, national authorities should determine appropriate mechanisms for gathering relevant information on all material financial institutions, markets and instruments. This information will allow national authorities to assess the potential for their failure or severe stress to contribute to systemic risk, either on their own, as part of a cluster, or through linkages with other segments of the financial system. Information on systemic risk should be monitored through a globally coordinated mechanism.

National authorities should have the authority to expand the perimeter of regulation in a timely way, recognizing that it may vary across countries and through time. They should do so in close coordination with appropriate global fora and standard-setters in order to achieve as much consistency as possible across jurisdictions.

- **Responsibility: National authorities, central banks, IOSCO, IAIS and BCBS, with recommendations from the expanded FSF and the IMF**
- **Timeline: Two stages: process to obtain information underway in Fall 2009, with system in place within 2 years**
- **Monitoring: Expanded FSF to ensure a consistent approach to the perimeter of regulation, and the information collection framework to be monitored by IMF-WB (through FSAP and Article IV)**

***Recommendation 6*: The systemic importance of financial institutions, markets and instruments depends on a wide range of factors, including their size, leverage, interconnectedness, as well as funding mismatches. The IMF, in consultation with the BIS and the expanded FSF and other bodies, should jointly develop a common international framework and guidelines to help national authorities assess whether a financial institution, market or an instrument is systemically important as consistently as possible across jurisdictions.**

This framework should strive to treat similar activities more similarly for regulatory or oversight purposes regardless of the legal form of the institution, so as to avoid regulatory arbitrage.

- **Responsibility: IMF, BIS, expanded FSF**
- **Timeline: Fall 2009**
- **Monitoring: G20**

***Recommendation 7*: Large complex financial institutions require particularly robust oversight given their systemic importance, which arises in part from their size and interconnectedness (or correlation) with other institutions, and from their influence on markets.**

- **Responsibility: Prudential supervisors, with recommendations from the expanded FSF**
- **Timeline: Ongoing**
- **Monitoring: Expanded FSF**

***Recommendation 8*: The boundaries of the regulatory framework should be reviewed periodically within national jurisdictions, in light of financial innovation and broader trends in the financial system. International bodies will promote good practice and consistent approaches in this area.**

- **Responsibility: Prudential supervisors, central banks, and securities regulators, with guidance from the expanded FSF and the IMF**
- **Timeline: Ongoing**
- **Monitoring: Expanded FSF**

Two areas of particular concern have been raised by members of the Working Group, which are given attention below: the oversight of credit rating agencies and of hedge funds.

4.1.2 Oversight of Credit Rating Agencies

Investors in fixed income markets failed to probe deeply enough into the nature of the assets they bought, and instead relied too much on credit ratings. In addition, several issues related to credit rating agencies (CRAs) and their ratings have been cited as contributing factors to the current crisis, including:

- Concerns that they relied on flawed rating methodologies in determining ratings for structured products;
- Insufficient transparency concerning their assumptions, criteria and methodologies used for rating structured products; and
- Potential conflicts of interest.

In response to these concerns, IOSCO updated its Code of Conduct Fundamentals for CRAs in May 2008. The revised Code of Conduct incorporates changes designed to directly address conflicts of interest and transparency issues associated with ratings of structured financial instruments. The Code of Conduct requires CRAs to disclose their own codes of conduct and explain how these individual codes are consistent with the IOSCO standards.

As originally envisioned, enforcement of the Code was left to market participants (*e.g.*, investors, issuers) by virtue of their ability to assess for themselves the degree of compliance of any given CRA with the Code and to adjust their views of this particular CRA's rating opinions accordingly. While this approach offered the benefit of flexibility, the difficulty of confirming compliance remained a weakness which IOSCO and securities regulators in many jurisdictions have been working towards addressing.

Action Item: Regulators should take steps to ensure that credit rating agencies meet the highest standards of IOSCO and that they avoid conflicts of interest, provide greater disclosure to investors and to issuers, and differentiate ratings for complex products. This will help ensure that credit rating agencies have the right incentives and appropriate oversight to enable them to perform their important role in providing unbiased information and assessments to markets. (For immediate action by March 31, 2009)

Action Item: IOSCO should review credit rating agencies' adoption of the standards and mechanisms for monitoring compliance. (For immediate action by March 31, 2009)

Action Item: Credit Ratings Agencies that provide public ratings should be registered. (For action in the medium term)

Process for Taking Forward the Leaders' Action Item

Following publication of the revised IOSCO *Code of Conduct Fundamentals for Credit Rating Agencies*, all of the major rating agencies adopted codes of conduct based on this enhanced set of guidelines. IOSCO is currently reviewing the extent to which these agencies' own codes satisfy its guidelines, and a report will be published in early March. The report indicates that the large global CRAs have largely adopted the changes to the Code or, in certain instances, such as in relation to considering a separate rating scale or subscript for structured products, have clearly explained why they have not adopted that part of the Code. Some smaller national agencies have not adopted the changes but appear likely to do so soon, and a few small agencies have yet to adopt codes based on the IOSCO Code.

Since the Code lacks legal authority, any enforcement of the Code rests with national regulators. Certain credit rating agencies whose ratings are used for regulatory purposes are registered in the U.S., and similar proposals are at various stages of the regulatory process in other jurisdictions, including in the European Union and Japan. The FSF is following these national and regional initiatives and is working to promote a globally consistent approach to oversight of credit rating agencies.

The IOSCO Task Force on Credit Rating Agencies has developed a model examination module for regulators undertaking inspections of CRAs in their jurisdictions. The module provides a model for monitoring compliance with the substance of the IOSCO Code. The Task Force is also in the process of drafting a paper outlining an approach that securities regulators can use to oversee globally active CRAs. This approach will include a permanent IOSCO committee for regular dialogue with the CRA industry and for information sharing among IOSCO members regarding the regulation of CRAs. This paper will also discuss a college of regulators approach and bilateral arrangements regarding ongoing supervision of globally active CRAs. The intention is for this paper to be available by mid March.

Working Group Assessment

The two action items for immediate action – taking steps towards ensuring compliance with the IOSCO code and developing mechanisms for monitoring compliance – are on track to be met by the April Leaders Summit, and the medium term action of national registration is already underway in many jurisdictions.

The Working Group is of the opinion that the IOSCO Code of Conduct is a helpful common frame of reference and that it establishes appropriate standards with respect to incentives alignment, due diligence and transparency. However, a self-regulatory framework does not appear sufficient to ensure compliance with the IOSCO Code. A sound regulatory framework with robust supervision of CRAs by public authorities is necessary to ensure that professional standards are applied, that procedures and policies agreed upon by CRAs are adequately followed, that the integrity of the rating process is upheld, and that conflicts of interest are eliminated or adequately managed. Effective supervision requires surveillance of CRAs' activities and, where necessary, enforcement of rules applying to CRAs. Therefore, rigorous but proportionate rules should be enacted, consistent with international standards, concerning:

- The prevention of conflicts of interest, and the adequate management of those conflicts that arise;
- Transparency about the quality of ratings and of the ratings methodology; and
- Transparency regarding the rating process, both in general and with respect to a specific issuer or financial instrument, to the credit rating agencies' historical performance and to how credit rating agencies operate internally. Moreover, a dual rating scale or an identifier distinguishing between corporate and sovereign debt, on the one hand, and structured financial products, on the other, would be desirable.

The Working Group has focused on strengthening enforcement mechanisms in order to foster discipline in the credit rating industry. Specifically, the Working Group recommends that Leaders complement their commitment on the registration of credit rating agencies with one to enhance enforcement, by empowering regulators with the ability to require changes to a CRA's practices and procedures for managing conflicts of interest at credit rating agencies and assuring the transparency and quality of the rating process.

Given the global scope of some credit rating agencies, it is desirable for the oversight framework to be consistent across jurisdictions in order to avoid regulatory arbitrage, and to avoid unnecessary compliance costs for those CRAs conducting international activities. Conflicting national-based regulation could have unintended consequences for users of credit ratings and should be avoided where possible. The common monitoring module developed by IOSCO and the role of the IOSCO Task Force on Credit Rating Agencies in ensuring global consistency in the supervision of CRAs are welcome developments in this regard.

A small number of rating agencies which have global operations, and others specialize within a national market. In order to avoid duplication, regulators should strengthen cooperation arrangements to effectively address supervisory issues of global nature. Enhanced international cooperation arrangements could be developed through IOSCO.

***Recommendation 9*: All credit rating agencies whose ratings are used for regulatory purposes should be subject to a regulatory oversight regime that includes registration and that requires compliance with the substance of the IOSCO Code of Conduct Fundamentals. National authorities should obtain the authority to enforce compliance and require changes to a rating agency's practices and procedures for managing conflicts of interest and for assuring the transparency and quality of the rating process. Given the global scope of some credit rating agencies, the oversight framework should be consistent across jurisdictions with appropriate sharing of information between national authorities responsible for the oversight of credit rating agencies.**

- **Responsibility**: National authorities
- **Timeline**: To be completed within 2 years
- **Monitoring:** by IOSCO and IMF-WB (through FSAP and Article IV)

4.1.3 Private Pools of Capital

While the benefits of hedge fund activity to the functioning of financial markets have been recognized, questions have been raised about the comparatively limited extent to which hedge fund managers and funds are subject to direct oversight. Concerns expressed relate, in particular, to the risks that their leverage and short-term funding represent for the stability of the financial system; and to a perceived lack of transparency of hedge funds *vis-à-vis* regulators and other financial market actors. Recently, there have also been concerns about the abusive use of short selling by hedge funds as well as some internal processes, in particular the manner in which hedge funds manage their risks, value their asset portfolios and avoid potential conflicts of interest.

Action Item: Private sector bodies that have already developed best practices for private pools of capital and/or hedge funds should bring forward proposals for a set of unified best practices. Finance Ministers should assess the adequacy of these proposals, drawing upon the analysis of regulators, the expanded FSF, and other relevant bodies. (For immediate action by March 31, 2009)

Process for Taking Forward the Leaders' Action Item

In 2007, the FSF called on the hedge fund industry to develop a code of best practices in the context of an update to its report on highly leveraged institutions. In response, two hedge fund associations, the Hedge Fund Standards Board in the U.K. and the Asset Managers' Committee in the U.S., have prepared separate codes of good practice for the industry. Additional standards have been developed by the Alternative Investment Management Association. Work is now underway amongst these private bodies to produce a single summary standards document. When this becomes available, the FSF and IOSCO will assess and comment on the adequacy of these proposals.

Working Group Assessment

Working Group members expressed concerns that some hedge funds – or groups of hedge funds – may generate systemic risk and impose externalities on the financial system.

There is some form of oversight over hedge funds in most G20 jurisdictions. First, the management companies, or advisors, of these funds may be required to register in order to do business in a jurisdiction. Second, regulators may be able to monitor the linkages between hedge funds and regulated institutions where there is a prime broker relationship, and thereby have some indirect oversight on the exposures and risk management practices with respect to the potential impact of hedge funds on systemically important institutions. Third, the activities of hedge funds on regulated markets are subject to the oversight of the market conduct authorities responsible for regulating these markets.

Given the global scope of activity by hedge funds from non-G20 jurisdictions, there are differing views on the extent to which these current arrangements need to be complemented by deepening of direct regulatory oversight of hedge funds, accompanied by some global or international capacity to aggregate information on financial system exposures to hedge funds.

There is a consensus within the Working Group that authorities need better information on the structure and activities of hedge funds, as well as on the risks they are exposed to, in order to assess whether hedge funds should be subject to a higher degree of oversight or regulation. There is also a consensus on the importance of achieving a coordinated policy response internationally.

Recommendations made by the Working Group to enhance the perimeter of the regulatory framework (see section 4.1.1, recommendations 5 through 8) address the need for national authorities to gather better information on all material financial institutions, including hedge funds, in order to determine the appropriate degree of regulation or oversight, commensurate with the risk posed. Recommendation 5 addresses the need to enhance the oversight and regulation of hedge funds as appropriate, depending on risks revealed by the analysis of the information obtained.

In order to help operationalize these recommendations for hedge funds, the Working Group is recommending they or their managers register with financial authorities and disclose appropriate information on the risks they pose. The data collected would likely include the size, investment style, leverage and performance of the fund along with its participation in certain systemically important markets. In addition, since one mechanism through which the failure of a systemically important hedge fund or cluster of hedge funds would be transmitted to the broader financial system – and potentially the real economy - is through its counterparties, it would be appropriate for regulators to develop and monitor common metrics to assess the significant exposures of counterparties, including prime brokers for hedge funds.

Global fora, such as IOSCO and the FSF, allow for global discussion of issues related to hedge funds and for coordinating possible policy responses.

While some Working Group members favoured a stronger recommendation on the regulation of hedge funds, there was common ground that authorities required information to assess the risks they pose and the need to regulate them if they are systemic. They recognized that systemic importance can change over time, and that hedge funds are at different stages of development across the G20.

***Recommendation 10*: Private pools of capital, including hedge funds, can be a source of risk owing to their combined size in the market, their use of leverage and maturity mismatches, and their connectedness with other parts of the financial system. They or their managers should therefore be required to register with financial authorities and disclose appropriate information to assess the risks they pose.**

- **Responsibility**: National Authorities
- **Timeline**: To be implemented within 2 years
- **Monitoring:** Expanded FSF

4.1.4 Transparent Assessment of Regulatory Regimes

The Financial Sector Assessment Program aims to promote the soundness of financial systems through evaluations supported by experts from a range of national agencies and standard-setting bodies with the objectives of identifying the strengths and vulnerabilities of a country's financial system; determining how key sources of risk are being managed; ascertaining the sector's developmental and technical assistance needs; and helping prioritize policy responses. As such, this program represents a useful tool for enhancing the regulatory framework.

Action Item: To the extent countries or regions have not already done so, each country or region pledges to review and report on the structure and principles of its regulatory system to ensure it is compatible with a modern and increasingly globalized financial system. To this end, all G-20 members commit to undertake a Financial Sector Assessment Program (FSAP) report and support the transparent assessments of countries' national regulatory systems. (For action in the medium term)

Process for Taking Forward the Leaders' Action Item

Fifteen member countries of the G20 have undertaken a FSAP assessment.

Working Group Assessment

The IMF and the World Bank are continuing to enhance the analytical framework for financial sector assessments. For instance, they are focusing more on systemic linkages and dynamics, and are taking a more systematic approach to stability and developmental assessments to enhance their comparability across countries.

Recent assessments for advanced economies have focused mainly on evaluating the risks of exposure to US subprime-related products. More broadly, they focused on the risk of external contagion, as well as cross-border crisis management.

Assessments in emerging market countries have focused on evaluating resilience to a range of possible shocks that could be triggered as a consequence of the unfolding crisis; for example, stress-testing scenarios where external sources of liquidity suddenly dry up. In addition, the assessment examines crisis management frameworks and, in countries where foreign banks predominate, cross-border cooperation arrangements among host and home country supervisors.

Outside the FSAP process, it is possible for jurisdictions to undertake self-assessments or assisted assessments to diagnose weaknesses in their systems and identify remedial actions. For example, India has recently undertaken such a self-assessment. IOSCO and the IAIS have developed self-assessment frameworks that can be used to identify areas for enhancement in preparing for the FSAP. To ensure objective and appropriate assessments, the appropriate self-assessment tools and sufficient methodology for assessments should be developed by international financial standard-setting bodies (IOSCO, IAIS, CPSS and BCBS) in cooperation with the IMF and the World Bank.

IOSCO and the IAIS encourage countries conducting self-assessments to obtain assistance from independent experts to develop action plans for addressing gaps in the implementation of global standards. They also facilitate this process. For instance, IOSCO recently conducted a workshop to train assessors to be able to undertake peer reviews of these self-assessments.

The Working Group recommends that Leaders reiterate their commitment made in Washington to undertake an FSAP and to make it public. The IMF and the WB should prepare a plan and timetable of completed and upcoming assessments by the Fall of 2009. Periodic self-assessments of regulatory frameworks should also be undertaken and these should be based on internationally agreed methodologies and tools. These actions would allow for a monitoring of progress on improvements to transparency and to compliance with international standards and regulations.

FSAPs should also be used to monitor consistency in regulatory frameworks and the perimeter of regulation. The basis upon which countries are assessed should be expanded to include macroprudential oversight and the regulatory oversight of the structure of compensation schemes at financial institutions

Given the increasing globalization of the financial system, G20 Leaders should also encourage non-G20 countries to take similar steps to assess the strength of their national financial systems.

Recommendation 11**: All G20 members should commit to undertake a Financial Sector Assessment Program (FSAP) report and to publish its conclusions. National authorities may also periodically undertake a self-assessment of their regulatory frameworks based on internationally agreed methodologies and tools.**

To improve the FSAP process, the basis upon which countries are assessed should be expanded to encompass macroprudential oversight, the scope of regulation, and supervisory oversight of the influence of the structure of compensation schemes at financial institutions on risk taking.

- **Responsibility**: Finance Ministries, IMF/WB
- **Timeline**: G20 countries that have not undertaken an FSAP should immediately commit to do so, in consultation with the IMF/WB; Countries with systemically important financial systems should be subject to a self-assessment every 5 years, and FSAP Updates in consultation with IMF/WB
- **Monitoring:** IMF/WB

4.2 Procyclicality

The crisis has raised questions whether certain aspects of accounting frameworks and capital regulation increase the natural tendency of the financial system to amplify business cycles. This tendency is particularly disruptive and apparent during an economic downturn or when the financial system is facing strains. There is a lack of incentives for the financial system to lean against rapid growth of credit and asset values during benign economic conditions. This would not only mitigate the build-up of imbalances that give rise to systemic risk but, by building up prudential buffers during the benign phase of an economic cycle, when it is easier and cheaper to do so, institutions would enter more challenging times from a stronger position.

Action Item: The IMF, expanded FSF, and other regulators and bodies should develop recommendations to mitigate pro-cyclicality, including the review of how valuation and leverage, bank capital, executive compensation, and provisioning practices may exacerbate cyclical trends. (For immediate action by March 31, 2009)

Process for Taking Forward the Leaders' Action Item

The FSF and its members have formed three workstreams to study the forces that contribute to procyclicality in the financial system and examine possible options for mitigating them, drawing on a framework paper prepared by the BIS. These workstreams have focused on (i) bank capital, (ii) loan loss provisioning, and (iii) the interaction of valuation and leverage practices. The FSF has also formed a workstream to develop sound practice principles for ensuring that compensation schemes do not provide incentives for excessive risk taking. This work is discussed in section 4.4.1.

- *Bank capital*: A Joint FSF-BCBS workstream is examining the impact of Basel II on the cyclicality of capital requirements and developing ways to mitigate the risk of regulatory capital amplifying shocks to the financial sector and the real economy going forward. The workstream is developing recommendations on changes to the regulatory capital framework so that it raises over time the quality and level of capital in the banking system during strong economic conditions that can be drawn down during periods of economic and financial stress; revision to the market risk framework of Basel II to reduce the reliance on cyclical VaR-based capital estimates; supplementing the risk-based capital framework with a simple, transparent measure to help contain the build up of leverage in the banking system; and recommending that supervisors use stress tests as part of the Pillar 2 supervisory review process to validate the adequacy of banks' capital buffers above the regulatory minimum during periods of rapid growth.
- *Loan loss provisioning*: A workstream is analyzing the potential contribution of loan loss provisioning to procyclicality with a view to recommending that accounting standard setters consider enhancements to loan loss provisioning practices and standards. Recommendations under consideration include that accounting standards setters issue a statement that reiterates the required use of sound management judgement as part of existing loan loss provisioning standards; and that they reconsider their current loan loss provisioning requirements and related disclosures on an expedited basis to reflect a broader range of available credit information, including by analysing expected loss and through-the-cycle provisioning approaches. Other recommendations under consideration include reviewing and eliminating constraints in Basel II that may limit banks from maintaining robust loan loss provisions; and reviewing and enhancing the Pillar 3 disclosures about loan loss provisioning practices and related credit risk and credit losses in loan portfolios.
- *Valuation and Leverage*: A joint FSF-CGFS workstream is analyzing the significance of the link between valuation and leverage as a source of procyclicality. It is considering the use of quantitative indicators and/or constraints on leverage and margins as macroprudential tools for supervisors; a research program to measure funding and liquidity risk

attached to maturity transformation and based on its findings, which information should be made available to supervisors on leverage and on maturity mismatches on a system-wide basis; the use of valuation reserves or adjustments be considered for fair valued financial instruments when data or modelling needed to support their valuation is weak; and an examination of possible changes to relevant standards to dampen adverse dynamics potentially associated with fair value accounting.

The FSF will discuss reports from these workstreams in mid-March.

Working Group Assessment

This action item has been achieved. The Working Group now proposes that recommendations from the FSF workstreams be assessed by the BCBS, accounting standard setters and other authorities, taking into consideration practical issues related to their use and implementation, and that regulation and standards be enhanced over time to mitigate procyclicality. The Working Group proposes that a roadmap be prepared for the Fall of 2009, and that annual updates be provided to the expanded FSF afterwards.

The assessment of these recommendations should include an analysis of the interaction between measures to mitigate procyclicality and the objective should be to attain a comprehensive strategy that achieves the best overall outcome. In the near term, consideration could be given to options that do not require a major reworking of accounting standards for provisions and impairment. The roadmap to address pro-cyclicality should also take into account the need for training and for technical assistance at institutions and regulators, with particular attention to those in emerging market economies.

Measures that are simple to understand and to implement would be preferable to more complex ones, and policy tools that are based on rules are attractive. However, as the recent crisis made plain, rules-based tools can be arbitraged, so the informed judgment of regulators will also be an important part of efforts to dampen procyclicality.

Although there is consensus on objectives and willingness to collaborate going forward, it has proven difficult to fully develop recommendations on the implementation of provisioning techniques that are more forward-looking or less procyclical. Accounting standards for provisioning of loan losses through the income statement require evidence, coupled with management judgment, that there is a deterioration in the loan portfolio. Through-the-cycle or less procyclical provisioning, where provisions are increased in good times for the possibility that the environment may deteriorate in the future is not consistent with accounting standards which strive to be neutral through the cycle, unless these provisions represent credit losses that are truly inherent in and accumulating in loan portfolios at balance sheet date. While accounting standards setters agree in principle that such through-the-cycle provisioning practices would be desirable from a financial stability perspective, they argue that provisions that do not reflect incurred credit losses would reduce the integrity of financial statements, whose function is to present an objective and accurate representation of the financial situation of an entity.

However, there is also a view that a key lesson from the current crisis is that accounting standards in fact have not succeeded in accurately representing the financial situation of entities, as they did not take into account available information on risks. While collaboration between supervisors and accountants is definitely important, this has been ongoing and in order for it to deliver, there must be a realization that accounting standards need to be strengthened to better reflect risks through the cycle. Mitigating the procyclicality arising from provisioning practices requires that the BCBS and accounting standards setters collaborate to identify solutions that are compatible with their complementary objectives of enhancing the stability of the financial sector and promoting transparency of economic results in financial reports, respectively.

***Recommendation 12*: The FSF and other bodies, particularly the BCBS, should develop and implement supervisory and regulatory approaches to mitigate procyclicality in the financial system by promoting the build-up of capital buffers during the economic expansion and by dampening the adverse interaction between fair valuation, leverage and maturity mismatches in times of stress.**

- **Responsibility**: FSF and member bodies, BCBS, CGFS
- **Timeline for development**: Strategic plan Fall 2009, with further progress reported by year end
- **Timeline for implementation**: As appropriate, with discussion with sector and coordination by the expanded FSF
- **Monitoring:** Expanded FSF

***Recommendation 13*: Accounting standard setters should strengthen accounting recognition of loan loss provisions by considering alternative approaches for recognizing and measuring loan losses that incorporate a broader range of available credit information. They should also examine changes to relevant standards to dampen adverse dynamics associated with fair value accounting, including improvements to valuations when data or modelling is weak. Accounting standards setters and prudential supervisors should work together to identify solutions that are consistent with the complementary objectives of promoting the stability of the financial sector and of providing transparency of economic results in financial reports.**

- **Responsibility**: Accounting standards setters, BCBS
- **Timeline for development**: Strategic plan Fall 2009
- **Timeline for implementation**: As appropriate, with discussion with sector and coordination by the expanded FSF
- **Monitoring:** Expanded FSF

4.3 Prudential Oversight

This section addresses actions to enhance prudential oversight with respect to capital and liquidity, in addition to the need for a sound infrastructure for OTC derivatives that would reduce their potential systemic risk.

4.3.1 Capital

The crisis has shown that a strong capital base is critical to bank resilience, and broader financial stability, by underscoring a number of weaknesses in capital adequacy, primarily with respect to banking institutions. First, the Basel II framework did not properly capture the risk associated with certain assets, in particular complex credit products in the *trading book*. These products, to date, have produced the majority of the losses at banks, as well as complex securitisations and contingent exposures to off-balance sheet vehicles. Second, the minimum level of capital, as well as its quality, failed to support the banks' risk exposures going into the crisis. Third, the cyclicality of capital buffers has amplified the economic downturn (see section 4.2). Fourth, discrepancies across financial institutions in measures of capital make solvency ratios difficult to compare.

<u>Action Item</u>: Authorities should ensure that financial institutions maintain adequate capital in amounts necessary to sustain confidence. International standard setters should set out strengthened capital requirements for banks' structured credit and securitization activities. (For immediate action by March 31, 2009)

<u>Action Item</u>: Definitions of capital should be harmonized in order to achieve consistent measures of capital and capital adequacy. (For action in the medium term)

<u>Process for Taking Forward the Leaders' Action Item</u>

The Basel Committee on Banking Supervision has announced a package of measures to strengthen the Basel II capital framework in order to address weaknesses revealed by the crisis in the banking sector, and additional measures are being developed. These measures form part of a comprehensive strategy to strengthen the regulation, supervision and risk management of internationally active banks.

In addition to mitigating the influence of the capital framework on risk-taking and the economic cycle (see section 4.2), two key building blocks of this strategy are:

- *<u>Strengthening the risk capture of the Basel II framework</u>*: In January 2009, the BCBS issued for consultation proposals to strengthen the risk capture of Basel II framework. These include enhancements to the capital treatment of securitizations, off-balance sheet exposures, and trading book activities.

- *Enhancing the consistency and quality of the Tier 1 capital base*: The BCBS is considering various measures to promote the quality of capital, in particular, ordinary shares and reserves in the Tier 1 capital base and enhancing the global consistency of minimum capital requirements. The definition of capital is being reviewed as part of this work in order to achieve global consistency. It will be a medium term project, however, as many jurisdictions are currently using new types of capital instruments to inject public money and strengthen the capital base of their banking system. The BCBS will review recommendations to achieve this at its March 2009 meeting.

These two building blocks are being considered in conjunction with a third strategic priority, mitigating procyclicality, which is addressed in section 4.2. The BCBS will consider preliminary recommendations to mitigate procyclicality at its March 2009 meeting, along with recommendations for enhancing the consistency and quality of capital.

Further initiatives of the BCBS to enhance the capital framework that are less advanced include:

- Reviewing the treatment of external ratings under the framework and whether there are any adverse incentives that should be mitigated (at the July 2009 BCBS meeting);
- Strengthening the treatment of counterparty credit risk under the three pillars of Basel II (at the December 2009 BCBS meeting); and
- Evaluating concrete ways to supplement the Basel II risk-based capital framework with a simple, transparent measure, for example to help contain the build up of leverage over the cycle.

The BCBS plans to develop recommendations in these areas by the end of 2009.

In the insurance sector, the IAIS is developing a comprehensive and cohesive set of supervisory papers which will take into account issues that have emerged from the financial crisis with respect to the assesment of the solvency of insurance companies. For instance, standards and guidance on the structure of regulatory capital requirements and on the use of internal models and enterprise risk management for solvency purposes which have been completed are undergoing review to address issues which have emerged from the financial crisis. Other solvency supervisory papers taking into account recent events are under development or review, including standards and guidance on capital resources, valuation for solvency purposes and investment and asset-liability management. The IAIS will continue to work with its members to facilitate proper implementation of these standards to enhance resilience of the solvency position of insurers.

Working Group Assessment

The capital adequacy framework for the banking sector has been enhanced in response to the action items above. For instance, enhancements to the risk capture of the Basel II framework have established stronger capital requirements for banks' structured credit and securitization activities, and the medium term action item of harmonizing definitions of capital is being addressed in conjunction with work to improve the quality of capital. Further, the strategic plan of the BCBS includes enhancements to the capital adequacy framework not part of the Washington Action Plan.

A strong, high quality capital base is critical for banks to be able to absorb losses and maintain lending during periods of severe economic and financial stress. Based on lessons drawn from recent developments, authorities should ensure that financial institutions maintain strong prudential buffers while accommodating a need for flexibility to raise capital in difficult market conditions.

The Working Group was of the view that the financial system had entered the current crisis undercapitalized and the international standard for the minimum level of capital for banks should be reviewed. It recommends that higher buffers above a minimum level of capital are needed for the system once the current crisis has abated and that the quality and global consistency of capital should be enhanced.

It is important for G20 Leaders to send a clear message that supervisors will be extremely cautious about adding to the already severe tension in the marketplace, and therefore will not consider raising capital buffers above minimum capital ratios during the crisis. Any enhancements will be introduced in a manner that promotes the near term resilience of the banking sector and its ability to provide credit to the economy, and would be communicated to markets at an appropriate time to mitigate the countercyclical effects of any proposed change in capital levels. Timelines for implementation may vary across the G20 depending on the technical capabilities of each country's institutions and regulators.

Recognizing the need to also mitigate procyclicality (see section 4.2), high quality capital should serve as a buffer which would be built up during periods of rapid earnings growth and be drawn down in a downturn.

The Working Group also recommends that G20 Leaders support the progressive adoption of the Basel II capital framework across the G20 once strains in markets have abated. The move to the Basel II framework improves risk capture and better handles periods of rapid innovation and the new products that such periods produce. Moreover, Basel II captures off-balance-sheet vehicles, ensuring they are subject to regulatory capital requirements. Timelines for implementation may vary across the G20 depending on the level of technical capabilities of each country's regulators and institutions (see section 5.2 for more on technical assistance).

Nonetheless, in the context of rapid financial innovation and risk-based regulatory capital requirements, a well constructed non-risk-based capital measure can at least partially address the problem of modelling deficiencies for the advanced approaches and ensure a minimum level of capital is retained in the banking system. The case for a complementary, non-risk-based capital measure as a regulatory "back-stop" to the Basel II risk-based capital requirement should be examined by the BCBS.

The Working Group welcomes efforts by the IAIS to address issues that have emerged from the crisis with respect to the solvency of insurance companies. This workplan should take into consideration the need for group-wide solvency requirements that take into account all the subsidiaries in internationally active insurance groups.

***Recommendation 14*: Capital should serve as an effective buffer to absorb losses over the cycle, so as to protect both the solvency of financial institutions in the event of losses, and their ability to lend.**

In the near term, capital buffers above required minimums should be allowed to decline in response to deteriorating economic conditions and credit quality, and urgent consideration should be given to measures that would facilitate access to additional private sector capital in the downturn.

Once conditions in the financial system have recovered, the adequacy of the international standard for the minimum level of capital for banks should be reviewed and the quality and global consistency of capital should be enhanced. In addition, capital buffers above minimum requirements and loan-loss provisions should be built up in good times in order to enhance the ability of regulated financial institutions to withstand large shocks.

In this context, the BCBS should develop standards to promote the build-up of capital buffers in good times that can be drawn down in periods of stress. The BCBS should also complement risk-based capital measures with simpler indicators to monitor the build-up of leverage.

The international standard for the minimum level of capital should remain unchanged until the financial system has recovered.

- **Responsibility**: BCBS
- **Timeline**: The review of international standards related to capital buffers and the quality and consistency of capital will be discussed at periodic BCBS meetings and the transition will be completed as appropriate, in consultation with the industry and with coordination by the expanded FSF.
- **Monitoring**: Expanded FSF

***Recommendation 15*: G20 Leaders should support the progressive adoption of the Basel II capital framework, which will continue to be improved on an ongoing basis, across the G20.**

- **Responsibility**: Prudential supervisors, BCBS
- **Timeline**: The transition to Basel II is to be completed as appropriate, in consultation with the industry and with coordination by the expanded FSF
- **Monitoring**: IMF-WB (through FSAP and Article IV), BCBS

4.3.2 Liquidity

Recent events have highlighted a number of limitations in the lines of defence of financial institutions during a period of severe liquidity strain. Many of the actions by which financial institutions can address liquidity pressures, for example by selling illiquid assets for cash or by competing more aggressively for retail deposits, suffer when liquidity pressures are widespread and many institutions attempt to use the same funding strategies.

The increasing complexity of financial instruments also creates challenges for managing liquidity. The inclusion of options in financial instruments (*e.g.*, credit rating downgrade clauses) and the fact that some instruments have short track records or do not trade actively, increases the difficulty in assessing the behaviour of these instruments during periods of stress and consequently, for managing liquidity.

Another weakness revealed by the crisis is that liquidity, which some large global financial institutions are increasingly managing in a centralised manner across borders, may not be fully transferable across borders in times of stress, as national supervisors and domestic crisis management policies may require that sufficient liquidity be held for local operations.

Action Item: Regulators should develop and implement procedures to ensure that financial firms implement policies to better manage liquidity risk, including by creating strong liquidity cushions. (For immediate action by March 31, 2009)

Action Item: Supervisors and central banks should develop robust and internationally consistent approaches for liquidity supervision of, and central bank liquidity operations for, cross-border banks. (For action in the medium term)

Process for Taking Forward the Leaders' Action Item

Standards for liquidity management in the banking sector will be materially raised by the BCBS' *Principles for Sound Liquidity Risk Management and Supervision*, published in September 2008. The foundation for this guidance is the fundamental principle that banks should establish a robust framework for managing liquidity risk, and that they maintain sufficient liquidity, including a cushion of unencumbered, high quality liquid assets, to withstand a range of stress events, including those involving the loss or impairment of both unsecured and secured funding sources. This guidance also clarifies expectations that supervisors should assess the adequacy of both a bank's liquidity risk management framework and its liquidity position, and should take prompt action if a bank is deficient in either area in order to protect depositors and limit potential damage to the financial system.

These guidelines include a principle calling for cooperation and information sharing among supervisors and other stakeholders, such as central banks, for the liquidity supervision of cross-border banks. This principle provides examples of firm-specific stress situations that should require closer and more frequent communication among stakeholders.

The BCBS Working Group on Liquidity has initiated work to promote greater consistency of liquidity regulation and supervision for cross-border banking groups, including by clarifying the roles of, and improving coordination between, supervisors in home and host countries. Regulatory cooperation in the oversight of cross-border institutions is addressed by G20 Working Group 2.

Enhancing liquidity supervision includes an evaluation of tools, metrics and benchmarks that supervisors can use to assess the resilience of banks' liquidity cushions and constrain any weakening in liquidity maturity profiles, diversity of funding sources, and stress testing practices. This will be discussed at the July 2009 BCBS meeting.

In addition, the Committee on the Global Financial System (CGFS) released a report in July 2008 to enhance the operational frameworks for the provision of liquidity by central banks, including cross-border banks. This report recommends that central banks enhance their capacity to address problems in the international distribution of liquidity by establishing or maintaining standing swap lines among themselves, and by accepting assets denominated in a foreign currency or obligations booked abroad as collateral. Moreover, the CPSS prepared a report on operational arrangements that central banks could make, on an individual or coordinated basis, to strengthen their operational readiness to cope with a wide range of scenarios under which they might seek to provide cross-border liquidity. Many central banks across the G20 have begun implementing these recommendations.

Although recent events did not reveal weaknesses with respect to the liquidity management in the insurance sector, the IAIS has expanded its planned review of solvency supervisory papers to take into account this issue. Insurance firms have not faced the same liquidity pressures as other types of financial institutions in part because they tend to have longer-term financial obligations.

Working Group Assessment

The BCBS guidance establishes guidelines for the management of liquidity risk, including the use of cushions of unencumbered, high quality assets to withstand a range of stress events. This adequately addresses the Washington action item to this effect, as the weaknesses that were revealed by the crisis with respect to liquidity pertained mainly to the banking sector. The BCBS will conduct a comprehensive review of whether its standards for liquidity have been effectively implemented in the second half of 2009.

The Working Group proposes that Leaders support the implementation of these principles. In order to improve liquidity resilience against future crises, financial institutions will need to hold increased levels of stable core funding that is more likely to be stable across the economic cycle.

An effective global liquidity framework for managing liquidity in large, cross-border financial institutions should include internationally agreed levels of liquidity buffers, and should encourage an increase in the quality of their composition. Such a framework needs to be comprehensive and take into account liquidity needs for the overall institution.

***Recommendation 16*: Prudential supervisors and central banks should deliver a global framework for promoting stronger liquidity buffers at banks, including cross-border institutions, to ensure that they can withstand prolonged periods of market and funding liquidity stress.**

In addition, the BCBS should enhance tools, metrics and benchmarks that supervisors can use to assess the resilience of banks' liquidity cushions and constrain any weakening in liquidity maturity profiles, diversity of funding sources, and stress testing practices.

- **Responsibility**: Prudential supervisors, central banks, BCBS
- **Timeline**: To be completed within 2 years
- **Monitoring:** Expanded FSF

4.3.3 Infrastructure for OTC Derivatives

The market for credit default swaps (CDS) operates on a bilateral, over-the-counter (OTC) basis and has grown to many times the size of the market for the underlying credit instruments. In light of problems involving some large players in this market, attention has focused on the systemic risks posed by CDS. For instance, the inability of certain protection sellers to meet their CDS obligations has raised questions about the potentially destabilizing effects of the CDS market on other markets. Also, the deterioration of credit markets generally has increased the likelihood of CDS payouts, thus prompting protection buyers to seek additional margin from protection sellers. These margin calls have strained the balance sheets of protection sellers, and may have forced asset sales that contributed to put downward pressure on cash securities markets.

Action Item: Supervisors and regulators, building on the imminent launch of central counterparty services for credit default swaps (CDS) in some countries, should: speed efforts to reduce the systemic risks of CDS and over-the-counter (OTC) derivatives transactions; insist that market participants support exchange traded or electronic trading platforms for CDS contracts; expand OTC derivatives market transparency; and ensure that the infrastructure for OTC derivatives can support growing volumes. (For immediate action by March 31, 2009)

Process for Taking Forward the Leaders' Action Item

A group of global prudential supervisors is working with the industry to strengthen the infrastructure for OTC credit derivatives. The top near-term priority is to oversee the implementation of central counterparties for CDS.

Representatives from regulatory agencies with direct authority over one or more of the existing or proposed CDS central counterparties (including those in the U.S., U.K., Germany and the European Union) and some central banks (including the ECB) have begun discussing possible information sharing arrangements and other methods of cooperation within the regulatory community. The primary objectives of this effort include the application of consistent standards and the promotion of consistent public policy objectives and oversight approaches for all CDS central counterparties, as well as logistical support in carrying out oversight responsibilities.

In the U.S., the President's Working Group announced in November 2008 a broader set of policy objectives to guide efforts aimed at addressing the full range of challenges associated with OTC derivatives, with a primary focus on CDS. Policy objectives include:

- Public reporting of prices, trading volumes and aggregate open interest;
- The development by supervisors of consistent policy standards and risk management expectations;
- The registration of all transactions in credit default swaps not cleared through a CCP in central contract repositories;
- Support for trading on exchanges or other centralized trading platforms for standardized CDS contracts; and
- A review by regulatory agencies to determine if they have adequate enforcement authority to police against fraud and market manipulation (with proposals for changes in authority where warranted).

The creation of a central counterparty for OTC credit derivatives is also a priority in Europe, where the European Commission has established a Working Group composed of market participants, national regulators and the European Central Bank to deliver progress in this area. As a result of discussions within this EC Working Group, a group of derivatives dealers and the European Banking Federation have committed to the use of at least one central counterparty established, regulated and supervised in the EU to clear CCP-eligible CDS on European reference entities and indices based on these entities. These associations have also committed to work closely with infrastructure providers, regulators and the European authorities including the European Central Bank in resolving outstanding technical, regulatory, legal and practical issues. These efforts mirror the engagement the industry has made in other jurisdictions.

At the same time, following a request from EU Member States, the Committee of European Securities Regulators and the European System of Central Banks are in the process of revising their recommendations for CCPs in order to ensure that they are appropriate for derivatives markets, particularly CDS. Furthermore, the European Commission is also examining whether additional regulatory requirements might be necessary to enhance transparency and deal with any systemic risks in the area of derivatives.

Working Group Assessment

The launch of central counterparties (CCPs) for OTC credit derivatives is an important step towards reducing systemic risk. Clearing and settling CDS contracts through a central counterparty means that the two counterparties to a CDS are no longer exposed to each other's credit risk. Hence, well-managed, and properly regulated CCP help contain the failure of a major market participant. Central counterparties also contribute to enhancing market efficiency by helping ensure that eligible trades are cleared and settled in a timely manner, thereby reducing the operational risks associated with significant volumes of unconfirmed and failed trades. Furthermore, the development of a CCP facilitates greater market transparency, including the reporting of prices for CDS, trading volumes, and aggregate open interest. The availability of pricing information can improve the fairness, efficiency, and competitiveness of markets — all of which enhance investor protection and facilitate capital formation. The degree of transparency, of course, depends on the extent of participation in the CCP, which is not mandatory. The industry's commitment to clear CDS through central counterparties should ensure a substantial increase in the transparency and safety of the market for these contracts.

Prudential supervisors have been collaborating with market participants to increase market transparency. One major step in this initiative is the publication of weekly aggregate market data from a central repository. Regulators are working to identify a consistent set of data that central counterparties should make available to the public on a regular basis, including market prices, market depth and open interest.

The Working Group supports central counterparty clearing for other types of derivatives trading over-the-counter. As such, it recommends that the financial industry take the necessary steps to clear OTC transactions in derivatives, including for credit derivatives, through central counterparties in order to reduce systemic risk. If needed, some incentives may be provided by national authorities, for example, by taking a higher capital charge for transactions not cleared through central counterparties.

In order to foster transparency and to promote the use of CCP and of exchange trading for credit derivatives, public authorities should also encourage the financial industry to standardize contracts and to use data repository for the remaining non-standardized contracts and promote fair and open access to central counterparty services.

In addition, in order to ensure that the infrastructure for centralized clearing and settlements meets high prudential standards, the Working Group recommends that a review of the CPSS-IOSCO Recommendations for Central Counterparties and the accompanying guidance be undertaken, and that prudential supervisors apply these (possibly enhanced) standards.

In order to mitigate systemic risk resulting from counterparty credit risk, in the short run, it would be beneficial for there to be a competitive environment for central counterparties without imposing regulatory requirements that unduly fragment the market.

***Recommendation 17*: Financial institutions should continue work to strengthen the infrastructure supporting OTC derivatives markets. In the case of credit derivatives, this includes standardizing contracts to facilitate their clearing through a central counterparty. National authorities should enhance incentives as needed for the use of central counterparties to clear OTC credit derivatives.**

- **Responsibility**: Financial institutions, prudential supervisors and other authorities, central banks
- **Timeline**: To be completed within two years; Industry to prepare an action plan on standardization in the Fall 2009
- **Monitoring**: Prudential supervisors and expanded FSF

***Recommendation 18*: Central counterparties should be subject to transparent and effective oversight by prudential supervisors and other relevant authorities, including central banks, and meet high standards in terms of risk management, operational arrangements, default procedures, fair access and transparency. The CPSS and IOSCO should review their experiences in applying their recommendations for central counterparties to derivatives.**

- **Responsibility**: Prudential supervisors, central banks, CPSS, IOSCO
- **Timeline**: To be completed within 2 years
- **Monitoring:** Expanded FSF

4.4 Compensation Schemes and Risk Management

4.4.1 Compensation Schemes

General consensus has emerged that compensation practices at financial institutions are one factor, among many, that contributed to the financial crisis. For instance, bonus payments were tied to short-term profits without adequate regard to the longer-term risks they imposed on their firms, and this misalignment of incentives amplified the risk-taking that severely threatened the global financial system.

Action Item: Financial institutions should have clear internal incentives to promote stability, and action needs to be taken, through voluntary effort or regulatory action, to avoid compensation schemes which reward excessive short-term returns or risk taking. (For immediate action by March 31, 2009)

Process for Taking Forward the Leaders' Action Item

To better understand the forces at play, an FSF Working Group reviewed relevant reports and analyses by other bodies and experts, engaged in discussions with experts from the financial industry, the public sector and academia, and investigated industry practice by conducting a global survey of practice at major financial firms. It also reviewed the results of a number of surveys commissioned by others.

In its assessment of compensation practices, the FSF has observed that too little attention was given to links between compensation and risks. In particular, the FSF observed that:

- Most financial institutions viewed compensation systems as being unrelated to risk management and risk governance; and
- Financial supervisory and regulatory authorities did not focus on the implications for risk of compensation systems.

In this context, it is clear that changes to existing practices are necessary on several fronts to ensure that perverse compensation incentives do not induce excessive risk-taking in financial institutions in the future. As such, the FSF developed Principles for Sound Compensation Practices for financial institutions to prevent incentives towards excessive risk taking that may arise from compensation schemes. The FSF formulated nine principles to achieve more effective governance in setting and in monitoring compensation within financial institutions, to better align compensation practices with prudent risk taking, and to ensure effective supervisory oversight and improve disclosure practices.

Additional initiatives undertaken to guide the adoption of improved compensation practices in the financial sector include the consultation guidance on Basel II Pillar 2 to enhance sound corporate governance and risk management, which will help reinforce adherence to sound compensation practices.

In addition, the OECD will explore, in the context of the OECD Principles of Corporate Governance, how compensation practices at both the management and operating levels should be amended to achieve sounder long-term strategies that better address the interests of the institution, its shareholders and other stakeholders.

Working Group Assessment

In order to build on the analysis of remuneration practices that was conducted and on the sound practice principles that were developed, the Working Group recommends that Boards of Directors and the management of financial institutions take appropriate actions to structure compensation in a manner consistent with the sound practice principles developed by the FSF.

A number of financial institutions have announced changes to their compensation structures. However, it is important that reforms in this regard be done on an industry-wide basis, so that improved risk management and compensation practices by some systemically important firms are not undermined by the unsound practices of others.

Since competitive pressures, a perceived first-mover disadvantage, or other factors could hinder the ability of financial institutions to effectively address deficiencies in compensation schemes, the Working Group views national authorities' supervisory and regulatory infrastructure as the appropriate vehicle for promoting compliance with sound compensation practices. In general, it is not intended, however, that national authorities or prudential supervisors would prescribe particular designs or levels of compensation. Since financial firms differ in goals, activities and culture, and since there is also a wide range of employees within a firm, any compensation system must work in concert with other management tools to promote prudent risk taking.

***Recommendation 19*: Large financial institutions should ensure that their compensation frameworks are consistent with their long-term goals and with prudent risk-taking. As such, the Boards of Directors of financial institutions should set clear lines of responsibility and accountability throughout their organizations to ensure that the design and operation of its remuneration system supports the firm's goals, including its overall risk tolerance. Shareholders may have a role in this process. Boards should also ensure there are appropriate mechanisms for monitoring remuneration schemes.**

- **Responsibility**: Boards of Directors of financial institutions
- **Timeline**: Fall 2009
- **Monitoring:** Prudential supervisors or other relevant national authorities

***Recommendation 20*: In order to promote incentives for prudent risk taking, each financial institution must review its compensation framework to ensure it follows sound practice principles developed by the FSF. These include the need for remuneration systems to provide incentives consistent with the firm's long-term goals, to be adjusted for the risk taken by employees, and for the variable components of compensation to vary symmetrically according to performance.**

- **Responsibility**: Financial institutions
- **Timeline**: Fall 2009
- **Monitoring:** Prudential supervisors or other relevant national authorities

***Recommendation 21*: Prudential supervisors should enhance their oversight of compensation schemes by taking the design of remuneration systems into account when assessing risk management practices. The BCBS should more explicitly integrate this dimension in its guidance for the assessment of risk management practices by national prudential supervisors.**

- **Responsibility**: Prudential supervisors, BCBS
- **Timeline**: Fall 2009
- **Monitoring:** Expanded FSF

4.4.2 Risk Management Practices

Shortcomings in risk management practices revealed by the current crisis reflect a failure to implement effective firm-wide risk management systems as well as a number of more technical limitations associated with risk management tools, including their inability to model severe financial shocks and the fact that most quantitative tools are backward looking. The many weaknesses in risk management practices that were revealed include the inability of financial institutions to adequately monitor risk concentrations across products and geographical areas, shortcomings in stress testing and inappropriate practices for managing risks arising from structured products.

Action Item: Regulators should develop enhanced guidance to strengthen banks' risk management practices, in line with international best practices, and should encourage financial firms to re-examine their internal controls and implement strengthened policies for sound risk management. (For immediate action by March 31, 2009)

Process for Taking Forward the Leaders' Action Item

In the banking sector, the BCBS is enhancing guidance for supervisory oversight in a number of important risk management areas, using Pillar 2 of Basel II as a foundation. The focus of this guidance is on:

- Enhancing firm-wide risk oversight, risk management and internal controls;
- Managing more effectively specific risk areas such as firm-wide risk concentrations, off-balance sheet exposures and associated reputational risks, securitization exposures, valuations and liquidity risk; and
- Improving banks' stress testing practices.

These enhancements were included as part of the Basel II consultative document issued in January 2009.

In addition to the BCBS guidance, supervisors from most G20 countries have published, or are in the process of publishing, supplementary guidance on a wide variety of areas in response to the crisis, including securitization, risk concentrations, contingency planning and stress testing.

The Senior Supervisors Group (SSG), a group of prudential supervisors, is undertaking an assessment of major institutions' strengths, weaknesses and gaps in relation to the recommendations for strengthened risk management practices that have been made in public and private sector reports during 2008 (*e.g.*, Financial Stability Forum, Senior Supervisors Group, U.S. President's Working Group, International Institute of Finance, Counterparty Risk Management Group III). A summary of the findings is expected in the Spring of 2009.

In the insurance sector, the IAIS is reviewing all existing and new supervisory papers to incorporate lessons drawn from the financial crisis. More specifically, the standards and guidance on asset-liability management and investment risk management are being updated to reinforce coverage on issues such as the use of stress testing in identifying risks, including concentration and liquidity risk. An issues paper on corporate governance is also being developed as foundation for future supervisory papers on corporate governance. In addition, an IAIS standard on reinsurance and other forms of risk transfer is addressing the assessment of the appropriateness of the reinsurance cover, the risk management strategy of direct insurers, as well as the appropriate supervision of reinsurance companies.

Working Group Assessment

The Working Group welcomes the BCBS consultative document to address a wide range of weaknesses in risk management practices that played a significant role in causing and accelerating the crisis.

In addition to shortcomings with risk management tools and with the supervision of risk management practices, the global financial crisis has highlighted the failure of the Boards of Directors of many financial institutions in fostering an effective risk management culture in their organizations. It should be recognized that, first and foremost, it remains the responsibility of the private sector to take the lead in strengthening firm-wide risk management frameworks. Both management and the Board of Directors are responsible for putting in place adequate risk management and control systems.

Action Item: Supervisors should ensure that financial firms develop processes that provide for timely and comprehensive measurement of risk concentrations and large counterparty risk positions across products and geographies. (For immediate action by March 31, 2009)

Process for Taking Forward the Leaders' Action Item

The BCBS's Basel II consultative document issued in January 2009 includes enhanced Pillar 2 guidance on the assessment by management and supervisors of risk concentrations. The Committee's enhanced guidance sets clear expectations for Boards of Directors and senior management to set incentives across the firm to control risk exposures and concentrations in accordance with the firm's stated risk appetite. The guidance also sets supervisory expectations for capturing firm-wide risk concentrations arising from both on- and off-balance sheet exposures and securitization activities. Generally, banks are expected to have in place effective internal policies, systems and controls to identify, measure, monitor, manage, control and mitigate their risk concentrations in a timely manner, and under various conditions, including stressed market situations.

Working Group Assessment

The BCBS guidance establishes processes that provide comprehensive measurement of concentration risk, ensure that banks have credit risk mitigation strategies and internal limits to risk concentrations and ensure that these risks should be assessed under a supervisory review process. This addresses the Washington action item in holding supervisors responsible for the due diligence of risk concentrations held by their financial institutions. The BCBS will begin a review of its existing guidance on sound practices for managing risk concentrations and large exposures later in 2009.

Action Item: The Basel Committee should study the need for and help develop firms' new stress testing models, as appropriate. (For immediate action by March 31, 2009)

Action Item: Firms should reassess their risk management models to guard against stress and report to supervisors on their efforts. (For immediate action by March 31, 2009)

Process for Taking Forward the Leaders' Action Item

The BCBS issued a consultative paper on principles for sound stress-testing practices and supervision in January 2009. This paper presents sound principles for the governance, design and implementation of stress testing programmes at banks and addresses weaknesses in stress testing exposed by the financial crisis.

Many Working Group members have indicated that the guidance from the BCBS will be used to help refine stress-testing practices in their countries. A number of Working Group members have also indicated plans to extend stress-testing activities as part of their supervisory framework in their countries, and some recommendations will be issued, following consultations, in the near-term.

In addition, the October 2008 follow-up report of the FSF urged private sector organisations that have recommended improvements to industry risk management practices to establish frameworks for rigorously monitoring and reporting on the timely implementation of these improvements. Implementation will be monitored by prudential supervisors and, in the case of banks, reinforced through Pillar 2 reviews under the Basel II framework. The Institute of International Finance has prepared and distributed an assessment framework for financial institutions to use.

<u>Working Group Assessment</u>

Stress testing is an ongoing process and the Working Group urges financial institutions to continuously improve their practices. Sound stress testing also involves selecting appropriate scenarios, and the Working Group encourages financial institutions to pay particular attention to this, including in reflecting the important system-wide interactions between the various institutions, markets and instruments in the financial system. This would facilitate the development of risk mitigation or contingency plans across a range of stressed conditions

Stress testing is an important tool to alert management to adverse unexpected outcomes related to a variety of risks, and it should be used as such. It is especially important after long periods of benign economic and financial conditions, when fading memory of negative conditions can lead to complacency and the underpricing of risk.

> *<u>Action Item</u>: Banks should exercise effective risk management and due diligence over structured products and securitization. (For immediate action by March 31, 2009)*

<u>Process for Taking Forward the Leaders' Action Item</u>

The Basel II consultative document issued in January 2009 includes enhanced Pillar 2 guidance in this area. Standards for the risk management and due diligence of structured products and securitization are being enhanced in most G20 countries where markets for these instruments are developed. Securitization practices are being clarified, and some countries are setting stronger due diligence standards over structured products and securitization.

<u>Working Group Assessment</u>

The Working Group welcomes the steps taken by the BCBS to address the risks of securitization. The BCBS' guidance to include a bank's on- and off-balance sheet securitization activities in risk management, including product approval, risk concentration limits and estimates of market, credit and operational risk largely addresses the previous deficiencies in risk-management of securitized products.

4.5 Transparency

In hindsight, weaknesses in public disclosures have played a significant role in the crisis. In addition, recent events in financial markets revealed some weaknesses and inconsistencies in the application of fair value accounting at financial institutions.

The type of information disclosed heading into the turmoil was often not sufficiently timely and useful to many investors and other market participants. Public disclosures by financial institutions did not always make clear the type and magnitude of their risk exposures, including those associated with their on- and off-balance sheet exposures. There were also shortcomings in the other information firms provided about market and credit risk exposures, particularly as these related to structured products. Where information was disclosed, it was often not done in an easily accessible or usable way.

Action Item: The key global accounting standards bodies should work to enhance guidance for valuation of securities, also taking into account the valuation of complex, illiquid products, especially during times of stress. (For immediate action by March 31, 2009)

Process for Taking Forward the Leaders' Action Item

Several accounting standard setting bodies published guidance to clarify expectations for the valuation of complex securities and other financial instruments during the Fall of 2008. These notices were broadly consistent with one another. They emphasized the need for greater management judgment in estimating fair values when markets are inactive and provided advice for evaluating the reliability of valuation inputs.

In addition, at the end of November 2008, the BCBS released a consultation paper that provides guidance to banks and banking supervisors to strengthen valuation processes for financial instruments. This guidance reinforces the guidance published by accounting standard setters.

The IASB is in the process of enhancing guidance for fair value measurement more generally, for both financial and non-financial assets and liabilities. This broad review of fair value measurement was initiated in November 2006 to simplify, clarify and harmonize the overall body of guidance that has been added piecemeal to a number of standards over the years. The objective of this project is to create a single source of guidance for fair value measurement and disclosure. An exposure draft is expected in the first half of 2009.

In February 2009, FASB indicated it would re-examine its guidance for fair value accounting and disclosures in 2009.

Working Group Assessment

Considerable work has been undertaken to enhance guidance for the valuation of financial instruments, including complex and illiquid instruments, and more work is underway. We consider that the action plan with respect to fair value guidance has been achieved.

In order to support transparency and allow the users of financial statements to assess the financial health of a company, fair value valuation needs to be complemented with sufficient disclosure standards on valuation techniques. When valuation models are used, notes to financial statements must include a description of assumptions taken and a discussion of the incidence of alternative inputs on valuation. The Working Group recommends that efforts to reduce the complexity of accounting standards for financial instruments and to enhance disclosure standards be accelerated in order to allow the users of financial statements to better evaluate the uncertainty surrounding valuation.

Some EMEs consider that accounting standard bodies should review accounting standards for currency conversion in the context of this work, with the objective of assessing whether the accounting treatment of fluctuations in the exchange rate introduces excessive fluctuations in financial results during periods of high volatility in foreign exchange markets. IASB has indicated that it will examine the issue.

***Recommendation 22*: Accounting standard setters should accelerate efforts to reduce the complexity of accounting standards for financial instruments and enhance presentation standards to allow the users of financial statements to better assess the uncertainty surrounding the valuation of financial instruments.**

- **Responsibility**: Accounting standard setters
- **Timeline**: Fall 2009
- **Monitoring:** Expanded FSF

Action Item: Accounting standard setters should significantly advance their work to address weaknesses in accounting and disclosure standards for off-balance sheet vehicles. *(For immediate action by March 31, 2009)*

Process for Taking Forward the Leaders' Action Item

The FASB issued, for public comment, proposed accounting changes for de-recognition of financial assets and consolidation of off-balance sheet entities. These revised standards are expected to be finalized in 2009 and effective in 2010. The FASB also issued enhanced disclosure standards for off-balance sheet entities that were effective beginning with 2008 year-end reporting.

The IASB issued, for public comment, proposed accounting changes for consolidation of off-balance sheet entities. This revised standard is expected to be effective in 2011. The IASB also accelerated its de-recognition project and expects to publish an exposure draft in the first half of 2009, to be effective no earlier than 2011.

Given the complexity of the issues involved, the effective dates could change.

Working Group Assessment

This Action Item has been largely met. While initiatives by accounting standards setters to enhance consolidation requirements, including disclosure standards for off-balance sheet entities have been underway since before the crisis began, the standards have been further strengthened and revisions accelerated, and the two major accounting bodies plan to converge their standards.

Action Item: Regulators and accounting standard setters should enhance the required disclosure of complex financial instruments by firms to market participants. (For immediate action by March 31, 2009)

Action Item: Financial institutions should provide enhanced risk disclosures in their reporting and disclose all losses on an ongoing basis, consistent with international best practice, as appropriate. Regulators should work to ensure that a financial institution's financial statements include a complete, accurate, and timely picture of the firm's activities (including off-balance sheet activities) and are reported on a consistent and regular basis. (For action in the medium term)

Process for Taking Forward the Leaders' Action Item

To enhance transparency and market confidence, the FSF recommended in its April 2008 report that financial institutions draw from leading practices to ensure that they provide robust meaningful disclosures about risk exposures, including those associated with complex financial instruments, in mid-year 2008 statements. Prudential supervisors of countries that are part of the FSF strongly encouraged their internationally active financial institutions to use these recommended practices in their mid-year reporting. The FSF also asked IOSCO to assess the adequacy of initiatives that private sector groups are taking forward to enhance issuer transparency for securitized products. This assessment was undertaken as part of IOSCO's work on securitized products, on which it will produce an interim report in March.

In January 2009 the BCBS issued for comment proposals to strengthen Pillar 3 disclosure standards for banks' securitisation activities, building on the recommended sound practice disclosures of the FSF.

In addition, the IASB has released several proposals in recent months to improve disclosure of financial instruments. These include enhancements to the disclosure of exposure to risk from off-balance sheet items, and an amendment to the standard for the presentation of financial statement (IFRS 7) to clarify and enhance disclosures about fair value measurements and the liquidity risk of financial instruments, including for complex financial instruments.

Working Group Assessment

Following the leading practice disclosure framework advanced by the FSF, large financial institutions have substantially expanded their disclosures about risk exposures, including those associated with complex financial instruments and other related policies.

> *Action Item: Regulators, supervisors, and accounting standard setters, as appropriate, should work with each other and the private sector on an ongoing basis to ensure consistent application and enforcement of high-quality accounting standards. (For action in the medium term)*

Process for Taking Forward the Leaders' Action Item

The IASB has established an external monitoring body composed of representatives of public authorities and of international organizations that have requirements for accountability to public authorities. This monitoring body includes IOSCO, the European Commission, the US SEC, and the Japan FSA. The BCBS will also be participating as an observer.

In addition the IASB and the U.S. FASB have established an advisory group comprised of senior leaders with broad international experience in financial markets to advise the Boards in considering accounting issues emerging from the global crisis. The primary function of the Financial Crisis Advisory Group (FCAG) is to advise the Boards about standard-setting implications of (1) the global financial crisis and (2) potential changes to the global regulatory environment. The group will conclude its activities within approximately six months, and will conduct advisory meetings during that time.

The FCAG will consider how improvements in financial reporting could help enhance investor confidence in financial markets. The advisory group also will help identify significant accounting issues that require the urgent and immediate attention of the Boards, as well as issues for long-term consideration. In providing that advice, the advisory group will draw upon work already underway in a number of jurisdictions on accounting and the credit crisis, as well as information gathered from the public roundtables—one each in Asia, Europe, and North America—that the Boards hosted in November and December 2008.

Working Group Assessment

High level committees established by accounting standard setters to obtain feedback from users of financial statements will help foster consistent application of accounting standards.

> *Action Item: The key global accounting standards bodies should work intensively toward the objective of creating a single high-quality global standard. (For action in the medium term)*

<u>Process for Taking Forward the Leaders' Action Item</u>

IFRS are in use in over 100 countries, and about 40 more are in the process of either adopting or converging with them. While some countries have adopted the IFRS without modifications, others have tailored the IFRS to their country-specific conditions during the process of convergence.

<u>Working Group Assessment</u>

The long-term benefits likely to result from the use of a harmonized set of international accounting standards are considerable, in particular from a market transparency and cost perspective. While adapting IFRS according to national circumstances rather than fully complying with them may be appropriate in some cases to take into account country-specific characteristics of markets, it also voids some of the benefits of a global set of accounting standards.

The Working Group recommends that the IASB facilitate the transition towards a single set of high-quality global standards globally by sharing the experience of countries that have completed this process and by providing global assistance.

Enhanced representation of EMEs within the IASB governance structure would also be desirable to allow for standards that better reflect the unique circumstances of these countries. We note that G20 Working Group 2 is addressing issues related to the governance of the IASB, including the level of involvement of individuals from EMEs within the IASCF and the various IASB working groups and committees.

***<u>Recommendation 23</u>*: The IASB should enhance its efforts to facilitate the global convergence towards a single set of high-quality accounting standards by sharing the experience of countries that have completed this process and by providing technical assistance.**

- **Responsibility**: IASB
- **Timeline**: Fall 2009
- **Monitoring**: Expanded FSF

5. Going beyond the Action Plan

In this section, we propose recommendations for addressing concerns not covered by the Washington Action Plan. They relate to ensuring that appropriate resources are available for effective enforcement and to providing assistance to countries that require it for enhancing their regulatory frameworks.

5.1 Enforcement

Achieving the objectives of the regulatory framework requires not only sound regulation but also effective enforcement. No matter how sound the rules are for regulating the conduct of market participants, if the system of enforcement is ineffective – or is perceived to be ineffective – the ability of the system to achieve the desired outcome is undermined.

It is thus essential that participants are appropriately monitored, that offenders are vigorously prosecuted and that adequate penalties are imposed when rules are broken. A regulatory framework with strong monitoring, prosecution, and application of penalties provides the incentives for firms to follow the rules. This, in the end, adds to the framework's credibility and enhances investor confidence in the financial system. Thus, a coordinated approach by securities regulators and self-regulatory organizations, law enforcement agencies and other actors in the legal system to monitor, investigate, and punish improper behaviour is necessary at a national and, in the context of globalization of the financial system, at the international level.

In terms of international cooperation, IOSCO has developed a multilateral memorandum of understanding (MMOU) on cooperation and information sharing for securities regulation and enforcement purposes. The MMOU is specific about the information, including banking and brokering information, which must be made available on request of signatories for the specific purpose set out in the MMOU. It has raised the standard of international information sharing by requiring that banking secrecy laws do not prevent the exchange of information for securities enforcement purposes. Applicants to become a signatory are required to undergo an independent verification process. Over two thirds of IOSCO's eligible members have become signatories or undergone the verification process and committed to addressing the gaps identified by the process, including seeking legislative change if necessary.

The IAIS has also put in place a *MMOU* framework back in February 2007 to facilitate information exchange among insurance supervisors both under normal circumstances and in times of crisis. The IAIS regards the MMOU initiative as a high priority and efforts are underway to expedite the operation of the regime in the near future.

Supervisory colleges, which are within the remit of G20 Working Group 2 are an effective mechanism for enforcement in cross-border institutions.

We recommend that authorities review the effectiveness of their enforcement activities and ensure that appropriate resources, including both human and financial resources, are available to achieve this.

***Recommendation 24*: The effective enforcement of regulation should be a priority of all financial regulators. As such, national financial regulators and oversight authorities should ensure the effectiveness of their enforcement activities and that appropriate resources are available for monitoring the application of regulation and for prosecuting offenders. The enforcement function should be independent from other activities or from external influences.**

- **Responsibility**: Prudential supervisors and other authorities
- **Timeline**: To be completed within 2 years
- **Monitoring**: IMF-WB (through FSAP and Article IV)

5.2 Technical Assistance and Capacity Building in Emerging Market Economies

For some countries, for example those with less-developed financial systems, transition towards the implementation of enhanced standards and regulations may present a greater challenge. The Working Group recommends that national authorities commit to assist each other in order to enhance the capacity of the G20 as a whole to strengthen the regulatory framework. Appropriate technical assistance should also be provided to these countries by international standard setting bodies in order to allow for the effective implementation of more challenging new regulations that are consistent with international standards and codes. Examples include those for mitigating procyclicality, for adopting the Basel II capital framework and for converging towards a global set of high-quality accounting standards.

Recommendation 25: Recognizing that the degree of development of financial systems varies considerably across the G20, national authorities should commit to assist each other in enhancing their capacity to strengthen regulatory frameworks. In addition, IOSCO, the IAIS and the BCBS should have the appropriate capacity to provide technical assistance. The needs of emerging market economies deserve particular consideration.

- **Responsibility:** Finance Ministries, prudential supervisors and other authorities, IOSCO, IAIS, BCBS
- **Timeline:** Ongoing
- **Monitoring:** IMF-WB (through FSAP and Article IV)

Annex 1 - Abbreviations

BCBS	Basle Committee of Banking Supervision
CDS	Credit default swaps
CGFS	Committee on the Global Financial System
CCP	Central counterparty
CPSS	Committee on Payment and Settlement Systems
CRA	Credit rating agency
EC	European Commission
EU	European Union
EME	Emerging market economy
FASB	Financial Accounting Standards Board
FCAG	Financial Crisis Advisory Group
FSA	Financial Services Agency (Japan)
FSAP	Financial Sector Assessment Program
FSF	Financial Stability Forum
IAIS	International Association of Insurance Supervisors
IASB	International Accounting Standards Board
IASCF	International Accounting Standards Committee Foundation
IMF	International Monetary Fund
IOSCO	International Organization of Securities Commission
MMOU	Multilateral memorandum of understanding
OECD	Organization for Economic Cooperation and Development
OTC	Over-the-counter
SEC	Securities and Exchange Commission (US)
SSG	Senior Supervisors Group
WB	World Bank

Annex 2 – List of Members of the Working Group

Co-Chairs	Tiff Macklem (Canada) Rakesh Mohan (India)
Argentina	Jose Rutman
Australia	Kerstin Wijeyewardene
Brazil	Nelson Barbosa
Canada	David Longworth
China	Han Mingzhi
European Union	Pierre Delsaux
France	Hervé de Villeroché
Germany	Dietrich Lingenthal
India	Anand Sinha
Indonesia	Hekinus Manao
Italy	Andrea Enria
Japan	Takehiko Nakao
Mexico	Guillermo Zamarripa
Russia	Yana Pureskina
Saudi Arabia	Fahad Al Mufarrij
South Africa	Nkosana Mashiya
South Korea	Jong-Goo Yi
Turkey	Ihsan Delikanli
United Kingdom	David Strachan
United States of America	Patrick Parkinson
Basel Committee for Banking Supervision	Stefan Walter
Financial Stability Forum	Svein Andresen
International Accounting Standards Board	John Smith
International Association of Insurance Supervisors	Yoshihiro Kawai
International Monetary Fund	Jaime Caruana
International Organization of Securities Commissions	Greg Tanzer
World Bank	Michael U. Klein

G20 Working Group on Reinforcing International Cooperation and Promoting Integrity in Financial Markets (WG2)

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Contents

Key messages

1. Regulatory and supervisory cooperation

Immediate actions:

Supervisory colleges (Action plan No. 35)

> *Supervisors should collaborate to establish supervisory colleges for all major cross-border financial institutions, as part of efforts to strengthen the surveillance of cross-border firms. Major global banks should meet regularly with their supervisory college for comprehensive discussions of the firm's activities and assessment of the risks it faces.*

1. In line with the action plan item supervisory colleges have been established for 25 of the major global financial institutions identified by the Financial Stability Forum (FSF). Supervisors have committed to establish supervisory colleges for major global financial institutions, as necessary, in order to strengthen the present supervisory models for global financial institutions.

2. We call on home supervisors of global financial institutions for which colleges or similar information sharing arrangements are not yet in place to expedite work toward establishment and operations by mid-2009.

3. We call on the FSF to review the college arrangements to ensure that all systemically important global financial institutions have a supervisory college. A list of financial institutions that have a supervisory college should be made available to all relevant national authorities.

4. We also call on the FSF to review the model of supervisory colleges, including the criteria for establishment and the guidelines of operation, once enough experience has been garnered, and work as needed, to ensure consistency in approaches. The FSF should also consider a process to pulling together non-financial institutions information of wider interest. The colleges should include relevant host supervisors, including – where appropriate – those from emerging economies. The arrangements for how the college will operate are a matter for the chair of the college.

5. We ask home supervisors and the FSF to consider ways to ensure an adequate exchange of information to host supervisors which are not core members in the college of a specific institution.

Information sharing arrangements (Action plan No. 29 and 30)

> *Our national and regional authorities should work together to enhance regulatory cooperation between jurisdictions on a regional and international level.*
>
> *National and regional authorities should work to promote information sharing about domestic and cross-border threats to market stability and ensure that national (or regional, where applicable) legal provisions are adequate to address these threats.*

6. We agree on the need to improve information sharing between supervisors, especially during periods of financial distress.

7. Bilateral Memoranda of Understanding are an important means for information sharing between banking supervisors. We ask the Basel Committee on Banking Supervision (BCBS) to consider up-dating its 2001 template for information exchange ("Essential Elements of a Statement of Cooperation between Banking Supervisors") in the light of current best practices and to consider further improvements that would enhance bilateral information exchange and supervisory collaboration world-wide.

8. We also call on BCBS's further work to consider the development of a global mechanism for information exchange. This mechanism should allow jurisdictions flexibility, recognising different legal and confidentiality constraints.

Cross-border crisis management (Action plan No. 36)

> *Regulators should take all steps necessary to strengthen cross-border crisis management arrangements, including on cooperation and communication with each other and with appropriate authorities, and develop comprehensive contact lists and conduct simulation exercises, as appropriate.*

9. In accordance with the action plan item, the FSF has agreed a set of principles for cross-border cooperation on crisis management. We endorse and commit to implementing these principles. This will involve home authorities, drawing on the work of colleges, leading cross-border discussions involving supervisors, central banks and, where appropriate, finance ministries, on issues and barriers that may arise when handling specific cross-border firms under severe stress.

Medium-term actions:

Resolution regimes and bankruptcy laws (Action plan No. 12)

> *National and regional authorities should review resolution regimes and bankruptcy laws in light of recent experience to ensure that they permit an orderly wind-down of large complex cross-border financial institutions.*

10. The BCBS's Cross-border Bank Resolution Group is developing recommendations for resolution regimes. The International Monetary Fund (IMF) has also issued proposals to deal with bank insolvencies. Recent experience has shown that global financial institutions bear contagion risks which could reach global scales, while existing crisis management and resolution arrangements do not deal comprehensively with cross-border institutions. Best practices tend to be addressed at a local level.

11. We support the ongoing efforts by international bodies, in particular the FSF, the BCBS, the IMF, and the World Bank, to develop an international framework for cross-border bank resolutions, and to address the issue of ring-fencing and financial burden-sharing.

12. In the absence of international arrangements to deal with insolvencies of cross-border financial institutions, international bodies should explore a framework to advance the co-ordination of regional cross-border resolutions in the medium term. We encourage the development of these mechanisms; they should consider the rights of the involved parties and avoid negative spill-over costs that could result from uncoordinated national responses to a crisis.

13. We also encourage authorities to work closely together, in line with the FSF principles for cross-border co-operation on crisis management, to share information about national resolution regimes and consider potential impediments to coordinated solutions stemming from them.

14. Meanwhile, we call on the FSF and the BCBS to explore the feasibility of common standards and principles as guidance for acceptable practices for cross-border resolution schemes thereby helping reduce the negative effects of uncoordinated national responses, including ring-fencing.

Convergence in regulatory practices (Action plan No. 37)

> *Authorities, drawing especially on the work of regulators, should collect information on areas where convergence in regulatory practices such as*

accounting standards, auditing, and deposit insurance is making progress, is in need of accelerated progress, or where there may be potential for progress.

15. The FSF has discussed the work of standard setting bodies with respect to convergence of international accounting standards, audit practices and deposit insurance arrangements. The IMF will assess the progress with international convergence in the provision of deposit insurances, drawing on the International Association of Deposit Insurers' (IADI's) Core Principles for Effective Deposit Insurance Arrangements. Such efforts will identify gaps and highlight best practices in terms of regulatory cooperation.

16. In this sense, we fully support the efforts made by the FSF, the IMF and other international bodies, such as the International Accounting Standards Board (IASB) and the IADI, to achieve convergence in accounting standards and the regulation of deposit insurance systems.

Exit strategies (Action plan No. 38)

Authorities should ensure that temporary measures to restore stability and confidence have minimal distortions and are unwound in a timely, well-sequenced and coordinated manner.

17. While our immediate priority is to mitigate the current financial crisis and to restore confidence in financial markets, some forward thinking is required on the issue of exiting from emergency measures. We recognise that the exit from temporary support measures in the period ahead will be easier if the actions taken today minimise distortions. Additionally, exit strategies have to be consistent with longer-run economic goals. There is also a need to taking into account the interests of emerging market economies.

18. Further discussion and international cooperation may be required on this issue. We support the ongoing work of the IMF, in collaboration with the FSF and the Organisation of Economic Cooperation and Development (OECD), to analyse how the measures interact, and how eventually exit strategies need to be coordinated to minimise market uncertainty, competitive inequality and arbitrage opportunities. We ask them to prepare reports on this issue for the next meeting of G20 Finance Ministers and Central Bank Governors.

2. The role of international bodies

Immediate actions:

FSF membership (Action plan No. 39)

The FSF should expand to a broader membership of emerging economies.

19. The FSF decided on 11 and 12 March 2009 to broaden its membership and to invite as new members the G20 countries that are not currently in the FSF. In addition, Spain and the European Commission will also become FSF members. We welcome the FSF's recent expansion.

20. FSF member countries will be expected to pursue financial stability, maintain the openness of the financial sector and implement international financial standards and principles, including the 12 key Standards and Codes, as well as the FSF- and G20-recommendations and agree to undergo periodic peer reviews, using as appropriate joint IMF/World Bank Financial Sector Assessment Programs (FSAPs). The expansion, together with an increased regional outreach, will increase the FSF's ability to develop standards and best practices that are broadly reflective of financial systems globally and contribute to broader implementation of its recommendations.

21. It is important that the FSF continues to be effective in promoting international financial stability. Thus, the mandate of the expanded FSF should be enhanced, in particular, to monitoring the implementation of the FSF- and G20-recommendations in close cooperation with the IMF.

IASB governance (Action plan No. 4)

With a view toward promoting financial stability, the governance of the international accounting standard setting body should be further enhanced, including by undertaking a review of its membership, in particular in order to ensure transparency, accountability, and an appropriate relationship between this independent body and the relevant authorities

22. The Trustees of the International Accounting Standards Committee Foundation (IASCF) approved in mid-January to establish a formal link to a newly created external Monitoring Board composed of public authorities, including the chairs of the expanded International Organisation of Securities Commissions (IOSCO) Technical Committee, the IOSCO Emerging Markets Committee, and the BCBS as an observer. They also approved to expand the IASB membership to 16 members and provided guidelines regarding geographic diversity.

23. We welcome the Trustees' recent decision that will enhance the IASB's accountability, governance and legitimacy. As part of the second phase of the current constitutional review the Trustees should consider complementary measures to further enhance the governance arrangements, including further expanding the membership and increasing the representation of all relevant stakeholders and interests.

Other international standard setting bodies' membership

24. The IOSCO Technical Committee decided in mid-February to invite Brazil, China, and India to join its membership. The BCBS also decided to invite new members to join its membership.

25. We encourage other international standard setting bodies to review their membership and consider expanding their membership to emerging economies to achieve greater representation. We also encourage the BCBS, International Association of Insurance Supervisors (IAIS), and IOSCO, the parent committees of the Joint Forum, to consider expanding the Joint Forum's membership. They should remain flexible with regard to outreach and the composition of ad hoc working groups to also include countries that are not members of the parent committees.

IMF-FSF collaboration (Action plan No. 40)

> *The IMF, with its focus on surveillance, and the expanded FSF, with its focus on standard setting, should strengthen their collaboration, enhancing efforts to better integrate regulatory and supervisory responses into the macro-prudential policy framework and conduct early warning exercises.*

26. The IMF and the FSF have recently taken important steps to strengthen their collaboration, in particular, by developing procedures to conduct regular joint Early Warning Exercises (EWEs). We expect that a pilot EWE is conducted for the next IMF Spring meeting. We call on the IMF and the FSF to report the results of the EWEs to the International Monetary and Financial Committee (IMFC) and the G20.

27. The IMF and the FSF should review the effectiveness of their collaboration, including of the operation of the EWEs after experience has been gained, and, if needed, submit further proposals to strengthen the processes to the IMFC and the G20 by the time of the next meeting of G20 Finance Ministers and Central Bank Governors.

28. We recognise that for effective early warnings data collection needs to be strengthened. We therefore ask the IMF and the FSF to explore gaps and provide

appropriate proposals for strengthening data collection before the next meeting of G20 Finance Ministers and Central Bank Governors.

29. We support the IMF's efforts to strengthen its existing surveillance tools, in particular, the FSAP and look forward to the IMF's and World Bank's review of the FSAP. All countries should commit to undergo an FSAP and to publish the results. Furthermore, countries with systemically important financial sector activities should undergo an FSAP and regular updates more frequently.

Drawing lessons (Action plan No. 41)

> *The IMF, given its universal membership and core macro-financial expertise, should, in close coordination with the FSF and others, take a leading role in drawing lessons from the current crisis, consistent with its mandate.*

30. The IMF and the FSF and other international bodies are working intensely on analysing the causes of the crisis and on drawing lessons. Some of this work has already produced concrete results in the form of, for example, proposals for new or updated international standards and guidelines. We welcome these efforts and call on the IMF and FSF to continue to cooperatively develop lessons learned from the crisis within their respective mandates. They should also give attention to the impact of global capital flows on global financial stability.

Medium-term actions:

Regulatory responsiveness to financial innovation (Action plan No. 27)

> *International standard setting bodies, working with a broad range of economies and other appropriate bodies, should ensure that regulatory policy makers are aware and able to respond rapidly to the evolution and innovation in financial markets and products.*

31. A prerequisite for responding to potential risks from financial innovation is that standard setting bodies identify risks at an early stage. We therefore welcome that international standard setting bodies have stepped up efforts to better prioritise workstreams. We also encourage them to enhance their interaction with the private sector. The FSF should monitor and assess these processes and report back to the next meeting of G20 Finance Ministers and Central Bank Governors.

Asset prices (Action plan No. 28)

> *Authorities should monitor substantial changes in asset prices and their*

implications for the macro-economy and the financial system.

32. We support that the IMF monitors asset prices as part of its work on early warning. We also ask the relevant international bodies, in particular the Bank for International Settlements (BIS) together with the Committee on the Global Financial System (CGFS) and the IMF, to produce a report on how authorities are currently monitoring and addressing asset prices and to develop recommendations in light of the current crisis. A report should be presented to the next meeting of G20 Finance Ministers and Central Bank Governors.

3. Promoting market integrity

Immediate actions:

Protection against market manipulation and fraud (Action plan No. 31)

National and regional authorities should also review business conduct rules to protect markets and investors, especially against market manipulation and fraud and strengthen their cross-border cooperation to protect the international financial system from illicit actors. In case of misconduct, there should be an appropriate sanctions regime.

33. In mid-February 2009 the IOSCO Task Force on Short Selling submitted to the IOSCO Technical Committee its report on short selling. The report proposes four high level principles for the effective regulation of short selling. We endorse these principles and urge all securities regulators to adapt their short selling regimes accordingly. We recommend that IOSCO consider adding detail to the principles following further consultation with the industry, international regulators, and the public. Furthermore, we ask the IOSCO to review the implementation and effectiveness of the principles and report back to the G20 by the time of the next meeting of G20 Finance Ministers and Central Bank Governors.

34. We also support the IOSCO's and other standard setting bodies' work on disclosure and market transparency that will contribute to investor protection. We encourage the IOSCO to continue its work on cross-border enforcement related cooperation through its Multilateral Memorandum of Understanding Concerning Consultation and Cooperation and the Exchange of Information (IOSCO MMoU).

35. We urge all firms to uphold high standards of business conduct. We ask the IOSCO to take stock of the national and international regulatory regimes with regard to business conduct rules and consumer protection, in order to identify supervisory and regulatory gaps and provide a report by the time of the 2010 meeting of G20

Finance Ministers and Central Bank Governors.

Medium-term actions:

Uncooperative and non-transparent jurisdictions that pose risks of illicit financial activity (Action plan No. 32); Financial Action Task Force (FATF) (Action plan No. 33) and tax information exchange (Action plan No. 34)

> *National and regional authorities should implement national and international measures that protect the global financial system from uncooperative and non-transparent jurisdictions that pose risks of illicit financial activity.*
>
> *The Financial Action Task Force should continue its important work against money laundering and terrorist financing, and we support the efforts of the World Bank – UN Stolen Asset Recovery (StAR) Initiative.*
>
> *Tax authorities, drawing upon the work of relevant bodies such as the Organisation for Economic Cooperation and Development (OECD), should continue efforts to promote tax information exchange. Lack of transparency and a failure to exchange tax information should be vigorously addressed.*

36. As the international community strengthens international standards, it is critical that these apply to uncooperative jurisdictions and tax havens. Actions taken in these areas are mutually reinforcing. As appropriate they should be implemented jointly and uniformly and tailored to specific country circumstances.

37. Enhanced efforts to deal with uncooperative jurisdictions are needed in the areas of securities regulation, market conduct and prudential supervision. We support the IOSCO contact initiative to ensure that securities regulators from under-regulated or uncooperative jurisdictions become able and willing to meet the international cooperation standard set by the IOSCO MMoU and to have the practical ability to implement those standards. We encourage the BCBS and the IAIS to review their approaches in the light of the objectives of prudential supervision.

38. We support the FATF's important work against money laundering and terrorist financing, in particular with regard to uncooperative jurisdictions through the International Cooperation Review Group (ICRG). We urge all countries to fully implement the FATF 40+9 Recommendations. The FATF should also take steps to increase its effectiveness, accelerate its efforts and examine available measures. The FATF should develop and adopt procedures to enhance information exchange and direct communication among and between global financial institutions ("group compliance"), supervisors and authorities, including financial intelligence units.

39. We reaffirm our commitment to the high standards of transparency and exchange of information for tax purposes as reflected in the OECD's Model Tax Information Exchange Agreement and Article 26 of the OECD Model Tax Convention. We urge all countries to fully implement the OECD standards. This model was also agreed by the UN.

40. We urge the international bodies responsible for prudential and regulatory standards, anti money laundering and terrorist financing, and tax matters - the FSF, the FATF and the OECD - to accelerate their work of identifying uncooperative jurisdictions and developing a toolbox of effective countermeasures against these jurisdictions; they should update G20 Finance Ministers and Central Bank Governors.

41. We reiterate our support for the World Bank – UN Stolen Assets Recovery Initiative (StAR) to champion the recovery of assets stolen from developing countries. The systematic enforcement of FATF standards with respect to the identification of beneficial ownership and the enhanced monitoring of Politically Exposed Persons would have a significant deterrence effect on corruption and make it easier to detect and deter the flow of proceeds of corruption. We also ask the World Bank to review and develop mechanisms for strengthening global cooperation.

4. Recommendations going beyond the Action plan

42. We recognise that further actions beyond the Action plan of November 2008 may be needed to ensure the effectiveness of the mechanisms for regulatory and supervisory collaboration:

- Against the background of the present crisis we recognize that lightly regulated or unregulated entities could undermine confidence in financial markets. We support the conclusions of the G20 Working Group 1 regarding the expansion of the perimeter of regulation and supervision. Once a regulatory framework is established, we should evaluate how international regulatory and supervisory cooperation can best be effected. The establishment of supervisory colleges for those entities, including rating agencies, could be considered.
- Measures in response to a crisis can have adverse effects on investment and trade decisions. We need to have support measures to ensure that crisis measures do not create protectionism, including financial protectionism, in the medium term.
- Regardless of the scope of regulatory regimes, the effectiveness of enforcement mechanisms should be considered.

I. Mandate of Working Group 2 and Introduction

1. WG2 was tasked by the G20 troika to develop proposals to enhance international cooperation and coordination in the regulation and oversight of international financial markets, improve the management and resolution of cross-border financial crises and protect the global financial system from illicit activities and non-cooperative jurisdictions.

2. In accordance with the action plan set out in the Leaders summit declaration of 15 November 2008 WG2 was asked to undertake work on the following issues:

- **Regulatory and supervisory cooperation** – develop proposals to enhance international cooperation in the regulation and oversight of international institutions and financial markets, and strengthen arrangements between national authorities for the management and resolution of cross-border financial crises. It should also consider the modalities for a timely and coordinated unwinding of temporary financial sector support measures consistent with restoring and maintaining stability and confidence.
- **IMF/FSF collaboration** – propose means of increasing collaboration between the two institutions to strengthen macro-financial surveillance and combine deeper analysis of emerging risks with specific policy responses that can be translated into concrete policy action at a global and national level. It should draw on work being prepared by both institutions to identify lessons from the crisis. It should also monitor progress on expansion of the membership of the FSF (and other major standard-setting bodies).
- **Promoting market integrity** – liaise with other competent bodies and develop proposals to protect the global financial system from illicit activities and non-transparent and uncooperative jurisdictions, including by reviewing business conduct rules.

3. The membership of the WG2 is at Attachment A. In undertaking its work, the Group held a conference call and a face-to-face meeting. The Co-chairs also invited the chairs of the FATF, IASB, IOSCO, and OECD to provide information on their institutions' response to the G20 Action plan.

II. Regulatory and supervisory cooperation

Immediate actions identified by Leaders:

A. Supervisory colleges

G20 Action Plan No. 35, immediate action: *Supervisors should collaborate to establish supervisory colleges for all major cross-border financial institutions, as part of efforts to strengthen the surveillance of cross-border firms. Major global banks should meet regularly with their supervisory college for comprehensive discussions of the firm's activities and assessment of the risks it faces.*

Process for taking forward the Leaders' action item

1. The FSF in its April 2008 report recommended establishing supervisory colleges for each of the largest global financial institutions. To take forward this recommendation, protocols for establishing the colleges were developed under the auspices of the FSF and an initial list of institutions to which the supervisory college should apply was drawn up.

2. The home supervisors reported that by year-end 2008 supervisory colleges have been established for 25 of the major global financial institutions identified by the FSF, and for the remaining colleges the process would be completed by mid-2009. First meetings of the supervisory colleges have been held or are due to be held in the first half of 2009. The FSF has called on home supervisors, in cases where the colleges are not yet in place, to accelerate work toward their establishment.

3. The FSF will undertake a review of experience with these college arrangements in 2009, while it will continue to follow up on this issue on an ongoing basis.

4. For insurance groups, the IAIS adopted a guidance paper on the role of a group-wide supervisor in October 2008, which provides among others guidance on mechanisms for required cooperation between the supervisors involved in the supervision of a group. In response to the FSF recommendation on the setting-up of supervisory colleges for large financial institutions, the IAIS also undertook a stocktaking exercise in 2008 to identify existing supervisory college arrangements for the largest global insurance groups. It is intended that this list will be kept updated and be used as input into the FSF review of experience with existing college arrangements in mid-2009. Furthermore, the IAIS plans to complete a guidance paper on the creation and use of supervisory colleges in group-wide supervision by October 2009. The IAIS is also liaising with the BCBS concerning financial

conglomerates and collaborating with the FSF on how the protocols for the largest global financial conglomerates could be adapted for insurance entities (using the IAIS guidance paper as a basis). A number of jurisdictions have recently held colleges for significant insurance groups.

5. IOSCO's Emerging Markets Committee has submitted a proposal to the FSF concerning the involvement of emerging market supervisors in supervisory colleges under the FSF model. This proposal suggests that some emerging market economy representation from jurisdictions where the institution has operations which are of systemic significance to the jurisdiction should be considered, and that the colleges establish mechanisms to communicate key issues and decisions with other jurisdictions in which the institution has a significant presence.

6. At the regional level, the Committee of European Banking Supervisors (CEBS) established 10 common principles, relevant for the banking, insurance and financial conglomerates sector regarding the functioning of colleges of supervisors based upon existing work and recent experience on the functioning of colleges of supervisors in a crisis situation.

Working Group assessment and recommendations

7. Progress has been achieved so far in establishing supervisory colleges for all systemically important global financial institutions and large global insurance groups. The FSF should review the college arrangements in 2009 once experience with the colleges has been garnered. The Working Group recommends that the FSF in its review of the college arrangements should also report whether the list of identified institutions needs to be adapted. A list of financial institutions under the auspices of supervisory colleges should be made available to all relevant national authorities.

8. The FSF should also work as needed, to ensure consistency in approaches so that supervisory colleges match the protocols developed by the FSF, while taking into consideration the work of the IAIS, IOSCO and the CEBS.

9. The colleges should include relevant host supervisors, including – where appropriate – those from emerging economies. Home supervisors as the chair/coordinator of the colleges should take the lead in determining the membership of the college and how best to promote confidential exchanges. They should focus initially on the formation of relatively small groups comprising supervisors responsible for those parts of the group that are most significant to its risk profile. Balancing the needs of a core group of key supervisors with those of a wider group of host countries might be achieved by having different forms of engagement in the college process. The FSF should also consider a process to pulling together non-financial institutions information of wider interest.

10. Home supervisors together with the FSF should consider ways to ensure an adequate exchange of information with host supervisors which are not members in the college of a specific institution.

11. The main focus of the colleges should be on supervisory aspects, including a comprehensive assessment of risks and their potential macro-impact of the financial institution by the home supervisor (and major host supervisors, if applicable) as well as the perspective of its business strategy.

B Regulatory cooperation and information sharing

G20 Action Plan No. 29, immediate action:
Our national and regional authorities should work together to enhance regulatory cooperation between jurisdictions on a regional and international level.

G20 Action Plan No. 30, immediate action:
National and regional authorities should work to promote information sharing about domestic and cross-border threats to market stability and ensure that national (or regional, where applicable) legal provisions are adequate to address these threats.

Process for taking forward the Leaders' action item

12. In order to promote information sharing, in particular to facilitate fast communication in the event of financial crises, the FSF has set up a Crisis Management Contact List including relevant authorities from 35 countries, International Financial Institutions (IFIs) and critical global financial service providers.

13. For the insurance sector, the IAIS is taking steps to expedite the operation of its MMoU framework that was put in place in February 2007 in order to facilitate information exchange among insurance supervisors both under normal circumstances and in times of crisis. There are a number of bilateral Memoranda of Understanding (MoUs) in place between insurance supervisors of some jurisdictions relating to information exchanges. The IAIS is also considering integrating its catastrophe related function of the Global Reinsurance Market Report in a crisis management framework, including a list of supervisory contact points.

14. IOSCO is also working on the global adoption of its MMoU Concerning Consultation and Cooperation and the Exchange of Information. The IOSCO MMoU specifies the type of information that must be able to be provided on request by another signatory for securities enforcement purposes and that banking secrecy provisions cannot be used to refuse a request. Over two thirds of the 114 IOSCO eligible members have become full signatories to the MMoU or committed to

removing the identified impediments to becoming signatories.

15. For the banking sector there are established information exchange agreements between supervisors in the form of bilateral MoUs. The FSF proposals for supervisory colleges and cross-border crisis management also support enhanced information sharing arrangements for specific firms.

Working Group assessment and recommendations

16. The Working Group recognises that bilateral MoUs are an important means for information sharing between banking supervisors. Nevertheless, the Group recommends asking the BCBS to consider up-dating its 2001 template for information exchange ("Essential Elements of a Statement of Cooperation between Banking Supervisors") in the light of current best practices and to consider further improvements that would enhance bilateral information exchange and supervisory collaboration world-wide.

17. Additionally, the Group recommends calling on the BCBS´s further work to consider the development of a global mechanism for information exchange, taking into consideration the work of IOSCO and the IAIS, which would allow banking supervisors to collaborate on a world-wide basis. This mechanism should allow jurisdictions flexibility, recognising different legal and confidentiality constraints and ensure full confidentiality of information and a sufficient flow of information between home and host banking supervisors.

18. This global mechanism for information exchange should provide for:

- timely communication among the community of banking supervisors including with regard to non-requested information;
- regular information exchange between home and host supervisors; and
- information exchange across national borders and between supervisors of different sectors.

19. Additionally, this global mechanism should consider how to ensure an exchange of information regarding:

- illicit activities and non-authorised activities or institutions;
- supervisory concerns or other sources of potential financial disruption (i.e. economic and financial aspects);
- relevant current events (i.e. news, regulatory changes, supervisory temporary measures or agreements).
- While planning supervisory visits to host intermediaries, the home supervisors should coordinate the visit with the host authorities so that the latter may inform the former on the status of the host intermediary. At the end of the inspection the home supervisor should brief the host supervisor on its findings and agree the

best way to go forward on preventive and remedial actions.

20. Home and host supervisory and other relevant authorities (e.g. central banks, finance ministries) should work closely together, in line with the FSF principles for cooperation on crisis management and where permitted by legal frameworks and confidentiality issues, to share and build an understanding of information that would help support a coordinated approach to a crisis affecting particular firms. This might include information on group structures, interlinkages between particular firms and domestic financial systems, and particular firms' contingency funding arrangements.

21. Finally, authorities should ensure that they stand ready to communicate effectively with each other in-crisis, and that firms themselves are capable of supplying in a timely fashion (and in useful format) the information that may be required by the authorities in managing a financial crisis. Authorities should share firm-specific information as freely as practicable with other relevant authorities from an early stage of a crisis in a way that does not materially compromise the prospect of a successful resolution and subject to the application of rules on confidentiality.

C. Cross-border crisis management

G20 Action Plan No. 36, immediate action:
Regulators should take all steps necessary to strengthen cross-border crisis management arrangements, including on cooperation and communication with each other and with appropriate authorities, and develop comprehensive contact lists and conduct simulation exercises, as appropriate.

Process for taking forward the Leaders' action item

22. The FSF established a sub-group last year to address crisis management planning issues for large cross-border financial firms. The sub-group met on end-January together with representatives of the G20 WG2 chairs and the chairs of the BCBS and Economic and Financial Committee (EFC) groups which are addressing related issues. At this meeting the sub-group agreed to develop, in particular, a set of principles for international crisis management.

23. The FSF principles cover practical and strategic ex-ante preparations and set out expectations for how authorities will relate to one another in-crisis. They draw upon recent and earlier experiences of dealing with cross-border firms in-crisis, the 2001 G10 Joint Taskforce Report on Winding Down Large and Complex Financial Institutions, and the 2008 European Union (EU) MoU on Financial Stability.

24. The sub-group also agreed to (i) develop a common systemic impact assessment framework and the gathering of key lessons from dealing with recent

cross-border banks in crisis; and (ii) write a "practical" addendum to the 2001 Joint Taskforce Report, which was largely theoretical in nature, to record the practical barriers faced by decision-makers.

Working Group assessment and recommendations

25. The FSF agreed at its plenary meeting in London on 11-12 March 2009 on the set of principles for cross-border cooperation on crisis management developed by the FSF sub-group. The Working Group recommends that national authorities should commit to implementing these principles which cover preparatory work in normal times, and appropriate sharing of information and cooperation in crisis times. This will involve home authorities, drawing on the work of colleges, leading cross-border discussions involving supervisors, central banks and, where appropriate, finance ministries, on issues and barriers that may arise when handling specific cross-border firms under severe stress.

Medium-term actions identified by Leaders:

D. Resolution regimes and bankruptcy laws:

G20 Action Plan No. 12, medium-term action: *National and regional authorities should review resolution regimes and bankruptcy laws in light of recent experience to ensure that they permit an orderly wind-down of large complex cross-border financial institutions.*

Process for taking forward the Leaders' action item

26. The BCBS's Cross-border Bank Resolution Group (CBRG) is taking stock of national resolution policies, responsibilities and legal frameworks for the resolution of cross-border banks. The IMF, together with the World Bank, recently issued a paper reviewing national legal, institutional and regulatory frameworks for bank insolvencies. The paper discusses the framework that a country should have in place in periods of financial stability and in a systemic crisis. There are also initiatives at the regional level; for example, the EU has established a working group on early intervention tools which will also address bank resolution issues.

27. The BCBS's CBRG, in its Interim report of December 2008, reviews resolution policies and draws out lessons of the current crisis for resolution mechanisms and their application across borders. It examines the impact of measures to protect domestic stakeholders' interests and limit contagion ("ring-fencing") as well as the implications of different legal and policy approaches on the termination, netting and settlement of financial contracts. It is revising this in light of recent experiences and legislative changes and will prepare a menu of options to address the identified

problems by October 2009.

28. The FSF's principles for cross-border cooperation on crisis management also include a commitment to share information on potential impediments to coordinated solutions stemming from the legal frameworks and bank resolution procedures of the countries in which cross-border firms operate.

Working Group assessment and recommendations

29. The Working Group recommends welcoming the efforts by international bodies, in particular the FSF, the BCBS, the IMF, and the World Bank to identify differences in resolution regimes, and build a better shared understanding of the potential conflicts between them. According to recent experience, global financial institutions bear contagion risks that could reach global scales, while existing crisis management and resolution arrangements do not deal comprehensively with cross-border jurisdictions. Best practices tend to be addressed at a local level.

30. In the absence of international arrangements to deal with insolvencies of cross-border financial institutions, international bodies should explore a framework to advance the co-ordination of regional cross-border resolutions in the medium term.

31. These mechanisms should consider the rights of the involved parties and avoid negative spill-over costs that could result from uncoordinated national responses to a crisis.

32. Arrangements also need to be considered for non-bank financial institutions (such as insurers) with cross-border activities that may be systemically important and large complex financial conglomerates.

33. Authorities should work closely together, in line with the FSF principles for cross-border cooperation on crisis management, to share information about national resolution regimes and consider potential impediments to coordinated solutions stemming from them.

34. Meanwhile, the Working Group recommends calling on the FSF and the BCBS to explore the feasibility of common standards and principles as guidance for acceptable practices for cross-border resolution schemes thereby helping reduce the negative effects of uncoordinated national responses, including ring-fencing.

E. Convergence in regulatory practices

G20 Action Plan No. 37, medium term action: *Authorities, drawing especially on the work of regulators, should collect information on areas where convergence in regulatory practices such as accounting standards, auditing, and deposit insurance is making progress, is in need of accelerated progress, or where there may be potential for progress.*

Process for taking forward the Leaders' action item

35. The FSF has encouraged its national members to provide their views on progress and issues regarding convergence in regulatory practices, including in areas such as accounting standards, auditing and deposit insurance. The FSF has put in place a programme to review the work of standard setting bodies, which will be updated to consider the harmonisation efforts underway with respect to international accounting and auditing standards.

36. The IASB has in place an extensive convergence programme for accounting standards. The International Auditing and Assurance Standards Board (IAASB) is close to completing its Clarity Project, which aims at bringing greater clarity to international auditing standards and may make them suitable for adoption by national authorities

37. In response to the recommendation from the FSF, the BCBS and the IADI issued the Core Principles for Effective Deposit Insurance Systems for public consultation. These core principles address a range of issues including deposit insurance coverage and funding and prompt reimbursement. They also address issues related to public awareness, resolution of failed institutions and cooperation with other safety net participants including central banks and supervisors.

38. The IMF will assess the progress with international convergence in the provision of deposit insurances, drawing on IADI's Core Principles for Effective Deposit Insurance Systems. Such efforts will identify gaps and highlight best practices in terms of regulatory cooperation.

39. Other initiatives include the adoption of the eXtensible Business Reporting Language (XBRL) (supported by the XBRL International, and other regional bodies).

Working Group assessment and recommendations

40. The Working Group recommends welcoming the efforts made by the FSF, the IMF and other international bodies, such as the IASB and the IADI, to achieve convergence in accounting standards and the regulation of deposit insurance systems.

41. Furthermore, the following aspect could be considered: Supporting the work being carried out by the International Forum of Independent Audit Regulators (IFIAR).

F. Temporary measures

G20 Action Plan No. 38, medium-term action: *Authorities should ensure that temporary measures to restore stability and confidence have minimal distortions and are unwound in a timely, well-sequenced and coordinated manner.*

Process for taking forward the Leaders' action item

42. The BIS, in cooperation with the CGFS, is developing a database on emergency measures to identify areas where differences may be creating distortions. The FSF will analyse how the measures interact, and how eventually exit strategies need to be coordinated to minimise market uncertainty, competitive inequality and arbitrage opportunities.

43. Furthermore, the OECD will also consider how to safeguard competition principles in the emergency measures for financial sector rescues and restructurings. It will study standards and safeguards that are needed to prevent distortions of competition when government funds are used for equity injections or guarantees, and exit plans or provisions that should be in place when governments inject equity, provide guarantees or purchase distressed or illiquid assets, in order to limit the duration of any distortions of competition.

44. As the timeline for exit strategies will depend on the progress on other actions, the OECD will also explore requirements for restoring a healthy balance between markets and government interventions, including privatisation strategies, pension funds (where arrangements have been devastated by the crisis), governance and competition.

45. Further work on the subject of exit strategies is also expected from the IMF.

Working Group assessment and recommendations

46. While the immediate priority is to mitigate the current financial crisis and to restore confidence in financial markets, some forward thinking is required on the issue of exiting from emergency measures.

47. The unwinding of temporary measures in the period ahead is going to be an important issue. The introduction and the continuation of these measures may have accentuated moral hazard concerns. However, it is also a potentially complicated issue, particularly given the broad range of measures that have been implemented

over the past year (including regulatory changes, equity injections, funding guarantees, deposit insurance arrangements, loan facilities and small business assistance).

48. The Working Group welcomes the steps initiated so far to take stock of the rescue packages and analyses of competitive effects and exit strategies and encourages further progress. Exit strategies may require a coordinated response to overcome ‘first mover’ problems. However, they also need to take into account individual circumstances.

49. Consideration should also be given to the potential impact the exit from temporary emergency measures in mature markets could have on resource flows to emerging countries.

50. As many financial institutions rely heavily on equity sourced from securities markets, any exit strategy is likely to depend on well functioning and liquid markets which have the confidence of investors. Securities regulators and market participants therefore could usefully participate in the development and implementation of these strategies.

51. Further discussion and international cooperation may be required on exit strategies, which may be facilitated by the IMF, FSF, IOSCO, OECD and G20. The IMF, in collaboration with the FSF and the OECD, should prepare reports on this issue for the next meeting of the G 20 Finance Ministers and Central Bank Governors.

III. Role of international bodies

Immediate actions identified by Leaders:

A. FSF membership

G20 Action Plan No. 39, immediate action: *The FSF should expand to a broader membership of emerging economies.*

Process for taking forward the Leaders’ action item

52. The FSF decided at its plenary meeting in London on 11-12 March 2009 to broaden its membership and to invite as new members the G20 countries that are not currently in the FSF. These are Argentina, Brazil, China, India, Indonesia, Korea, Mexico, Russia, Saudi Arabia, South Africa and Turkey. In addition, Spain and the European Commission will also become FSF members. The FSF also declared that it

will be acting to strengthen the institutional foundations of the FSF, as well as its procedures and working methods to ensure continued effective functioning with a larger membership.

Working Group assessment and recommendations

53. The Working Group recommends welcoming the FSF's recent expansion.

54. The Group also advises that FSF member countries should be expected to pursue financial stability, maintain the openness of the financial sector and implement international financial standards and principles, including the 12 key Standards and Codes, as well as the FSF- and G20-recommendations and agree to undergo periodic peer reviews, using as appropriate joint IMF/World Bank FSAPs. The expansion, together with an increased regional outreach, will increase the FSF's ability to develop standards and best practices that are broadly reflective of financial systems globally and contribute to broader implementation of its recommendations.

55. The Working Group underlines that it is important that the FSF continues to be effective in promoting international financial stability. Thus, the mandate of the expanded FSF should be enhanced, in particular, to monitoring the implementation of the FSF- and G20-recommendations in close cooperation with the IMF.

B. IASB Governance

G20 Action Plan No. 4, immediate action: *With a view toward promoting financial stability, the governance of the international accounting standard setting body should be further enhanced, including by undertaking a review of its membership, in particular in order to ensure transparency, accountability, and an appropriate relationship between this independent body and the relevant authorities.*

Process for taking forward the Leaders' action item

56. The IASCF is currently reviewing its constitution. At their meeting in mid-January 2009 the Trustees completed the first part of the Constitution Review, which addressed the issue of public accountability (the link to an external monitoring body), and the composition, geographical diversity, and the size of the IASB.

57. The Trustees approved to establish a formal link to a newly created external Monitoring Board composed of public authorities. The membership of the Board will comprise the relevant leaders from the IOSCO Emerging Markets and Technical Committees, the European Commission, the Japan Financial Services Agency (FSA), and the US Securities and Exchange Commission (SEC). The BCBS will also participate in the Monitoring Board as an observer. The Trustees also approved the

text of the MoU that will govern the relationship between the Trustees and the Monitoring Board. The Trustees have indicated that the initial membership of the Monitoring Board does not preclude the Monitoring Board adding new members as circumstances dictate.

58. Furthermore, the Trustees approved the constitutional change that will expand the IASB membership to 16 members and provides guidelines regarding geographic diversity. In order to ensure a broad international basis, there shall normally be four members from the Asia/Oceania region; four members from Europe; four members from North America, one member from Africa; one member from South America; and two members appointed from any area, subject to maintaining overall geographical balance.

59. The remaining part of the Constitutional Review on a broad range of constitutional issues was launched with a discussion document of December 2008 (the issues addressed include the standard-setting process, the agenda-setting process, "fast-track" procedures, the procedures and composition of the Standards Advisory Council (SAC) and the organisation's funding). The consultation period will end by 31 March 2009. The Trustees are considering holding a series of round-table meetings to encourage further debate and comment from stakeholders around the world.

Working Group assessment and recommendations

60. The Working Group welcomes the Trustees' recent decision that will enhance the IASB's accountability, governance and legitimacy. As part of the second phase of the current constitutional review the Trustees should consider complementary measures to further enhance the governance arrangements, including further expanding the membership and increasing the representation of all relevant stakeholders and interests. The Working Group also encourages more regular meetings between global accounting standard setters, including the IASB and the Financial Accounting Standards Board (FASB).

Other international standard-setting bodies' membership

61. In the context of the discussion about the FSF and IASB membership the issue of other international standard-setting bodies' membership was raised.

62. The IOSCO Technical Committee decided in mid-February to invite Brazil, China, and India to join its membership. The new members were chosen on the basis of the size of their capital markets, the international nature of their markets and the development of their regulatory system and authority. The BCBS also decided at its 10-11 March 2009 meeting to expand its membership and invite representatives from the following countries to join the Committee: Australia, Brazil, China, India, Korea,

Mexico and Russia. The Basel Committee's governance body will also be enlarged to include the Central Bank Governors and Heads of Supervision from these new member organisations.

Working Group assessment and recommendations

63. The Working Group recommends encouraging other international standard setting bodies to review their membership and consider expanding their membership to emerging economies to achieve greater representation. The Group also recommends encouraging the BCBS, IAIS, and IOSCO, the parent committees of the Joint Forum, to consider expanding the Joint Forum's membership. They should remain flexible with regard to outreach and the composition of ad hoc working groups to also include countries that are not members of the parent committees.

C. IMF/FSF collaboration

G20 Action Plan No. 40, immediate action:
The IMF, with its focus on surveillance, and the expanded FSF, with its focus on standard setting, should strengthen their collaboration, enhancing efforts to better integrate regulatory and supervisory responses into the macro-prudential policy framework and conduct early warning exercises.

Process for taking forward the Leaders' action item

64. On 13 November 2008 the IMF Managing Director and the FSF Chairman sent a joint letter to the G20 Ministers and Governors to clarify their organizations' respective tasks and responsibilities, including the cooperation in conducting early warning exercises. The IMF should assess macro-financial risks and systemic vulnerabilities; the FSF should assess financial system vulnerabilities, drawing on the analyses of its member bodies, including the IMF and standard setting bodies. The IMF and FSF would consider providing joint risk assessments and mitigation reports.

65. In line with the November joint letter and drawing on their complementary areas of focus, the IMF and the FSF have recently stepped up their collaboration on developing a framework on early warnings. The two bodies have begun to discuss modalities for a collaborative process for identifying and mitigating systemic risks and vulnerabilities:

66. Both the IMF and the FSF are enhancing their processes and capabilities for early warning:

- The IMF has, for example, set up a new macro-financial unit, which will focus on developing an analytical framework for better understanding macro-financial linkages. The spring 2009 issue of the Global Financial Stability

Report (GFSR) will address the ongoing development of the Fund's early warning methodologies. The IMF is also planning together with the World Bank, to review the FSAP with a view to better integrating financial sector analyses and FSAP assessments into surveillance.

- The FSF, for its part, is working to produce more actionable outputs from, and more systematic follow up of, its vulnerabilities exercise. It is putting in place a more articulated and iterative process to pool information from members, identify potential concerns, mobilise the resources of FSF member institutions to drill down and evaluate these concerns, develop potential courses of action, and track and evaluate mitigation measures taken by its members or market participants. The FSF's vulnerability exercise will draw on and complement the macro-financial analysis undertaken by the IMF and others.

67. The Fund has recently submitted a paper to the IMF Executive Board that proposes a procedure for regular Fund-FSF EWEs which the Board discussed and broadly supported in early February. The EWEs would aim at identifying and prioritising macro-financial risks and systemic vulnerabilities and provide policy makers with options to mitigate risks and vulnerabilities. Both quantitative and qualitative approaches would be employed. The IMF and the FSF would cooperate closely with the Fund staff taking the lead on macro-financial concerns and the FSF focusing more on underlying regulatory challenges. They would share inputs on risks and vulnerabilities at an early stage of their respective processes. Thereafter their processes would focus on evaluating the materiality of concerns identified and the development of possible responses. The results of the exercises would be communicated to the Board and the IMFC jointly by the IMF Managing Director and the FSF Chair.

Working Group assessment and recommendations

68. The IMF and the FSF have recently taken important steps to strengthen their collaboration, in particular, by developing procedures to conduct regular joint EWEs. The Working Group expects that a pilot EWE is conducted for the next IMF Spring meeting. The Group recommends calling on the IMF and the FSF to report the results of the EWEs to the IMFC and the G20.

69. The IMF and the FSF should review the effectiveness of their collaboration, including of the operation of the EWEs after experience has been gained, and, if needed, submit further proposals to strengthen the processes to the IMFC and the G20 by the time of the next meeting of G20 Finance Ministers and Central Bank Governors.

70. The Working Group also recognises that for effective early warnings data

collection needs to be strengthened. The IMF is already seeking to enhance its collaboration with national authorities responsible for financial stability assessments to enhance data availability, including with regard to cross-border exposures. For example, an interagency group has been established to strengthen finance statistics, chaired by the IMF and including the BIS, ECB, OECD, Eurostat, the UN, and the World Bank. The Group recommends asking the IMF and the FSF to explore gaps and provide appropriate proposals for strengthening data collection before the next meeting of G20 Finance Ministers and Central Bank Governors.

71. The Working Group supports the IMF's efforts to strengthen its existing surveillance tools, in particular, the FSAP and looks forward to the IMF's and World Bank's review of the FSAP. The Group recommends calling on all countries to commit to undergo an FSAP and to publish the results. Furthermore, countries with systemically important financial sector activities should undergo an FSAP and regular updates more frequently.

D. Drawing lessons

G20 Action Plan, No. 41, immediate action:
The IMF, given its universal membership and core macro-financial expertise, should, in close coordination with the FSF and others, take a leading role in drawing lessons from the current crisis, consistent with its mandate.

Process for taking forward the Leaders' action item

72. Following up on its April 2008 report to the IMFC ("The Recent Financial Turmoil—Initial Assessment, Policy Lessons, and Implications for Fund Surveillance"), the IMF staff recently published a set of papers drawing initial lessons of the current financial crisis.

- The overview paper titled "Initial Lessons of the Crisis" summarises the initial lessons of the financial crisis along three dimensions – financial regulation, macroeconomic policy, the global architecture. Further staff papers elaborate on these three dimensions.

- The first staff paper titled "Lessons of the Financial Crisis for Future Regulation of Financial Institutions, Markets and for Liquidity Management" focuses on regulation issues and specifically on the following five areas: First, it concentrates on the perimeter of financial regulation and refers to action undertaken so far by the G20. Second, the paper summarises the discussion surrounding policies to mitigate procyclicality. Third, the paper addresses the existing information gaps and calls for a multilateral approach to fill these gaps. Fourth, the progress and possible future reforms regarding cross-border/cross-functional regulation is examined. Finally, the paper comments on the different topics surrounding systemic liquidity management.

- The second staff paper titled “Lessons of the Global Crisis for Macroeconomic Policies” re-examines the role of macroeconomic policy in the management of credit and asset booms. First, the paper briefly reviews the macro-financial conditions prevailing in the run-up to the crisis. Second, it investigates the relationship between asset price booms and macroeconomic and financial stability. Third, the paper re-evaluates the role and the responsibility of monetary and fiscal policies in limiting credit and asset booms.

- The third staff paper titled “Initial Lessons of the Crisis for the Global Architecture and the IMF” deals in more detail with the shortcoming the financial crisis revealed about the current global architecture. It focuses on four key areas where reform is deemed necessary, namely surveillance of systemic risk, international coordination of macro-prudential responses to systemic risk, cross-border arrangements for financial regulation, and funding for liquidity support or external adjustment.

73. The FSF with its April 2008 “Report on Enhancing Market and Institutional Resilience” and follow-up work has also already started drawing lessons from the crisis. The FSF published a first progress report in October 2008. The FSF also initiated work to develop recommendations to address additional lessons drawn since the April 2008 report, notably to dampen pro-cyclicality and incentives to excessive risk taking in compensation schemes. At its meeting on 11-12 March 2009 the FSF assessed further progress including on the new workstreams.

- The FSF endorsed recommendations to mitigate procyclicality in the financial system. This work comprises a framework for evaluating policy options as well as recommendations in three priority areas: the bank capital framework, loan loss provisioning practices and standards, and the interaction between leverage and valuation. The recommendations are addressed to national authorities and prudential and accounting standards setters. (These issues are being addressed in detail in the G20 Working Group 1.)

- The FSF also endorsed a set of principles that will reinforce sound compensation practices in the financial industry. The principles aim to ensure effective governance of compensation, alignment of compensation with prudent risk taking, and effective supervisory oversight and stakeholder engagement in compensation. (This issue is also being addressed in detail in the G20 Working Group 1.)

- Finally, the FSF endorsed a set of high level principles for cross-border cooperation on crisis management (see section II C.)

Working Group assessment and recommendations

74. The IMF and the FSF and other international bodies are working intensely on analysing the causes of the crisis and on drawing lessons. Some of this work has already produced concrete results in the form of, for example, proposals for new or updated international standards and guidelines. The Working Group welcomes these efforts and calls on the IMF and FSF to continue to cooperatively develop lessons learned from the crisis within their respective mandates. They should also give attention to the impact of global capital flows on global financial stability.

Medium-term actions identified by Leaders:

E. Regulatory responsiveness to financial innovation

G20 Action Plan No. 27, medium-term action:
International standard setting bodies, working with a broad range of economies and other appropriate bodies, should ensure that regulatory policy makers are aware and able to respond rapidly to the evolution and innovation in financial markets and products.

Process for taking forward the Leaders' action item

75. A prerequisite for responding to vulnerabilities emanating from financial innovation is that standard setting bodies become aware of potential risks at an early stage. In order to increase the awareness the FSF has asked standard setting bodies to review their work programmes in the light of the G20 Action plan, in particular with a view to better prioritise workstreams. Several standard setting bodies have already responded to this request. For example, the BCBS will conduct regular discussions on emerging issues and risks and their implications for supervisory priorities. The IAIS has begun the assessment of its existing and new supervisory papers currently under development against a list of issues emerging from the financial crisis in the insurance sectors to ensure that all the issues are adequately dealt with and to identify potential gaps. The IAIS believes that it is important to draw lessons from the other sectors where relevant and to react proactively rather than to wait for similar problems to occur in the insurance sector as well. IOSCO has established high level task forces to analyse the risks posed by unregulated or under-regulated products, markets and entities from a securities regulation perspective. It has recently published a consultation report on possible approaches to improving the regulation of hedge funds, and will shortly publish a consultation report on securitised products and credit default swaps.

76. Several international organisations and standard-setting bodies have also recently stepped up interaction with the private sector. Regular interaction with the private sector is important, since the involvement of the industry is key to the proper implementation of measures.

Working Group assessment and recommendations:
77. The Working Group recommends welcoming that international standard setting bodies have stepped up efforts to better prioritise workstreams. The Group also encourages them to enhance their interaction with the private sector. The FSF should monitor and assess these processes and report back to the next meeting of G20 Finance Ministers and Central Bank Governors.

F. Asset prices

G20 Action Plan No. 28, medium-term action: *Authorities should monitor substantial changes in asset prices and their implications for the macro-economy and the financial system.*

Process for taking forward the Leaders' action item
78. The IMF papers on initial lessons of the crisis and, in particular, the paper on lessons of the global crisis for macroeconomic policies address the issue of asset prices. Asset prices are expected to be an input into the IMF/FSF Early Warning Exercises. In addition, the FSF has set up three workstreams on procyclicality that indirectly deal with asset price cycles and their implications for the regulatory and supervisory frameworks.

Working Group assessment and recommendations:
79. The Working Group supports that the IMF monitors asset prices as part of its work on early warning. The Group also asks the relevant international bodies, in particular the BIS together with the CGFS and the IMF, to produce a report on how authorities are currently monitoring and addressing asset prices and to develop recommendations in light of the current crisis. A report should be presented to the next meeting of G20 Finance Ministers and Central Bank Governors.

IV. Promoting market integrity

Immediate actions identifies by Leaders:

A. Protection against market manipulation and fraud

> ***G20 Action Plan No. 31, immediate action:***
> *National and regional authorities should also review business conduct rules to protect markets and investors, especially against market manipulation and fraud and strengthen their cross-border cooperation to protect the international financial system from illicit actors. In case of misconduct, there should be an appropriate sanctions regime.*

Process for taking forward the Leaders' action item

80. During the current financial crisis concerns have been raised that short selling, in particular naked short selling, contributed to market manipulation, securities fraud, and disorderly markets. In order to strengthen confidence in financial markets and to protect investors, many jurisdictions introduced temporary measures to strengthen short selling regulations, in particular with regard to restricting (naked) short selling and to enhance transparency of short positions. These measures vary both in terms of what is permissible and what is reportable, many are still in a state of flux.

81. In response, the IOSCO Technical Committee created in end-2008 a Task Force on Short Selling. The general mandate of the task force is to consider the currently implemented regulatory measures related to short selling and attempt to develop international high level principles. The task force submitted its report to the IOSCO Technical Committee in mid-February 2009. It recommends four principles for effective regulation of short selling: short selling activities should be subject to appropriate controls, to an appropriate reporting regime, to an effective compliance and enforcement system. In addition, short selling regulation should allow exceptions for certain transactions that are necessary for efficient market functioning and development. The consultation report has recently been published.

82. More generally with regard to business conduct rules, at the regional level the European Commission is currently reviewing its regulatory framework to identify potential gaps with regard to business conduct. This includes work to ensure that high levels of consumer protection apply consistently and effectively to the key investment products targeted at the retail market as well as an analysis of the role and regulation of credit intermediaries. Some regulators are also contemplating steps to further strengthen the role and effectiveness of the compliance function within

banks and investment firms.[1]

83. In order to strengthen cross-border enforcement in the securities sector, IOSCO, in 2002, adopted the MMoU Concerning Consultation and Cooperation and

the Exchange of Information (IOSCO MMoU). The IOSCO MMoU expresses a commitment by IOSCO member regulators to put in place efficient and effective arrangements for information-sharing to address the illegal use of the securities and derivatives markets, including market abuse and fraud. Since 2005 the IOSCO has strived to create an international network within the framework of the IOSCO MMoU. IOSCO has set itself the target of having all ordinary members apply to become signatories to the IOSCO MMoU by 2010; currently 52 securities regulators have become signatories. Furthermore, for those jurisdictions that are not represented within the IOSCO membership but which are identified as strategically important, yet uncooperative in terms of cross-border enforcement related cooperation, IOSCO has launched a contact initiative (this is being addressed in more detail under Action Plan No. 32).

Working Group assessment and recommendations:

84. The Working Group recommends endorsing the principles developed by the IOSCO's Task Force on Short Selling and urging all securities regulators to adapt their short selling regimes accordingly. The Group also advises that IOSCO consider adding detail to the principles following further consultation with the industry, international regulators, and the public. Furthermore, the Group recommends asking the IOSCO to review the implementation and effectiveness of the principles and report back to the G20 by the time of the next meeting of G20 Finance Ministers and Central Bank Governors.

85. The Working Group also supports the IOSCO's and other standard setting bodies' work on disclosure and market transparency that will contribute to investor protection. The Group encourages the IOSCO to continue its work on cross-border enforcement related cooperation through its MMoU Concerning Consultation and Cooperation and the Exchange of Information.

86. Finally, the Group recommends urging all firms to uphold high standards of business conduct. The IOSCO should be asked to take stock of the national and international regulatory regimes with regard to business conduct rules and consumer protection, in order to identify supervisory and regulatory gaps and provide a report by the time of the 2010 meeting of G20 Finance Ministers and Central Bank

[1] Lack of disclosure and transparency with regard to financial market products prevent the enforcement of market discipline. However, this issue is being addressed by the G20 Working Group 1 on Enhancing Sound Regulation and Strengthening Transparency.

Governors.

Medium-term actions identified by Leader:

B. Uncooperative and non-transparent jurisdictions that pose risks of illicit financial activity, FATF

G20 Action Plan, No. 32, medium-term action: *National and regional authorities should implement national and international measures that protect the global financial system from uncooperative and non-transparent jurisdictions that pose risks of illicit financial activity.*

G20 Action Plan, No. 33, medium-term action: *The Financial Action Task Force should continue its important work against money laundering and terrorist financing, and we support the efforts of the World Bank – UN Stolen Asset Recovery (StAR) Initiative.*

Process for taking this forward in the securities sector

87. For the securities sector, as mentioned before, IOSCO has launched a contact initiative that is seeking to ensure that the securities regulators from those jurisdictions that are not represented within the IOSCO membership but which are identified as strategically important, yet uncooperative in terms of cross-border enforcement related cooperation, become able and willing to meet the international cooperation standard set by the IOSCO MMoU even if they are not yet signatories.

88. Under this initiative to date, six jurisdictions have been identified by IOSCO members due to past demonstrated cases of non-compliance with requests for information for enforcement purposes, and have commenced a detailed dialogue on the specific requirements of the IOSCO MMoU. In three of these cases, the relevant jurisdictions have either amended their laws or changed their practices and made an application to become a signatory to the IOSCO.

Process for taking forward the Leaders' action item in the area of money laundering and terrorist financing

89. The current FATF Ministerial mandate together with the priorities of the current FATF Presidency (Brazil) sets out the FATF focus for the immediate future, and include addressing high risk/uncooperative jurisdictions; commencing to re-examine the FATF standards while also continuing to ensure effective global implementation; deepening global surveillance of systemic criminal and terrorist threats; enhancing the cooperation and coordination with key stakeholders and partners (in particular the FATF Style Regional Bodies and the Egmont Group); and building a stronger, practical and ongoing partnership with the private sector.

90. The FATF's action against high risk/uncooperative jurisdictions, in order to reduce the vulnerability of the international financial system to money laundering and terrorist financing and on a more general level to enhance corporate transparency and market integrity, is carried out through the work of the FATF's ICRG.

91. The ICRG addresses jurisdictions or cases where international cooperation has been difficult or impossible and/or where severe deficiencies in the Anti–Money Laundering (AML)/Combating the Financing of Terrorism (CFT) regime have been identified. Under the ICRG process the FATF has identified several jurisdiction which lack effective AML/CFT controls. In public statements the FATF has called on its members and urged all jurisdictions to advise their financial institutions to take the risk arising from the deficiencies in the AML/CFT systems in some of these jurisdictions into account for enhanced due diligence. Many FATF members have responded to these calls. Thus, for these initial actions, a degree of harmonisation exists in terms of alerting on the potential ML/FT risks and advising the financial sector to take these risks into account.

92. In addition to the enhanced due diligence, and in line with FATF Recommendation 21, FATF members have had the flexibility to apply appropriate "counter-measures" that they choose. In its February 2009 ICRG and Plenary meeting the FATF has decided to enhance ICRG procedures to make them more transparent and rules-based and allow more jurisdictions to be examined and followed up by the ICRG. Also, a discussion has started on the need to more closely harmonise counter-measures.

C. Tax information exchange

G20 Action Plan No. 34, medium-term action *Tax authorities, drawing upon the work of relevant bodies such as the Organisation for Economic Cooperation and Development (OECD), should continue efforts to promote tax information exchange. Lack of transparency and a failure to exchange tax information should be vigorously addressed.*

Process for taking forward the Leaders' action item

93. Initiated by the G7 countries in 1996, the OECD has developed high standards of transparency and exchange of information in tax matters, as reflected in the Model Tax Information Exchange Agreement (2002) and Article 26 of the OECD Model Tax Convention. These standards provide for full exchange of information in criminal and civil tax matters and availability of ownership and accounting information on request. These standards are now widely endorsed, including by the UN and the G7/8. G20 Finance Ministers and Central Bank Governors committed to these standards and called upon all countries to adopt them in their statement issued in Berlin, in 2004.

94. While many jurisdictions have committed to these standards, implementation is not complete. Moreover, as some committed jurisdictions rightly point out, some OECD member countries and also some major financial centres have not yet accepted the OECD standards: Significant financial centres continue to offer bank

secrecy for tax purposes and they lack transparency about the ownership and control of legal entities which is a pervasive global problem that impedes effective exchange of information.

95. The OECD Global Forum has recently decided to change the way it presents the summary assessments for each country with respect to acceptance and implementation of the OECD standard. Thus, the forthcoming evaluation will clearly identify jurisdictions that have substantially implemented the OECD standard on exchange of information.

96. In October 2008, a group of OECD member countries met to discuss what they could do to support implementation of the OECD standards. The G7 Heads in July 2008 "urged all countries to implement OECD standards without further delay".

Working Group assessment and recommendations

97. As the international community strengthens international standards, it is critical that these apply to uncooperative jurisdictions and tax havens. Actions taken in these areas are mutually reinforcing. As appropriate they should be implemented jointly and uniformly and tailored to specific country circumstances.

98. Enhanced efforts to deal with uncooperative jurisdictions are needed in the areas of securities regulation, market conduct and prudential supervision. The Working Group supports the IOSCO contact initiative to ensure that securities regulators from under-regulated or uncooperative jurisdictions become able and willing to meet the international cooperation standard set by the IOSCO MMoU and to have the practical ability to implement those standards. The Group recommends encouraging the BCBS and the IAIS to review their approaches in the light of the objectives of prudential supervision.

99. The Working Group supports the FATF's important work against money laundering and terrorist financing, in particular with regard to uncooperative jurisdictions through the ICRG. The Group recommends urging all countries to fully implement the FATF 40+9 Recommendations. The FATF should also take steps to increase its effectiveness, accelerate its efforts and examine available measures. The FATF should develop and adopt procedures to enhance information exchange and direct communication among and between global financial institutions ("group compliance"), supervisors and authorities, including financial intelligence units.

100. The Working Group recommends that the G20 reaffirm their commitment to the high standards of transparency and exchange of information for tax purposes as reflected in the OECD's Model Tax Information Exchange Agreement and Article 26 of the OECD Model Tax Convention. All countries should be urged to fully implement

the OECD standards. This model was also agreed by the UN.

101. The Working Groups also recommends urging the international bodies responsible for prudential and regulatory standards, anti money laundering and terrorist financing, and tax matters - the FSF, the FATF and the OECD - to accelerate their work of identifying uncooperative jurisdictions and developing a toolbox of effective countermeasures against these jurisdictions; they should update G20 Finance Ministers and Central Bank Governors.

102. Finally the Working Group reiterates the support for the World Bank – UN Stolen Assets Recovery Initiative (StAR) to champion the recovery of assets stolen from developing countries. The systematic enforcement of FATF standards with respect to the identification of beneficial ownership and the enhanced monitoring of Politically Exposed Persons would have a significant deterrence effect on corruption and make it easier to detect and deter the flow of proceeds of corruption. The Working Group recommends asking the World Bank to review and develop mechanisms for strengthening global cooperation.

V. Recommendations going beyond the Action plan

103. The Working Group recognises that further actions beyond the Action Plan of November 2008 may be needed to ensure the effectiveness of the mechanisms for regulatory and supervisory collaboration:

- Against the background of the present crisis the Group recognises that lightly regulated or unregulated entities could undermine confidence in financial markets. It supports the conclusions of the G20 Working Group 1 regarding the expansion of the perimeter of regulation and supervision. Once a regulatory framework is established, we should evaluate how international regulatory and supervisory co-operation can best be effected. The establishment of supervisory colleges for those entities, including rating agencies, could be considered.
- Measures in response to a crisis can have adverse effects on investment and trade decisions. There is a need to have support measures to ensure that crisis measures do not create protectionism, including financial protectionism, in the medium term.
- Regardless of the scope of regulatory regimes, the effectiveness of

enforcement mechanisms should be considered.

Abbreviations

AML	Anti-Money Laundering
BCBS	Basel Committee on Banking Supervision
BIS	Bank for International Settlements
CBRG	Cross-border Bank Resolution Group (BCBS)
CEBS	Committee of European Banking Supervisors
CFT	Combating the Financing of Terrorism
CGFS	Committee on the Global Financial System
ECB	European Central Bank
EFC	Economic and Financial Committee
EU	European Union
EWE	Early Warning Exercise
FASB	Financial Accounting Standards Board
FATF	Financial Action Task Force
FSA (Japan)	Financial Services Agency (Japan)
FSAP	Financial Sector Assessment Program
FSF	Financial Stability Forum
GFSR	Global Financial Stability Report
IAASB	International Auditing and Assurance Standards Board
IADI	International Association of Deposit Insurers
IAIS	International Association of Insurance Supervisors
IASB	International Accounting Standards Board
IASCF	International Accounting Standards Committee Foundation
ICRG	International Cooperation Review Group
IFI	International Financial Institution
IMF	International Monetary Fund
IMFC	International Monetary and Financial Committee
IOSCO	International Organization of Securities Commissions
MoU	Memorandum of Understanding
MMoU	Multilateral Memorandum of Understanding
OECD	Organization for Economic Cooperation and Development
SAC	Standards Advisory Committee
SEC (US)	Securities and Exchange Commission
StAR	Stolen Asset Recovery
UN	United Nations
XBRL	eXtensible Business Reporting Language

Attachment A

Members of the G20 Working Group 2

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Ministry of Finance (Germany)	Jörg Asmussen; Secretary of State
Ministry of Finance (Mexico)	Alejandro Werner; Vice Minister of Finance

Country representatives:

Central Bank of Argentina	Jorge Carrera
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Ministry of Finance (Brazil)	Alvaro Vereda
Ministry of Finance (Canada)	Clément Gignac
People's Bank of China	Xuan Changneng
Bank of France	Pierre Jaillet
Deutsche Bundesbank	Erich Harbrecht
Reserve Bank of India	H.R. Khan
Bank Indonesia	Halim Alamsyah
Bank of Italy	Marco Committeri
Ministry of Finance (Japan)	Takehiko Nakao
Ministry of Finance (Mexico)	Guillermo Zamarripa
Bank of Russia	Andrey Shinaev
Saudi Arabian Monetary Agency	Khaled ALkhattaf
National Treasury of South Africa	Ismail Momoniat
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OECD	Pascal Saint-Amans
World Bank	Robert B. Kahn
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G-20 WORKING GROUP 3:
REFORM OF THE IMF

Final Report

4 March 2009

G-20 WORKING GROUP 3: REFORM OF THE IMF

Final Report

On November 15, 2008 the G-20 Leaders committed to a series of measures to restore financial market stability and global growth and achieve needed reforms in the world's financial system. Included among these measures was a commitment to reforming the International Financial Institutions (IFIs).

Working Group 3 was tasked with advancing the actions covered in the November 2008 Leaders' Declaration dealing with the reform of the IMF. Leaders instructed Finance Ministers to implement the initial list of actions identified in the Action Plan as well as – in consultation with other economies, existing bodies and experts – to formulate additional recommendations, including in the area of reviewing the mandates, governance, and resource requirements of the IFIs.

As part of the outreach in undertaking the group's work, an issues paper was circulated to all members of the IMF Executive Board and to the Chairman of the IMFC, who indicated he would circulate it to all IMF members. The Executive Board was advised of the group's progress and comments were invited. The co-chairs also met with academics, think-tanks and other private sector bodies.

GROUP'S CONCLUSIONS AND RECOMMENDATIONS

I. The financial crisis and the role of the IMF

1. The G-20 members reaffirm the central role of the IMF as a critical forum for multilateral consultation and cooperation on monetary and financial issues as well as in promoting international financial and monetary stability.

2. The G-20 members recognise that the global financial crisis has highlighted the urgency of accelerating changes to the IMF so that it can more effectively fulfil its mandate. Such changes should address any underlying deficits in resources, lending instruments, and governance structures, with a view to enhancing legitimacy, ownership and efficiency, and clarifying the roles and responsibilities of the Fund.

Items Identified in Leaders' November 2008 Action Plan

A. Immediate measures

II. IMF to take a leading role in drawing lessons from the crisis

> *'The IMF, given its universal membership and core macro-financial expertise, should, in close coordination with the FSF and others, take a leading role in drawing lessons from the current crisis, consistent with its mandate.'*

3. G-20 members welcome the initial work of the IMF on lessons from the crisis. G-20 members are committed to respond effectively to address identified weaknesses in financial regulation and supervision, macroeconomic policies, international cooperation, the operation of the Fund, and the international monetary system.

4. G-20 members reaffirm the Fund's leading role in this ongoing work, and the need for close coordination with other bodies, such as the expanded FSF.

III. Review of the adequacy of IMF resources

> *'We should review the adequacy of the resources of the IMF, the World Bank Group and other multilateral development banks and stand ready to increase them where necessary'.*

5. In the current uncertain international environment the Fund needs a substantial increase in its lending capacity through additional borrowings. The IMF is a quota-based organisation and due consideration should be given to the need for a permanent increase in the Fund's resources.

6. To meet these objectives, the G-20 members:

   6.1. Support immediate action to strengthen the IMF's position to respond to increased members' demands through a substantial increase in the IMF's lending capacity, including through a possible doubling of IMF resources. Most members support the doubling of IMF resources relative to their pre-crisis level. Given the need for prompt action, this should be achieved through borrowing designed to temporarily supplement the Fund's resources, including additional bilateral or multilateral borrowing from members. In this regard, the G-20 members commend Japan's commitment of up to US$100 billion under the agreement signed on February 13.

   6.2. Support the commencement of the processes for an expansion and increase in the New Arrangements to Borrow (NAB), on the basis of fair burden sharing, recognising that an increase in the NAB will require legislative changes for a number of Fund members.

6.3. Call for the urgent ratification of the package of quota and voice changes agreed by the IMF Board of Governors in April 2008, which would also contribute to an increase in the Fund's resources.

6.4. Call for an acceleration in the next general review of quotas. This review will allow an assessment to be made as to whether the permanent resources of the Fund need to be increased taking account of the magnitude of the crisis, the significant change in international economic conditions, changes to the Fund's financing instruments and the unanticipated increase in financing demands on the Fund since the Thirteenth Review of Quotas was completed in January 2008. Most G-20 members indicated that this review should be concluded by January 2011. Some members indicated that their support was conditional on the review being preceded by the entry into force of the April 2008 quota and voice measures.

7. G-20 members support the Fourth Amendment of the Fund's Articles which would double SDR allocations, boosting reserve holdings and enabling all Fund members to participate in the SDR system in proportion to their quotas. G-20 members call for the Fund to give due consideration to the merits of a further SDR allocation.

IV. Review of IMF lending instruments and lending role

'The IFIs should also continue to review and adapt their lending instruments to adequately meet their members' needs and revise their lending role in the light of the ongoing financial crisis.'

8. G-20 members support a substantial increase in members' access limits to Fund financing as a proportion of their quotas.

9. G-20 members call on the Fund to urgently establish more effective crisis prevention and resolution instruments. Such instruments should be attractive to all members – through high access, a precautionary nature and quick disbursements – while balancing these considerations against the need for appropriate safeguards for Fund resources. The Fund should take into account the full range of implications stemming from the introduction of these facilities.

10. G-20 members call on the Fund to continue to review and streamline conditionality, so that it is focused on areas directly related to a program's objectives while safeguarding IMF resources.

11. G-20 members strongly support the Fund expediting a review of its lending instruments for low-income countries, which would include assessing the need to increase access limits under the PRGF and the Exogenous Shocks Facility so that it has increased flexibility to meet the requirements of low-income countries adversely affected by the crisis. This review should also examine the need for an increase in the Fund's ability to provide concessional financing to low-income

countries including a widening of donor support for its concessional lending instruments.

12. G-20 members support the IMF working with the World Bank in restoring emerging and developing countries' access to credit and private capital flows, and supporting the provision of finance for counter-cyclical fiscal responses. G-20 members underscore the importance of ongoing close cooperation between the IMF and the World Bank within their mandates.

V. IMF/FSF collaboration

> *'The IMF, with its focus on surveillance, and the expanded FSF, with its focus on standard setting, should strengthen their collaboration, enhancing efforts to better integrate regulatory and supervisory responses into the macro-prudential policy framework and conduct early warning exercises.'*

13. Building on the work of Working Group 2, G-20 members welcome the steps taken by the IMF and FSF to strengthen their collaboration and to conduct regular early warning exercises to identify and prioritise systemic macro-financial risks, propose policy responses, and report to policymakers. We expect that the process of expansion of the FSF will be completed by the Leaders' Summit of April 2009.

14. G-20 members support a strengthened role for the IMF in the identification of macro-financial vulnerabilities and emphasise the importance of regular reports by the IMF and expanded FSF to the IMFC.

15. G-20 Finance Ministers and Central Bank Governors commit to undertake candid discussions on the findings of the early warning exercises, the results of multilateral surveillance and appropriate policy options and responses. To this end we invite the IMF and an expanded FSF to prepare input for consideration at future meetings of the G-20 Finance Ministers and Central Bank Governors.

B. Medium-term actions

VI. Strengthening Fund surveillance

> '*The IMF should conduct vigorous and even-handed surveillance reviews of all countries, as well as giving greater attention to their financial sectors and better integrating the reviews with the joint IMF/World Bank financial sector assessment programs. On this basis, the role of the IMF in providing macro-financial policy advice would be strengthened.'*

16. G-20 members highlight that the crisis has demonstrated that the Fund must strengthen its capability to provide independent, objective and persuasive assessments of the risks and dangers that policy makers face at the national and international level, including the implications of large cross-border capital flows. In the current context the IMF can contribute to the development and monitoring

of global policy responses, including fiscal, monetary and financial sector policies.

17. G-20 members recognise that the IMF's shareholders have their responsibility in ensuring the effectiveness of the Fund's surveillance. We acknowledge that countries need to be more responsive to Fund surveillance, especially the systemically important ones.

18. To improve the effectiveness of Fund surveillance, G-20 members:

18.1. Emphasise the importance of candid, even-handed surveillance across all IMF members.

18.2. Call on the IMF to strengthen its bilateral and multilateral surveillance, especially in respect of advanced economies with major financial centres, highly-leveraged economies and large cross-border capital flows.

18.3. Call on the Fund to accelerate its efforts to better integrate financial sector issues into surveillance with a sharper focus on the risks to international financial stability. In addition, the Fund's expertise on financial sector issues should be increased and the resource implications duly considered.

18.4. Call on the IMF and World Bank to reform the FSAP to improve its usefulness and to facilitate regular updating.

18.5. Reiterate our commitment to undertake an FSAP report, noting that improvements to the FSAP should assist individual members in adhering to such commitments.

18.6. Some G-20 members underline the benefits from IMF members agreeing to publication of their Article IV and FSAP reports. Others pointed to the drawbacks of publication.

VII. Greater voice and representation in the IMF for emerging markets and developing economies

'We underscored that the Bretton Woods Institutions must be comprehensively reformed so that they can more adequately reflect changing economic weights in the world economy and be more responsive to future challenges. Emerging and developing economies should have greater voice and representation in these institutions.'

19. The effectiveness of the Fund, and its ability to fulfil its mandate, are critically dependent on urgent action to correct underlying deficiencies with regard to the common ownership, voice and representation of its universal membership. Quota distribution should more adequately reflect the changing

economic weights in the world economy. Emerging markets and developing economies, including the poorest countries, should have greater voice and representation in the Fund, and G-20 members look forward to accelerated progress towards these objectives.

20. Towards achieving these reforms, G-20 members:

20.1. Call for urgent ratification of the package of quota and voice measures approved by the Board of Governors in April 2008.

20.2. Call for a realignment of quota shares that is expected to result in increases in the quota shares of dynamic economies, and hence in the share of emerging market and developing countries as a whole. Most G-20 members indicated that this realignment should be concluded by January 2011. Some members indicated that their support was conditional on the realignment being preceded by the entry into force of the April 2008 quota and voice measures.

20.3. Call for a review of the structure of representation on the Executive Board and IMFC and the decision making rules, consistent with the comprehensive reform of the IMF, so as to more adequately reflect changing weights in the world economy and to ensure that emerging markets and developing countries have greater voice and representation. Such a review should include deepening the participation of low-income countries, lifting the burden on constituencies that have a large number of members, and the consideration of a third chair for Sub-Saharan Africa.

VIII. IMF involvement in capacity building

'Advanced economies, the IFIs, and other international organizations should provide capacity-building programs for emerging market economies and developing countries on the formulation and the implementation of new major regulations, consistent with international standards'.

21. G-20 members encourage the IMF to enhance its capacity building activities for emerging markets and developing economies in assisting with the broad adoption of a strengthened financial regulatory framework.

22. G-20 members encourage the Fund to continue to strengthen partnerships with donors in delivering technical assistance.

23. G-20 members are committed to increasing their capacity building activities for emerging markets and developing countries.

C. Additional Recommendations

IX. Review the mandate and governance of the IMF

> '*We request our Finance Ministers to formulate additional recommendations, including in the area of reviewing the mandates, governance, and resource requirements of the IFIs.'*

24. G-20 members recognise the importance of the IMF ceasing to rely primarily on the income of its lending activities to cover its administrative expenses. In this regard we call for a swift activation of the IMF's new income model, including the speeding up of the process required for the agreed sale of a limited amount of the IMF's gold, and taking the legislative steps required to expand the IMF's investment authority.

25. Most G-20 members support a review of the role of the Fund in the international economy and in the light of the lessons drawn from the crisis, including those relating to the international monetary system and the role of reserve currencies.

26. Many working group members supported the G-20 encouraging the Executive Board and management to expedite the work being undertaken on reviewing governance in the IMF and in particular ensure that the staff, management and the Board are operating as efficiently as possible, that there is a better delineation over roles and responsibilities, and that there is a strong accountability framework. Many other working group members believed this was micro-managing the Fund, and that internal administrative matters such as the delineation of roles and responsibilities of staff and management of the Board are better left to the Fund and IMFC, and consider that these issues are already being duly considered in the aforementioned fora.

27. G-20 members support enhancing the quality of the policy dialogue and political legitimacy of the IMF, within the IMFC and other fora, by ensuring more consistent and effective engagement by Governors in the Fund's collaborative work. Some G-20 members support the activation of a Council of Ministers as a mechanism to elevate the level of policy dialogue in the Fund. Many others were of the view that such a Council of Ministers can only be established after meaningful quota, voice and representation reform is achieved for emerging markets and developing countries. Some stressed the need to safeguard the role of the Executive Board.

28. There is broad support from G-20 members for open, merit-based selection processes, irrespective of nationality and geographical preferences, for the appointment of the next Managing Director and Deputy Managing Directors of the IMF. While beyond the scope of the Working Group, it must be linked to a similar mechanism which should apply to the selection of senior management in the World Bank and other MDBs.

X. Implementation and follow-up processes

29. G-20 members emphasise the importance of closely monitoring progress in advancing IMF reforms and invite the Fund to regularly advise G-20 Finance Ministers and Central Bank Governors of progress in the implementation of these reforms.

ATTACHMENT A

G-20 WORKING GROUP 3 ON REFORM OF THE IMF

MEMBERS AND PARTICIPANTS

Country/organisation	**Representative**
Argentina	Mr Pablo Pereira IMF Executive Director
Australia (Co-chair)	Mr Mike Callaghan Prime Minister's Special Envoy for the International Economy
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Canada	Mr Jim Haley General Director, International Trade and Finance, Finance Canada
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	Mr Amar Bhattacharya Director of the G-24 Secretariat

ATTACHMENT B

G-20 WORKING GROUP 3: REFORM OF THE IMF

CO-CHAIRS' ISSUES PAPER

This paper has been prepared by the Working Group 3 Co-chairs and provides background to the Working Group's final report of 4 March 2009. The paper reflects discussions within the Working Group, however it may not represent the views of all members of Working Group 3.

A. INTRODUCTION

25. On November 15, 2008 the G-20 Leaders committed to a series of measures to restore financial market stability and global growth and achieve needed reforms in the world's financial system. Included among these measures was a commitment to reforming the International Financial Institutions (IFIs).

26. Working Group 3 was tasked with advancing the actions covered in the November 2008 Leaders' Declaration dealing with the reform of the IMF. In paragraph 10 of the November Declaration, Leaders instructed Finance Ministers to implement the initial list of actions identified in the Action Plan as well as – in consultation with other economies, existing bodies and experts – to formulate additional recommendations, including in the area of reviewing the mandates, governance, and resource requirements of the IFIs.

- In undertaking their work, the co-chairs circulated an issues paper to all members of the IMF Executive Board and to the Chairman of the IMFC, who indicated he would circulate it to all IMF members. The Executive Board was advised of the group's progress and comments were invited. The co-chairs also met with academics, think-tanks and other private sector bodies.

I. The Financial Crisis and the Role of the IMF

27. The unprecedented upheaval in financial markets in 2008 and subsequent downturn in economic activity have highlighted the importance of the IMF's role both as a 'crisis responder' — by providing advice and financial support to countries adversely impacted by the crisis — as well as its role in promoting policies that will minimise the prospects of future crises and strengthen the international financial system.

- The global financial crisis has demonstrated that the world needs an effective and cooperative international financial institution — one that promotes economic growth and financial stability, facilitates close international cooperation and coordination in recognition of the close interdependence between economies, and provides support to countries facing balance of payments difficulties so that they can avoid policy responses with adverse impacts on other countries. By standing ready to provide resources to its members, the Fund builds confidence in global financial stability and therefore functions as a critical pillar of global integration and open markets. This is why the IMF was established over 60 years ago.

28. It is unrealistic to expect that the IMF should have prevented the crisis. The IMF does not have the power to compel nation-states to act in accordance with the IMF Board's conclusions. And while the IMF analyses of the global economy and financial system took note of many of the vulnerabilities that ultimately led to the crisis, recent events have exposed weaknesses in the effectiveness of the Fund, particularly given its remit to promote global financial stability and economic growth. The crisis has highlighted the fact that changes are urgently required in the operation of the IMF for it to be more effective in facilitating global financial stability.

29. The IMF represents more than the management and staff of an organisation based in Washington. It is a collective institution whose members have obligations and rights that go with membership, along with a joint responsibility in fulfilling the Fund's mandate.

30. The way the IMF responds to the crisis will have a significant impact on how it is perceived in the future and the role it will play in the international financial system. Its response to the crisis will determine whether countries in the future will have confidence that they can rely on the IMF for financial support as needed and for effective and firm surveillance over members' policies. Complete trust cannot exist if the IMF is unwilling to speak out about major problems affecting the international monetary system. Insufficient trust will add to the trend toward alternative and less efficient arrangements, including self insurance.

31. The G-20 Leaders indicated in their November 2008 Declaration that they are committed to reforming the IMF and in particular, to enhancing its effectiveness in promoting sound policies that support growth and stability, as well as its ability to identify risks and vulnerabilities to the international financial system, and its capacity to provide financial support to countries as needed.

32. Many of the issues raised by G-20 Leaders are on the work program of the IMF Executive Board and there has been an ongoing process of reform and change within the IMF. A number of these issues are complex, contentious, and have been under consideration for some time. However, as previously noted, given the magnitude of the crisis, it is important that the process of reform be accelerated. The IMF's response must not be perceived as 'business as usual'.

33. The working group highlighted that the G-20 process should not attempt to micro-manage the IMF. However, the response to the Leaders' 2008 Declaration can provide political impetus to the direction and speed of reform of the IMF – with the details left to the Fund's consultative and decision making bodies. A positive statement from the Leaders of countries representing more then 85 per cent of world GDP that they are committed to reforming and strengthening the IMF so that it can effectively fulfill its mandate to promote international monetary and financial stability would give a significant and much needed boost to confidence.

34. To deliver a confidence boosting message at the G-20 London Summit, it will be important to identify and build consensus around concrete measures which demonstrate, particularly in the context of the crisis, that the Fund will operate more effectively.

35. Accordingly, and consistent with the approach taken in the Leaders' Declaration, the working group has focused on areas where consensus may be possible on changes that can be implemented relatively early, and where processes can be put in place to advance as quickly as possible those issues requiring longer-term consideration. The deterioration in economic conditions since November 2008 has underlined the need for urgency on some aspects of reform. On the other hand, discussions on issues relating to the IMF's mandate and role in the international monetary system are at a formative stage and will take time to explore. Moreover, the issues raised by the Leaders' Declaration are inter-related. For example the adequacy of the Fund's resources must be considered in the context of reassessing its financing role in member countries. In addition, the ability of the IMF to strengthen its surveillance, enhance its lending instruments and develop more effective early warning exercises will depend on the robustness and legitimacy of its governance structures.

36. Achieving consensus on needed reforms will require political leadership and a commitment to strengthened international cooperation.

B. IMMEDIATE ACTIONS IDENTIFIED BY LEADERS

II. IMF to take a leading role in drawing lessons from the crisis

> *'The IMF, given its universal membership and core macro-financial expertise, should, in close coordination with the FSF and others, take a leading role in drawing lessons from the current crisis, consistent with its mandate.'*

37. The IMF has prepared papers on: 'Initial Lessons of the Crisis'; 'Lessons of the Financial Crisis for Future Regulation of Financial Institutions and Markets and for Liquidity Management'; 'Lessons of the Global Crisis for Macroeconomic Policy'; and, 'Initial Lessons of the Crisis for the Global Architecture and the IMF'.

These papers are being discussed by the IMF Executive Board. They cover issues directly relevant to the performance of the Fund, the operation of macroeconomic policy, the financial regulatory framework and the need for greater international cooperation. It is important that there be a comprehensive assessment of the lessons from the crisis along with ensuring that the lessons are translated into meaningful changes to policies and organisational arrangements.

38. In terms of initial lessons of the crisis for the global architecture and the IMF, the staff identified that reform is needed in four key areas:

- Surveillance of systemic risk. Noting that vulnerabilities can arise from a variety of sources, including unexpected events, bad policies, misaligned exchange rates, credit-fuelled asset booms, external imbalances, or data deficiencies that obscure trends.

- International coordination of macro-prudential responses to systemic risk. This refers to arrangements that govern collective policy decisions, covering forums such as the G-20 and that systemic concerns about the international economy should be reported directly to policy makers with the ability and mandate to take action.

- Cross-border arrangements for financial regulation. Focusing on the need for best practices to help avoid regulatory arbitrage and assist in burden sharing across jurisdictions by international financial conglomerates, with understandings on regulation, supervision, and resolution.

- Funding for liquidity support or external adjustment. The Fund has a central role to help countries weather short-term liquidity strains and it is important that the Fund have the resources to do so and that the processes for providing short-term liquidity be better defined.

39. The Working Group is of the view that the Fund should continue to respond to the Leaders Declaration and deepen its analysis of lessons from the crisis, including further self-reflections regarding the lessons for the role of the IMF. G-20 Finance Ministers and Central Bank Governors may wish to invite the Fund to formally present the results of this work at their next meeting (after March 14).

III. Review of the adequacy of IMF resources

> *'We should review the adequacy of the resources of the IMF, the World Bank Group and other multilateral development banks and stand ready to increase them where necessary'.*

40. The IMF has prepared a paper on 'Review of the Adequacy of and Options for Supplementing Fund Resources', which was considered by the Executive Board on 5 February 2009. IMF management recommended a doubling of the

Fund's pre-crisis lending capacity (including potential lending) to around $US500 billion.

41. The sharp increase in IMF credit commitments in recent months and the uncertainty over the fallout of the crisis has raised questions about whether Fund resources will be adequate to meet possible future demand from members for financial support.

42. The IMF's loanable resources are derived from part of members' quota subscriptions and potentially from bilateral borrowing arrangements with individual members and groups of members. A US$50 billion line of credit is available under the New Arrangements to Borrow (NAB) and General Arrangements to Borrow (GAB). At the G-20 Leaders Summit in November 2008, Japan offered the Fund a line of credit of up to US$100 billion. The agreement was signed on February 13, 2009.

43. In the last quarter of 2008, the IMF's available resources declined by over a fifth. Outstanding credit increased from SDR7.6 billion at end-September 2008 to SDR17.5 billion at end-December 2008. Commitments rose over the same period by SDR29.7 billion, leading to a reduction in the forward commitment capacity of the Fund from SDR127.6 billion to SDR97.6 billion (US$145 billion).

44. The sharp increase in demand for Fund resources was not predicted and it is difficult to predict the future demand for Fund financing in the wake of the crisis. Discussions are currently under way with several countries on possible use of Fund financial support, with potential commitments of around SDR22 billion. The sharp reduction in financial flows to emerging markets as a result of the still ongoing de-leveraging process in mature financial markets, could result in increased calls on the Fund for support. Furthermore, global de-leveraging may hamper the potential catalytic role of Fund financing, with the result that the Fund may be called upon to provide a substantial amount of a country's financing needs.

45. As a proportion of world GDP, global capital and trade flows, IMF loanable resources are at low levels. The quota reviews since the mid-1970s resulted in quota increases that generally maintained the size of the Fund relative to GDP at around 1.25 per cent. However, it is currently estimated that quotas have declined to around 0.8 per cent of global GDP. Nevertheless, the Fund is regarded as an effective first line of defence for global balance of payments lending.

46. The Fund's resource position remains sound, notwithstanding the recent increase in IMF credit commitments, and the Fund has the capacity to meet members' expected financing needs. However, the environment is highly uncertain and members' demands for Fund financing could increase significantly. In such a situation, it is assessed that it would be prudent to increase the Fund's contingent lending capacity. This view is not based on a detailed assessment of a

likely increase in particular members' financing needs as a result of the crisis, but the judgment that a substantial increase in the Fund's contingent lending capacity would help promote confidence that the Fund is well placed to meet additional requests for financial support from its members at a time of great uncertainty.

47. In the IMF's most recent assessment of the adequacy of its resources, Fund staff proposed a doubling of its pre-crisis lending capacity. While recognising the difficulty in assessing the scale of the additional Fund resources needed, when the issue was considered by the Executive Board most Directors considered it prudent to err on the side of preparedness and supported a doubling of the Fund's pre-crisis resources. Some Directors, however, considered that further analysis would help clarify the appropriate size of an immediate augmentation in the Fund's resources. It would be a significant outcome if G-20 Ministers/Leaders publicly indicated their support for a substantial increase in Fund resources in the context of the global financial crisis.

i) Fund borrowing

48. Quota subscriptions are the basic source of the Fund's financing. However, borrowing by the Fund can provide an important, temporary and relatively speedy increase in the Fund's resource base. This borrowing could be through additional bilateral loan arrangements with Fund members similar to the agreement signed with Japan in February 2009, the placement of Fund paper with the official sector, or an expansion and enlargement of the multilateral NAB. The modalities of Fund borrowing are a matter for the Fund to decide, although the impact of a public statement supporting an increase in the resources of the Fund would be greater if it was accompanied by some countries indicating they would make substantial loans to the Fund. This would also be the quickest way to increase Fund resources.

49. If the Fund is to increase its resource capacity through borrowing, it would be appropriate for G-20 Ministers/Leaders to recommend that processes commence for an increase and expansion in the Fund's existing line of credit with members, namely the NAB, and to encourage the participation of countries that have accumulated significant foreign reserves. Both an increase in current arrangements and an amendment to the NAB would require a decision of the Fund and the concurrence of participants representing 85 per cent of total credit arrangements. In addition, legislative approval may be required in a number of countries to increase their credit arrangements or other significant changes in the NAB. While NAB members should work towards expediting legislative approval processes, increasing the NAB is not a rapid way to increase the Fund's resources.

ii) Quota increase

50. A general quota increase is not a practical way to quickly increase Fund resources in the near term. The Articles of Agreement provide for general

reviews of quotas by the Board of Governors at intervals of no more than five years. The Thirteenth General Review of Quotas was completed on January 28, 2008 with the Board concluding that on balance there was not a sufficiently strong case for a general quota increase at that time, particularly given the Fund's strong liquidity position. However, much has changed over the course of 2008, in terms of current and possible demands on Fund resources.

51. Related to a general quota increase is the package of quota and voice reforms agreed by the Board of Governors in April 2008 and currently with national authorities for ratification. In addition to a new quota formula and a shift in voting and quota shares from developed to emerging markets, the resolution asks the Executive Board to recommend further realignment of quota shares in the context of general quota reviews, to ensure that they reflect developments in the world economy and to close the gap between actual and calculated quota shares. Further work related to the quota formula is required before it is used again.

52. While it still has to be resolved whether a permanent increase in the Fund's resources is required given the magnitude of the crisis and the shape of the post-crisis global financial system, the significant change in international economic conditions and increased financing demands on the Fund since the completion of the Thirteenth Review in January 2008, would suggest that it would be prudent to accelerate the next general quota review. The implication of any changes to the Fund's role in the system, lending instruments, and in turn its role in providing financial support to members, would also have to be considered when reviewing the permanent resource needs of the Fund. An acceleration of the next general review should not impede the ratification of the package of quota changes agreed by the Board of Governors in April 2008, which will involve an 11.5 per cent increase in resources available to the Fund.

53. Consequently, in the context of ensuring that the resources of the Fund are adequate, in addition to G-20 Ministers/Leaders supporting a substantial increase in the Fund's resources through borrowing as a contingent measure, they could also call for the acceleration of the next general review of quotas. A number of members indicated that it would be a stronger message if a timeline for the next general review was specified, proposing the next review be completed by January 2011. Other members supported an acceleration of the next general review as soon as the April 2008 quota and voice reforms have been ratified.

iii) SDR allocation

54. An issue that could be considered is whether an SDR allocation would be an appropriate confidence-building response in current circumstances, providing unconditional liquidity by supplementing members' reserve holdings rather than increasing the resources of the Fund. A decision to allocate SDRs under the present Articles of Agreement would require agreement by members holding 85 per cent of voting power that there is a long-term global need to supplement

existing reserve assets. To be effective in relieving the liquidity constraints being faced by some members, an SDR allocation, which must be made to all SDR Department participants in line with their quotas, would either have to be very large or there would need to be a voluntary agreement among members for a post-allocation distribution of quotas. The prospects and relative merits of an SDR allocation could be further considered by the Fund, which would include consideration of the appropriate balance between the supplementation of members' reserve holdings and enhancement of conditional IMF lending capacity.

55. Before embarking on a possible further allocation of SDRs, it would be appropriate to advance the special one-time allocation of SDRs that was approved by the IMF's Board of Governors in September 1997 through the proposed Fourth Amendment of the Articles of Agreement. This allocation would double cumulative SDR allocations. Its intent, however, was to enable all members of the IMF to participate in the SDR system in proportion to their quotas and correct for the fact that countries that joined the Fund after 1981 – more than one fifth of the current membership – have never received an SDR allocation. The Fourth Amendment will become effective when three fifths of the IMF membership (111 members) with 85 per cent of the total voting power have accepted the amendment. Currently, 131 members with 77.68 per cent of total voting power have accepted the proposed amendment.

56. A decision by the G-20 membership to support the Fourth Amendment would ensure that it would become effective and this may have a confidence boosting impact in that it would increase the reserve holdings as well as demonstrate support for equity in the allocation of SDRs across all Fund members.

iv) Mobilising bilateral resources complementary to IMF programs

57. If the IMF organises financial packages raising funds from different countries and international financial institutions that are to be linked to a specific IMF program, these funds should be properly safeguarded so that such funding arrangements are not to be discouraged.

IV. Review of IMF lending instruments and lending role

> *'The IFIs should also continue to review and adapt their lending instruments to adequately meet their members' needs and revise their lending role in the light of the ongoing financial crisis.'*

58. The Fund is reviewing its financing role in member countries. It has prepared papers on the following topics:

- Review of Access to Financing in the Credit Tranches and Under the Extended Fund Facility and Overall Access Limits Under the General Resources Account.

- Charges and Maturities — Proposals for Reform.

- Review of the Fund Facilities – Analytical Basis for Fund Lending and Reform Options.

- Conditionality in Fund-Supported Programs — Purposes, Modalities and Options for Reform.

59. It is important that the review of the Fund's lending and financing role be undertaken in a transparent and comprehensive manner, although it is also important that it be completed as quickly as possible. Some of the factors influencing this review of the Fund's financing role include the following:

- Members' needs for Fund financing have evolved significantly since the Fund was created, and the Fund has adapted to members' changing needs and introduced a range of new facilities. However, the stand-by arrangement, where financing is provided to a member to support adjustment to a balance of payments need and disbursed in tranches on meeting conditions, remains at the core of the Fund's lending instruments.

- The Fund's lending toolkit was primarily designed when balance of payments pressures largely emerged over a period of time and through the current account. In an increasingly integrated global economy with large-scale movement of capital flows, crises can arise from global shocks, which unfold quickly, or from sharp changes in investor sentiment, sometimes caused by doubts over a member's policies and vulnerabilities.

- Prior to the crisis, there was reduced demand for Fund resources by members. This was in large part due to a strong world economy, higher private capital flows and strengthened policy frameworks. There was also hesitancy by some emerging market countries to approach the Fund because of the stigma associated with a Fund program. Countries were looking for balance of payments support, if needed, from sources other than the Fund. There was increasing regional pooling and financing arrangements. A number of countries were self-insuring through the acquisition of substantial reserves and some were exploring contingent financing and other loans offered by multilateral banks.

- The Fund has been reviewing conditionality in an effort to ensure that conditions are tailored to a country's needs and focused on the core areas needed to achieve the program goals without compromising the need to safeguard Fund resources. The concept of outright purchase subject to special qualification requirements exists in the recently introduced Short-

Term Liquidity Facility (SLF), which provides short-term liquidity support to members with strong fundamentals and a track record of sound policies.

- Demand for the Fund's resources has increased with the advent of the crisis. In November 2008 alone, the Fund approved loan commitments totalling $US42 billion.

- The Fund has been considering for some time the implementation of a new crisis prevention instrument. The challenge has been to find a design that strikes the right balance between developing an instrument that is attractive to potential borrowers and provides adequate safeguards to the Fund. Concerns include the first mover problem, negative signalling effects, and the fear of creating an instrument that goes unused. Staff have recently proposed the introduction of a new crisis prevention instrument catering for high performing members, or alternatively to modify the SLF.

- The Fund has been considering an increase in members' access limits, notwithstanding that in exceptional circumstances involving capital account crises, the limits can be waived. Access limits will influence the level of charges and are influenced by quota increases.

- The Fund has been considering the scope to streamline the number of existing lending facilities. Staff have proposed eliminating all special facilities in the General Resources Account.

- The Fund's financing role in low-income countries has been evolving. The PRGF framework, with its focus on poverty reduction and growth, has been the Fund's primary tool of engagement with low-income countries, particularly in the context of the HIPC/MDRI debt relief process. The Fund has provided additional financial support to low-income counties adversely affected by the crisis by augmenting pre-existing PRGF arrangements. In addition the Fund has modified the Exogenous Shocks Facility in order to make it more responsive to members' needs. While low-income countries can request traditional stand-by arrangements to address short-term balance of payments needs, these are not on concessional terms like the PRGF. Some countries graduating from the PRGF still benefit from close engagement with the Fund, a role being met by the Policy Support Instrument.

60. The Fund continually needs to ensure that its lending instruments are flexible and can meet members' needs, particularly in the context of the global crisis. A challenge is to remove as far as possible any perceived stigma associated with a Fund program, recognising that a certain degree of stigma may be associated in dealing with an institution which provides financial support to countries experiencing balance of payments difficulties. However, it is important to recognise the significant progress that many countries have made in improving institutions and policies, allowing them to rely on their own frameworks for

achieving macroeconomic stability – the ability of these countries to 'graduate' from IMF lending is welcome and should not be conflated with 'stigma'. Moreover a key benefit of a Fund supported program is that it can help unlock other sources of funding by providing credibility to a member's adjustment policies. Members should have confidence that the Fund will assist in their finance needs, but also that they may approach the Fund in circumstances other than when a crisis is well underway and all other options are exhausted.

61. Another challenge for the Fund is to ensure that it has a flexible and effective lending instrument, which can help members prevent a crisis. The Short-Term Liquidity Facility allows countries with a strong track record to obtain short-term liquidity support with one outright purchase. This new facility has not been used and concerns have been expressed that the access limits are too low, the maturity is too short and that it is not available on a precautionary basis – attributes that limit its effectiveness as a crisis prevention instrument. Closely related to the future of the SLF are questions about high access precautionary instruments. In considering such instruments, it is important that there be a comprehensive assessment of the implications for the Fund, including ensuring that there are proper safeguards, the resource implications, and the optimal pricing structure for insurance type instruments.

62. The G-20 Leaders also called for IFIs to explore ways to restore emerging and developing countries' access to credit and resume private capital flows which are critical for sustainable growth and development, including ongoing infrastructure investment. In cases where severe market disruptions have limited access to the necessary financing for counter-cyclical fiscal policies, the Leaders called for multilateral development banks to ensure arrangements are in place to support, as needed, those countries with a good track record and sound policies. This also points to a gap between the type of balance of payments support envisaged in the Fund's Articles of Agreement, and the type of instruments that may be required at times of exceptional adversity in global capital markets. Work on these matters is at an early stage, but the Working Group is of the view that it will be essential for MDBs to work closely with the IMF to develop proposals that respond to these imperatives.

63. The global financial crisis presents a serious threat to low-income countries and it is important that the Fund ensure that it has the resources and instruments to meet their financing needs. The Fund staff have prepared papers for the Executive Board on 'The Fund's Facilities and Finance Framework for Low-Income Countries' and 'Changing Patterns in Low-Income Country Financing and Implications for Fund Policies on External Financing and Debt'. Given the magnitude of the crisis, it would be prudent to examine the need to enhance the flexibility of the PRGF to assist countries significantly impacted by lifting access limits under the PRGF. To ensure that the possible increase in demand for concessional facilities can be met, it would also be prudent to examine whether there is a need to increase donor contributions to the PRGF-ESF Trust to support increased concessional lending. A further element to be

covered is whether to enhance the flexibility of the Fund to provide concessional financial support to low-income countries facing balance of payments needs and whether an expanded PRGF-ESF Trust should be amended to support a concessional stand-by facility for low-income countries. However, it is important that any expansion in the Fund's lending to low-income countries is consistent with its mandate and that the Fund does not expand into areas that might be better provided by the World Bank. The Fund's review of its lending role in low-income countries should be completed as quickly as possible.

64. The working group recognizes the importance of the IMF moving away from an income model that relies primarily on charges paid by borrowing members. The proposed new income model, considered by the Fund in 2008, would include creating an endowment with the profits from the limited sale of some of the Fund's gold holdings (with strong safeguards to avoid any risk of market disruption), and broaden the Fund's investment authority to enhance returns. The expansion of the Fund's investment authority will require an amendment of the Article's which has been agreed by IMF Governors and is currently with IMF members for ratification. The proposed gold sales would begin once the required 85 per cent majority is reached at the Executive Board.

V. IMF/FSF collaboration

> *'The IMF, with its focus on surveillance, and the expanded FSF, with its focus on standard setting, should strengthen their collaboration, enhancing efforts to better integrate regulatory and supervisory responses into the macro-prudential policy framework and conduct early warning exercises.'*

65. Strengthening cooperation between the IMF and an expanded FSF is considered to be a priority by Leaders, particularly in developing early warning capabilities. In January 2009 the IMF produced a paper outlining a proposed procedure for the IMF-FSF early warning exercise.

66. The proposed procedure would involve integrating macro-financial and regulatory perspectives, identifying and prioritising systemic macro-financial risks, and reporting to policymakers. The IMF and FSF would cooperate closely, with the Fund taking the lead on macro-financial concerns and the FSF on underlying regulatory challenges. Fund staff would rank principal risks and vulnerabilities by their systemic importance, based on expected likelihood and potential impact. The Fund and the FSF would then agree on a final list of identified risks and vulnerabilities. For the top concerns, policy responses would be suggested or, where policy solutions are not apparent, work agendas would be proposed for further analysis. This work will focus on systemic economies and mature financial markets.

67. It is envisaged that there would be joint IMF/FSF presentations on the outcome of each early warning exercise to the Spring and Annual meetings of the IMFC and also to the G-7/G-20 and other policy makers. Information would also

be made public (in suitable form) through the World Economic Outlook (WEO), Global Financial Stability Report (GFSR) and published Article IV reports. A 'dry run' is proposed for the spring of 2009, with the first full exercise launched for the 2009 Annual meeting.

- IMF staff note that the follow-up on earlier policy recommendations could be an important part of the discussion with policymakers.

68. While the preparation of a rigorous early warning exercise is important, its value will ultimately be determined by the traction that the outcome of this work has in influencing policy makers. In this regard, joint IMF/FSF presentations to the IMFC and to international fora such as the G-20 Finance Ministers and Central Bank Governors will be important. Such presentations should involve a candid discussion between Ministers of the risks and vulnerabilities, along with appropriate policy responses. The G-20 Ministerial process is a highly suitable forum for an in depth discussion of financial risks and vulnerabilities, in that it involves both Finance Ministers and Central Bank Governors from the systemically important economies.

69. The IMF/FSF early warning exercise will, as noted subsequently, also be an important vehicle to strengthen the Fund's financial sector surveillance overall and in particular, bridge the gap between multilateral activities and bilateral surveillance. The IMF is also taking other steps to strengthen its early warning capabilities, including extending its vulnerability exercise to advanced economies, enhancing its macro-financial analytical capacity and reviewing the Financial Sector Assessment Program (FSAP), which is a joint product between the IMF and the World Bank. These issues are considered below under Strengthening Fund surveillance. Ultimately, however, it should be acknowledged that early warning exercises can only serve to highlight potential risks and vulnerabilities; their predictive power should not be over-estimated.

C. MEDIUM-TERM ACTIONS IDENTIFIED BY LEADERS

VI. Strengthening Fund surveillance

> '*The IMF should conduct vigorous and even-handed surveillance reviews of all countries, as well as giving greater attention to their financial sectors and better integrating the reviews with the joint IMF/World Bank financial sector assessment programs. On this basis, the role of the IMF in providing macro-financial policy advice would be strengthened.'*

70. The IMF Articles of Agreement require that the IMF 'oversee the international monetary system in order to ensure its effective operation' and to 'oversee the compliance of each member with its obligations' to the Fund. In particular, 'the Fund shall exercise firm surveillance over the exchange rate

policies of member countries and shall adopt specific principles for the guidance of all members with respect to these policies.'

71. The Fund conducts bilateral surveillance, usually involving the preparation of an Article IV report once a year for most members. With the global financial system becoming increasingly interconnected, the Fund also conducts multilateral surveillance, which includes the production of two bi-annual reports, the WEO and the GFSR, four regional reports and regular contributions to intergovernmental meetings, such as G-20 meetings.

72. The 2008 Triennial Surveillance Review conducted by the Fund, contained an ex post assessment of whether Fund surveillance saw the crisis coming. This assessment focused on what surveillance saw, did not see, and what it could not have expected to see. It was, however, completed in early September 2008, before the full ramifications of the crisis were felt by the international community.

73. The findings of the Surveillance Review included:

- Justified concern at the fact that the full scale and impact of the crisis were not foreseen should not obscure the progress made in monitoring and analysing financial systems.

- That said, surveillance should strive harder to (i) avoid wrong calls, including by asking 'what if' questions and not being blinded by past good performance, (ii) think the unthinkable, and (iii) highlight known unknowns more forcefully.

- Greater analytical efforts are needed to improve the Fund's ability to 'make the right calls' and to 'connect the dots' in the future.

- Many of the diagnostic 'misses' reflect resource allocation choices that were not necessarily misguided at the time they were made. Thus difficult prioritisation challenges lie ahead.

- Closer attention to feedback between multilateral and bilateral surveillance would help.

- More robust exchange rate analysis and focus on external stability risks.

- Concern that the Fund had not implemented the 2007 decision well.

- The Fund needs to learn to be bolder in communicating its concerns including on known unknowns.

74. A 2006 report by the IMF's Independent Evaluation Office (IEO) found that 'multilateral surveillance has not sufficiently explored options to deal with policy spillovers in a global context; the language of multilateral advice is no more

based on explicit considerations of economic linkages and policy spillovers than that of bilateral advice'.

75. A concern of emerging markets and developing countries is that Fund surveillance has not been even-handed, in that the Fund's assessment of the policies of some developed countries has been less critical than that for other economies, and some developed economies largely ignore the IMF's bilateral surveillance. There have been counter concerns that the Fund has not pursued sufficiently rigorously issues with some emerging markets nor ensured annual Article IV reviews for all emerging markets. Related to these concerns, there have been calls for Fund staff and management to be more independent in the conduct of surveillance and engage more directly in 'ruthless truth-telling'. In part, some of these concerns relate to deficiencies in the Fund's governance arrangements and imbalances in the representation of its members. There is also an imbedded tension between the concept of 'peer review' which underpins the bilateral surveillance process, and the expectation that the Fund should deliver objective and independent assessments.

76. The crisis has highlighted that the Fund has to perform better across all aspects of surveillance, both in identifying risks, providing the right advice, and in being more persuasive so that its advice is acted upon. However, the crisis also demonstrates that members of the IMF have to be more responsive to the Fund's advice and be more conscious of the need to respect the obligations that go with Fund membership. Achieving such an outcome is related to improving the governance of the Fund, including greater political 'buy-in' by all members.

77. Some specific measures to strengthen Fund surveillance – and a number are under way - could include:

- Incorporating the most important financial sector developments into the WEO, with a quantitative assessment of the downside macroeconomic risks from financial sector vulnerabilities.

- Enhancing financial sector expertise within the Fund, while taking into account the resource implications for the Fund.

- Highlighting vulnerabilities that are common to a number of countries, and having the flexibility to establish cross-country task forces to examine those high-priority financial sector issues.

- Drawing stronger links between multilateral and bilateral surveillance to identify risks that might spill-over to other countries and to draw out their implications in Article IV reports.

- Better prioritising FSAP workflows to focus more sharply on the biggest risks to regional and/or international financial stability, as well as improving coordination with the World Bank and increasing the resources and level of expertise going into the FSAPs.

78. On the question of FSAPs, the consistency between financial stability and macroeconomic assessments needs to be significantly enhanced. The IEO has observed that there was too little use of the results of FSAPs in Article IV consultations, and in many FSAPs too little attention was paid to financial cross-border issues. The FSAP stability assessments have generally been limited to the segments and risks of the financial system that have domestic implications, even when some external /macro risks were considered for the stress testing analysis. In terms of the articulation of findings, the IEO noted that the main findings were couched in cautious language and there were significant shortcomings in the prioritization of recommendations in many cases. In addition, the IEO noted that the discussion at the Executive Board of financial sector issues has been weak. In addition, 20-25 per cent of countries that are 'systemically important' have not yet completed an FSAP.

79. The statement of surveillance priorities for 2008-2011, agreed by the Executive Board in October 2008, provides a comprehensive outline of many of the improvements that are required and should establish the integration of macroeconomic and financial surveillance and its multilateral emphasis as central objectives for Fund surveillance.

80. In January 2009 the IMF prepared a progress report on integrating financial sector issues and FSAP assessments into surveillance. The report noted that the joint IMF/FSF early warning exercise, which is currently in preparation, should help bridge the gap between multilateral and bilateral surveillance. It was also assessed that the FSAP – appropriately reshaped – should continue to be the key element of better integrating financial sector work into surveillance. The forthcoming review of the FSAP will examine further different options for implementing the reshaping required to enhance its contribution to surveillance.

VII. Greater voice and representation in the IMF for emerging markets and developing economies

> *'We underscored that the Bretton Woods Institutions must be comprehensively reformed so that they can more adequately reflect changing economic weights in the world economy and be more responsive to future challenges. Emerging and developing economies should have greater voice and representation in these institutions.'*

81. A key aspect of reforming the governance and enhancing the legitimacy of the IMF involves enhancing the voice and representation of developing countries and emerging markets. An important aspect of enabling the Fund to respond effectively to the immediate challenges posed by the current crisis would be for the G-20 Leaders to follow up their call for comprehensive reform, with concrete actions that signal their determination to proceed with this agenda. G-20 Leaders could demonstrate that IMF reform was accelerating by putting in place processes to advance as quickly as possible issues requiring medium-term

consideration, especially the rebalancing of voice and representation and reforms to Fund governance.

82. A package of quota and voice reforms was approved by the Board of Governors in April 2008 and is currently still before many national governments awaiting ratification. The package of reforms involves a new quota formula plus one-off additional elements, a second round of quota increase (the first round was agreed in Singapore in 2006) and an increase in basic votes and an increase in the capacity of the two African constituencies. In addition to approving a quota increase for 54 of the Fund's 185 member countries and an increase in voting shares of 135 countries (through increases in both quotas and basic votes), the resolution approved by the Board of Governors:

- Requested the Executive Board to recommend further re-alignments of members' quota shares in the context of future quota reviews, to ensure that quota shares continue to be adjusted at regular intervals to make further progress in closing the gap between actual and calculated quota shares and to reflect members' relative positions in the world economy.

83. The Leaders' Declaration on quota and voice reform implies a commitment for faster progress in aligning quotas with economic weight, calling for greater voice and representation for emerging and developing economies, including the poorest countries. Critics of the April 2008 package of quota and voice reforms say that it falls far short of what is needed, even before the current crisis, either in terms of the resources it would make available (an 11.5 per cent increase in quotas) or the changes it would bring about to the governance structure of the Fund. However, priority should be given to the ratification of the April 2008 measures, since it is a first step towards improving the distribution of quota and voting shares, was the outcome of protracted negotiations and would also contribute to increasing the Fund's resources.

84. In keeping with the commitment by Leaders to accelerate the redistribution of quota shares, it would be appropriate to call on the Executive Board to accelerate its response to the Board of Governors' request for a further recommendation on the realignment of quota shares in the context of a general review of quotas. The Executive Board should be asked to complete this work by January 2011 and the Managing Director could be asked to report to G-20 Finance Ministers at their meetings on progress. Some members of the Working Group support this work commencing after the April 2008 package of quota and voice measures have come into force.

VIII. IMF involvement in capacity building

'Advanced economies, the IFIs, and other international organizations should provide capacity-building programs for emerging market economies and developing countries on the formulation and the

> *implementation of new major regulations, consistent with international standards'*.

85. The Leaders' Declaration called on advanced economies, the IMF, and other international organisations to provide capacity-building programs for emerging market economies and developing countries on the formulation and the implementation of new major regulations.

86. About 90 per cent of IMF technical assistance goes to low-income and lower middle income countries. Technical assistance is provided in the Fund's areas of core expertise, including financial sector sustainability. Countries have asked for Fund assistance to address weaknesses identified in FSAPs, to adopt and adhere to international standards and codes, implement recommendations from off-shore financial centre assessments, and to strengthen measures to combat money laundering and the financing of terrorism.

87. To meet the rising demand for Fund capacity building programs as well as to better coordinate assistance delivery, the Fund is seeking to strengthen its partnerships with donors by engaging them on a broader, longer-term, and more strategic basis. Towards this end, the Fund is proposing to pool donor resources in multi-donor trust funds that would supplement the Fund's own assistance. The funding model will operate by region and topic.

88. The demands for Fund supported capacity building programs are likely to increase with additional efforts to strengthen regulatory regimes. It will place a premium on the Fund prioritising its efforts and leveraging off the contributions of donors. Increased donor contributions are likely to be necessary.

D. ADDITIONAL RECOMMENDATIONS

IX. Review the mandate and governance of the IMF

> '*We request our Finance Ministers to formulate additional recommendations, including in the area of reviewing the mandates, governance, and resource requirements of the IFIs.'*

89. Paragraph 10 of the Leaders November 2008 Declaration instructed Finance Ministers to formulate additional recommendations in a number of areas, including reviewing the mandates, governance and resource requirements of the IFIs.

90. The immediate resource requirements of the IMF have been previously addressed. However, the nature of the Fund's role and mandate will have implications for its governance and long-term resource needs.

i) Reviewing the mandate of the IMF

91. There is the issue whether the Articles of Agreement of the Fund should be updated, and the role and mandate of the Fund reassessed, in line with the changes in the global economy. The international financial system is significantly different to that which prevailed when the Fund was established over half a century ago. For example, there is perhaps a case that the mandate of the Fund with respect to multilateral surveillance needs to be clarified. There is also the issue of whether the Fund should be given a specific mandate to oversee all aspects of financial stability.

92. Amending the Fund’s Articles would be a major, longer-term but important task. It will be contentious and an effective way that it could be advanced is by the IMF commissioning an experts group. This group could review the role of the Fund in the current international economy and in the light of the lessons drawn from the crisis, including those relating to the international monetary system. The task of such a group could also extend beyond providing recommendations on the role of the Fund and possible changes to the Articles, to negotiating what amendment to the Fund’s Articles would be acceptable to the majority of the Fund’s membership. Starting the process of considering an updating of the Fund’s Articles, particularly in the light of the crisis, would be a significant achievement in the reform of the IMF.

ii) Review the governance of the IMF

93. Critical to improving the governance of the IMF is realigning quotas and representation in line with countries’ relative position in the global economy. This will enhance the legitimacy of the IMF and in turn its effectiveness. Towards that end, and as noted above, the work of the Executive Board to provide further recommendations on the realignment of quota shares should be accelerated.

94. Effective and efficient internal governance arrangements are also critical to the performance of a large, international organisation. In terms of improving the governance in the IMF, in September 2008, the Managing Director appointed a committee of eminent persons, chaired by Trevor Manuel, Minister of Finance of South Africa, to ‘assess the adequacy of the Fund’s current framework for decision making and to advise on any modifications that might enable the institution to fulfill its global mandate more efficiently’. The work of this committee will take into account the findings of the IMF’s Independent Evaluation Office’s (IEO) assessment of governance of the IMF which was completed and published in April 2008. The committee is expected to report to the Managing Director around mid-March 2009. In addition, a joint task group involving Executive Directors and IMF management has been established to coordinate work under way, including that undertaken by an Executive Director’s working group established in response to the IEO’s report.

95. Given the importance of internal governance arrangements, a number of working group members believe it would be appropriate for the G-20 to encourage the Executive Board and management to expedite the current work being undertaken on governance and in particular ensure that the staff, Management and the Board are operating as efficiently as possible, there is clarity over roles and responsibilities, and there is a strong accountability framework. However, a number of other working group members believe this would be a case of the G-20 micro-managing the Fund.

96. It is also appropriate to ensure that IMF Governors are given a higher political profile in the work of the Fund. An important step towards building greater ownership of Fund processes and decisions would be further reforms to voice and representation. That being said, it is also critical to enhance the quality of policy dialogue and political legitimacy by ensuring more consistent and effective engagement by Ministers /Central Bank Governors and senior Ministry officials in the Fund's collaborative decision making processes.

97. The structure of representation on the Executive Board does not give sufficient voice to many members and some regions are over-represented. Rebalancing representation on the Board of the IMF, along with the size of the Board, are important aspects that must be considered in the review of Fund governance. There are a number of underrepresented regions. However, recognition by the G-20 of the demands placed on the representatives of Sub-Saharan Africa, and support for the establishment of a third chair for these countries, would be a significant demonstration of efforts to deepen the participation of low-income countries in the Fund's decision making processes.

98. An important reform which would improve governance arrangements and assist in enhancing the legitimacy of the IMF would be a decision that the selection of the Managing Director and Deputy Managing Directors involve an open, merit-based selection process, irrespective of nationality and geographical preferences. A similar mechanism should be applied to the selection of the President and senior management of the World Bank and other MDBs. To provide the necessary signal with respect to the urgency of reform, this approach should apply to the appointment of the next office bearers.

March 4, 2009

G-20 Working Group 4

The World Bank and other Multilateral Development Banks

FINAL REPORT

March 2009

G-20 WORKING GROUP 4 REPORT

Executive Summary

G-20 members express concern over the sharp fall in capital flows to emerging markets. The reduction in credit availability has generated a significant economic impact on emerging markets and low-income countries (LICs) as businesses and households find it difficult to access finance. This may hamper progress towards achieving Millennium Development Goals.

G-20 members urge the multilateral development banks (MDBs) and other international financial institutions (IFIs) to step up their counter-cyclical efforts and to off-set capital flight and maintain demand by providing on a consolidated basis fiscal expansion, support to social safety nets, trade financing, bank recapitalization, and infrastructure investment in emerging markets and LICs.

G-20 members commit to use more thoroughly the resources of these institutions to bring forward global expenditure support financing to developing countries by $US100 billion over the next three years based on currently agreed capital.

They emphasize the counter-cyclical role MDBs have in support of their longer-term development mandate. They call for the MDBs, in close coordination with the IMF where appropriate, to move forward on flexible, fast-disbursing and front-loaded instruments designed to substantially and quickly assist developing countries facing financing gaps in the contect of the current crisis, in a manner that would not endanger their financial sustainability and investment ratings.

G-20 members will partner with MDBs in providing short-term financing and risk sharing and in protecting the poorest people through the crisis. They will provide additional resources for these purposes, for instance through contributions to concessional funds or new facilities.

The World Bank and the IMF should also review the application of the Debt Sustainability Framework with a view to make full use of its existing flexibility to reflect the diversity of situations across LICs.

Furthermore, G-20 members, through their involvement in the Boards of Governors, commit to urgently review the adequacy of the capital resources of all MDBs to provide appropriate increases in funding to mitigate the consequences of the crisis. Any increases should maintain appropriate safeguards and development effectiveness, and entail commitments to ongoing governance reform.

The Asian Development Bank should immediately proceed with a substantial general capital increase of 200% or $US100 billion. G-20 members, through their representatives at the Executive Boards of the African Development Bank and the Inter-American Development Bank, stand ready to initiate a review process of the capital adequacy of both institutions, at their respective 2009 Annual Meetings. The EBRD should promptly review its statutory capital constraints to give leeway to interventions by the Bank while preserving its financial strength. The Islamic Development Bank currently has a reasonable level of resources to appropriate lending growth and should continue to keep its resource needs under review in light of the evolving situation in its member countries.

G-20 members stress that MDBs' reforms should be guided by the principle of shared and common responsibility, increasing legitimacy and partnership of member countries in addressing global challenges of the 21st century.

G-20 members urge the MDBs to strengthen accountability of their management, and improving the processes to assess their performance. There is broad support from G-20 members for open, transparent, competitive, and merit-based selection process, irrespective of nationality and geographical preferences for the appointment of the senior management of the MDBs

G-20 members urge the World Bank Group to pursue comprehensive reforms of its ownership structure and internal governance. They restate their support for a full-fledged governance reform in the World Bank Group in order to increase voice and representation of emerging markets and developing economies. They call for the Development Committee at its 2009 Spring Meeting to launch a wider discussion on improving governance and effectiveness of the World Bank, and to set an accelerated timeline for the second step of the Voice and Representation reform package, with an aim to reach an agreement at the 2010 Spring Meeting. Within that process, some G-20 members call for an increase of the shares of developing countries as a whole without dilution of any individual developing member, leading over time towards an equitable voting power between developed and developing countries, while some others consider that only under-represented countries should benefit from such a measure.

Introduction

- **Mandate and purpose of the group**

The G-20 Leaders met in Washington DC on November 15th, 2008 and resolved to reform the World Bank (WB) and other MDBs, as a means to effectively counter and mitigate the effects of the ongoing financial crisis, as well as to prevent similar crises in the future. The G-20 Leaders defined the immediate action plan for reforming international financial institutions, including MDBs, by putting the emphasis on short-term crisis responses, as written in the Leaders' Declaration as follows:

  - *We should review the adequacy of the resources of the IMF, the World Bank Group and other multilateral development banks and stand ready to increase them where necessary. The IFIs should also continue to review and adapt their lending instruments to adequately meet their members' needs and revise their lending role in the light of the ongoing financial crisis.*
  - *We should explore ways to restore emerging and developing countries' access to credit and resume private capital flows which are critical for sustainable growth and development, including ongoing infrastructure investment.*
  - *In cases where severe market disruptions have limited access to the necessary financing for counter-cyclical fiscal policies, multilateral development banks must ensure arrangements are in place to support, as needed, those countries with a good track record and sound policies.*

While in the medium-term, the Leaders stated their commitment to undertake more comprehensive reform as written in the Declaration as follows:

  - *We underscored that the Bretton Woods Institutions must be comprehensively reformed so that they can more adequately reflect changing economic weights in the world economy and be more responsive to future challenges. Emerging and developing economies should have greater voice and representation in these institutions*.

- **Summary of the Working Group's approach to tackling its mandate**

WG 4 members have reviewed some immediate aspects of reform, including MDBs' mandates, adequacy of resources, instruments for counter-cyclical policies, and mechanisms to support low-income countries and the private sector during crisis periods. Furthermore, as a means to enable MDBs to respond effectively to the development challenges of the 21st century, WG 4 members have examined the broad principles and processes for wider reform over the medium-term

WG 4 members note that in the short-term the crisis affects the poorest and most fragile populations, endangering global efforts to achieve the Millennium Development Goals. In line with this, WG 4 members believe that MDBs can provide solutions to address promptly the impact of the financial crisis. WG 4 members agree that appropriate ways need to be found in order to collectively – both politically and financially – support the WB and other MDBs. WG 4 members also consider that MDBs' ability to respond effectively is closely connected with issues such as the adequacy of their capital, the issue of the scope of the MDBs' mandates and instruments. WG 4 considered that all of this needed to be fully addressed.

In its work, WG 4 focused on concrete and practical measures to address the crisis over the short-term and the medium term. In particular, WG 4 focused on measures to address the financial crisis noting they should be timely, targeted and temporary. In order to make them consistent with the MDBs' core development focus, WG 4 took the view that the measures should be aimed at supporting countries in maintaining reasonable levels of economic growth and sustaining development in the face of external shocks. Consequently, the resource requirements and instruments related to the crisis should be aligned with the MDBs' long-term strategies in a coordinated manner with other IFIs including the IMF.

- **Outreach process**

From the beginning of its working process, WG 4 has included the World Bank and the IMF as observers.

As part of an outreach process, WG 4 heard presentations and received submissions from the following MDBs: (i) the Asian Development Bank (ADB); (ii) the African Development Bank (AfDB); (iii) the Inter-American Development Bank (IADB); (iv) the European Bank for Reconstruction and Development (EBRD); and (v) the Islamic Development Bank (IsDB).

Non G-20 countries were informed and consulted through their representative at the World Bank, ADB and AfDB during meetings between co-chairs and executive boards and management.

Some non G-20 countries were consulted (Netherlands, Switzerland), as were the G-24 and the African Union, in order to better reflect the voice of developing countries. WG 4 also welcomes useful comments by the Peterson Institute for International Economics and the Zedillo Committee.

Institutional bodies and countries consulted during the outreach process were provided with all relevant working material and their comments were welcomed. Some of them (the RDBs, African Union, G-24, and the Netherlands) made direct presentations to the WG 4 members during an outreach session organized in Jakarta, back-to-back with the WG 4 second meeting on 2 March, 2009. WG 4 had first met in Paris on 29 January, 2009.

Main section

Action Plan for Reforming Multilateral Development Banks (MDBs)

The G-20 tasked Working Group 4 (WG 4) to explore ways to collectively support the World Bank and other MDBs. In addition, WG 4 was tasked to analyze the reforms required so that MDBs can effectively harness their full potential to achieve sustainable and inclusive global economic and social development.

This section sets forth a recommended work plan for MDBs to implement the principles of counter-cyclical response and reform.

The current financial crisis has affected developing countries, endangering global efforts to achieve the Millennium Development Goals. Tens of millions of people in developing countries are at risk of remaining or falling back into extreme poverty as a result of the crisis.

Developing countries – middle and low income – are finding that every source of their development financing – export and commodity demand: trade and project finance; aid flows; remittances; capital flows – has been affected by the unprecedented scale and coverage of the crisis.

G-20 members commit to working through the Multilateral Development Banks (MDBs) to provide solutions in the form of immediate increases in financing, using the full capacity of their balance sheets to provide counter-cyclical support during the crisis. In addition, G-20 members will work with MDBs to ensure that they have the instruments to counter and mitigate the effects of the financial crisis, and ensure that they are prepared to respond to future challenges.

WG 4 has reviewed some immediate constraints and strengths of MDBs, and the corresponding political and financial support they need, in order to respond to crisis effectively. WG 4 has also analyzed aspects of reform, including MDBs' mandates, adequacy of the resources, instruments for counter-cyclical policies, and mechanisms to support developing countries, in particular in low-income countries, as well as the private sector during crisis periods. In addition, as a means to enable MDBs to respond effectively to the development challenges of the 21st century, WG 4 has examined the broad principles and processes for wider reform in the medium-term.

A. Common Principles for Reform

G-20 members:

1. confirm MDBs in their legitimacy, under their mandate of *'poverty reduction, promoting sustainable development and inclusive growth',* and with an aim to foster regional cooperation, to play a counter-cyclical role to tackle crisis. Recognizing their complementary roles, MDBs should take into account their respective comparative advantages, while at the same time improving their coordination for more efficiency and minimizing overlap with both other IFIs - including the IMF - and private finance institutions; without adversely affecting the access of borrower countries to financing from different sources;

2. call MDBs to increase substantially their mobilization of resources and net transfers to developing countries in the context of the current crisis;
3. recommend the MDBs be provided with the necessary resources based on their capital adequacy under the ongoing reviews, to carry out their core mandate of development assistance in the long-term perspective as well as to cope with the crisis;
4. urge MDBs to ensure that initiatives are well coordinated and that potential borrowers or recipients are informed of new resources, instruments and procedures;
5. support a strong role for shareholders in setting out the strategic directions of the banks and agreeing on Statements of Strategic Priorities for the next few years;
6. stress that MDBs reforms should be guided by the principle of shared and common responsibility, increasing legitimacy and partnership of member countries in addressing global challenges of the 21st century. G-20 members urge the World Bank Group (WBG) to pursue comprehensive reforms of ownership structure and internal governance; and they restate their support for a full-fledged governance reform in the WBG in order to increase voice and representation of emerging markets and developing economies;
7. urge MDBs to accelerate their work on result measurements to improve performance.

Some members also:

8. call for the MDBs to continue to ensure that their business models are geared towards covering their administrative expenses, achieving cost-effectiveness for both themselves and their clients, and to maintain their potential to contribute to concessional windows to the extent permitted by their long-term financial capacity.

B. Crisis Instruments

G-20 members welcome the actions taken by MDBs to better mobilize their resources and help developing countries face the current crisis. They call for MDBs to promptly implement the following crisis response measures and report their actions by the next WB/IMF annual meeting.

B1. Regarding counter-cyclical instruments, G-20 members call for the MDBs, in close coordination with the IMF, where appropriate, to move forward on flexible, fast disbursing, and front-loaded instruments designed to substantially and quickly assist developing countries facing financing gaps in the context of the current crisis, in a manner that would not endanger their financial sustainability and investment ratings.

MDBs should:

9. advance their work to fast-track instruments and to streamline operational standard approaches and procedures, while maintaining

appropriate safeguards and ensuring development effectiveness. However, all measures adopted specifically to address the current crisis should be reviewed;

10. reinforce or expand their:
    - o existing lending facilities with more resources to cope with additional demand during times of crisis;
    - o existing instruments to cope better with market volatility, including local currency borrowing and risk-mitigating hedging instruments;
11. review and expand as needed borrowing limits for developing countries while considering their debt sustainability as well as macro and debt management capacity;
12. continue to develop flexible instruments designed to support specific development budget financing as contingency arrangements during times of market disruption for countries with sound policies;
13. review the obstacles to an expansion of sub-sovereign lending and guarantees for credit enhancement, supported by a suitable national framework, and provided that local administrative capacities are sufficiently developed;
14. promote the resumption of international trade through emergency support to trade financing. In doing so, MDBs could increase time-bound guarantees, direct financing of infrastructure for trade and capacity building to trade facilitation. They could share views on their respective risk assessment policies and coordinate their initiatives. They should engage broader coordinated dialogue with other financial institutions, including export credit agencies (ECAs), to agree on principles to further increase the commercial sectors access to trade finance;
15. explore the merits of extending guarantees for credit enhancement of government issuances on the market.

For their part, G-20 members:

16. will partner with MDBs in providing short-term financing and risk-sharing. Such partnerships could involve participating in liquidity or credit facilities, such as the Liquidity Program for Growth Sustainability at the Inter-American Development Bank (IADB) and similar instruments of other MDBs.

B2. Regarding support for poor countries:

17. mindful of the impact that reduced ODA flows would have on the achievement of the Millennium Development Goals, G-20 members reaffirm the importance of the development assistance commitments they have made, and urge both developed and emerging economies to undertake commitments consistent with their capacities and roles in the global economy, which will increase ODA above the pre-crisis level.
18. G-20 members reaffirm that they will meet their commitments to the concessional arms of the MDBs. The G-20 emphasize the need for

countries that have made commitments to finance Multilateral Debt Relief Initiative (MDRI) to fulfill them.

The World Bank and the IMF:

19. should review the application of the Debt Sustainability Framework (DSF) with the view to make full use of its existing flexibility to reflect the diversity of situations across low-income countries. This should contribute to better leverage resources and to facilitate lending for investments with high economic returns without endangering the financial sustainability of the institutions. Lending should also be aligned with national strategies to ensure full country ownership.

MDBs should promptly:

20. assess the feasibility to increase concessional financing to the poorest countries as it is crucial in order to avoid setbacks in achieving MDGs due to the financial crisis;

21. ensure an effective response by exercising flexibility within country strategies and program and instrument choice. The response should be based on countries specific characteristics and needs, and enhanced through strengthening knowledge sharing, including through south-south cooperation, and conditionality appropriate to the crisis;

22. support sound and effective budgetary policies in low-income countries to help protect development expenditures in key areas such as health, education, nutrition and safety nets;

23. develop new tools — or customize existing ones — to facilitate sovereign risk management and access to markets, such as catastrophic risk insurance and local currency issuance.

For their part, G-20 members:

24. will partner the MDBs to protect the poorest people through the crisis, and provide additional resources for this purpose, for instance through increasing contributions to concessional funds or new facilities.

B3. Regarding support to the private sector, MDBs should selectively increase their activity on the basis of their comparative advantages, within the context of their risk management framework and clear long term strategies, including by:

25. evaluating guarantee facilities to make them more effective in leveraging other means of finance, and fully transparent to markets. This could also step-up efforts to develop bond-insurance schemes for creditworthy corporate actors;

26. better using balance sheets to meet infrastructure needs, in particular promoting private investment, and make readily available bridge financing, such as the IFC's infrastructure crisis facility, not only on a significantly bigger scale but also to bridge the financing gap for public infrastructure projects;

27. supporting financial institutions by reinforcing their capital basis where appropriate;

28. assisting investors from developed and emerging economies willing to invest in poorer countries during difficult times. MDBs also need to step up their outreach efforts towards private investors by better informing them about the situation in developing countries and providing enhanced risk mitigation solutions;

29. calling on the private sector arms of MDBs to play an important direct and catalytic role, including through syndicated ("B-loan") instruments, in light of the large refinancing requirement of developing economies, emerging market corporates, and the need to help institutions access finance. This includes trade finance and promoting the recapitalization of viable financial institutions;

30. reaffirming their commitments to meet targets for funding in low income countries and "frontier markets" to ensure that the overall portfolio of private sector operations remain balanced;

31. strengthening support for financial sector development in the formulation and implementation of financial regulations, in particular where private financial markets are not functioning properly, with a view to support long term development.

C. Resources and Capital Adequacy

32. G-20 countries will work with the MDBs to increase the Banks' financing (above usual financing commitments) by $US100 billion over 2009, 2010 and 2011 based on currently agreed capital. Furthermore, countries will continue working with the MDBs to see if there are other ways to more comprehensively utilize their balance sheets in responding to the crisis.

33. G-20 countries, through their involvement in the Boards of Governors, commit to urgently review the adequacy of the capital resources of all MDBs to provide appropriate increases in funding to mitigate the consequences of the crisis. Any increases should maintain appropriate safeguards and development effectiveness, and entail commitments to on-going governance reform.

34. The Asian Development Bank (ADB) should immediately proceed with a substantial general capital increase of 200%, or $US100 billion, to enable a sustainable level of lending in conjunction with the adoption of strong safeguards and governance reform. This decision requires a strengthening of the Bank's operational and risk management capacities.

35. The European Bank for Reconstruction and Development (EBRD) should promptly review its statutory capital constraints to give leeway to interventions by the Bank, while preserving its financial strength.

36. The G-20 countries through their representatives at the Executive Board of the African Development Bank (AfDB) stand ready to initiate a review process of the Bank's capital adequacy in May 2009, based on a review

of the Bank's operational limits and demand for basic development investment, and support for trade, the private sector, and the poorest.

37. The G-20 countries through their representatives at the Executive Board of the IADB are committed to initiate a review process of the adequacy of the Bank's capital by March 2009, alongside a review of the Bank's operational limits and demand for basic development investment, and support for trade, the private sector, and the poorest. G-20 countries stand ready to consider such a process for the Inter-American Investment Corporation.

38. The Islamic Development Bank (IsDB) currently has a reasonable level of resources to support appropriate lending growth. The IsDB should continue to keep its resource needs under review in light of the evolving situation in its member countries.

39. While the WBG is well capitalized and has sufficient resources for an initial response to the crisis, it should continue to make full use of its balance sheet and review its capital adequacy in the context of the deepening crisis, with special attention to the capital needs of the IFC to expand support for private sector recovery and the adequacy of concessional resources of IDA countries.

40. MDBs should make a concerted effort to design a common understanding of prudential ratios and capital adequacy, thereby enhancing transparency and comparability of their financial reporting, though this should not delay any required capital increase.

D. Governance Reform

MDBs should:

41. strengthen accountability of their management, and improving the processes to assess their performance. There is broad support from G-20 members for open, transparent, competitive, and merit-based selection process, irrespective of nationality and geographical preferences for the appointment of the senior management of the MDBs;

42. increase, in an open, transparent, competitive, and merit-based process, the proportion of employees, in particular senior management, from developing countries when they are under-represented in order to strengthen their country-based model, reinforce ownership on development strategies, and improve proximity to clients, including by delegating authorities to local offices.

The World Bank should:

43. accelerate reform of the voting power to reflect changing economic weights and systemic importance in the world economy, leading to a greater role of developing and emerging markets, while taking account of the uniqueness of MDBs' development mission, including contributions to concessional windows and the need to foster partnership within the development process.

G-20 members:

44. commit to ratify and implement promptly the first step of the Voice and Representation reform agreed to by the Governors during the 2008 World Bank Annual Meetings;

45. call for the Development Committee at its 2009 Spring Meeting to launch a wider discussion on improving governance and effectiveness of the World Bank, and to set an accelerated timeline for the second step of Voice and Representation reform package, with the aim to reach an agreement at the 2010 Spring Meeting.

    Within that process, members should consider the evolving weight of all members in the world economy and other Bank specific criteria consistent with the WBG's development mandate, moving over time towards equitable voting power between developed and developing members. Some members call for this enhancement of voting power to be achieved without dilution of any individual developing members.