

Final Report of the Committee on Market Best Practices: Principles of Conduct and Best Practice Recommendations

Financial Services Industry Response to the Market Turmoil 2007-2008

Presented to the International Insurance Foundation

7 November 2008

Background

- In the aftermath of extensive financial system liberalization, market conditions of abundant liquidity encouraged excessive risk-taking; this revealed several **areas of weakness in industry practices**.
- A **decline in lending standards** and inadequate risk management, among other factors, set the stage for a sharp deterioration in the U.S. subprime mortgage market. This has eroded confidence in securitization markets.
- The *Final Report* represents broad industry agreement on the need for urgent action to address identified weaknesses.
- The *Final Report* has much in common with recent reports issued by the **FSF** and the **SSG**, and will facilitate industry cooperation with the official sector.

Industry Response: Scope of Participation

- An industry-wide effort to address weaknesses in market practices; the IIF represents over **385 member firms**.
- Based on the conviction that the private sector must take primary responsibility for correcting its weaknesses.
- Benefiting from the active participation of over **65 firms**, represented by over **170 senior executives**. (A full list of participating firms is provided below.)
- **Six Working Groups** address key areas of focus (see below).
- Critical task: encourage the industry to embrace **Principles of Conduct** and implement **Recommendations**.



IIF Board, Committee on Market Best Practices and Working Group Members

- ABN AMRO Bank N.V.
- Abu Dhabi Commercial Bank
- AIB Group
- Allen & Overy
- Allied Irish Bank Plc
- Alpha Bank
- American International Group, Inc. (AIG)
- Arab African International Bank
- Banco Itaú S.A.
- Banco Santander
- Bank of America
- Bank of China
- Barclays PLC
- BBVA
- BNP Paribas
- Capital Group International
- Citi
- Clifford Chance LLP
- Commerzbank AG
- Credit Suisse
- DBRS
- Deutsche Bank
- Dresdner Bank
- Ernst & Young
- Erste Bank
- Fitch Ratings
- Garanti Bankasi A.S.
- HSBC
- ICICI Bank PLC
- ING Group
- International Capital Market Association
- Intesa Sanpaolo S.p.A.
- JPMorgan Chase & Co.
- KBC Group N.V.
- Kookmin Bank
- Lazard & Co.
- Lehman Brothers
- Lloyds TSB
- McKinsey & Company, Inc.
- Mercantil Servicios Financieros
- Merrill Lynch & Co.
- Mitsubishi UFJ Financial Group, Inc
- Mizuho Corporate Bank, Ltd.
- Moody's Corporation
- Morgan Stanley
- National Bank of Kuwait, S.A.K.
- Nordea Bank AB
- Oliver Wyman
- RBC Financial Group
- RBS
- Scotiabank
- SEB
- Société Générale
- Standard & Poor's
- Standard Chartered Bank
- Sumitomo Mitsui Banking Corporation
- Swedbank AB
- Swiss Reinsurance
- The Bank of N.T. Butterfield & Son Limited
- The Bank of New York Mellon Corporation
- The Norinchukin Group
- The Rohatyn Group
- TIAA-CREF
- UBS
- UniCredit Group
- Wachovia Corporation
- Zurich Financial Services

The Approach Taken

- The Committee's work and productive engagement with public-sector bodies focused on **helping the industry address market weaknesses** and rebuild confidence.
- *Principles of Conduct* provide a broad explanation of the core values and goals that should guide firms' conduct.
- *Best Practice Recommendations* are specific to each of the areas examined, to be implemented by each firm as appropriate to its business.
- *Considerations for the Official Sector* are intended for discussion with policymakers and regulatory authorities.

Briefings: Progress to Date

Following its release in July 2008, the *Final Report* has been presented in private sessions with key official sector and regulatory institutions in the US, Canada, Europe and Asia, including these below.

Federal Reserve Board

Federal Reserve Bank of New York

U.S. Treasury

U.S. Securities and Exchange Commission

European Central Bank

Hong Kong Monetary Authority

Canadian Department of Finance

Bank of Canada

**Canadian Office of the Superintendent
of Financial Institutions**

Financial Stability Forum

International Monetary Fund

Basel Committee on Banking Supervision

**U.K. Financial Services Authority
and other European Regulators**

International Accounting Standards Board

Financial Accounting Standards Board

Bank of Japan

Japanese Financial Services Authority

Japanese Ministry of Finance

Inter-American Development Bank

Six Areas for Industry Action

- **Risk Management**
- **Compensation Policies**
- **Liquidity Risk, Conduits & Securitization**
- **Valuation**
- **Credit Underwriting, Ratings and Investor Due Diligence in Securitization Markets**
- **Transparency and Disclosure**

Next steps: Industry Followup and Implementation

Area 1: Risk Management

Goal:

A strengthened framework for identifying and managing key risks, taking a comprehensive, firm-wide approach.

Focus:

Cultivate and embed a firm-wide risk culture, highlighting the crucial roles of the CRO, the CEO and the Board of Directors; take an integrated approach to capturing all sources of risk.

Risk Management: Key Recommendations

- **Risk Culture and Accountability**: Develop a robust risk culture - incorporated in the way the firm operates - covering all areas and activities. Accountability for risk management should be a priority for the whole institution, with particular care taken in challenging areas such as risk modeling and stress testing.
- **Role of the Board**: Senior management, particularly the CEO, is responsible for risk management; the Board has an essential oversight role.
- **Role of the CRO**: Ensure that the CRO can influence decision making within the firm and assess firm-wide risk.
- **Comprehensive perspective**: Define and articulate risk appetite and ensure its adoption throughout the firm; take an integrated approach to capturing all sources of risk (notably off-balance sheet exposures); risk models should not be based on a single risk methodology.
- **Official Sector Considerations**: The Basel II framework for securitization should be improved, allowing options for firms to use external ratings in conjunction with internal models; greater collaboration between the official and private sectors is needed in the area of stress testing, promoting practices suitable to the specifics of each firm.

Area 2: Compensation

Goal:

Principles and policies aimed at aligning incentives with shareholders' interests, taking risk-adjusted performance into consideration.

Focus:

Core principles on compensation include emphasis on risk-adjusted performance; performance over time, including severance pay; making compensation transparent to stakeholders.

Compensation: Key Recommendations

- **Shareholders' interests**: Incentives should be aligned with long-term, firm-wide profitability.
- **Risk-adjusted compensation**: Incentives should not induce risk-taking in excess of the firm's risk appetite; firms should base compensation on risk-adjusted performance.
- **Severance pay**: Should take into account realized performance for shareholders over time, and consider the circumstances of severance.
- **Transparency**: The industry must show leadership in developing more transparent approach to compensation policies.

Area 3: Liquidity

Goal:

A more robust, comprehensive framework for addressing both market and funding liquidity risk, particularly in turbulent market conditions.

Focus:

Exposure to all structured finance vehicles should be captured in effective liquidity-risk management; additionally, robust methodologies should be in place to monitor and manage funding strategies.

Liquidity: Key Recommendations

- **IIF Liquidity Report**: Recommendations of the IIF's 2007 *Principles of Liquidity Risk Management* have been validated by recent experience and updated in the *Final Report*; firms should complete their implementation.
 - Clear, firm-wide liquidity governance and control; continuous review and critical assessment process.
 - Internal liquidity-risk transfer pricing to create incentives.
- **Funding and Stress Testing**: Firms should diversify their funding sources for asset portfolios held for liquidity purposes; firms should ensure that stress testing includes contingent liquidity exposures.
 - Stress testing as diagnostic tool; aid to management decision-making; should not be mechanistic.
 - Regular review of metrics; firm-specific, and market-related stresses; include conditions under which balance sheet might expand.
 - Discussion with ESCB on system-wide stress testing: don't impose single models; be sensitive to costs; behavioral not output focused tests needed.

Liquidity: Key Recommendations

- **Contingency Planning**: Firms that rely on market funding, particularly asset securitization or conduits, should conduct rigorous contingency planning for market liquidity risks.
 - Evaluation of asset liquidity under varied conditions.
 - Cooperative planning with official sector for market risk developments.
- **Official-Sector Considerations**:
 - Market-wide liquidity problems: central bank role essential to stability of market-based financial system: need for new tools to be kept available for use when needed.
 - Coordination and cooperation among central banks has been extraordinary, needs to be institutionalized; maximum harmonization.
 - Permanent expansion of central-bank collateral (with safeguards).

Liquidity: Key Recommendations

- Harmonization and interoperability of central-bank collateral to facilitate global liquidity management; minimize “trapped pools of liquidity”.
- Greater clarity for quick, effective responses:
 - Firm-specific crises: clarity about requirements and conditions (but constructive ambiguity on when lender-of-last resort available).
 - Market crises: constructive clarity on availability and terms of market-focused measures; avoidance of stigma.
- Market-wide liquidity problems: central bank role essential to stability of market-based financial system: need for new tools to be kept available for use when needed.
- Cooperation with industry contingency planning.
- Home-host cooperation/harmonization of liquidity regulation among supervisors.
- Capital generally not the answer for liquidity issues; quantitative measures unlikely to fit diverse business mixes, models, jurisdictions: qualitative supervision of internal risk-management models challenging but essential.

Area 4: Valuation

Goal:

To address the inherent challenges of valuing complex asset classes and instruments, particularly in illiquid and/or turbulent markets.

Focus:

A high-level dialogue with standard setters on valuation, provisioning, capital and related factors is needed, with symmetrical discussions to include issues of pro-cyclicality and convergence. To compliment the technical dialogue on mark-to-market techniques in the context of illiquid markets.

Valuation: Key Recommendations

- **Fair-value accounting**: Essential for global capital markets, fosters transparency, discipline and accountability. However, mark-to-market valuation is challenging in illiquid markets.
- **Valuation in illiquid markets**: Comprehensive technical dialogue should address the problems of assigning appropriate values in dislocated or illiquid markets. IASB experts' panel as first step.
- **Convergence**: Aligning U.S. GAAP and International Accounting Standards is more critical than ever and should be accelerated.
- **Official Sector Considerations**:
 - **Dialogue needed**: A high-level dialogue of all relevant parties with both standard setters should consider the interaction of mark-to-market techniques with provisioning, capital and other issues during times of excess liquidity as well as illiquid markets, and procyclicality in the system that appears to have macroeconomic implications.
 - **Standard setters** should provide additional guidance on valuation in inactive, illiquid or stressed market conditions.

Area 5: Credit Underwriting, Ratings and Investor Due Diligence in Securitization Markets

Goal:

Given the growing importance of ratings, particularly for structured products, to develop a governance framework to improve the originate-to-distribute model.

Focus:

Rating agencies should strengthen their internal processes of validating and monitoring rating models for structured products; establish an external mechanism to review adherence to standards; and introduce a separate rating scale for structured products.

Credit Underwriting, Ratings and Investor Due Diligence: Key Recommendations

- **Broad scope**: Recommendations cover the process from origination and underwriting through to ultimate investors. Firms should subject assets they help originate and distribute to the same credit due diligence standards as used for similar assets that are to be carried on their own balance sheets.
- **External Review**: Establish an external review of rating agencies' internal processes for monitoring and validation of models against defined industry standards, *not* review of ratings as such.
- **Separate Rating Scale**: Rating agencies should introduce a differentiated rating scale for structured products.
- **Official Sector Considerations**:
 - **Underwriting**: Non-bank mortgage originators should be held to the same standards as banks on consumer protection and loan origination.
 - Authorities should consider **external review** of internal processes within Credit Rating Agencies, possibly via an SRO.
 - Review of official-sector mandates of ratings.

Area 6: Transparency and Disclosure

Goal:

To enhance transparency of products and of firms' activities;
to provide more concise, investor-focused disclosure.

Focus:

Firms should provide a short, informative summary of offer documents for structured products, and ensure that institutional disclosure about the current risk profile of the firm includes securitization activities and off-balance sheet exposures.

Transparency & Disclosure: Key Recommendations

- **More accessible and useful information**: Better disclosure on products is required to restore market confidence, as is more useful transparency of firms themselves.
- **Structured products**: Recommendations here include:
 - a short-form summary of the offer document;
 - global harmonization of market definitions and structures; and
 - common platforms (such as data portals) for improved access to information on structured products.
- **Firms' risk profiles**: Institutions should ensure that disclosure provides a sufficient overview of current risk profiles – including securitization activities and off-balance sheet exposures.
- **Official Sector Considerations**: Regulators should support the private sector's efforts to improve transparency, with particular reference to harmonization of disclosure requirements among different jurisdictions. The official sector should work closely with industry and market participants to improve market understanding of Pillar 3 disclosure content. Disclosure requirements should be based on a risk- and principles-based approach to qualitative as well as quantitative information. Give consideration to regulatory obstacles to transparency.

The Market Monitoring Group

- A new proposal for a forum to **monitor global financial markets** for vulnerabilities having systemic implications and changes in market dynamics that could lead to major financial market strains.
- This will be a **unique and unprecedented effort** on the part of the industry, as such groups have tended to be concentrated in the official sector. The MMG will combine current market experts and seasoned veterans in global finance.
- MMG findings may be **used by member institutions** in their risk management process.
- Regular **exchanges of views** with appropriate counterparts in the **official sector** – should help contribute to systemic stability.

Implementation and Follow-up

Implementation

- Over 65 firms and 170 executives participated directly in the development of the Principles and Recommendations. They have embraced the Principles, and there is a **firm commitment to following through with implementation** of the Recommendations as appropriate in individual circumstances.
- The Board has strongly encouraged IIF member firms – over 385 at present – to **implement the Recommendations as appropriate** in the context of their business models, goals and regulatory requirements.
- **Industry leaders** from across the spectrum – banks, investment banks and other financial services firms – are solidly **committed** to the success of these proposals.
- Implementation will be based first and foremost on **self-assessment** by firms.

Benchmarking and Review

- Each firm must judge which Recommendations are appropriate in the context of its business models, goals and regulatory requirements. These **Recommendations** will provide sound **benchmarks** for performance assessment.
- The first step will be for firms to conduct an initial **self-assessment** of current performance, identifying potential gaps or lapses in practices. This will provide an initial reference point on where firms stand relative to these benchmarks.
- The second step would be, perhaps a year after the initial review, for firms to **assess their own progress on implementation**.
- The IIF will be considering how best to report industry-wide experience with implementation, and any need for revision or augmentation of Principles or Recommendations.
- It should be noted that improvements to compensation practices present particular challenges in terms of implementation. This area will require careful consideration and treatment.