FINANCIAL REFORM

A Framework for Financial Stability

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30 Group of Thirty

About the Authors

The views expressed in this paper are those of the Working Group on Financial Reform and do not necessarily represent the views of all of the individual members of the Group of Thirty.

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ACRONYMS AND ABBREVIATIONS

CCP	Central counterparty [clearing]
CDO	Collateralized debt obligation
CDS	Credit default swap
CLO	Collateralized loan obligation
CRMPG	Counterparty Risk Management Policy Group
FDIC	Federal Deposit Insurance Corporation
FVA	Fair value accounting
GSE	Government-Sponsored Enterprise
NAV	Net asset value
NRSROs	Nationally Recognized Securities Ratings Organizations
OTC	Over-the-counter
SEC	Securities and Exchange Commission
SIV	Structured Investment Vehicle
TARP	Troubled Asset Relief Program

FOREWORD

In July 2008, the Group of Thirty (G30) launched a project on financial reform under the leadership of a Steering Committee chaired by Paul A. Volcker, with Tommaso Padoa-Schioppa and Arminio Fraga Neto as its Vice Chairmen. They were supported by other G30 members who participated in an informal working group. All members (apart from those with current and prospective national official responsibilities) have had the opportunity to review and discuss preliminary drafts.

The Report is the responsibility of the Steering Committee and reflects broad areas of agreement among the participating G30 members, who participated in their individual capacities. The Report does not reflect the official views of those in policymaking positions or in leadership roles in the private sector. Where there are substantial differences in emphasis and substance, they are noted in the text.

The G30 undertook this project as the global financial crisis entered its second year. The analysis has been informed by the extreme events later in 2008, which rocked the very foundation of the established financial system and which led to unprecedented and massive government intervention both in the United States and in many other countries to contain a spreading financial panic.

The Report does not address the need for these or possible further emergency actions. Difficult questions of weaning markets and financial institutions from official life support are sure to arise. While the analysis and recommendations deal in some instances with the need for legislation, regulation, and supervision, the Report is not directed toward questions about the appropriate focus and nature of national administrative arrangements. These are, in any event, influenced by the particular constitutional, legal, and administrative traditions of individual nations and regional arrangements.

The Report, rather, focuses on how the financial system might reasonably be organized once the present crisis has passed, to better assure a reasonable degree of stability. Policymakers, central bankers, and financial regulators will necessarily remain focused on dealing with immediate threats to the effective functioning of markets. However, in taking what are in effect emergency measures, a consensus on the desirable and lasting elements of a reformed system can be useful, and even necessary, to speed restoration of confidence in sturdy, competitive, and efficient financial arrangements serving both national and international markets. The Report, benefitting from the experience and broad perspective of G30 members, is intended to help inform the needed debate among policymakers and the international financial community on these issues. The Report addresses:

a. The policy issues related to redefining the scope and boundaries of prudential regulation;

b. Reforming the structure of prudential regulation, including the role of central banks, the implications for the workings of "lender-of-last-resort" facilities and other elements of the official "safety net," and the need for greater international coordination;
c. Improving governance, risk management, regulatory policies, and accounting practices and standards; and
d. Improvements in transparency and financial infrastructure arrangements.

Two final notes are in order.

First, this Report is intended to be useful to policymakers in all the countries whose financial systems have been disrupted in this crisis. For this reason, most recommendations are framed in terms that should permit consideration in different countries in a fashion that takes account of particular features of their national systems. However, since this crisis has been rooted in developments within the United States, and given the particular importance of reforms to the U.S. financial system in terms of its size and global impact, several of the issues and recommendations have a direct U.S. focus.

Second, the focus of this Report is on the safety and soundness aspects of financial regulation. There are many other important aspects of financial regulation that are touched upon here only to the extent that they bear on financial stability, including competition policies, customer and investor protection, market practices oversight, and financial fraud and crime prevention. Also, to the extent distinctions are drawn between regulation and supervision, the former encompasses the setting of policies, principles, rules, and standards, while the latter encompasses the judgmental application of those policies and standards to particular institutions.

The key issue posed by the present crisis is crystal clear: How can we restore strong, competitive, innovative financial markets to support global economic growth without once again risking a breakdown in market functioning so severe as to put the world economies at risk?

The search for viable answers to that question needs to begin.

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On behalf of the entire Group of Thirty (G30), I would like to express appreciation to those whose time, talent, and energy have driven this project to successful fruition.

In particular, we acknowledge the leadership of the Steering Committee, chaired by Paul Volcker and Vice Chairmen Arminio Fraga Neto and Tommaso Padoa-Schioppa. Their collective understanding of the nature of the financial crisis and insights as to the necessary reforms are invaluable.

Special recognition must also go to those members of the G30 who actively participated in the working group project deliberations and discussions.

Crafting a thoughtful report that addresses many difficult supervisory, regulatory, market, and other matters requires considerable knowledge of the issues and an ability to synthesize the views of numerous individuals. We particularly appreciate the work of Stephen Thieke, who served as principal draftsman of the report, who brought extraordinary experience and accomplishment to that role and to our deliberations.

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APPENDIX

LIST OF RECOMMENDATIONS

CORE RECOMMENDATION I

Gaps and weaknesses in the coverage of prudential regulation and supervision must be eliminated. All systemically significant financial institutions, regardless of type, must be subject to an appropriate degree of prudential oversight.

Prudential Regulation and Supervision of Banking Organizations

Recommendation 1:

a. In all countries, the activities of government-insured deposit-taking institutions should be subject to prudential regulation and supervision by a single regulator (that is, consolidated supervision). The largest and most complex banking organizations should be subject to particularly close regulation and supervision, meeting high and common international standards.

b. Large, systemically important banking institutions should be restricted in undertaking proprietary activities that present particularly high risks and serious conflicts of interest. Sponsorship and management of commingled private pools of capital (that is, hedge and private equity funds in which the banking institutions own capital is commingled with client funds) should ordinarily be prohibited and large proprietary trading should be limited by strict capital and liquidity requirements. Participation in packaging and sale of collective debt instruments should require the retention of a meaningful part of the credit risk.

c. In general, government-insured deposit-taking institutions should not be owned and controlled by unregulated non-financial organizations, and strict limits should be imposed on dealings among such banking institutions and partial non-bank owners.

d. To guard against excessive concentration in national banking systems, with implications for effective official oversight, management control, and effective competition, nationwide limits on deposit concentration should be considered at a level appropriate to individual countries.

Consolidated Supervision of Non-Bank Financial Institutions

Recommendation 2:

a. For those countries lacking such arrangements, a framework for national-level consolidated prudential regulation and supervision over large internationally active insurance companies should be established.

b. An appropriate prudential regulator should be designated for those large investment banks and broker-dealers that are not organized as bank holding companies.

Money Market Mutual Funds and Supervision

Recommendation 3:

a. Money market mutual funds wishing to continue to offer bank-like services, such as transaction account services, withdrawals on demand at par, and assurances of maintaining a stable net asset value (NAV) at par should be required to reorganize as special-purpose banks, with appropriate prudential regulation and supervision, government insurance, and access to central bank lender-of-last-resort facilities.
b. Those institutions remaining as money market mutual funds should only offer a conservative investment option with modest upside potential at relatively low risk. The vehicles should be clearly differentiated from federally insured instruments offered by banks, such as money market deposit funds, with no explicit or implicit assurances to investors that funds can be withdrawn on demand at a stable NAV. Money market mutual funds should not be permitted to use amortized cost pricing, with the implication that they carry a fluctuating NAV rather than one that is pegged at US$1.00 per share.

Oversight of Private Pools of Capital

Recommendation 4:

a. Managers of private pools of capital that employ substantial borrowed funds should be required to register with an appropriate national prudential regulator. There should be some minimum size and venture capital exemptions from such registration requirement.
b. The prudential regulator of such managers should have authority to require periodic regulatory reports and public disclosures of appropriate information regarding the size, investment style, borrowing, and performance of the funds under management. Since introduction of even a modest system of registration and regulation can create a false impression of lower investment risk, disclosure, and suitability standards will have to be reevaluated.
c. For funds above a size judged to be potentially systemically significant, the prudential regulator should have authority to establish appropriate standards for capital, liquidity, and risk management.
d. For these purposes, the jurisdiction of the appropriate prudential regulator should be based on the primary business location of the manager of such funds, regardless of the legal domicile of the funds themselves. Given the global nature of the markets in which such managers and funds operate, it is imperative that a regulatory framework be applied on an internationally consistent basis.

Government-Sponsored Enterprises (GSEs)

Recommendation 5:

a. For the United States, the policy resolution of the appropriate role of GSEs in mortgage finance should be based on a clear separation of the functions of private sector mortgage finance risk intermediation from government sector guarantees or insurance of mortgage credit risk.

b. Governmental entities providing support for the mortgage market by means of market purchases should have explicit statutory backing and financial support. Hybrids of private ownership with government sponsorship should be avoided. In time, existing GSE mortgage purchasing and portfolio activities should be spun off to private sector entities, with the government, if it desires, maintaining a capacity to intervene in the market through a wholly owned public institution.

CORE RECOMMENDATION II

The quality and effectiveness of prudential regulation and supervision must be improved. This will require better-resourced prudential regulators and central banks operating within structures that afford much higher levels of national and international policy coordination.

Regulatory Structure

Recommendation 6:

a. Countries should reevaluate their regulatory structures with a view to eliminating unnecessary overlaps and gaps in coverage and complexity, removing the potential for regulatory arbitrage, and improving regulatory coordination.

b. In all cases, countries should explicitly reaffirm the insulation of national regulatory authorities from political and market pressures and reassess the need for improving the quality and adequacy of resources available to such authorities.

Role of the Central Bank

Recommendation 7:

a. Where not already the case, central banks should accept a role in promoting and maintaining financial stability. The expectation should be that concerns for financial stability are relevant not just in times of financial crisis, but also in times of rapid credit expansion and increased use of leverage that may lead to crises.

b. In countries where the central bank is not the prudential regulator, the central bank should have: (i) a strong role on the governing body of the prudential and markets regulator(s); (ii) a formal review role with respect to proposed changes in key prudential policies, especially capital and liquidity policies and margin arrangements; and (iii) a supervisory role in regard to the largest systemically significant firms, and critical payment and clearing systems.

c. A sharp distinction should be maintained between those regulated banking organizations with normal access to central bank liquidity facilities and other types of financial institutions whose access, if any, should be limited to extreme emergency situations of critical systemic importance.
d. Central bank emergency lending authority for highly unusual and exigent circumstances should be preserved, but should include, by law or practice, support by appropriate political authorities for the use of such authority in extending such credit to non-bank institutions.
e. Central bank liquidity support operations should be limited to forms that do not entail lending against or the outright purchase of high-risk assets, or other forms of long-term direct or indirect capital support. In principle, those forms of support are more appropriately provided by directly accountable government entities. In practice, to the extent the central bank is the only entity with the resources and authority to act quickly to provide this form of systemic support, there should be subsequent approval of an appropriate governmental entity with the consequent risk transfer to that entity.

International Coordination

Recommendation 8:

a. National regulatory authorities and finance ministers are strongly encouraged to adapt and enhance existing mechanisms for international regulatory and supervisory coordination. The focus of needed enhancements should be to: (i) better coordinate oversight of the largest international banking organizations, with more timely and open information sharing, and greater clarity on home and host responsibilities, including in crisis management; (ii) move beyond coordinated rule making and standard setting to the identification and modification of material national differences in the application and enforcement of such standards; (iii) close regulatory gaps and raise standards, where needed, with respect to offshore banking centers; and (iv) develop the means for joint consideration of systemic risk concerns and the cyclicality implications of regulatory and supervisory policies. The appropriate agencies should strengthen their actions in member countries to promote implementation and enforcement of international standards.
b. Given the recurring importance of excessive leverage as a contributing factor to financial disruptions, and the increasingly complex ways in which leverage can be employed on and off balance sheets, prudential regulators and central banks should

collaborate with international agencies in an effort to define leverage and then collect and report data on the degree of leverage and maturity and liquidity mismatches in various national systems and markets.

c. To the extent new international regulatory organizations are ultimately needed, the initial focus should be on developing more formal regional mechanisms, such as in the European Union, but with continued attentiveness to the global dimension of most significant financial markets.

CORE RECOMMENDATION III

Institutional policies and standards must be strengthened, with particular emphasis on standards for governance, risk management, capital, and liquidity. Regulatory policies and accounting standards must also guard against procyclical effects and be consistent with maintaining prudent business practices.

Regulatory Standards for Governance and Risk Management

Recommendation 9:

Regulatory standards for governance and risk management should be raised, with particular emphasis on:

a. Strengthening boards of directors with greater engagement of independent members having financial industry and risk management expertise;
b. Coordinating board oversight of compensation and risk management policies, with the aim of balancing risk taking with prudence and the long-run interests of and returns to shareholders;
c. Ensuring systematic board-level reviews and exercises aimed at establishing the most important parameters for setting the firm's risk tolerance and evaluating its risk profile relative to those parameters;
d. Ensuring the risk management and auditing functions are fully independent and adequately resourced areas of the firm. The risk management function should report directly to the chief executive officer rather than through the head of another functional area;
e. Conducting periodic reviews of a firm's potential vulnerability to risk arising from credit concentrations, excessive maturity mismatches, excessive leverage, or undue reliance on asset market liquidity;
f. Ensuring that all large firms have the capacity to continuously monitor, within a matter of hours, their largest counterparty credit exposures on an enterprisewide basis and to make that information available, as appropriate, to its senior management, its board, and its prudential regulator and central bank;

g. Ensuring industrywide acceptance of and action on the many specific risk management practice improvements contained in the reports of the Counterparty Risk Management Policy Group (CRMPG) and the Institute of International Finance.

Regulatory Capital Standards

Recommendation 10:

a. International regulatory capital standards should be enhanced to address tendencies toward procyclicality. Benchmarks for being well capitalized should be raised, given the demonstrable limitations of even the most advanced tools for estimating firmwide risk.
b. These benchmarks should be expressed as a broad range within which capital ratios should be managed, with the expectation that, as part of supervisory guidance, firms will operate at the upper end of such a range in periods when markets are exuberant and tendencies for underestimating and underpricing risk are great.
c. The existing international definitions of capital should be reevaluated, looking toward close alignment on national definitions.
d. Capital and risk disclosure standards should be reevaluated to provide a higher degree of transparency of a firm's risk appetite, its estimated needs for and allocation of economic capital, and its valuation practices.

Standards for Liquidity Risk Management

Recommendation 11:

a. Base-level liquidity standards should incorporate norms for maintaining a sizable diversified mix of long-term funding and an available cushion of highly liquid unencumbered assets. Once such standards are developed, consideration should be given to what is the preferred mix of senior and subordinated debt in bank capital structures.
b. Supervisory guidance for liquidity standards should be based on a more refined analysis of a firm's capacity to maintain ample liquidity under stress conditions, including evaluation of the quality and effectiveness of its liquidity management policies and contingency funding plan.
c. Liquidity disclosure standards, building on the suggested practices in the Basel Committee Principles, should complement the suggested improved disclosure practices for capital and risk profile information.

Fair Value Accounting

Recommendation 12:

a. Fair value accounting principles and standards should be reevaluated with a view to developing more realistic guidelines for dealing with less liquid instruments and distressed markets.
b. The tension between the business purpose served by regulated financial institutions that intermediate credit and liquidity risk and the interests of investors and creditors should be resolved by development of principles-based standards that better reflect the business model of these institutions, apply appropriate rigor to valuation and evaluation of intent, and require improved disclosure and transparency. These standards should also be reviewed by, and coordinated with, prudential regulators to ensure application in a fashion consistent with safe and sound operation of such institutions.
c. Accounting principles should also be made more flexible in regard to the prudential need for regulated institutions to maintain adequate credit loss reserves sufficient to cover expected losses across their portfolios over the life of assets in those portfolios. There should be full transparency of the manner in which reserves are determined and allocated.
d. As emphasized in the third report of the CRMPG, under any and all standards of accounting and under any and all market conditions, individual financial institutions must ensure that wholly adequate resources, insulated by fail-safe independent decision-making authority, are at the center of the valuation and price verification process.

CORE RECOMMENDATION IV

Financial markets and products must be made more transparent, with better-aligned risk and prudential incentives. The infrastructure supporting such markets must be made much more robust and resistant to potential failures of even large financial institutions.

Restoring Confidence in Securitized Credit Markets

Recommendation 13:

a. Market Supervision: Extensive innovation in the capital markets and the rapid growth of securitization make it imperative that securitized and other structured product and derivatives markets be held to regulatory, disclosure, and transparency standards at least comparable to those that have historically been applied to the public securities markets. This may require that a broader range of markets be monitored, that there be adequate transparency as to transaction volumes and holdings across all products, and that both credit and leverage elements of each product be thoroughly understood and monitored.

b. Credit Underwriting Standards: The healthy redevelopment of securitized credit markets requires a restoration of market confidence in the adequacy and sustainability of credit underwriting standards. To help achieve this, regulators should require regulated financial institutions to retain a meaningful portion of the credit risk they are packaging into securitized and other structured credit products.

c. Off-Balance-Sheet Vehicles: Pending accounting rule changes for the consolidation of many types of off-balance-sheet vehicles represent a positive and needed improvement. It is important, before they are fully implemented, that careful consideration be given to how these rules are likely to impact efforts to restore the viability of securitized credit markets.

Rating Agency Reforms

Recommendation 14:

Regulatory policies with regard to Nationally Recognized Securities Rating Organizations (NRSROs) and the use of ratings should be revised, preferably on an internationally coordinated basis, to achieve the following:

a. Users of risk ratings, most importantly regulated users, should be encouraged to restore or acquire the capacity for independent evaluations of the risk of credit products in which they are investing.

b. Risk ratings issued by the NRSROs should be made more robust, to reflect the risk of potential valuation losses arising not just from default probabilities and loss in the event of default, but also from the full range of potential risk factors (including liquidity and price volatility).

c. Regulators should encourage the development of payment models that improve the alignment of incentives among the providers of risk ratings and their clients and users, and permit users to hold NRSROs accountable for the quality of their work product.

The Oversight of Credit Default Swaps (CDS) and Over-the-Counter (OTC) Markets

Recommendation 15:

a. Much-needed planned improvements to the infrastructure supporting the OTC derivatives markets should be further supported by legislation to establish a formal system of regulation and oversight of such markets.

b. Given the global nature of the market, it is essential that there be a consistent regulatory framework on an international scale, and national regulators should share information and enter into appropriate cooperative arrangements with authorities of other countries responsible for overseeing activities.

A Resolution Mechanism for Financial Institutions

Recommendation 16:

a. In countries where this is not already the case, a legal regime should be established to provide regulators with authority to require early warning, prompt corrective actions, and orderly closings of regulated banking organizations, and other systemically significant regulated financial institutions. In the United States, legislation should establish a process for managing the resolution of failed non-depository financial institutions (including non-bank affiliates within a bank holding company structure) comparable to the process for depository institutions.
b. The regime for non-depository financial institutions should apply only to those few organizations whose failure might reasonably be considered to pose a threat to the financial system and therefore subject to official regulation.
c. A regulatory body having powers comparable to those available for the resolution of banking institutions should be empowered to act as a receiver or conservator of a failed non-depository organization and to place the organization in liquidation or take action to restore it to a sound and solvent condition.
d. The special treatment accorded to various forms of financial contracts under current U.S. law should be examined in light of recent experience, with a view toward resolving claims under these contracts in a manner least disruptive to the financial system.

Improving Transparency of Structured Product Markets

Recommendation 17:

a. The disclosure and dissemination regime for asset-backed and other structured fixed-income financial products (including securities and other financial products) in the public and private markets should be enhanced.
b. The appropriate national regulator should, in conjunction with investors, determine what information is material to investors in these products and should consider enhancing existing rules or adopt new rules that ensure disclosure of that information, for both asset-backed and synthetic structured products.
c. The appropriate national regulator should condition transactions in the private and wholesale markets on satisfaction of appropriate information disclosure standards.

Sharing Market Activity and Valuation Information

Recommendation 18:

Efforts to restore investor confidence in the workings of these markets suggest a need to revisit evaluations of the costs and benefits of infrastructure investments that would facilitate a much higher level of transparency around activity levels, traded prices, and related valuations. Part of the costs of such changes is the impact on firm-specific concerns regarding the private nature of their market activity. These concerns, and direct investment costs, need to be weighed against the potential benefits of higher levels of market transparency.

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