Financial Services Regulatory Practice

Regulatory Practice Letter

ADVISORY

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Group of Thirty - Financial Reform: A Framework for Financial Stability

Subject:
Financial Reform: A Framework for Financial Stability

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Executive Summary

The Group of Thirty ("G 30") released a report on January 15 entitled, "*Financial Reform: A Framework for Financial Stability*," which addresses the authors' views on how the financial system might be organized in order to better assure a reasonable degree of stability once the present financial crisis has passed. It is intended to be useful to all policymakers in all of the countries whose financial systems have been disrupted by the current economic crisis. The report contains four core recommendations and eighteen more detailed and specific recommendations.

The G30 is a private, nonprofit international body composed of senior representatives of the private and public sectors, as well as academia.

Background

The G30 initiated a project on financial reform in July 2008, as the global financial crisis entered its second year. The project, which resulted in the January 15 report, was under the leadership of a Steering Committee and supported by inputs from participating G30 members. It was further informed by the "extreme events" later in 2008, which resulted in unprecedented and extensive government intervention in the United States and other countries to contain a "spreading financial panic." The report does not take a position with respect to such actions taken or to be taken by governments, agencies or legislators to stem the financial crisis in individual countries. Rather, the purpose of the report is to inform the debate among policymakers and the international financial community for purposes of reaching a consensus on the desirable and lasting elements of a reformed financial system.

Description

Guiding Principles

The G30 report is responsive to the following five guiding principles:

- The primary aim of prudential regulation should be to maintain the health of the system and contain systemic risk. Banking and nonbanking institutions judged to be systemically important should

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be held to the highest international standards for ongoing regulation and supervision;
- Financial services common to different institutions should be treated uniformly with regard to regulatory policies and approaches;
- Official oversight and crisis response should be based on a strong, professionally managed structure of public agencies that are substantially insulated from political or private interests;
- A high degree of international consistency in application and coordination is needed for effective application of these principles; and
- The need for high standards of institutional governance and risk management must be recognized in boards of directors, corporate culture, and regulatory and supervisory policies.

Core Recommendations

The following core recommendations provide a framework for the G30's overall program of financial reform:

1. 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.
2. 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.
3. 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 (i.e., moving with the market) and be consistent with maintaining prudent business practices.
4. 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.

(Note: A prudential regulator and supervisor can be defined as one that establishes standards of operation and monitors compliance with those standards.)

Supporting Recommendations

The core recommendations are supported by several corresponding recommendations, including:

Core Recommendation #1 – Boundaries of Prudential Regulation

- Government insured deposit-taking institutions should be subject to prudential regulation and supervision by a single regulator. In general, they should not be owned and controlled by unregulated nonfinancial organizations.
- National level consolidated prudential regulation and supervision should be established for large, internationally active insurance companies, and a prudential regulator should be named for those investment banks and broker-dealers not organized as bank holding companies.
- Money market mutual funds offering bank-services should reorganize as special-purpose banks with appropriate regulation, supervision, and government insurance, with access to central bank lender-of-last resort facilities.
- Managers of private pools of capital that employ substantial borrowed funds should be required to register with a national prudential regulator. For systemically significant pools, the regulator should be able to set capital, liquidity, and risk management standards.
- Government entities that support the mortgage market by purchases should have explicit authority and backing.

Core Recommendation #2 – Structure of Prudential Regulation and International Coordination

- Countries should reevaluate their regulatory structures to eliminate overlaps and gaps that create opportunity for arbitrage, and reaffirm the insulation of regulatory authorities from political and market pressures.
- The central bank should accept a role in promoting and maintaining financial stability. A distinction should be made between institutions with access to central bank liquidity facilities and those with access based on systemic importance. Central bank liquidity facilities should not include purchases of assets or capital support,
- National regulatory authorities should adapt and enhance existing mechanisms for international regulatory and supervisory

coordination. Regulators and central banks should coordinate with international agencies to define leverage and collect and report on leverage.

Core Recommendation #3 – Improving Standards for Governance, Risk Management, Capital and Liquidity

- Regulatory standards for governance and risk management should be raised.
- International regulatory capital standards should be enhanced to address procyclicality. Benchmarks should be raised. Existing international definitions of capital should be reevaluated toward alignment with national definitions.
- Supervisory guidance for liquidity standards should be based on a refined analysis of a firm's capacity to maintain ample liquidity under stress.
- Fair value accounting principles and standards should be reevaluated with a view to developing guidelines able to deal with less-liquid instruments and distressed markets.

Core Recommendation #4 – Improving Transparency and Incentives, and Strengthening the Financial Structure

- To restore confidence in the securitized credit markets, the related markets and products should be held to regulatory, disclosure and transparency standards at least comparable to those applied to public securities markets. Regulators should require financial institutions to retain a meaningful portion of the risk they package into securitized products. It is important to consider how accounting rules for off-balance sheet vehicles will impact the securities market.
- Regulatory policies with regard to NRSROs (Nationally Recognized Statistical Rating Organizations) should be revised. Ratings should reflect a full range of risks, including liquidity and price volatility. The alignment of incentives for risk rating providers and their users should be improved, and NRSROs should be accountable for their work.
- A formal system of regulation and oversight should be developed for the over-the-counter ("OTC") derivatives market with a consistent regulatory framework on an international scale.
- Legislation should establish a process for resolving failed non-depository financial institutions that pose a threat to the financial system. A regulatory body should be appointed to act as receiver or conservator for the failed institutions.
- Disclosure standards in the asset-backed and other structured fixed-income markets need to be reexamined and enhanced for both public and private markets. Transactions in the public and wholesale markets should be conditioned on satisfaction of appropriate disclosure standards.
- Investments in infrastructure that would facilitate a higher level of transparency should support restoration of investor confidence, especially in the OTC markets.

KPMG Commentary

The G30 notes that this report should be read in conjunction with other private and public sector reform proposals, emphasizing that policymakers should have an extensive set of proposals for framing the issues needed in the overhaul of the national and international financial systems, including financial regulatory reform.

Many news articles have made much of the fact that the Chairman of the Steering Committee is Paul Volcker, former Chairman of the Federal Reserve Board and current advisor to the Obama administration. They suggest that because of Mr. Volcker's role in the current administration, the G30 report is signaling many of the reforms under likely consideration. The report, however, states that it does not reflect the official views of those in policymaking positions or leadership roles in the private sector.

The recommendations are quite extensive and interested parties are encouraged to read the report in its entirety. Please refer also to RPL #08-02 for a summary of the Department of the Treasury's *Blueprint for a Modernized Financial Regulatory Structure* (March 2008), and RPL #09-04 for a summary of the General Accountability Office's recent report, GAO 09-216, *A Framework for Crafting and Assessing Proposals to Modernize the Outdated U.S. Financial Regulatory System* (January 2009).

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