



# Management outlook

## G-20 WORKING GROUP 1 REPORT- Findings



G20 Leaders tasked the Working Group on Enhancing Sound Regulation and Strengthening Transparency (Working Group 1) Co Chairman : Dr. Rakesh Mohan, Deputy Governor, RBI, 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.



G20 Working Group 1  
Enhancing Sound Regulation and  
Strengthening Transparency

Final Report

March 25, 2009



## Identified Drivers of 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.





# SEVEN BIG STOCK MARKET FALLS - AND WHAT HAPPENED NEXT



Date	% fall	Reasons for fall	What happened next
Jan 21, 2007	5.8	World credit crunch and recession	Up 2.54 pc on January 22
Jan 20-27, 2003	7.88	War with Iraq and fears over U.S. economy	Prices recovered within two months
July 8-15, 2002	13.19	Problems with U.S. economy	Recovered within two months
Mar 15-22, 2001	7.23	Fear of recession	Recovered by April 10
Sept 11, 2001	5.72	Attack on World Trade Center	Recovered by October 5
Oct 21-28 1997	9	Asian stock market crisis	Recovered by January 5
Oct 19-26, 1987	17.9	Fears over UK economic outlook	Index climbing by end of year

## What is a Credit Default Swap?

A credit default swap is an agreement between two parties that works like a side bet on a football game. Swap sellers promise swap buyers a big payment if a company's bonds or loans default. In return for the promise they get quarterly payments. Neither needs to hold the underlying debt when entering into a swap.



### Credit Default Swap Seller

Promises to pay swap buyer a set amount if Widgets "R" Us defaults, often \$10 million

- Receives annual payments from swap buyer in return for "insurance"
- Can include banks, insurance companies, hedge funds or others



**Widgets "R" Us Corp.**  
Borrows money from banks or issues bonds to finance operations.



### Credit Default Swap Buyer

Promises quarterly payments to swap seller

- Receives promise of large payout if bond defaults
- Can include banks, insurance companies, hedge funds or others
- If Widget's financial fortunes turn sour, the swap becomes more valuable. A swap holder can resell it and get high payments in return

Scott Pollock



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 underappreciated 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 frame-

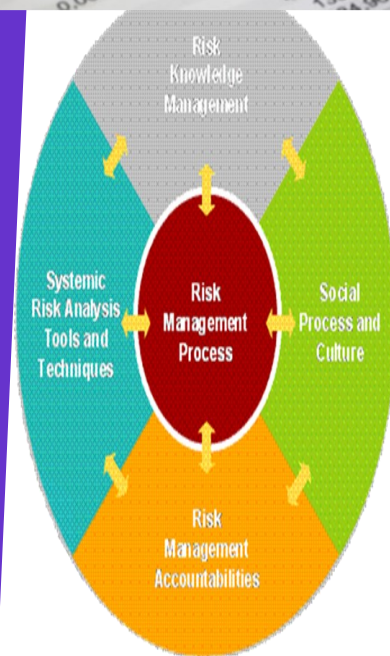
works and capital regulation tend to enhance the natural tendency of the financial system to amplify business cycles, affecting both the degree of credit expansion in benign conditions and the degree of credit contraction in the downturn.

**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.



## 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 macroprudential 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.



LEGAL AND  
REGULATORY  
FRAMEWORK