



# **Summary of the Committee on Capital Markets Regulation Report entitled:**

## **“A plan for regulatory reform”**

2009



International Centre for  
Financial Regulation

## Committee on Capital Markets Regulation

On 26 May 2009, the Committee on Capital Markets Regulation published a report on the plan for financial reform (the “**Report**”). The Report offers a comprehensive and detailed plan for regulatory reform in the light of the global financial crisis.

The Report focuses on key points which include the reduction of systemic risks, increased investor protection through greater transparency, increased level of critical information in the capital markets, coordination with other national regulators and cooperation with regional and international authorities.

The Report contains 57 recommendations which address the shortcomings with proposals to reform capital requirements, improving accounting standards, increasing the supervision and transparency of complex financial instruments and updating regulations for non bank financial institutions.

# KEY RECOMMENDATIONS

**CREDIT DEFAULT SWAPS**

**REGULATION OF CAPITAL**

**NON BANK FINANCIAL INSTITUTIONS**

**MARKET WIDE DISCLOSURES**

**CREDIT RATING AGENCIES**

**ACCOUNTING STANDARDS**

**US REGULATORY STRUCTURE**

**INTERNATIONAL COOPERATION**

# CREDIT DEFAULT SWAPS

The Report believes that credit default swaps (“**CDS’s**”) are an important tool for measuring credit risk. CDS’s allow participants to take positive or negative credit views on specific reference entities.

The Report states that the current CDS market has significant potential for systemic risk through the chain reaction of counterparty defaults.

- The Report makes the following recommendations:

➡ To refrain from prohibiting CDS contracts as they are an important tool for measuring and diversifying credit risk.

➡ To mandate centralised clearing, the Report supports the US Treasury’s recent recommendations for greater centralised trading.

➡ To increase the capital requirements for non centrally cleared CDS’s.

➡ To improve netting capabilities by applying mandatory clearing rules to other standardised types of derivatives.

➡ To establish one or two international clearing facilities between US, EU and other international policymakers.

➡ To adopt a CDS reporting system, by regulators facilitating the adoption within the CDS market of a transaction reporting system.

➡ To pass legislation for the listing and trading of certain standardised, high volume CDS’s on exchanges.

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# REGULATION OF CAPITAL

The Report considers the major structural weakness in the regulatory capital framework focussing on institutional coverage, calibration, timing effects, the risk of large institutions, framework design and capital composition.

- The Report makes the following recommendations:

- ➔ To adopt standards for institutional coverage, which means that institutions should have the ability to borrow from the Federal Reserve and the amount of borrowing should be subject to capital regulation.
- ➔ The Report suggests that the most prudent approach for now is to leave the “steady state” capital calibration unchanged.
- ➔ To adopt counter cyclical capital ratios.
- ➔ To hold large institutions to higher solvency standards and propose a safety margin that would subject US banks to an additional capital buffer above the current levels.
- ➔ To focus and enhance the BASEL II changes which would then lead to the strengthening of pillars II and III.
- ➔ To maintain a leverage ratio in the US similar to the UK’s Financial Stability Board and to later adopt an internationally recognised leverage ratio.

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# NON BANK FINANCIAL INSTITUTIONS

The Report suggests recommendations for hedge funds, private equity firms, money market mutual funds and failed financial institutions.

- **Hedge Funds:** The Report believes that very large, unsustainably leveraged funds exposes a large number of financial institutions to increased counterparty risk. The Report focuses upon seeking to curb this systemic risk whilst also enabling the hedge fund industry to continue to perform its critical role in providing liquidity and increased efficiency of capital markets.
- The Report makes the following recommendations:
  - ➔ The Report supports hedge fund registration but rejects the proposal made by other regulators seeking to force hedge funds to publicly disclose information.
  - ➔ The Report recommends the adoption of a confident reporting requirement to which each hedge fund would be required to register and provide a regulator with relevant information.
  - ➔ To provide the Federal Reserve with temporary responsibility for receiving and evaluating information supplied by hedge funds.
  - ➔ To encourage non US authorities to adopt similar requirements for hedge fund regulation and facilitate information sharing between international regulators.

# NON BANK FINANCIAL INSTITUTIONS

- **Private Equity Firms:** Private equity firms have made greater use of debt to finance deals recently than they had in previous years. This has caused some analysts to imply that defaults of private equity sponsored companies may increase dramatically in the coming years.
- The Report makes the following recommendations:
  - ➡ To limit regulation for private equity funds to only information collection.
  - ➡ To relax the acquisition standards under the Bank Holding Company Act and Savings and Loan Holding Company Act. The Report recommends the approval of any acquisitions of banks by one or more private equity funds.
  - ➡ To permit private equity firms to acquire a bank, provided their banking and commercial activities are separated.

# NON BANK FINANCIAL INSTITUTIONS

- **Money Market Mutual Funds:** The current financial crisis has created tremendous instability for the money market mutual funds, drying up the flow of short term liquidity they provided to the market. The crisis has highlighted the need for a reform of the regulatory structure underpinning the money market mutual funds.
- The Report makes the following recommendations:
  - ➔ To introduce procedures for better crisis management, transparency, risk evaluation and monitoring and to endorse the proposals recently made by the Investment Company Institute.
  - ➔ To study and give thought to the government guarantees provided to support shareholder accounts in money market mutual funds.
  - ➔ To devise an appropriate compensation structure to support shareholder accounts.
  - ➔ To study possible alternatives of money market mutual funds protecting themselves by purchasing credit derivatives that would absorb losses up to a specified percentage of net asset value.

*The Investment Company Institute discussion paper can be found at the following link - [http://www.ici.org/pdf/ppr\\_09\\_reg\\_reform.pdf](http://www.ici.org/pdf/ppr_09_reg_reform.pdf)*

# NON BANK FINANCIAL INSTITUTIONS

- **Failed Financial Institutions:** The current financial crisis has seen some insolvencies which have had a far greater systemic effect than others, partially because the law that governs the insolvency of a financial company depends on the company's form of organisation. Recent markets have demonstrated both the strengths and weakness of the current financial insolvency regime.
- The Report makes the following recommendations:
  - ➔ To establish a single insolvency regime applicable to all financial institutions. The Report suggests the creation of a Financial Company Resolution Act applicable to all financial companies.
  - ➔ To vest a single regulator with the above mentioned resolution powers with preferably a newly established US financial services authority.
  - ➔ To apply the *least cost test*\* on all resolutions.
  - ➔ To authorise the enhanced resolution powers for systemic risks which would include recapitalisation and extending loans or guarantees.
  - ➔ To consider financing methods that would protect the taxpayer.
  - ➔ To consolidate cross border insolvency proceedings.

***Least Cost Test - The Least Cost Test is a series of Microsoft® Excel based spreadsheets that accumulates information on the failing institution and then compares the costs of various resolution options.***

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# MARKET WIDE DISCLOSURES

During the current financial crisis many investors and issuers mispriced the risk associated with various financial instruments.

- One of the reasons why such mispricing took place during the crisis was due to the inadequate disclosures made in connection with the issuance of various financial instruments such as mortgage related securitised debt, collateralised debt obligations and residential mortgage backed securities.

- The Report makes the following recommendations:

- ➔ To amend *Regulation AB*\* to increase loan level disclosures to require issuers of mortgage backed securities to provide loan level data.
- ➔ To initiate a study by the SEC of ways to improve the standardised disclosure package.
- ➔ To revisit the applicability of *section 15(d)*\* and to seek statutory changes that would exempt residential mortgage backed securities from its provisions.

***Regulation AB - Regulation AB is a comprehensive set of new rules and amendments that address the registration, disclosure and reporting requirements for asset-backed securities.***

***Section 15(d) - A company subject to Section 15(d) of the Securities Exchange Act, as amended is an SEC reporting company. Companies that have issued equity or debt securities to the public in a registered offering, but have not listed on any securities exchange also become subject to Section 15(d) of the Exchange Act.***

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**NON BANK FINANCIAL INSTITUTIONS**

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**CREDIT RATING AGENCIES**

**ACCOUNTING STANDARDS**

**US REGULATORY STRUCTURE**





**INTERNATIONAL COOPERATION**

# CREDIT RATING AGENCIES

Credit rating agencies have been said by some to be substantially responsible for the current financial crisis. The failure of the credit rating agencies to assess accurately the risk associated with the global credit markets led to huge losses for investors and others who relied on their ratings.

Credit rating agencies have been criticised for their lack of transparency of the rating process, confusion over the meaning of structured finance ratings and excessive reliance on ratings by investors.

- The Report makes the following recommendations:

-  To develop and apply standard conduct and regulatory framework on a global platform.
-  To place the enforcement powers of credit rating agencies regulation with the highest governmental level within any jurisdiction.
-  To give the credit rating agencies a free hand in developing their rating processes and methodologies, free from any government involvement.
-  To provide a greater disclosure of additional factual and other information on which credit ratings are based to enhance the ability of investors and other market participants to assess and monitor the ratings accuracy.

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**REGULATION OF CAPITAL**

**NON BANK FINANCIAL INSTITUTIONS**

**MARKET WIDE DISCLOSURES**

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**ACCOUNTING STANDARDS**

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# ACCOUNTING STANDARDS

The two accounting issues raised in the financial crisis were the use of fair value accounting and the requirements for consolidation. As per the fair value accounting concept it is very difficult to present a single “fair” value to an asset.

The second accounting issue refers to the relevant rules on consolidation. During the financial crisis institutions used different risky securitisation vehicles in order to be removed from their balance sheets.

- The Report makes the following recommendations:

- ➔ The Financial Accounting Standards Board (“**FASB**”) and International Accounting Standards Board (“**IASB**”) to jointly conduct an in depth research and study to bring about improvements in fair value accounting.
- ➔ FASB to require additional dual presentation of the balance sheet for level 2 and level 3 assets using credit and market values to supplement fair value reporting.
- ➔ To allow the Federal Reserve to use a non GAAP methodology as for regulatory accounting.
- ➔ To implement the *FIN 46R*\* approach.

***FIN 46R – It is a statement for the purposes of US GAAP published by the FASB which requires a reporting enterprise to consolidate a variable interest entity (VIE) if it is the primary beneficiary of the VIE based on variable interests.***

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**MARKET WIDE DISCLOSURES**

**CREDIT RATING AGENCIES**

**ACCOUNTING STANDARDS**

**US REGULATORY STRUCTURE**

**INTERNATIONAL COOPERATION**

# US REGULATORY STRUCTURE

The Report states that going forward effective financial regulation requires a reorganisation of the current US regulatory structure.

- The Report makes the following recommendations:

- ➔ To retain only two or three independent regulatory bodies overseeing the financial system.
- ➔ To increase the role of the Federal Reserve with respect to accountability, to regulate matters pertaining to systemic risk and to set capital requirements for all financial institutions.
- ➔ To establish the US Financial Services Authority (“**USFSA**”) which would regulate all aspects of the financial system, including the market structure and the financial safety and soundness of all financial institutions.
- ➔ To enhance the role of the US Treasury department, which would include coordination of the Federal Reserve and the USFSA. The Treasury would also be responsible for the expenditure of public funds used to provide support to the financial sector.
- ➔ To introduce an investor protection body with respect to financial products.

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# INTERNATIONAL COOPERATION

The Report advocates the implementation of an effective system of international financial oversight that would look to harmonise the global regulatory environment and serve as an early warning system that could coordinate swift responses to any future potential financial crisis.

- The Report makes the following recommendations:

➡ To support the global regulatory forums, by creating a Financial Stability Board and provide it with harmonised baseline rules for the regulation of international finance.

➡ To delegate the task of early warning for financial crisis to the IMF.

➡ To strengthen regulatory dialogues between various regions especially between US and Europe.



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