IIF's Final Report on Market Best Practices for Financial Institutions and Financial Products

By Peter Green and Jeremy Jennings-Mares

The Institute of International Finance (IIF)'s Board of Directors established a Committee on Market Best Practices in October 2007 with a view to galvanizing the banking industry's efforts to develop practical ways to address market weaknesses and to rebuild confidence. The Final Report of the Committee on Market Best Practices: Principles of Conduct and Best Practice Recommendations—Financial Services Industry Response to the Market Turmoil of 2007-2008 (the Report) concludes the work of the Committee. It follows the publication of the IIF's Interim Report in April 2008 on the need to address the many shortcomings highlighted by the recent market turbulence. The Report sets out Proposed Principles of Conduct, Best Practice Recommendations, and Considerations for the Official Sector in the areas of risk management, compensation, liquidity risk, valuation, securitization, and transparency and disclosure issues.

Principles of Conduct and Best Practice Recommendations

The Report differentiates between Principles of Conduct, which capture broad standards of conduct reflecting core values and goals, and underlying Best Practice Recommendations, which provide specific benchmarks for best practices within those Principles of Conduct.

The Report stresses that firms need to develop tailored approaches to manage their own risks, which should be based on the Principles and Recommendations, and that the IIF will monitor their implementation.

We summarize below the principal conclusions in the Report.

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Risk Management

Governance and risk culture: Cultivation of a consistent "risk culture" throughout firms is the most important element in risk management. Each firm should (1) make clear that senior management, particularly the CEO, is responsible for risk management; (2) establish the Board's essential oversight role in risk management; and (3) develop a robust risk culture that is embedded in the way the firm operates across the board, with accountability for risk management being a priority.

Risk appetite: Firms should (1) set basic goals for risk appetite and strategy and monitor performance against such strategy over time; (2) consider all types of risk when defining risk appetite, including risks arising from off balance-sheet vehicles; and (3) involve finance and treasury functions as well as risk management in monitoring the firm's overall risk.

Role of the Chief Risk Officer: Firms should (1) assign responsibility for risk management to a Chief Risk Officer (CRO) with sufficient seniority, authority, and independence from line business management to have a meaningful impact on decisions; (2) ensure that the CRO has the ability to influence key decision makers in the firm, with the mandate to (a) ascertain that the firm's risk level is consistent with its risk appetite, (b) support senior management by identifying emerging risks, and (c) assess and control the firm-wide risk level.

Risk models and integration of risk management areas: Firms should (1) ensure that risk management does not rely on a single risk methodology and analyze group-wide risks on an aggregate basis; (2) ensure that metrics are calibrated appropriately to risk-appetite horizons; (3) take into account the technical limitations of risk metrics, models, and techniques; (4) take a comprehensive approach to risk; and (5) ensure an appropriate governance structure is adopted and actually implemented.

Securitization and complex structured products: In respect of securitization and complex structured products, firms should (1) take an integrated approach to risk management when dealing with complex structured products; (2) ensure that risk models look through the direct risk to capture the market sensitivities of underlying exposures; and (3) identify and manage risk concentrations, including off-balance sheet risks.

Stress testing: Firms should (1) ensure that methodologies take into account firm-wide risk concentrations; (2) ensure that stress testing includes warehousing risks (*e.g.*, securitizations and leveraged loans) when firms have accumulated positions for subsequent distribution; (3) take account of the effect of stresses on exposures to leveraged counterparties; and (4) take an analytical and exploratory approach to stress testing, so that the output is not used automatically, but with a degree of judgment.

Compensation Policies

Firms should (1) base compensation on risk-adjusted performance and align incentives with shareholder interests and long-term, firm-wide profitability; (2) ensure that compensation incentives do not induce excessive risk-taking; (3) align payout with the timing of related risk-adjusted profit; (4) take into account realized performance for shareholders in determining severance pay; and (5) make the approach, principles, and objectives of the firm's compensation policies transparent.

To comply with these policies it is suggested in the Report that firms could (1) structure a significant portion of incentive pay in the form of deferred or equity-related components; (2) use risk-adjusted compensation metrics; and (3) link a more material portion of pay packages to the risk time horizon.

Liquidity Risk, Conduit, and Securitization Issues

Firms should (1) have an agreed-upon and well-communicated strategy for day-to-day liquidity risk management approved by the Board of Directors and executed by an effective management structure and (2) establish robust methodologies to monitor and manage their funding strategies by such categories as currency, maturity, and jurisdiction.

Challenges of liquidity risk management: Liquidity risk management practices should be tailored to each firm's business model and the extent to which it participates in liquidity-dependent securitized markets. Firms should (1) diversify asset portfolios held for liquidity purposes, optimizing access to diversified funding sources, and (2) ensure that risk management procedures maintain a comprehensive, group-wide view of liquidity requirements.

Internal transfer pricing: Firms should (1) create a well-understood and resilient liquidity risk culture so that liquidity issues are reflected in planning, product design, and decision making and (2) ascertain that information on liquidity risk is appropriately disseminated to relevant departments.

Liquidity risk stress testing: Firms should (1) tailor their funding liquidity risk management practices to their business models in light of recent experience, (2) ensure that stress testing includes contingent liquidity exposures, and (3) examine through stress testing and analysis the conditions under which their balance sheets might expand during times of stress and consider suitable contingency plans.

Market liquidity: Firms that rely on funding from securitizations or use of conduits need to evaluate asset liquidity and potential reputational risks under stressed market conditions and conduct rigorous contingency planning for market risks.

Considerations for the official sector on liquidity: (1) Instruments such as term auction, securities lending, and swap facilities should become parts of central banks' toolkits and harmonized across national systems; (2) central banks should consider providing greater clarity regarding their roles in addressing market-related liquidity needs; and (3) central banks should consider continued expansion and harmonization of eligible collateral, which is increasingly critical to liquidity in an integrated, international global financial system.

Structured finance vehicles: (1) Exposure to structured finance vehicles such as conduits should be captured in liquidity planning, disclosure, and management; and (2) sound liquidity risk management would cover contingent obligations to off-balance-sheet vehicles and a clear appraisal of the potential impact of supporting such vehicles.

Additionally, the Recommendations emphasize that (1) firms' risk management and governance procedures should carefully assess all material potential exposures to securitization products and commitments to off balance-sheet vehicles, including exposures to guarantors (such as mono-line insurers); (2) there should be a periodic look-through analysis of securitized assets, providing the firm with early warnings of deteriorating assets or other emerging risks; and (3) if managed in accordance with appropriate implementation of the Recommendations, securitization in its various forms should remain available as a highly useful capital management tool.

Valuation Issues

Management and governance of the valuation process: The report highlights that recent stressed market conditions have made valuation of many instruments very challenging. Consequently, with the objective of assisting firms in providing more stable, transparent, and comprehensible valuations, promoting market confidence, it recommends that firms should (1) maintain robust valuation processes in accordance with applicable accounting and regulatory guidance, incorporating critical expert input; (2) have an appropriate governance framework for valuations, including relevant functions such as risk management, finance, and accounting policy; (3) have an internal governance structure that ensures independence of control and validation of valuations, while providing for regular involvement of the CRO and CFO; (4) ensure that all relevant parties apply judgment in valuation, not relying solely on mechanical processes; and (5) ensure consistent application of independent and rigorous valuation practices, using all available modeling techniques and regularly reviewing independent price-verification procedures and sources.

Infrastructure: Price discovery for valuation purposes should be available through multiple channels.

Valuation under difficult circumstances: Firms should (1) ensure that model validation and price verification are a regular part of the firm's operations; (2) ensure that valuations are subject to sensitivity analysis; and (3) have appropriate infrastructure in place to allow a move from observable market prices to other valuation techniques where warranted by market conditions.

Technical and high-level dialogues are needed: A comprehensive technical dialogue among firms, auditors, rating agencies, investors, analysts, accounting standard setters, and supervisors should address valuations in the market-to-market environment.

The Report stresses that the current work on convergence of standards (on valuation and other issues) by US and international accounting standards setters should remain a priority and be intensified.

Credit Underwriting, Ratings, and Investor Due Diligence in Securitization Markets

Having considered the originate-to-distribute process in the run up to the credit market turmoil, the Report states that, standards weakened at various points in the chain as the number of structured deals grew. Moreover, pressures to keep costs down caused risk assessment to become excessively model-driven.

The Report also finds that credit ratings agencies did not properly communicate all the risks embedded in structured products, the assumptions behind the modeling of particular structures or on the sensitivity of outcomes to varying assumptions. Furthermore, although it concludes that more sophisticated institutional investors are largely capable of making their own assessments, concerns were raised that many less sophisticated investors may rely excessively on external credit ratings when making credit decisions. In this context, the Report suggests the following Principles and Recommendations, depending on the market constituency.

Originators/Sponsors, Underwriters, and Distributors

Underwriting standards: (1) Firms involved in the originate-to-distribute process should apply the same credit due diligence standards at all stages, whether assets are to be held on the books or distributed; (2) the performance of the underlying collateral should be properly monitored and disclosed on an ongoing basis; and (3) for leveraged loans and other corporate obligations, basic credit principles must be carefully heeded, while closely analyzing the risk implications of negotiated terms of lending.

Considerations for the official sector on credit underwriting: Certain legal obstacles may prevent the dissemination of critical data (such as loan-to-value distribution for mortgages). Insufficient information may have contributed to the recent problems in the MBS market. Therefore, the authorities should consider possible changes to regulations that impede the release of loan-by-loan information to all market participants (*e.g.*, Rule 144A in the United States). Non-bank mortgage originators should be held to the same consumer protection and loan origination standards as banks.

Ratings Agencies

The Report makes a number of Recommendations to the rating agencies that complement the reforms already under way, including the following:

- Improving structured product rating reports. To improve the quality of rating reports, the Committee recommends that such reports clearly articulate key risk factors and provide greater clarity for structured product ratings (*e.g.*, definition of default and probability of default should be set out clearly).
- Establishing internal processes and monitoring of rating models. Given the essential role of models used to rate structured products, the Committee recommends that (a) rating agencies adopt standards on internal processes for independent internal validation and monitoring of the structured product models; and (b) independent monitoring units within the agencies review the reasonableness of the assumptions and stress tests against ongoing performance data on the loans in the pools as well as any changes in qualitative factors.
- Establishing external review of the rating process. The Committee recommends that an external mechanism be created to develop standards and to review and assess ratings agencies' internal processes against such standards. The Committee supports the Committee of European Securities Regulators (CESR)'s recommendation to create a standard setting and monitoring body for international rating agencies.
- Introducing different ratings symbols or a scale for structured products. Ratings agencies currently use the same rating scale for structured products as for less complex securities (*e.g.*, corporate bonds). The Committee shares the view of many other organizations, such as the Financial Stability Forum (FSF), International Organization of Securities Commissions (IOSCO), and the US Securities and Exchange Commission (SEC), that ratings agencies should develop a different or additional scale (and/or system of symbols) for rating structured products.

Investors

To help address the issue of investors relying too heavily on ratings when investing in structured products, the Committee has made a number of Recommendations regarding the use of ratings, particularly for structured products.

Enhancing investor due diligence: The Committee recommends that investors (1) conduct their own due diligence with respect to their investment mandates, horizons, and risk appetites and not rely solely on ratings when deciding whether to invest in structured products; (2) develop robust in-house risk assessment processes that enables them to conduct a thorough analysis of structured products before investment decisions and establish better governance and valuation processes with regard to structured product investments; (3) ensure that they have sufficient technical skills and resources to understand the products and to conduct in-house risk assessments.

Considerations for the official sector on ratings: The Committee raised concerns that certain legislators and regulators might artificially require or induce investors to over-rely on credit ratings. In this regard, regulations and supervisory rules should not induce uncritical reliance on credit ratings as a substitute for independent evaluation of the relevant risks. The Committee noted that the SEC has already announced proposals to diminish official references to credit ratings and to encourage investors to be alert to the meaning of the ratings.

Transparency and Disclosure Issues

The Committee advocates avoiding over-disclosure, which it believes has contributed to lack of investor understanding of structured products. Disclosures should be kept "relevant and useful" for their intended purposes and users.

Structured product level: In order to increase transparency of the structured products, the Committee recommends, *inter alia*, (1) the development of a short-form summary of the offer document to highlight key characteristics of an offering and to make it simpler for investors to understand the risks of products they purchase, including a summary of risk factors; (2) global harmonization of market definitions and structures; (3) harmonization of the principles for transparency and disclosure across major markets; and (4) adoption of common platforms and technology, such as data portals, to improve access to information.

Considerations for the official sector on structured products: Accounting standards for structured products should be clear and consistent, without significant divergence between accounting and financial reporting standards (*e.g.*, IFRS and US GAAP). Given the globalization of the structured products industry, endorsement from standards setters and regulators of private sector efforts is critical to standardize market definitions and harmonize disclosure practices.

Financial institution level: The Committee believes that the disclosure provided by many firms must be more useful to their shareholders, counterparties, and regulators as regards their overall (direct and indirect) exposures to securitized products. It recommends that (1) firms ensure that their disclosure provides a sufficient overview of their current risk profiles and risk management processes and highlights key changes (from previous periods) to their current risk profile (including their securitizations); (2) firms' disclosures cover substantive quantitative and qualitative features of the valuation process; (3) firms actively participate in efforts of governments, regulators and standards setters to develop meaningful and comparable disclosures on valuation uncertainties and sensitivities, with a materiality threshold to limit information overload; and (4) firms properly disclose qualitative and quantitative information about their liquidity risk management practices as well as material funding requirements for off-balance sheet vehicles.

Considerations for the official sector on disclosure at the financial institution level: The Committee highlighted a concern that the new types of disclosures mandated by Pillar 3 of Basel II may not be easily understood or may need refinement which could potentially lead to market confusion. Accordingly, legislators and regulators should consider working with industry and market participants to improve market understanding of Pillar 3 disclosure.

Systemic Risks and the Creation of a Market Monitoring Group

The IIF Board of Directors has endorsed the formation of a Market Monitoring Group (MMG) under the auspices of the IIF. The MMG will serve as a forum for member firms to monitor global financial markets for early detection of vulnerabilities with systemic implications, to examine market dynamics that could lead to financial market strains, and to discuss ways to address such risks.

MMG will assist firms in their risk management, focusing their efforts, *inter alia*, on perceived mispricing of risk, crowded trades, and concentration risk.

The MMG is expected to provide private sector interface with various public sector groups that are engaged in similar monitoring activities, meeting regularly to share perspectives and concerns.

Conclusion

The extensive Report contains many specific recommendations for financial institutions, aimed at promoting financial stability and prudent risk management policies. We have summarized the main Principles and Recommendations; however, we would encourage financial institutions to read the Report in its entirety as they formulate their own internal policies in the areas outlined above. Moreover, that this Report can be accurately assessed only in the context of the number of other initiatives that are currently taking place. These include the recent report by CRMPG III, chaired by Gerald Corrigan and entitled "Containing Systemic Risk: The Road to Reform"; the proposed changes to the Capital Requirements Directive; and the US SEC's and the European Commission's respective proposals to reform credit rating agencies. Many market participants regard these initiatives as an inevitable response to the events surrounding the market turmoil of the last year. Although many of the proposals are not unexpected, it is important that regulators across the key global financial markets, including the EU and the US, give careful thought to the proposals and that market participants engage in a dialogue with the regulators. Such consultation is likely to be critical to ensure that new rules and regulations provide a stable regulatory framework that enhances investor protection and reduces the risk of systemic failures in the financial market while giving financial institutions the freedom to continue to innovate and develop new products to meet investors' demands and risk appetites. While there will inevitably be specific concerns that need to be addressed in different markets, it is important that legislators and regulators across the key financial markets seek, where possible, to provide a coordinated response.

Start studying financial markets and institutions. Learn vocabulary, terms and more with flashcards, games and other study tools.Â Financial intermediaries benefit by carrying risk at relatively low transaction costs. Since higher risk assets on average earn a higher return, financial intermediaries can earn a profit on a diversified portfolio of risky assets. Individual investors benefit by earning returns on a pooled collection of assets issued by financial intermediaries at lower risk.Â primary market. increases the funds of the firm issuing them. not very well known to public as it is done through investment banks. investment banks underwrite securities: the IB guarantees a price for a corporations securities and then sells them to the public. invest banks _____ securities Financial Advice Market Review â€" Final Report. FAMR notes that there have already been a number of market developments in this space. FAMR therefore recommends building on this momentum by developing a clear framework to give firms the confidence to deliver streamlined advice on simple consumer needs in a proportionate way.Â A further contributing factor was a lack of trust in advisers, due in part to historic examples of mis-selling of products such as personal pensions and structured products. Although the RDR made significant progress in professionalising the advice industry, trust remains relatively low and it seems likely that it will take longer for awareness of the changes introduced by the RDR to lead to higher levels of confidence in the industry.