SECTION VI: EMERGING ISSUES

The July 2005 Report of the CRMPG II contained a section entitled “Emerging Issues”. In that section, a number of issues were presented as discussion items that, at the time, were thought to have future implications for emerging financial market practices and supervisory policies and practices. The emerging issues section did not by design include recommendations. The emerging issues discussed by CRMPG II in 2005 were the following:

- sales of complex financial instruments to retail investors;
- managing conflicts of interest;
- risk management for fiduciaries;
- official oversight of hedge funds; and
- supervisory challenges.

Building on the experience of 2005, and with an added sense of urgency, CRMPG III concluded that an open-ended discussion of several emerging issues would represent a further and valuable conclusion to this Report. There are five emerging issues discussed in this section of the Report:

- valuation and price verification;
- asset price bubbles;
- near banks;
- regulatory structure; and
- supervisory policy and practice.

A. Valuation and Price Verification

Over the course of the credit market crisis, one issue that has captured the attention of almost all market participants and public officials is the difficulties of valuation and price verification for complex financial instruments, particularly when the market for such instruments is illiquid. To a considerable extent this issue arises in the context of instruments that are subject to so-called “fair value” (or “mark-to-market”) accounting, but valuation and price verification problems also arise for financial instruments that are not subject to mark-to-market accounting.

The debate over fair value accounting for financial instruments has raged for many years. It has been brought into even sharper focus over the past 12 months by the belief in some circles that the application of fair value accounting to certain complex financial instruments in a highly illiquid market has exaggerated market instability and added to downward price pressures. Thus, it is said that the application of fair value introduces artificial elements of volatility into financial statements and results, thereby intensifying the crisis. For some who hold this view, it has been suggested that one or more alternatives to fair value accounting should be permitted in certain market conditions, although even the proponents of such concepts tend to recognize the enormous difficulties in defining how such alternatives would work in practice. Others seem to have real doubts as to whether any such alternative could be sufficiently credible so as to not further damage the credibility of financial institutions whose collective reputation is already under strain.

Those who essentially favor the *status quo* regarding fair value accounting – or even its broader application – argue that the overriding benefit of fair value accounting is the discipline it brings to the risk-taking process. These proponents further stipulate that volatility – by its nature – is a reality, particularly in circumstances in which valuations and price verification, properly performed, can produce reasonable results even in difficult market conditions. Finally, those who advocate fair value accounting would also argue that, even with its limitations, there is no reasonable alternative that would be superior.

It is also noteworthy that both sides of the debate recognize that (1) in certain circumstances – notably financial instruments with easily available “market” prices – fair value is the right answer and (2) an alternative of “historic cost” accounting buttressed with discounted cash flow analysis and impairment tests for sub-par assets is not without its own problems. Finally, both sides of the debate acknowledge that there is an element of asymmetry associated with concerns that apply to the market downside, but not the market upside.

Under any circumstance, the details surrounding the application of either set of standards are frustratingly complex for even the most sophisticated observers and practitioners. In all of these circumstances, fresh attention is being devoted to a systematic review of these accounting standards. For example, on June 3, 2008, the IASB announced the formation of an "Advisory Panel of Experts", drawn from preparers and users of financial statements as well as regulators and auditors, to "discuss the valuation of financial instruments in inactive markets." Similarly, on July 9, 2007, the SEC conducted a "roundtable" on fair value accounting with a similar objective and a similar cross-section of participants.

It is far too early to anticipate what will emerge from these and other deliberations. However, regardless of what may emerge, the Policy Group is strongly of the view that 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 failsafe independent decision-making authority, are at the center of the valuation and price verification process. While the details of approaches and the family of techniques used for these purposes may – and will – differ from time to time and from institution to institution, these efforts should always pass <u>the two common sense</u> tests of (1) reasonableness and (2) consistency, both of which apply equally to positions or instruments that have gains and positions or instruments that have losses.

B. Asset Price Bubbles

It is painfully obvious that practitioners and policy makers alike have been less than successful in recognizing the implications of building asset price bubbles even in the advanced stages of their development. In the private sector, this failure reflects the competitive reality that there is a natural aversion against being the last institution in or the first institution out when selective sectors of the economy and financial markets are booming. In the public sector, and especially among monetary authorities, there has been something of an aversion against monetary policy initiatives designed to "target" asset price bubbles on the grounds that (1) such bubbles are difficult to recognize and (2) such policy initiatives may have a disproportionately large impact on the economy as a whole. Even worse, efforts to curtail bubbles may misjudge whether a bubble even exists, such that policy initiatives driven by false signals would have wholly unnecessary adverse consequences for the economy as a whole.

The issue of whether the private sector can do a better job of anticipating asset price bubbles is discussed in the core precepts and in the section on Risk Management. Similarly, public authorities, particularly central banks, are also reconsidering whether monetary authorities might be able – at the margin – to better anticipate asset price bubbles and respond with at least a "tilt" toward a more restrictive monetary policy. Finally, some have also raised the question as to whether the use of contra-cyclical supervisory policies (*i.e.*, selective increases in capital charges) might be contemplated.

The Policy Group believes that active consideration of all of these areas of inquiry is desirable, but in saying so it is also mindful of the "laws of unintended consequences". That is, this subject matter is highly complex and is one where miscalculation or misjudgment can have serious adverse consequences. Finally, and most importantly, there is no substitute for sustained discipline in both public policy and private action, which remains the best recipe to limit the severity of asset price bubbles and contain their damage when inevitably they occur.

C. Near Banks

In the period since the Long Term Capital Management (LTCM) episode in 1998, so-called "near banks" or "private pools of capital" have become a major force in the overall financial intermediation and risk-taking process. In the eyes of most informed observers, the term "near bank" applies to hedge funds and private equity funds, although some observers would cast a wider net to include large money managers, pension funds and even endowments. However narrowly or broadly defined, the one common denominator shared by all such institutions is that they are not, for the most part, subject to official prudential supervision.

The subject as to whether hedge funds, and to a lesser extent private equity funds, should be subject to some form of direct prudential supervision has been hotly debated since the LTCM episode in 1998. To some extent, and in some jurisdictions, hedge funds have over the past few years become subject to some limited forms of prudential oversight, but not of the nature and scope that is commonplace for traditional banks and the major investment banks in the United States.

The alternative to direct prudential supervision of near banks has been for the authorities to look to the counterparty relations between major <u>regulated</u> institutions and individual hedge funds to provide a meaningful degree of indirect prudential oversight and, when necessary, insights into information on emerging market trends and risks associated with the near banks. As a part of this process of indirect oversight, the major supervisory authorities evaluate, with care and in some detail, the manner in which major regulated financial institutions conduct their counterparty relationships with hedge funds.

During the credit market crisis, a number of hedge funds, including several very large hedge funds, have experienced major difficulties. Some have ceased to exist while others have received substantial financial support from their “owners” or “sponsors”. This has, in some cases, added to the already bloated balance sheets of regulated institutions.

On the whole, regulated institutions have done a credible job in managing their exposures to hedge funds even in the midst of the virtually unprecedented turmoil of the past 12 months. We have not, to date, witnessed a re-run of the hedge fund-driven systemic issues raised by the LTCM episode. On the other hand, it cannot be denied that the activities of at least some hedge funds (and some private equity funds) were important contributing factors to the reach and severity of the crisis.

Quite naturally, therefore, the question as to whether hedge funds and other private pools of capital should be subject to some form of direct supervision is receiving fresh attention. The primary downside to direct supervision is, of course, the so-called “moral hazard” risk of extending direct supervision to these institutions. CRMPG I and CRMPG II expressed serious reservations about such direct supervision, primarily on moral hazard grounds, a reservation that remains with CRMPG III.

In the current circumstances, some attention has been given to a modified form of direct, but standby, supervision. Under this approach, the authorities (*i.e.*, the Federal Reserve in the United States) would step in when problems at one or more hedge funds raise systemic concerns. While such an approach will no doubt be debated in public and official circles, CRMPG III believes that this approach too raises moral hazard questions. Moreover, as a practical matter it would be very difficult to administer such an approach, in part, because of the danger that the standby authority might be triggered when it is already too late or, because the triggering of such authority might aggravate the very problem it is seeking to mitigate.

D. Regulatory Structure

Not surprisingly, the credit market crisis has brought into even sharper focus the issue of regulatory structure, particularly in the United States and the United Kingdom. In both of these jurisdictions one of the central questions on the table for discussion relates to the role of the central bank in the conduct of supervisory policy with particular emphasis on seeking to better mitigate concerns about systemic risk.

This sharpened focus on the role of central banks is a natural outgrowth of the observed fact that central banks, for all practical purposes, are the only instrumentalities of public policy that (1) literally have day-to-day operational presence in financial markets and (2) can provide financial markets with large amounts of liquidity on short notice, while retaining the flexibility to also withdraw that liquidity when conditions warrant.

CRMPG III welcomes the initiative of the United States Department of Treasury in setting forth its “blueprint” for regulatory reform in the United States. The Policy Group recognizes that the public and political debate on the particulars of that blueprint will occur over an extended period of time. Regardless of the outcome of that lengthy debate, CRMPG III believes that the issue of the role of the central bank in the arena of prudential supervision and financial market oversight requires expedited consideration and resolution. Needless to say, and in the aftermath of recent developments, including but not limited to the Bear Stearns case, the resolution of this issue will have to carefully weigh and balance the implications of such resolution for the moral hazard dilemma while recognizing the unique role that central banks play in helping to promote financial stability. In weighing and balancing these factors, the Policy Group would note the following: (1) if the supervisory reach of the Federal Reserve, for example, is to be extended, it must have the direct and ongoing authority to discharge those responsibilities; and (2) legitimate moral hazard concerns notwithstanding, there will always be extreme circumstances in which extraordinary interventions by central banks or governments are necessary. However, as witnessed in recent months, extraordinary intervention by the authorities clearly does not mean that financial institutions and their shareholders will be protected from substantial losses.

E. Supervisory Policy and Practice

As noted throughout CRMPG II and CRMPG III, supervisory practice and policy as applied to large integrated financial intermediaries constitute a sizeable challenge for the international community of prudential supervisors. On the whole, however, the supervisory process works reasonably well, especially as the emphasis of supervisory practices has shifted, in recent years, toward a principles-based approach. As noted earlier in this Report, nowhere are the benefits of such a shift in emphasis more apparent than in the March 6, 2008 Report of the Senior Supervisors Group. Thus, the Policy Group believes that there are clear opportunities to apply the philosophy of that effort to other aspects of supervisory practice. Moreover, because the effort of the Senior Supervisory Group included officials from a number of national jurisdictions, the effort was an obvious plus in terms of enhanced international communication and coordination. Needless to say, the follow-up to such efforts as related to individual institutions must largely be conducted by national level primary supervisors on a case-by-case basis. Even allowing for that fact, the cross-border benefits of the approach of the Senior Supervisors Group are a large and positive step in the direction of more effective supervisory practice.

While acknowledging the gains that have been made in supervisory practice, the Policy Group believes that the case for devoting greater resources to the supervisory effort is clear and compelling. The case for greater resources starts with attracting and retaining more, and more highly skilled, personnel and compensating such personnel in ways that will not fully match private sector practices, but will at least narrow the so-called “public service discount” in compensation.

There are, obviously, direct and indirect fiscal costs associated with devoting more resources to the supervisory process that are quite real in the current setting of pressing fiscal problems in virtually all countries. However, in weighing and balancing fiscal priorities, recent experience reminds us that the fiscal costs of enhancements to the resources applied to the supervisory process must be evaluated relative to the costs of failing to move in that direction.

In the arena of supervisory policy, one particular subject that is in need of further progress is implementing Basel II capital adequacy standards. The Policy Group and virtually all observers agree that a risk-based framework for capital standards is the optimal available approach to such standards, especially across borders, individual institutions and classes of institutions.

However, for understandable reasons, the design and implementation of Basel II has consumed almost a decade. Even now, implementation schedules differ among countries, reflecting in part differing views of individual regulatory bodies (especially in the United States). In addition, further refinements in the methodology for calculating the Basel II capital requirements have been recommended by the Financial Stability Forum and are now on the drawing boards. Finally, some observers have long-standing concerns about the potential for a pro-cyclical bias in the application of Basel II. This concern, in part, grows out of the important role of credit ratings in the Basel II methodology; a concern that, if anything, has probably been magnified by the recent issues that have arisen regarding credit ratings.

The Policy Group is under no illusion that there is a quick and easy solution to any of these issues regarding Basel II. Having said that, the Policy Group wishes to urge all deliberate speed on the part of the international community of supervisory authorities in (1) seeking to stabilize, at least for a reasonable period of time, the methodology associated with Basel II, (2) moving toward a common implementation date across major jurisdictions and (3) ensuring a competitive and supervisory level playing field in the application of Basel II across classes of institutions and across national boundaries.

* * * * * * * *