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IOSCO publishes recommendations to address Subprime Crisis

IOSCO has today published the final report of its Technical Committee's Task Force on the Subprime Crisis. The report contains an analysis of the underlying causes of the subprime crisis, the implications for international capital markets and recommendations that address the issues facing securities regulators.

The report focuses on the market for structured finance products and the specific areas where failings were identified by the task force in November 2007. The paper contains a comprehensive analysis of the particular problems encountered in the four key areas and contains recommendations by the Technical Committee for future IOSCO work to counter these issues in three of these areas. These are:

- issuer transparency and investor due diligence;
- firm risk management and prudential supervision;
- valuation and accounting issues.

The work on the roles and duties of credit rating agencies has recently been completed by the Credit Rating Agencies Task Force:

IOSCO's report complements the work undertaken by other regulatory and governmental bodies, including the Financial Stability Forum (FSF) and the Senior Supervisors Group (SSG).

Michel Prada, Chairman of IOSCO's Technical Committee, said:

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“The proposals for future IOSCO work, contained in today’s report, are designed to address the failings in the private structured finance market which have been brought to light by the ongoing subprime crisis and have had an impact on the operations of the credit markets, financial institutions and securities regulators.”

Christopher Cox, U.S. Securities and Exchange Commission Chairman and co-chair of the IOSCO Task Force, said:

“This report makes clear that, while financial innovation is to be encouraged and plays an important role in the allocation of capital and risk, new financial products need to be accompanied by a thorough analysis of the risks as well as benefits they may bring. This report also highlights the need for all market participants, institutional investors and financial regulators to focus on adequate risk assessment and risk management.

“Recent events have shown how closely linked the world’s capital markets are and how great is the need for increased co-operation between regulators in developing and implementing international principles of regulation. The future work that we have committed ourselves to will help enhance that already deep cooperation.”

The recommendations for future work by IOSCO’s Technical Committee for each of these issues are outlined below. The work will be carried out by the Technical Committee’s Standing Committees.

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Recommendations of the IOSCO Task Force on the Subprime Crisis

Issuer Transparency and Investor Due Diligence

The Task Force has found that the recent market turmoil had relatively less effect on publicly traded structured finance products in some markets, and that secondary trading of structured finance products, for a variety of reasons, is opaque, the Task Force is recommending:

- The Standing Committee on Multinational Disclosure and Accounting will consult with market participants regarding the typical structures and disclosure practices for private placements of asset-backed securities to determine the degree to which these practices are as developed as they are for publicly traded asset-backed securities;
- The Standing Committee on Multinational Disclosure and Accounting will review the degree to which existing IOSCO issuer disclosure standards and principles are applicable to publicly traded asset-backed securities and will develop international principles regarding disclosure requirements these securities if it finds that existing standards and principles are inapplicable to such offerings;
- The Standing Committee on Investment Management will review the degree that investment managers who offer collective investment schemes to retail investors have invested in structured products, the type of due diligence typically conducted when making these investments, the degree to which these investment managers have been affected by the current market turmoil;
- The Standing Committee on the Regulation of Secondary Markets, together with the financial service industry, will examine the viability of a secondary market reporting system for different types of structured finance products.

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Firm Risk Management and Prudential Supervision

The Task Force has found that many institutional investors and investment banking firms had inadequate risk modeling and internal controls in place to understand and address the risks they were assuming when buying many types of structured finance products, relied heavily (or even exclusively) on external credit ratings for their risk analysis, had inadequate balance sheet liquidity even when adequately capitalized, and given the work of the SSG on analyzing these issues, the Task Force is recommending that:

- The Standing Committee on Market Intermediaries will survey members' experience on liquidity risk management and liquidity standards to assist and supplement the work being undertaken jointly with the Basel Committee on Banking Supervision;
- The Standing Committees on Market Intermediaries and Investment Management will undertake a study of the internal control systems of financial firms and asset managers and develop principles to address any concerns identified;
- The Technical Committee will ask originators and sponsors of securitization programs to develop best practices to reinforce their due diligence and risk management practices such that the quality of assets originated for transfer off their balance sheets is of the same quality and subject to the same evaluations as for those kept on their balance sheet;
- The Standing Committee on Multinational Disclosure and Accounting or a Chairs Task Force will consider whether additional guidance and disclosure relating to off-balance sheet entities would be valuable in meeting the needs of investors.

Valuation

The Task Force has found that concerns have been raised regarding the role fair value accounting principles have played in providing investors and regulators with adequate information about the strength of financial firms facing illiquid market conditions and that some financial firms appear to have

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inadequate human and technological resources to model their financial positions using fair value accounting principles under illiquid market conditions, the Task Force recommends that:

- The Technical Committee's Standing Committee on Multinational Disclosure and Accounting or a Technical Committee Chairs Task Force will consider whether additional guidance and disclosure related to measurement at fair value would be valuable in meeting the needs of investors;
- The Standing Committees on Market Intermediaries and Investment Management will explore whether, as a matter of internal control, registered intermediaries and investment advisers avail themselves of practitioners who are skilled or trained enough to model fair valuation adequately in illiquid market conditions.

Credit Rating Agencies (CRAs)

The Task Force on Credit Rating Agencies published its final report yesterday on changes to the IOSCO Code of Conduct Fundamentals for Credit Rating Agencies. The changes contained in that report are aimed at strengthening their processes and procedures to protect the integrity of the ratings process, ensure that investors and issuers are treated fairly and safeguard confidential material information provided to them.

NOTES FOR EDITORS

1. [Report on the Subprime Crisis – Final Report, Report of the Technical Committee of IOSCO](#) is available on the IOSCO website.
2. [The Role of Credit Rating Agencies in Structured Finance Markets – Final Report](#) published on 28 May 2008 is available on the IOSCO website.
3. [IOSCO Briefing Note 2 outlines the Task Force's recommendations.](#)
4. IOSCO's Technical Committee launched the Task Force on the [Subprime Crisis](#) during its Tokyo meeting on 6 November 2007.

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5. IOSCO's Technical Committee recommended in a [statement](#) on 6 February 2008 outlined several key steps that can be taken by market participants to help restore confidence in the operation of the market:
 - Financial institutions are encouraged to enhance the information available to the primary market for structured finance instruments;
 - Market participants should cooperate to identify information that would be relevant and useful in achieving an appropriate level of transparency in the secondary market;
 - Financial institutions should make accurate and complete disclosure of the size and the level of their exposures related to structured finance to the market;
 - Institutional investors and asset managers are encouraged to develop and undertake strict due diligence processes in their assessment prior to any investment into complex, structured products.
6. IOSCO is recognized as the leading international policy forum for securities regulators. The organization's wide membership regulates more than 90% of the world's securities markets and IOSCO is the world's most important international cooperative forum for securities regulatory agencies. IOSCO members regulate more than one hundred jurisdictions and the Organization's membership is steadily growing.
7. The [Technical Committee](#), a specialised working group established by IOSCO's Executive Committee, is made up of fifteen agencies that regulate some of the world's larger, more developed and internationalized markets. Its objective is to review major regulatory issues related to international securities and futures transactions and to coordinate practical responses to these concerns. Mr. Michel Prada, Chairman of the Autorité des Marchés Financiers (AMF) of France, currently acts as Chairman of the Technical Committee. The members of the Technical Committee are Australia, France, Germany, Hong Kong, Italy, Japan, Mexico, the Netherlands, Ontario, Quebec, Spain, Switzerland, United Kingdom and the United States.
8. IOSCO aims through its permanent structures:
 - to cooperate together to promote high standards of regulation in order to maintain just, efficient and sound markets;
 - to exchange information on their respective experiences in order to promote the development of domestic markets;
 - to unite their efforts to establish standards and an effective surveillance of international securities transactions;
 - to provide mutual assistance to promote the integrity of the markets by a rigorous application of the standards and by effective enforcement against offenses.

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Calle Oquendo 12
28006 Madrid
ESPAÑA
Tel.: (34.91) 417.55.49 • Fax: (34.91) 555.93.68
mail@oicv.iosco.org • www.iosco.org

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David Cliffe

Email:

+ 34 679 969 004

d.cliffe@iosco.org

Website:

www.iosco.org