SECTION I: INTRODUCTION

On January 15, 2005, the organizational meeting of the Counterparty Risk Management Policy Group II (CRMPG II) was held in New York. CRMPG II is comprised of senior officials from major financial institutions and is chaired by E. Gerald Corrigan, Managing Director, Goldman Sachs. The members of CRMPG II, including its Vice Chairmen (David Bushnell, Senior Risk Officer, Citigroup, and Don M. Wilson III, Chief Risk Officer, JPMorgan Chase) and its Secretariat, are listed in Exhibit I, and the members of its various working groups are listed in Exhibit II.

The primary purpose of CRMPG II — building on the 1999 report of CRMPG I — is to examine what additional steps should be taken by the private sector to promote the efficiency, effectiveness and stability of the global financial system. As practitioners, the members of CRMPG II recognize that periodic financial disruptions and shocks are inevitable. However, the Policy Group also believes that it is possible to take steps that would be capable of reducing the frequency of such shocks and, especially, to reduce the risk that such shocks would take on the contagion features that can produce systemic damage to the financial system and the real economy.

In approaching its task, the Policy Group shared a broad consensus that the already low statistical probabilities of the occurrence of truly systemic financial shocks had further declined over time. The belief that the risk of systemic financial shocks had fallen was based on a number of considerations including: (1) the strength of the key financial institutions at the core of the financial system; (2) improved risk management techniques; (3) improved official supervision; (4) more effective disclosure and greater transparency; (5) strengthened financial infrastructure; and (6) more effective techniques to hedge and widely distribute financial risks.

Indeed, members took some collective comfort from the fact that in the post LTCM/Russia period, financial markets had absorbed with remarkable resiliency the effects of multiple disturbances, including but not limited to: (1) the bursting of the technology bubble of the late 1990s; (2) a mild recession; (3) September 11; (4) two wars; (5) an oil shock; and (6) a wave of corporate scandals (including a handful of major bankruptcies).

That sense of comfort, however, must be tempered by the recognition that the collective capacity of financial market participants and policy makers to anticipate the specific triggers that spawn financial shocks is very low. Indeed, if that collective capacity to anticipate such triggers were high, logic would tell us that major shocks would almost never occur. There is a further complication — namely, while the Policy Group members believe that the risks of large scale financial shocks occurring are lower, they also recognize that even very rare financial shocks can produce significant damage to the financial system and/or the real economy. Moreover, many factors make it impossible to anticipate in advance how financial shocks will play out once triggered: the complexity of the financial markets; the tighter linkages between financial markets and participants; and the enormous speed with which market developments are transmitted throughout the financial markets, all on a global scale. Ironically, perhaps, this rise in speed and complexity and the attendant tightening of linkages are driven by the very same advances in technology and telecommunications that are driving the profound positive changes we are witnessing in financial practices.

Thus, we are left with a classic dilemma — that is, how do we design programs, practices and policies that can reasonably cope with very low probability financial contingencies having potentially large consequences without undermining the substantial societal benefits generated by the contemporary global financial system?

The members of CRMPG II are under no illusion that they can or will resolve that dilemma. However, as noted above, the Policy Group does believe that its analysis, its Recommendations and its Guiding Principles can help reduce the frequency and contain or limit the damage associated with major financial shocks when, on occasion, they inevitably occur.

In approaching its mission, the design of the Policy Group's work was based on the premise that the informational building blocks for this Report should include four major elements as follows:

- First, to compile a comprehensive inventory of major developments in financial markets — and in supervisory and regulatory policies — since the publication of the 1999 CRMPG I report. (As a part of that inventory of post-1999 developments, an overview of changing investment strategies — and their risk management implications — of major institutional fiduciaries was also prepared);

- Second, to revisit the recommendations of CRMPG I, examine how they have withstood the test of time and identify areas in which those earlier recommendations should be strengthened and enhanced;
- Third, to systematically explore a family of complex financial products in order to illustrate their behavioral characteristics and to analyze their implications for risk management, risk distribution and transparency; and
- Fourth, to examine a number of so-called "Emerging Issues" that were not covered by CRMPG I but are now of such importance that the Policy Group determined they should not be ignored.

With regard to complex financial instruments, the primary objectives of the Policy Group were two-fold. One objective was the seemingly straightforward — but critically important — goal to enhance understanding of these complex instruments with emphasis on how their prices respond to specified stress factors. The second objective of the exercise was to frame Recommendations and Guiding Principles regarding the use, risk monitoring and risk management of such instruments, both for financial intermediaries and their institutional clients.

As noted above, as the work of the Policy Group progressed it became obvious that there were four subjects not directly related to counterparty risk management that could not be ignored in the current setting, all of which are related primarily to reputational risk. Those subjects are:

- First, the heightened issues of suitability and disclosure associated with the sale of complex financial products to retail investors;
- Second, the management of the reputational and financial risks associated with potential conflicts of interest that are inherent in the activities of financial intermediaries;
- Third, the increasingly complex risk management challenges faced by institutional investors having fiduciary responsibilities; and
- Fourth, the official oversight of hedge funds.

Finally, in the discussion of "Emerging Issues," the Policy Group has spelled out four "Supervisory Challenges" representing major areas where both the official and the

private sector should work together to better harmonize supervisory, regulatory and accounting policies with the practicalities of managing complex financial institutions.

With those introductory remarks in mind, the content of the Report is presented as follows:

Section I:	*Introduction*	Pages 1 to 4
Section II:	*Executive Summary and Recommendations*	Pages 5 to 40
Section III:	*Risk Management and Risk-Related Disclosure Practices*	Pages 41 to 68
Section IV:	*Financial Infrastructure: Documentation and Related Policies and Practices*	Pages 69 to 118
Section V:	*Complex Financial Products: Risk Management, Risk Distribution and Transparency*	Pages 119 to 138
Section VI:	*Emerging Issues*	Pages 139 to 154
Appendix A:	*Complex Financial Products*	Pages A-1 to A-54
Appendix B:	*Financial Market Developments 1999-2005*	Pages B-1 to B-22
Appendix C:	*Major Legislative and Regulatory Developments*	Pages C-1 to C-16
Appendix D	*Risk Management Challenges Facing Institutional Fiduciaries*	Pages D-1 to D-9