Executive Summary

This Executive Summary contains a series of excerpts from different parts of this Report, including (1) the five core precepts for mitigating systemic risk discussed in Section I, (2) the specific recommendations of the Policy Group contained in Sections II through V and (3) some highlights of the emerging issues discussion in Section VI of this Report.

With regard to implementation of the core precepts and recommendations, the Policy Group expects that substantial progress will be made over the balance of 2008. However, in some instances, especially the recommendations in Section V relating to Enhanced Credit Market Resiliency, the implementation timetable will stretch out through 2009.

Part I: Mitigating Systemic Risk: Core Precepts for Large Integrated Financial Intermediaries

Precept I: The Basics of Corporate Governance

The Policy Group recommends that, from time-to-time, all large integrated financial intermediaries must examine their framework of corporate governance in order to ensure that it is fostering the incentives that will properly balance commercial success and disciplined behavior over the cycle while ensuring the true decision making independence of key control personnel from business unit personnel.

Precept II: The Basics of Risk Monitoring

The Policy Group recommends that all large integrated financial intermediaries must have, or be developing, the capacity (1) to monitor risk concentrations to asset classes as well as estimated exposures, both gross and net, to all counterparties in a matter of hours and (2) to provide effective and coherent reports to institutional senior management regarding such exposures to high-risk counterparties.

Precept III: The Basics of Estimating Risk Appetite

The Policy Group recommends that all large integrated financial intermediaries must periodically conduct comprehensive exercises aimed at estimating risk appetite. The results of such exercises should be shared with the highest level of management, the board of directors and the institution's primary supervisor.

Precept IV: Focusing on Contagion

Looking to the future, the Policy Group recommends that all large integrated financial intermediaries must engage in a periodic process of systemic "brainstorming" aimed at identifying potential contagion "hot spots" and analyzing how such "hot spots" might play out in the future. The point of the exercise, of course, is that even if the "hot spots" do not materialize or even if unanticipated "hot spots" do materialize, the insights gained in the brainstorming exercise will be of considerable value in managing future sources of contagion risk.

Precept V: Enhanced Oversight

The Policy Group recommends arrangements whereby the highest level officials from primary supervisory bodies should meet at least annually with the boards of directors of large integrated financial intermediaries. The purpose of the meeting would be for the supervisory authorities to share with the board of directors and the highest levels of management their views of the condition of the institution with emphasis on high-level commentary bearing on the underlying stability of the institution and its capacity to absorb periods of adversity. This recommendation may have to be adapted to accommodate local legal and cultural considerations.

Part II: Recommendations

Section II: Standards for Accounting Consolidation

II-1. The Policy Group endorses, in principle, the direction of the changes to the US GAAP consolidation rules provided that the changes are (1) principles-based, (2) convergent with International Financial Reporting Standards, and (3) accompanied by suitable disclosure and transition rules regarding regulatory capital which will provide flexibility in the implementation of these rules over a reasonable period of time.

II-2. The Policy Group recommends adoption of a single, principles-based global consolidation framework that is based on control and the ability to benefit from that control. The analysis of whether an entity (the investor) has a controlling interest in another entity (the investee) should be based on:

- the investor's power over the investee, including the ability to make decisions that determine the success of the investee;
- the degree of investor exposure to the risks and rewards of the investee, including through guarantees, commitments and all other explicit and implicit arrangements between the two entities; and

- the design and sponsorship of the investee, including the degree to which the activities of the investee expose the investor to commercial, legal, regulatory and reputational risks.

II-3. The Policy Group further recommends that the new consolidation framework require a reassessment of the consolidation analysis each reporting period based on changes in the control indicators specified in the preceding recommendation.

II-4. The Policy Group encourages standard setters and industry participants to work together toward achieving the goals discussed in this section on a global basis as soon as possible.

II-5. The Policy Group recommends that standard setters and industry participants consider a holistic and principles-based approach to disclosure of off-balance sheet activities similar to that found in international standards. The disclosure framework should be fully integrated with enterprise-wide disclosures across the full spectrum of risks: market, credit, liquidity, capital, operational, and reputational.

Enterprise-wide disclosure should be supplemented with detailed information that links to enterprise-wide disclosures and that changes in response to changing risks and uncertainties; for example, in the current environment, disclosures about residential and commercial real estate and leveraged loan exposures.

II-6. The Policy Group recommends that firms provide tabular disclosures about the effects of restrictions on the use of consolidated assets, non-recourse liabilities, and minority interests.

Section III: High-Risk Complex Instruments

The Policy Group strongly recommends that high-risk complex financial instruments should be sold only to sophisticated investors.

III-1. The Policy Group recommends establishing standards of sophistication for all market participants in high-risk complex financial instruments. In recommending specific characteristics and practices for participants, it is guided by the overriding principle that all participants should be capable of assessing and managing the risk of their positions in a manner consistent with

their needs and objectives. All participants in the market for high-risk complex financial instruments should ensure that they possess the following characteristics and make reasonable efforts to determine that their counterparties possess them as well:

- the capability to understand the risk and return characteristics of the specific type of financial instrument under consideration;
- the capability, or access to the capability, to price and run stress tests on the instrument;
- the governance procedures, technology, and internal controls necessary for trading and managing the risk of the instrument;
- the financial resources sufficient to withstand potential losses associated with the instrument; and
- authorization to invest in high-risk complex financial instruments from the highest level of management or, where relevant, from authorizing bodies for the particular counterparty.

Large integrated financial intermediaries should adopt policies and procedures to identify when it would be appropriate to seek written confirmation that the counterparty possesses the aforementioned characteristics.

The Policy Group believes that there are opportunities to enhance and strengthen the documentation and disclosures provided to prospective investors in high-risk complex financial instruments, while being mindful that documentation and disclosure practices will (and should) vary somewhat from instrument to instrument and will also vary over time. With that qualification in mind, the Policy Group recommends the following as a matter of industry best practice.

III-2a. The documentation of all high-risk complex financial instruments in cash or derivative form should include a term sheet: a concise summary highlighting deal terms and, where appropriate, collateral manager capabilities, and portfolio and deal payment structure. The term sheets for all high-risk complex financial instruments, the full scope of which is outlined in Appendix A, must, among other factors, include the following:

- a clear explanation of the economics of the instrument including a discussion of the key assumptions that give rise to the expected returns; and
- rigorous scenario analyses and stress tests that prominently illustrate how the instrument will perform in extreme scenarios, in addition to more probable scenarios.

III-2b. The documentation associated with asset-backed high-risk complex financial instruments should include:

- A Preliminary and Final Offering Memorandum: The offering memorandum should include prominently within its first several pages the nature of the economic interest of the underwriter or placement agent (and its affiliates) in the transaction, including a clear statement of the roles to be undertaken and services to be provided by the underwriter or placement agent (or its affiliates) to the transaction, as well as any interests in the transaction (if any) that the underwriter or placement agent (or its affiliates) are required or expected to retain.

- A Marketing Book: The marketing book should include an in-depth description of the materials contained in the term sheet. It should especially focus on the collateral manager (in the case of a managed portfolio) and deal structure.

- Portfolio Stratifications: This documentation should be in the form of spreadsheets containing bond level information (sector, rating, par balance, etc.), where known, and weighted average loan level information (FICO, service, LTV, % fixed, occupancy, geographic distribution, 2nd liens, *etc*.).

- Cash Flow/Stress Scenarios: This documentation should be in the form of spreadsheets and cash flow model outputs. Standard runs should be provided for each tranche offered. The output will typically be in the form of tranche cash flows and default/loss percentages for the tranches and collateral.

III-2c. In addition to the documentation standards covered above, the Policy Group further recommends that term sheets and offering memoranda for all financial instruments having one or more of the key characteristics associated with high-risk complex financial instruments as discussed on pages 54, 56 must have a "financial health" warning prominently displayed in bold print indicating that the presence of these characteristics gives rise to the potential for significant loss over the life of the instrument. The "health warning" should also refer to all risk factors in the offering documents.

The Policy Group further recommends that complex bilateral transactions that are privately negotiated between sophisticated market participants are not subject to Recommendations IV-2b and 2c but are subject to Recommendation IV-2a regarding terms sheets. In certain circumstances, however, and by mutual written consent, the term sheet requirement may be waived for bilateral transactions between highly sophisticated market participants or in the context of a repeated pattern of transactions of a particular type.

The Policy Group recommends strengthening the relationship between intermediaries and counterparties in sales, marketing, and ongoing communications associated with high-risk complex financial instruments. While its first recommendation calls for establishment of a

common standard of sophistication for all market participants in high-risk complex financial instruments, the Policy Group believes there is a responsibility on the part of large integrated financial intermediaries to provide clients with timely and relevant information about a transaction beyond the disclosures discussed in its Recommendation III-2 above.

III-3a. The intermediary and counterparty should review with each other the material terms of a complex transaction prior to execution.

III-3b. Both the intermediary and counterparty must make reasonable efforts to confirm the execution of a complex transaction in a timely manner.

- The counterparty should be promptly notified of any expected delay in the creation of a confirmation.
- The intermediary should disclose whether evidence of agreement, such as a signed term sheet, is binding as to transaction terms. Each party should review the terms and promptly notify the other of any error.

III-3c. When a counterparty requests a valuation of a high-risk complex financial instrument, the intermediary should respond in a manner appropriate to the purpose of the valuation. The intermediary's sales and trading personnel may provide a counterparty with actionable quotes or indicative unwind levels. Only groups independent of sales and trading should provide indicative valuations and only in writing. Where relevant, such indicative valuations should include information describing the basis upon which the valuation is being provided.

III-3d. As a part of the relationship between intermediaries and their counterparties following trade execution, the intermediary should make reasonable efforts on a case-by-case basis to keep the counterparty informed of material developments regarding the performance of key positions.

With respect to high-risk complex asset-backed securitizations, underwriters and placement agents should have in place an ongoing framework for evaluating the performance and reputation of issuers as well as effective and clearly articulated procedures for evaluating the quality of assets. The Policy Group <u>strongly urges</u> that underwriters and placement agents redouble efforts to adhere fully to the letter and spirit of existing diligence standards, and seek opportunities to standardize and enhance such standards. These enhancements include the following recommendations:

III-4a. Requiring all firms to follow statistically valid sampling techniques in assessing the quality of assets in a securitization; and

III-4b. Encouraging disclosure to investors of due diligence results, including making the AUP letter publicly available.

Section IV: Risk Monitoring and Risk Management

IV-1a. The Policy Group recommends that risk management and other critical control functions be positioned within all large integrated financial intermediaries in a way that ensures that their actions and decisions are appropriately independent of the income producing business units and includes joint approval of key products and transactions. This would generally mean having a Chief Risk Officer (CRO) with a direct line of responsibility to the Chief Executive Officer (CEO) and having the CEO and the board take a highly active role in ensuring that the culture of the organization as a whole recognizes and embraces the independence of its critical control functions. Even without the direct reporting, the CRO should have a clear line of communication to the board.

IV-1b. The Policy Group further recommends that institutions ensure that their risk management functions are staffed appropriately for both the upside and the downside and are able to understand and properly size risks in tranquil markets as well as during periods of market stress. The risk management functions must also have the capacity to function effectively in periods of spikes in processing volumes and under various disaster recovery scenarios.

IV-2a. The Policy Group recommends that all large integrated financial intermediaries evaluate the manner in which information relating to risk taking, risk monitoring, and risk management is shared with senior management and the board of directors and make necessary improvements to ensure that such information flows are timely, understandable, and properly presented. As a part of this effort, senior management should actively encourage ongoing discussion with board members in order to improve the quality, coverage and utility of information made available to the board. Each institution should evaluate how effective its information flows are as they relate to the intersection of credit, market, operational and liquidity risk.

IV-2b. The Policy Group recommends that each institution ensure that the risk tolerance of the firm is established or approved by the highest levels of management and shared with the board. The Policy Group further recommends that each institution ensure that periodic exercises aimed at estimation of risk tolerance should be shared with the highest levels of management, the board of directors and the institution's primary supervisor in line with Core Precept III, as discussed on pages 11, 12.

IV- 2c. The Policy Group further recommends that large integrated financial intermediaries ensure that their treasury and risk management functions work with each other and with business units to manage balance sheet size and composition in a manner that ensures that the established risk tolerance is consistent with funding capabilities and ongoing efforts to manage liquidity risk.

IV-2d. The Policy Group further recommends that each institution review its internal systems of both formal and informal communication across business units and control functions to ensure that such communication systems encourage the

prompt and coherent flow of risk-related information within and across business units and, as needed, the prompt escalation of quality information to top management.

IV-3a. The Policy Group recommends that, when schedules permit, the CEO and the second ranking officers of all large integrated financial intermediaries should frequently attend and participate in meetings of risk management-related committees.

IV-3b. The Policy Group further recommends that the highest levels of management periodically review the functioning of the committee structure to ensure, among other things, that such committees are appropriately chaired and staffed and there is an appropriate overlap of key business leaders, support leaders, and enterprise executives across committees to help foster firm-wide cooperation and communication.

IV-3c. The Policy Group further recommends that for certain classes of firm-wide committees, such as those responsible for the approval of new products – especially new products having high financial, operational or reputational risks – the committee oversight process should include a systematic post-approval review process. This post-approval review process would assess the extent to which new products have, in commercial terms, performed as expected. Equally important, the process would assess whether the risk characteristics of the new product have been consistent with expectations, including the burden of the new products on technology and operating systems. Further, it is particularly appropriate to review at the earliest opportunity outsized profitability and market share gains to ensure that this does not reflect a problem with the original pricing or risk assessment of the product.

IV- 4a. The Policy Group recommends that sustained investment in risk management systems and processes, and the careful calibration of such investment to business opportunities being pursued, be a key area of focus for a firm's senior management team.

IV-4b. The Policy Group further recommends that each firm's CRO commission a periodic review and assessment of the firm's investments in risk management for presentation to its senior management and the audit committee of its board.

IV-5a. The Policy Group recommends that all market participants implement a paradigm shift in credit terms, establishing arrangements that create more stable trading relationships, are less pro-cyclical, and thus reduce systemic risk.

IV-5b. The Policy Group further recommends that each firm's senior management commission a periodic review of credit terms extended over a cycle, together

with an assessment of the stability of such terms, for discussion with the firm's senior management.

IV-6a. The Policy Group recommends that large integrated financial intermediaries ensure that their credit systems are adequate to compile detailed exposures to each of their institutional counterparties on an end-of-day basis by the opening of business the subsequent morning. In addition, the Policy Group recommends that large integrated financial intermediaries ensure their credit systems are capable of compiling, on an *ad hoc* basis and within a matter of hours, detailed and accurate estimates of market and credit risk exposure data across all counterparties and the risk parameters set out below. Within a slightly longer timeframe this information should be expandable to include: (1) the directionality of the portfolio and of individual trades; (2) the incorporation of additional risk types, including contingent exposures and second and third order exposures (for example, Structured Investment Vehicles (SIVs), Asset-Backed Securities (ABS), *etc*.); and (3) such other information as would be required to optimally manage risk exposures to a troubled counterparty. Large integrated financial intermediaries should be able to use exposure aggregation data both prospectively to avoid undue concentrations and, if necessary, in real time to react to unanticipated counterparty credit events.

IV-6b. To demonstrate their compliance with the aforementioned standards, the Policy Group recommends that firms conduct periodic exercises for both individual and multiple institutional counterparties, and, to the extent that deficiencies are observed, develop remediation plans as a matter of urgency.

IV-7a. The Policy Group recommends that large integrated financial intermediaries' risk analytics incorporate sufficient granularity to reveal less obvious risks that can occur infrequently but that may potentially have a significant impact (for example, basis risks between single name underliers and index hedges). However, risk management professionals and senior management must recognize the limitations of mathematical models, and that the tendency to overly formalize arcane aspects of an analysis can often detract from an understanding of the bigger picture implications of the total risk position. Incremental analytical detail must not be allowed to overwhelm users of the data. The salient risk points must be drawn out and made apparent, especially to senior management. Adequate time and attention by senior management must also be allotted to socializing the implications of the risk data.

IV-7b. The Policy Group recommends that large integrated financial intermediaries ensure that assumptions underlying portfolio analyses are clearly articulated and are subject to frequent, comprehensive review. Alternative measures should be presented to demonstrate the sensitivity of the calculated metrics to changes in underlying assumptions.

IV-7c. The Policy Group recommends that credit risks be viewed in aggregate across exposures, giving full consideration to the effects of correlations between

exposures. Further, counterparty credit risks, including correlations and directionality, should be evaluated based not only on positions within a large integrated financial intermediary, but also considering available data regarding the size and direction of positions the counterparty has at other firms.

IV-7d. The Policy Group further recommends that large integrated financial intermediaries work to supplement VaR as the dominant risk measure of market risk and current exposure as the dominant risk measure for credit risk, both for public reporting and for risk discussion purposes. Supplemental measures should include statistical information intended to display the most likely ways a large integrated financial intermediary or a managed portfolio could sustain significant losses, as well as an indication of the potential size of those losses.

IV-8a. The Policy Group recommends that firms think creatively about how stress tests can be conducted to maximize their value to the firm including the idea of a reverse stress test where the emphasis is on the contagion that could cause a significant stress event to the firm.

IV-8b. The Policy Group further recommends that firms incorporate the expanded suite of stress tests into a formalized production schedule, against which trends and developments in key risk factors and exposure amounts can be tracked.

IV-9a. The Policy Group recommends that large integrated financial intermediaries adjust quantitative measures of potential credit risk with margined counterparties to take into account exceptionally large positions, as well as position concentrations in less liquid instruments. The adjustment should anticipate potentially protracted unwind periods and the risk of price gapping during unwinds.

IV-9b. The Policy Group further recommends that consideration be given to collecting higher initial margin and higher haircuts from counterparties with outsized positions relative to market liquidity. Large integrated financial intermediaries should also evaluate the need to adjust internal pricing for large positions.

IV-10a. The Policy Group recommends that large integrated financial intermediaries ensure that they employ robust, consistent pricing policies and procedures, incorporating disciplined price verification for both proprietary and counterparty risk trades. Special attention should be given to bespoke trades, structured products, illiquid products, and other difficult to price assets. A robust monitoring process should be employed to track stale prices and elevate unresolved issues.

IV-10b. The Policy Group further recommends that firms and industry groups promote standardized and strengthened dispute resolution mechanisms and encourage the application of higher levels of resources to position pricing. Firms should also promote enhanced understanding of the need for cooperative behavior among firms (for example, when requested to provide indicative bids).

IV-10c. The Policy Group further recommends that increased emphasis be given to using, wherever possible, transparent and liquid instruments rather than bespoke products. To incentivize this conduct, large integrated financial intermediaries should consider imposing internal charges against the P & L of hard to value and illiquid transactions, or other methods, such as higher capital charges, higher haircuts to collateralized borrowers, and the imposition of limits on allowed trade volumes. The recommendations incorporated in the section on High-Risk Complex Financial Instruments regarding documents and disclosure are of particular relevance to bespoke products.

IV-11a. The Policy Group recommends that large integrated financial intermediaries ensure, in the absence of exceptional circumstances, that when the same instrument is held by different business units, such instrument is marked at the same price in each unit. Large integrated financial intermediaries should restrict those personnel and groups that are authorized to provide marks to internal and external audiences. Any differentials in pricing across applications or units should be carefully considered and the rationale for such differences should be fully documented. Notwithstanding the above, it is recognized that for large integrated financial intermediaries, there are communication walls that are designed to fulfill regulatory requirements for the restriction of information flows. In these instances, it is understood that legitimate differences in pricing may occur.

IV-12a. The Policy Group recommends that large integrated financial intermediaries ensure that a review of the systemic risk implications of incentives and consequent remedial actions is an integral component of each firm's risk management practices. Regulators should encourage this proactive review and assessment on a regular periodic basis. Regulators should identify practices that have the potential to destabilize markets during periods of stress and communicate their concerns aggressively.

IV-12b. The Policy Group further recommends that, when considering new trade structures, strategies, or other opportunities, systemic risk implications be evaluated by the senior management of large integrated financial intermediaries. Trades or structures which materially add to systemic risk should be subject to particular scrutiny.

IV-13a. The Policy Group recommends that all large integrated financial intermediaries should, on a regular basis, conduct liquidity stress tests to measure their

Maximum Liquidity Outflow (MLO). Stress tests should be based on scenarios that consider how normal sources of liquidity, both secured and unsecured, could be disrupted for the firm, the markets, or both. The stress test scenarios should focus on potential liquidity outflows, taking into account a firm's particular vulnerabilities.

IV-13b. The Policy Group further recommends that, in addition, at a minimum, firms monitor their MLO within the first 30 days and for additional intervals within this timeframe (for example, overnight, one week, two weeks). The MLO is defined as the net loss of liquidity under the firm's most severe scenario from the time of the calculation for the tenors prescribed.

IV-13c. The Policy Group recommends that stress scenarios, both for purposes of stress testing and calculation of MLO, should:

- Include both firm-specific and systemic events and their overlapping nature.
- Consider extreme shocks as well as progressive events.
- Take into account implicit as well as explicit risks and potential damage of a firm's actions to its franchise.
- Review the potential for loss of key sources of secured and unsecured funding, including deposits, commercial paper, and other short- and long-term debt. Firms should also consider the impact of funding illiquidity on asset-backed commercial paper conduits and on the ability to securitize pools of assets.
- Analyze the potential outflows related to customer activity, including prime brokerage.
- Examine the impact of on- and off-balance sheet exposures, including the potential outflows related to derivative transactions, liquidity commitments and special purpose vehicles.
- Consider the impact of intra-day liquidity exposures, including the heightened interest of counterparties to accelerate trades and settlements in times of stress and other time-related mismatches in the flow of funds.
- Consider other large cash payments including salaries, taxes and lease payments.
- As with all liquidity practices, evaluate the impact on both individual legal entities, as well as the consolidated firm.
- Consider the availability of central bank facilities. Generally speaking, extraordinary central bank facilities, such as the Federal Reserve System's Primary Dealer Credit Facility, should not be considered an element of an effective liquidity plan.

These stress tests, and their results, would be internally classified, confidential documents that would be shared with senior management, boards of directors and primary supervisors on a periodic basis. The information provided by the stress tests should be used to identify funding gaps and assess where gaps are incompatible with the firm's risk appetite. Since the stress test information provided to supervisors would be confidential supervisory information, it would and should be protected from public disclosure.

IV-14. The Policy Group recommends that all large integrated financial intermediaries maintain, on an ongoing basis, an unencumbered liquidity reserve of cash and the highest grade and most liquid securities. The liquidity reserve should be sized in relation to the firm's stress tests and MLO and should explicitly reflect the firm's liquidity risk tolerance and desired survival periods.

IV-15. The Policy Group recommends that all large integrated financial intermediaries maintain long-term structural liquidity in excess of their illiquid assets. In making this assessment, large integrated financial intermediaries should analyze the term structure of their long-term liabilities, the long-term stable portion of their deposits (where applicable), as well as equity capital. Illiquid assets should include those assets that cannot be converted to cash within a specified horizon and potential growth of those assets, as well as the haircuts necessary to convert generally liquid assets to cash through sale, securitization, or secured financing.

The baseline assessment of whether a large integrated financial intermediary has long-term structural liquidity in excess of its illiquid assets should reflect current business conditions. However, the amount of this excess ("the cushion") should reflect an evaluation of the assets and liabilities under stressed conditions. This cushion should be replenished with structured long-term liabilities, with tenors appropriate to market conditions, business strategy, and existing debt maturities.

IV-16. The Policy Group recommends that a firm's liquidity plan and any stress tests mentioned above include, in all instances, the full set of on- and off-balance sheet obligations. In addition, they must reflect a clear view of how the firm will address non-contractual obligations that have significant franchise implications. While some non-contractual obligations may not lend themselves to incorporation into the core stress scenarios, an evaluation of how such exposures will play out in different market environments should be an overlay to the core stress scenarios. In addition, a clear assessment of how practices in relevant markets (for example, SIVs and auction rate securities) will affect an individual firm's conduct should be directly factored into liquidity planning. The above liquidity exposures should be fully priced under the firm's transfer pricing policies (see Recommendation V-17).

IV-17. The Policy Group recommends that all large integrated financial intermediaries incorporate appropriate pricing-based incentives for the full spectrum of their funding activities. This includes a funds transfer pricing policy that assigns the cost of funding to businesses that use funding and credits the benefits of funding to businesses that provide it. This must encompass both on- and off-balance sheet activities (for example, contingent funding), as well as potential funding needs related to actions that might be taken to preserve the institution's reputation. The funds transfer pricing process should be informed by stress testing efforts that identify potential vulnerabilities and assign the related costs to the businesses that create them. The methodology should provide direct economic incentives factoring in the related liquidity value of assets and behavioral patterns of liabilities. The costs and benefits identified should be assigned to specific businesses and, under all circumstances, used in evaluating the businesses' performance.

IV-18. The Policy Group recommends that to manage, monitor, and control funding liquidity risk, treasury officials in particular need to be included in an enterprise-wide risk management process with appropriate channels of communication. The evaluation of the interconnected elements of these risks requires seamless communication across all risk disciplines, as well as between risk management functions, treasury and the underlying businesses. All integrated financial services firms should hold regularly scheduled meetings of an oversight committee represented by the above disciplines to monitor the firm's liquidity positions.

IV-19. The Policy Group recommends that firms explicitly coordinate across their liquidity and capital planning processes and, at a minimum, ensure that critical information flows between the two processes. Executive management must have the capacity to evaluate and incorporate the highly integrated nature of the two disciplines into its planning activities.

IV-20a. The Policy Group re-affirms its recommendation that for large integrated banks and investment banks, Basel II should remain the primary capital standard that such institutions, their primary supervisors, and the marketplace generally look to in making judgments about capital adequacy.

IV-20b. The Policy Group recommends, at least for the present, that the existing Basel II standards for minimum capital and well-capitalized institutions be maintained. In taking that position, the Policy Group recognizes that the experience of the credit market crisis provides a sobering reminder to individual institutions, their senior management and their supervisors that future judgments about capital adequacy should be more sensitive to downside risks than perhaps has been the case in the past.

IV-20c. The Policy Group further recommends that supervisory judgments about capital adequacy for all large integrated banks and investment banks give primary weight to case-by-case evaluations based on the range of criteria contained in Basel II, Pillar II, and, when necessary, such judgments should be promptly shared with individual institutions.

V-20d. The Policy Group strongly recommends that every reasonable effort be made by the international community of supervisory authorities to (1) seek to stabilize, at least for a reasonable period of time, the methodology associated with Basel II, (2) move toward a common implementation date across major jurisdictions, and (3) insure a competitive and supervisory level playing field in the application of Basel II across classes of institutions and across national boundaries.

IV-21a. The Policy Group recommends that where the use of leverage ratios is compulsory, supervisors monitor such leverage ratios using the Basel II, Pillar II techniques and intervene regarding the adequacy of such leverage ratios only on a case-by-case basis.

IV-21b. The Policy Group recommends that efforts be directed at either (1) framing more meaningful leverage ratios where they exist or (2) phasing out their use and implementing alternative risk measures that more effectively fulfill their intended objectives.

Section V: Enhanced Credit Market Resiliency

V-1. The Policy Group recommends trade date (T+0) matching for electronically eligible transactions.

Goal: End 2009.

V-2. The Policy Group recommends the linkage of confirmation and settlements.

Goal: Dealers early 2009.

V-3. The Policy Group recommends a tiered approach to market participation and incentive structure.

Goal: Ongoing.

V-4. The Policy Group recommends incentives to buy-side participants.

Goal: Ongoing.

It is important to recognize that buy-side market participants will operate at different volumes. Moderate to large volume participants (more than four trades per month) will be expected to adhere to the same standards as dealer-side firms with respect to transmission standards, trade date confirmation, settlement, and mark-to-market comparisons. As with adoption of the Novation Protocol, dealers should consider limiting trading activity with firms that do not adhere to industry standards. Adherence to industry standards should be part of a routine dealer operational due diligence (side-by-side with the normal credit due diligence).

V-5. The Policy Group recommends that market participants should seek to streamline their methods for trade execution and confirmation/affirmation, which should facilitate an end-to-end process flow consistent with same-day matching and legal confirmation.

V-6. The Policy Group recommends that senior leaders of trading support functions should clearly articulate to senior management the resource requirements necessary to achieve the same-day standards. Recognizing the expense management imperatives driven by recent market conditions, senior management should make every effort to help support functions achieve these standards for the overarching benefit of enhancing market resilience.

Goal: Ongoing.

V-7. The Policy Group strongly urges that major market participants should deploy a combination of utility and vendor-supplied solutions and should, at a minimum, ensure interoperability of those solutions.

Goal: End of 2009.

V-8. The Policy Group recommends that major market participants on both the sell- and buy-sides should make every reasonable effort to speed up the adoption of electronic platform usage. This should entail revisiting the priorities in development and testing schedules.

Goal: End of 2009.

V-9. Consistent with Recommendation V-7 above, the Policy Group further recommends that major market participants on both the sell- and buy-sides should hasten their adoption of tools that facilitate standardization in the marketplace. This will in turn facilitate the achievement of the next generation goals for the timeliness and integrity of transaction details.

Goal: End of 2009.

V-10. The Policy Group further recommends frequent portfolio reconciliations and mark-to-market comparisons, including on collateralized instruments.

Goal: Weekly end 2008, moving to daily for electronically eligible trades mid 2009.

V-11. ISDA Credit Support Annex documents spell out the bilateral terms of the margin process. While the process is generally standardized, the Policy Group recommends that the industry needs to find an effective means to resolve valuations disputes, particularly for illiquid products. Doing so is likely to be a difficult and demanding matter and therefore an industry-wide approach may have to be considered.

Goal: End of 2009.

V-12. The Policy Group recommends that, as mark-to-market disputes inevitably surface through the collateral portfolio reconciliation process, the information should be passed to the executing trading desks on a real-time basis to allow for research and resolution. This should, of course, be done with appropriate anonymity of the counterparty's identity, positions, and broader portfolio. A close alignment of the collateral team with trading desks – without violating the fire walls and controls that are critically important to the integrity of the financial system – would facilitate such information sharing. As necessary, significant and large value collateral disputes should promptly be escalated to the appropriate senior officers.

Goal: Immediate.

V-13. The Policy Group recommends that dealers, investors and the clearing banks agree on "Best Practices" to govern the tri-party repo market. Components of such Best Practices should include the following:

- tri-party repo program size;
- margin;

- collateral eligibility; and
- collateral valuation.

V-14. The Policy Group recommends that market participants actively engage in single name and index CDS trade compression. ISDA has agreed on a mechanism to facilitate single name trade compression with Creditex and Mark-it Partners. Established vendor platforms exist for termination of offsetting index trades, and we urge major market participants to aggressively pursue their use.

V-15. Based on the considerations above, the Policy Group recommends that the industry, under the auspices of the current ISDA Portfolio Compression Working Group, commit immediately and with all due speed to achieve consistency of the current product, including potentially:

- utilizing industry preferred Reference Obligations or elimination of Reference Obligations;
- eliminating Restructuring Basis distinctions, recognizing that this needs to be considered in a broader global perspective taking into account regional and national differences; and
- standardizing fee calculations based on a single, common model analytic.

V-16. The Policy Group recommends that ISDA should update its Credit Derivative Definitions to incorporate the auction mechanism so that counterparties to new credit default swap trades commit to utilize the auction mechanism in connection with future credit events.

V-17. The Policy Group recommends that ISDA should run a protocol (a so-called "big bang" protocol) to provide market participants with an operationally efficient means to amend their existing credit default swap trades to utilize the auction mechanism in connection with future credit events. This protocol should not effect any other changes to the bilateral agreements in effect between adopting counterparties.

V-18. The Policy Group recommends that all large integrated financial intermediaries (*e.g.*, the major dealers) should promptly adopt the Close-out Amount approach for early termination upon default in their counterparty relationships

with each other. We note that this can be agreed and suitably documented without making any other changes to the ISDA Master. The Policy Group expects that these arrangements will be in place in the very near term.

V-19. The Policy Group recommends that a working group should be formed under the auspices of ISDA, with representatives of both dealer and buy-side firms, to review the methodology for counterparty terminations in order to (1) produce a set of best practices and suggested bilateral templates for the transparency of valuation methodologies and parameters, as noted above, for use by all market participants, (2) consider how contractual provisions could reflect prior reconciliation of valuation parameters and (3) seek to reconcile the differing views on what is necessary to evidence agreement that market inputs will be used unless commercially unreasonable. The Policy Group hopes that the working group will be able to report a recommended approach by December 31, 2008.

V-20. The Policy Group recommends that all major market participants should periodically conduct hypothetical simulations of close-out situations, including a comprehensive review of key documentation, identification of legal risks and issues, establishing the speed and accuracy with which comprehensive counterparty exposure data and net cash outflows can be compiled, and ascertaining the sequencing of critical tasks and decision-making responsibilities associated with events leading up to and including the execution of a close-out event.

V-21. The Policy Group recommends that all market participants should both promptly and periodically review their existing documentation covering counterparty terminations and ensure that they have in place appropriate and current agreements including the definition of events of default and the termination methodology that will be used. Where such documents are not current, market participants should take immediate steps to update them. Moreover, each market participant should make explicit judgments about the risks of trading with counterparties who are unwilling or unable to maintain appropriate and current documentation and procedures.

V-22. The Policy Group recommends that the industry should consider the formation of a "default management group", composed of senior business representatives of major market participants (from the buy-side as well as the sell-side) to work with the regulatory authorities on an ongoing basis to consider and anticipate issues likely to arise in the event of a default of a major market counterparty.

V-23. Recognizing the benefits of a counterparty clearing arrangement (CCP) as discussed above, the Policy Group strongly recommends that the industry develop a CCP for the credit derivatives market to become operational as soon as possible and that its operations adhere to the BIS Recommendations.

Part III: Emerging Issues Highlights

A. Valuation and Price Verification

"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 the two common sense 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

"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 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

"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."

"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

"The Policy Group believes that the case for devoting greater resources to the supervisory effort is clear and compelling."

"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 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) insuring a competitive and supervisory level playing field in the application of the Basel II across classes of institutions and across national boundaries."

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