August 6, 2008



The Honorable Henry M. Paulson, Jr.
Secretary of the Treasury, and
Chairman, President's Working Group on Financial Markets
1500 Pennsylvania Ave., NW
Washington, DC 20220

The Honorable Mario Draghi
Governor, Bank of Italy, and
Chairman, Financial Stability Forum
Via Nazionale 91
00184 Rome
Italy

Dear Secretary Paulson and Governor Draghi:

On behalf of CRMPG III we are pleased to convey to you our Report entitled "Containing Systemic Risk: The Road to Reform." As the title of the Report suggests, the Policy Group considers the financial crisis of 2007 and 2008 to be the most severe we have experienced in the post-war period. While this turn of events had multiple causes and contributing factors, the root cause of financial market excesses on both the upside and the downside of the cycle is collective human behavior – unbridled optimism on the upside and fear – bordering on panic – on the downside. As history tells us in unmistakable terms, it is virtually impossible to anticipate when optimism gives rise to fear or fear gives rise to optimism. The last twelve months have been no exception to this sobering reality.

It is this sobering reality that, for centuries, has given rise to the universal recognition that finance and financial institutions must be subject to a higher degree of official oversight than is necessary for virtually all other forms of commercial enterprise. However, official supervision is not a substitute for effective management of financial institutions which is –and should remain – a private function. Yet, here too, there is a dilemma; namely, in a highly competitive marketplace it is very difficult for one or a few institutions to hold the line on best practices or to stand on the sidelines in the face of booming markets. What is needed, therefore, is a form of private initiative that will complement official oversight by insisting on industry practices that will help mitigate systemic risk. The "core precepts" and recommendations in this Report have been framed with that objective in mind.

The Policy Group places particular importance on the five core precepts for containing systemic risk that are discussed in Section I. The subsequent four sections of the Report include the following: Section II which covers a reconsideration of the standards for consolidation under US GAAP that contemplates a significant shift of currently off-balance sheet status entities to on-balance sheet status; Section III which is directed at measures to better understand and manage high-risk complex financial instruments with particular emphasis on (1) the establishment of standards of sophistication that would apply to all participants in the market for high-risk complex financial instruments; (2) enhanced disclosures; (3) improved sales and marketing practices; and (4) strengthened issuer and loan diligence; Section IV which focuses on substantial enhancements to risk monitoring and management with particular emphasis on sound corporate governance, risk monitoring, and fostering a single integrated discipline for managing capital adequacy and liquidity and funding; and Section V which outlines a series of truly sweeping measures to enhance the resiliency of financial markets generally and the credit markets in particular with special emphasis on the OTC derivatives market and the credit default swap market. The recommendations in Section V – including the call for the prompt creation of a clearing corporation that would begin clearing credit default swaps in the fourth quarter of 2008 – are extremely ambitious.

The final section of the Report discusses a number of important "emerging issues". While this section, by its design, does not have recommendations, it does point, in very concrete terms, to subject matter that will require close attention during the period ahead on the part of policy members and practitioners alike.

Achieving the sweeping enhancement and reform set forth in the Report will require collective and concerted industry-wide initiatives, supported by progressive and enlightened prudential supervision conducted in the spirit of the March 6, 2008 Report of the Senior Supervisors Group. In the private sector, greater financial discipline at individual institutions must be reinforced by a renewed commitment to collective discipline in the spirit of elevated “financial statesmanship” that recognizes that there are circumstances in which individual institutions must be prepared to put aside specific interests in the name of the common interest.

Such a commitment may require market participants to (1) make costly investments in infrastructure (human capital and technology) and (2) change business processes, and accept changes to market practices, that in the past have generated sizeable revenues but at the cost of weakening the underlying foundation of the markets. Costly as these reforms will be, those costs will be minuscule compared to the hundreds of billions of dollars of write downs experienced by financial institutions in recent months to say nothing of the economic dislocations and distortions triggered by the crisis.

In an effort to ensure implementation of these enhancements, the Policy Group strongly urges that all major financial institutions should analyze their internal policies, procedures and practices against the recommendations and reforms outlined in this Report. Senior management at these institutions should ensure ongoing monitoring of progress in relation to these reforms.

In closing, we wish to express our gratitude to the Policy Group members and their respective Working Groups for their extraordinary contributions to this Report. We also want to acknowledge that in our work, we have benefited enormously from the earlier efforts of the President’s Working Group on Financial Markets and the Financial Stability Forum.

Sincerely,

E. Gerald Corrigan

Douglas J. Flint