



The Counterparty Risk Management Policy Group III Report Includes Detailed Suggestions for Financial Intermediaries

Overview

On August 6, 2008, the Counterparty Risk Management Policy Group III (CRMPG III) released a report entitled “Containing Systemic Risk: The Road to Reform.” This report is the latest in the series published by a Policy Group that includes senior management from major financial institutions. The report, which was published in response to the credit crisis, recommends a number of changes aimed at mitigating risk in financial sectors and urges major financial institutions to “analyze their internal policies, procedures and practices against the recommendations and reforms outlined in the Report” and monitor their progress in meeting these recommendations.

The report lays out five “Core Precepts” that all large integrated financial intermediaries should follow in implementing the Policy Group’s recommendations. The precepts require that financial institutions adhere to (1) the basics of corporate governance; (2) the basics of risk monitoring; (3) the basics of estimating risk appetite; (4) policies intend to limit contagion; and (5) enhanced oversight.

In making its recommendations regarding risk mitigation, the Policy Group focused on four aspects of financial reform including: (1) the standards of consolidation under US GAAP of entities currently off-balance sheet coming on-balance sheet; (2) measures to better understand and manage high-risk financial instruments; (3) significant enhancements to risk monitoring and management; and (4) measures to enhance the resiliency of financial markets generally and the credit markets in particular, with a special emphasis on OTC derivatives and credit default swaps. The Report briefly touches on “emerging issues” that will require close attention, including (1) the resources allocated to, and the independence of, valuation and price verification; (2) asset price bubbles; (3) supervision of hedge funds; (4) the role of the central bank; and (5) supervisory policy and practice.

Mitigation Systemic Risk: Five Core Precepts for Large Integrated Financial Intermediaries

The Report stresses that management and supervision of large integrated financial intermediaries must rest on five core precepts, which are easy to understand, communicate to all corporate constituents and evaluate regularly.

Precept I: The Basics of Corporate Governance

The corporate governance culture must create incentives that properly balance commercial success and disciplined behavior, and also ensure that the decisions of key control personnel are independent from business units.

Precept II: The Basics of Risk Monitoring

Large integrated financial intermediaries must have the ability to monitor all positions and risk exposures within hours and provide effective reports to senior management regarding exposures to high-risk counterparties.

Precept III: The Basics of Estimating Risk Appetite

All large integrated financial intermediaries must periodically conduct exercises to estimate risk appetite and communicate those results to senior management, the board of directors and the institution's primary supervisor.

Precept IV: Focusing on Contagion

All large integrated financial intermediaries should periodically brainstorm to identify potential contagion risks and how these risks might emerge.

Precept V: Enhanced Oversight

At least annually, the highest-level officials from primary supervisory bodies should meet the boards of directors of large integrated financial intermediaries to exchange views and, thus, help each other to better discharge their oversight duties.

Recommendations

Standards for Accounting Consolidation

The Policy Group endorses the direction of the changes to the US GAAP consolidation rules but recommends a principles-based global consolidation framework that converges with IFRS and is based on control and the ability to benefit from that control. Whether an entity (the investor) is considered to have control over another entity (the investee) should be based on the investor's power over that entity, including the investor's "ability to make decisions that determine the success of the investee." The analysis should also include an evaluation of the extent to which the investor is exposed to the risks/rewards of the investee and other arrangements (implicit and explicit) between the investor and investee and whether the structure of the investee could "expose the investor to commercial, legal, regulatory and reputation risks." The consolidation analysis should be reassessed periodically based on changes in control.

High-Risk Complex Instruments

Investors

The Policy Group recommends that only "sophisticated investors" should be allowed to invest in high-risk complex financial instruments. Investors must be able to assess and manage the risk of an investment and should specifically: (1) be able to understand the risk/return of an instrument; (2) have the capability to price and run stress tests on the instrument; (3) have the appropriate corporate governance, technology and internal controls to trade and manage the instrument's risks, (4) have the financial resources to absorb losses; and (5) have authorization to invest from the senior management or where appropriate, an authorizing body for the counterparty.

Disclosure Documents

Additionally, the Policy Group recommends strengthening disclosure documents for high-risk complex financial instruments. Documentation for a high-risk complex financial instrument (in cash or derivative form) should include a term sheet describing the economics of the instrument, the key assumptions giving rise to the expected returns and scenario analyses and stress tests. Documentation for asset-backed high-risk complex financial instruments should include a preliminary and final offering memorandum, a marketing book, spreadsheets showing portfolio stratifications and spreadsheets and cash flow model outputs showing cash flow/stress scenarios. The term sheets and offering memoranda for high-risk complex financial instruments should have a prominently displayed bold print “financial health” warning indicating the high-risk characteristics and the potential for significant loss.

Relationship with Intermediaries

The Policy Group also recommends “strengthening the relationship between intermediaries and counterparties in sales, marketing and ongoing communications with high-risk financial instruments” so intermediaries can provide clients with timely and relevant information about a transaction beyond the disclosure documents. Specifically, (1) prior to execution of a transaction, the intermediary and counterparty should review the material terms together; (2) the intermediary and counterparty should use reasonable efforts to make a timely trade confirmation; (3) if a counterparty requests a valuation, only groups independent of sales and trading should provide a valuation and only in writing; and (4) following trade execution, on a case-by-case basis, the intermediary should keep the counterparty apprised of “material developments regarding the performance of key positions.”

Performance Evaluations

Finally, the Policy Group also recommends that for asset-back high-risk complex financial instruments, underwriters and placement agents should put in a place a framework for “evaluating the performance and reputation of issuers as well as effective and clearly articulated procedures for evaluating the quality of assets.” Underwriters and placements agents must follow diligence standards and enhance those standards where appropriate.

Risk Monitoring and Risk Management

The Policy Group’s recommendations focus on ensuring that risk management is independent of income producing business units and that risks are understood, communicated and managed.

Toward that end, the Policy Group recommends that financial intermediaries appoint a Chief Risk Officer reporting directly to the CEO, with an open line of communication to the board of directors. Institutions should provide sufficient staff for risk management so risks can be understood and managed during times of market stress. Processes must be in place so that information relating to risk can be presented to the board of directors in a timely and understandable way. The Policy Group also recommends that the board of directors or senior management establish or approve the firm’s risk tolerance. The treasury of a firm, risk management and business units should coordinate to control the size of the balance sheet and ensure that risk tolerance is consistent with available funding and efforts to manage liquidity risk. Communication channels should facilitate a prompt and coherent flow of information across business units and up to management, when appropriate.

The Policy Group recommends that the CEO and other senior management should, when possible, attend risk management-related committee meetings, and senior management should periodically assess the functioning of risk-management committees. When a committee approves a new high-risk product, the committee oversight process should include a systematic post-approval review process, including whether the risk characteristics are in line with predictions. The Policy Group also recommends sustained and periodic review of investment in risk

management systems. Further, to reduce systemic risk, all market participants should “implement a paradigm shift in credit terms” so that trading relationships are more stable and less cyclical. Senior management should commission and discuss a periodic review of credit terms over a cycle with an assessment of the stability of such terms.

Additionally, the Policy Group recommends that institutions implement credit systems that adequately compile detailed exposures to each institutional counterparty as of the end of the day by the opening of business the following day. Large financial intermediaries should be able to assess company-wide market and credit risk in a matter of hours, and given more time should be able to compile more detailed assessments of directionality and contingent risk. Firms must conduct periodic exercises both for individual and multiple institutional counterparties, and, if deficiencies are observed, put in place urgent remediation plans. The risk analytics of large financial intermediaries must incorporate “sufficient granularity” to facilitate the discovery of less obvious risks that may have a big impact. Assumptions underlying portfolio analyses must be clearly articulated and frequently reviewed. The Policy Group also recommends that credit risks be “viewed in the aggregate across exposures, giving full consideration to the effects of correlations between exposures” and that for reporting and discussion purposes, large integrated financial intermediaries find supplements to VaR as the dominant risk measure of market risk and to current exposure as the dominant risk measure for credit risk.

The Policy Group recommends that large integrated financial intermediaries consider ways of maximizing the value of stress tests, including running stress tests on a formal schedule so that key risk factor trends can be followed. The Policy Group further recommends that intermediaries, in evaluating potential credit risk with margined counterparties, adjust quantitative measures to take into account exceptionally large positions and position concentrations in instruments with little liquidity. Intermediaries should consider collecting “higher initial margin and higher haircuts” from counterparties with “outsized positions relative to market liquidity.” Large integrated financial intermediaries must employ vigorous and consist pricing policies and procedures that include price verification for both proprietary and counterparty risk trades. When possible, transparent and liquid instruments should be used rather than bespoke products. To this end, the Policy Group suggests imposing charges against the P&L of hard to value and illiquid transactions or higher capital charges. The Policy Group also recommends that each firm review the implications incentives and consequent remedial actions have on systemic risk. Senior management should also review the systemic risk implications of new trade structures, strategies or other opportunities.

The Report calls for large integrated financial intermediaries to conduct liquidity stress tests to measure maximum liquidity outflow on a regular basis and for firms to monitor their maximum liquidity outflow within the first 30 days and for additional intervals within the first 30 days. The stress tests should take into account firm-specific and systemic issues, extreme shocks and progressive events, implicit and explicit risks, the loss of key sources of funding, the potential outflows related to customer activity, the impact of on- and off-balance sheet exposures, the impact of intra-day liquidity exposures, large cash payments, the impact on individual legal entities as well as the consolidated firm and the availability of central bank facilities. Long term structural liquidity should exceed illiquid assets.

The Policy Group also recommends that, in their funding activities, large institutional integrated financial intermediaries use appropriate pricing-based incentives. To manage, monitor and control funding liquidity risk, treasury officials should be included in the risk management process. The firm should explicitly coordinate across their liquidity and capital planning processes. The Policy Group also re-affirmed that Basel II should remain the primary capital standard that institutions, their primary supervisors and the marketplace consider in evaluating capital adequacy.

Enhanced Credit Market Resiliency

The Policy Group recommends: (1) trade date (T + 0) matching for electronically eligible transactions, (2) linkage of confirmations and settlements, (3) a tiered approach to market participation and incentive structure and (4) incentives to buy-side participants. Market participants should streamline their trade execution and

confirmation/affirmation methods in order to facilitate matching and legal confirmation on the same day. Sell-side and buy-side participants should adopt electronic platform usage and work to standardize the marketplace. The Policy Group also recommends frequent portfolio reconciliations and mark-to-market comparison, and the development of quick resolutions of mark-to-market disputes and valuation disputes.

Best Practices

The Policy Group also recommends that dealers, investors and clearing banks should agree on “Best Practices” to govern the tri-party repo market and engage in single name and index CDS trade compression. Under the auspices of the current ISDA Portfolio Compression Working Group, the industry should strive for consistency. ISDA should (1) revise the credit derivative definitions to include the auction mechanism so that going forward counterparties to credit default swap trades use the auction mechanism and (2) provide market participants with a means of amending existing credit default swap trades to use the auction mechanism. All large financial intermediaries should promptly adopt the Close-out Amount approach for early termination upon default in their counterparty relationships and conduct hypothetical simulations of close-out situations and review existing documentation regarding counterparty terminations. The Policy Group recommends that senior management from major market participants should consider forming a “default management group” 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. The Policy Group also suggests that the industry develop a counterparty clearing arrangement for the credit derivatives market as soon as possible.

Conclusion

The extensive report provides detailed suggestions and recommendations for financial intermediaries and their advisers to consider. We have summarized above the precepts and the principal recommendations; however, we urge financial intermediaries to review the detailed report as they evaluate their own internal processes and procedures. Following in the aftermath of the Long-Term Capital Management failure, the Policy Group’s prior reports proved very useful to the financial community and helped regulators formulate new product approval processes and respond to derivatives challenges. We are certain that the recommendations contained in this report will also prove useful to regulators as they contemplate and formulate new guidelines for financial institutions.

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