

Progress Update on March Policy Statement on Financial Market Developments

The President's Working Group on Financial Markets



**Department of
the Treasury**



**Board of Governors
of the
Federal Reserve
System**



**Securities and
Exchange
Commission**



**Commodity Futures
Trading
Commission**

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In March 2008, the President's Working Group on Financial Markets (PWG) issued its "Policy Statement on Financial Market Developments," which contained an analysis of underlying factors that were contributing to the continuing market turmoil. The PWG concluded that the primary trigger of events was the escalation in delinquencies associated with U.S. subprime mortgages. The recognition of noticeably weak underwriting in U.S. subprime mortgages uncovered and exacerbated other weaknesses in the global financial system. Because financial markets are interconnected, both across asset classes and borders, the impact has been widespread and the deleveraging process in financial markets has been pronounced. In this interim period, PWG member agencies have designed and implemented a number of global financial market solutions to the problems associated with this unprecedented period of market turmoil and have remained diligent in advancing the March 2008 recommendations. This follow-up status statement provides an update of intervening actions and identifies further areas that the PWG will explore in their ongoing work to restore confidence and stability in global financial markets.

The PWG's analysis identified weaknesses in global markets, institutions, and regulatory policies that triggered, amplified, or failed to mitigate financial market stresses. The PWG issued a comprehensive set of recommendations to address those weaknesses, with the broader objectives of mitigating systemic risk, helping to restore investor confidence, and facilitating economic growth. Specifically, the goal of the recommendations was to strengthen market discipline, enhance risk management, and improve the efficiency and stability of capital markets by improving market transparency, disclosure, risk awareness, risk management, capital and regulatory policies, practices regarding and use of credit ratings, and market infrastructure for over-the-counter derivatives products.

The PWG found that the principal underlying causes of the turmoil in financial markets were:

- a breakdown in underwriting standards for subprime mortgages;
- a significant erosion of market discipline by those involved in the securitization process, including originators, underwriters, credit rating agencies, and global investors, related in part to failures to provide or obtain adequate risk disclosures;
- flaws in credit rating agencies' assessments of subprime residential mortgage-backed securities (RMBS) and other complex structured credit products, especially collateralized debt obligations (CDOs) that held RMBS and other asset-backed securities (CDOs of ABS);
- risk management weaknesses at some large U.S. and European financial institutions; and
- regulatory policies, including capital and disclosure¹ requirements, that failed to mitigate risk management weaknesses.

¹ In this document, disclosure requirements refer to the requirements of prudential regulators of financial institutions rather than to the Securities and Exchange Commission's (SEC) disclosure regulations and requirements applicable to U.S. public companies.

While no single measure can be expected to place financial markets on a sound footing, implementation of the PWG's comprehensive and complementary set of recommendations is an important step in addressing these identified weaknesses. The PWG's recommendations include measures for implementation by government authorities and market participants to:

- reform key parts of the mortgage origination process in the United States;
- enhance disclosure and improve the practices of sponsors, underwriters, and investors with respect to securitized credits, thereby imposing more effective market discipline;
- reform the credit rating agencies' processes for and practices regarding rating structured credit products to ensure integrity and transparency;
- ensure that global financial institutions take appropriate steps to address the weaknesses in risk management and reporting practices that the market turmoil has exposed; and
- ensure that prudential regulatory policies applicable to banks and securities firms, including capital and disclosure requirements, provide strong incentives for effective risk management practices.

Progress towards implementing the recommendations is discussed in six sections:

- A. Reforms to the mortgage origination process
- B. Improvements to investors' contributions to market discipline
- C. Reforms to rating agencies' processes and practices for securitized and structured products
- D. Strengthening of global financial institutions' risk management practices
- E. Enhancements to prudential regulatory policies
- F. Enhancements to the infrastructure for OTC derivatives markets

As this update demonstrates, market participants and supervisory authorities have taken substantial steps toward implementing the PWG's recommendations. Federal authorities have cooperated effectively with each other and with relevant state authorities. The PWG continues to work internationally with foreign regulators, finance ministries, and central banks through the Financial Stability Forum (FSF), which in April 2008 issued a report on the global financial turmoil to the G-7 Finance Ministers and Governors that made broadly consistent recommendations to address weaknesses and issues. More progress has been made in some areas than in others as efforts have been prioritized to address the most immediate problems. The pace of implementation must be balanced with a need to avoid exacerbating strains on markets and institutions. The effectiveness of some recommendations also must be judged over a longer period of time than has elapsed since the release of the PWG's policy statement.

When it issued its policy statement in March, the PWG recognized that market turmoil was still continuing and that subsequent events might demonstrate the need for additional recommendations. The PWG has and will continue to recommend and encourage actions to improve financial market stability, but does not believe that there is a need for additional specific recommendations at this time. However, recent market events have highlighted the importance and increased relevance of the March recommendations and the need for a consideration of

changes to the financial regulatory structure to restore confidence in financial markets and institutions. Additionally, the PWG is continuing to carefully monitor markets, and it will not hesitate to make recommendations in these and other areas if necessary.

Recent market events

Since the PWG issued its policy statement in March, financial markets have continued to experience considerable stress. Although this update was intended to be a status report on implementation of the PWG recommendations contained in the March policy statement, recent events and the government's response to them merit inclusion.

Fannie Mae and Freddie Mac

The Presidents Working Group's March policy statement acknowledged that turmoil in financial markets clearly was triggered by a dramatic weakening of underwriting standards for U.S. subprime mortgages, beginning in late 2004 and extending into 2007. The first area of PWG recommendations concerned reforms to key areas of the mortgage origination process. A number of major steps were taken at the state and federal levels and by the private sector to address the PWG recommendations.

Despite the significant progress made in the last year to reform this process, the portfolios of two major mortgage industry entities, Fannie Mae and Freddie Mac, underperformed expectations partially due to their holdings of mortgage assets created during the period of weak underwriting.

Over the summer of 2008, investors began to express growing concern regarding the stability of Fannie Mae and Freddie Mac and the long-standing uncertainty and ambiguity with respect to their charters and the scope and strength of government backing. In response, the Treasury Secretary asked Congress for extraordinary authorities with regard to Fannie Mae and Freddie Mac in order to support the U.S. housing market and to foster the stability of financial markets more broadly. Congress acted promptly and decisively and provided the needed legislation. Using these new authorities, the Director of the Federal Housing Finance Agency (FHFA), Federal Reserve Chairman, and Treasury Secretary concluded that further action was necessary.

The action plan for Fannie Mae and Freddie Mac had four main components:

- *Conservatorship.* After the FHFA Director found that the entities were insufficiently capitalized to operate safely and soundly, Fannie Mae and Freddie Mac were placed into conservatorship to ensure that they are managed in a manner that fulfills their mission to support the mortgage finance market while mitigating systemic risk. New CEOs supported by new non-executive Chairmen have taken over management of the enterprises, with the goals of stabilizing the entities, increasing the availability of mortgage finance and mortgage affordability, and mitigating the effects of the housing correction on economic growth and financial markets. To promote stability in the

secondary mortgage market and lower the cost of mortgage funding, Fannie Mae and Freddie Mac will increase modestly their MBS portfolios, and then gradually reduce them until they stabilize at a smaller, less risky size.

- *Preferred Stock Purchase Agreement.* In addition, the Department of the Treasury will use the authorities recently granted by Congress to ensure that each GSE maintains a positive net worth and eliminate any mandatory triggering of receivership. Treasury will do this by making senior preferred equity investments to ensure that the entities are solvent, committing up to \$100 billion per institution. To protect taxpayers, Treasury in return has received from the companies \$1 billion in senior preferred stock and warrants that provide an option to purchase up to 79 percent of the companies' outstanding shares at a nominal price. This will support market stability, provide additional confidence to investors, and protect taxpayers.
- *GSE Secured Lending Credit Facility.* Treasury also has established a secured lending backstop available to Fannie Mae, Freddie Mac, and Federal Home Loan Banks to fund, if necessary, their regular business activities in the capital markets. This facility is intended to serve temporarily as a liquidity backstop to maintain credit availability.
- *Mortgage-Backed Securities (MBS) Purchase Program.* Treasury also has established a program that allows it to invest in GSE or "agency" MBS through purchases in the secondary market. These purchases provide MBS investor confidence, additional capital for the mortgage market, and mortgage finance availability and affordability.

Resolution of Stressed Financial Institutions

The PWG also had recommended reforms for credit rating agencies regarding subprime residential mortgage-backed securities and other structured credit products, notably asset-backed security collateralized debt obligations, which had become a significant source of exposure and uncertainty for financial institutions globally. Comprehensive reforms were underway, and the need for a more transparent ratings process was all too clear.

Uncertainty regarding exposures and funding pressures in the financial markets continued, particularly with respect to Lehman Brothers, Merrill Lynch, and AIG. In mid-September, following its inability to find an investor or buyer, Lehman Brothers filed for Chapter 11 (reorganization) bankruptcy protection. At the same time, Merrill Lynch was bought by Bank of America.

The bankruptcy filing of Lehman Brothers heightened concern about systemic risk. AIG, one of the largest insurance companies in the world, which held a large portfolio of over-the-counter derivatives, soon faced credit rating downgrades and severe funding constraints. Recognizing the potential systemic risk, the Federal Reserve provided AIG with an \$85 billion secured liquidity facility; the U.S. government will receive a 79.9 percent equity interest in the company.

The difficulties of Lehman Brothers and AIG had a further chilling effect on financial institutions' extension of credit to one another. In particular, the \$4.6 trillion money market mutual fund industry, which had been a major provider of funding in credit markets, experienced sharp investor redemptions after several declines in net asset values and the reporting of fund liquidations. Market participants became increasingly concerned about money funds' exposure to troubled institutions. This led to a curtailment of funds' holdings of financial instruments in order to boost cash needed to meet investor redemption requests. This unwillingness or inability to lend led to further increases in the cost of credit for both financial and non-financial companies, increasing the difficulties faced by corporations rolling over maturing debt and funding their operations.

In late September, investor concerns about credit quality issues and the dislocations in various credit markets, including the interbank lending market, resulted in the sale of Washington Mutual. Later, Wachovia, facing similar market pressures, entered into negotiations with Citigroup and Wells Fargo, intending to either merge or sell substantial business lines.

Liquidity Actions

The Federal Reserve responded to the market turmoil by providing significant liquidity injections through open market operations, expansion of existing lending facilities, and the introduction of several new liquidity facilities. Throughout, the Federal Reserve and other central banks have consulted and cooperated in the provision of liquidity to financial markets. In support of these efforts, the Federal Reserve established reciprocal current swap arrangements (swap lines) with a number of central banks to increase their capacity to provide dollar funding to institutions in their jurisdictions. The quantity of liquidity provided through these facilities has been greatly expanded over recent weeks.

The rapid expansion of the Federal Reserve's balance sheet has complicated its task in keeping the effective federal funds rate close to the target set by the Federal Open Market Committee. Congress recently granted the Federal Reserve the authority to pay interest on reserve balances, and the Federal Reserve began to pay interest on reserves beginning October 9. This authority should be helpful in allowing the Federal Reserve to keep the federal funds rate closer to the target while at the same time meeting elevated and volatile demands for liquidity through its various facilities.

In response to the turmoil in financial markets, the Federal Reserve has taken a series of actions to address specific pressures in funding markets and to provide liquidity to markets more generally. These actions are detailed chronologically in a special section of the Board of Governors' web site: <http://www.federalreserve.gov/newsevents/recentactions.htm>.

Additional Measures

Despite these actions, it became clear that in order to create long-term market stability, the turmoil needed to be addressed through additional measures. The Administration announced its intention to work with Congress to develop a troubled asset relief program, which would

purchase illiquid assets from financial institutions in order to help unlock frozen credit markets and help restore market confidence.

In addition, it was announced that Fannie Mae and Freddie Mac would increase their purchases of mortgage-backed securities in order to provide critical additional funding to mortgage markets, and the Treasury Department would expand its MBS purchase program announced previously.

To help ease liquidity constraints, the Treasury Department acted to restore confidence in money market mutual funds through a \$50 billion guaranty program. This guaranty offers previously-unavailable government insurance in order to address the recent market stresses and concerns about whether money market mutual fund investments are safe and accessible. The Federal Reserve also is taking steps to provide additional liquidity to such funds, which also will help to ease pressure on financial markets.

The Emergency Economic Stabilization Act (EESA) empowered Treasury to use up to \$700 billion to inject capital into financial institutions, to purchase or insure mortgage assets, and to purchase any other troubled assets that the Treasury and the Federal Reserve deem necessary to promote financial market stability. Treasury will use all of its tools to maximize effectiveness, including strengthening the capitalization of financial institutions of every size, and is designing programs, such as the Troubled Asset Relief Program (TARP) that will purchase troubled assets from financial institutions.

Progress towards implementing the Recommendations

A. Reforms to the Mortgage Origination Process

The PWG made several recommendations for reforming key parts of the mortgage origination process, including:

- All states should implement strong nationwide licensing standards for mortgage brokers;
- Federal and state regulators should strengthen and make consistent government oversight of entities that originate and fund mortgages and otherwise interface with customers in the mortgage origination process. All states should work towards adopting the principles set forth in the guidance developed by the federal regulators for nontraditional and subprime mortgage lending and ensure that effective enforcement mechanisms are in place to deal with noncompliance with such standards; and
- The Federal Reserve should issue stronger consumer protection rules and mandate enhanced consumer protection disclosures, including disclosures that would make affordability over the life of the mortgage more transparent and that would facilitate comparison of the terms with those of alternative products. State and federal authorities should coordinate to enforce the rules evenly across all types of mortgage originators.

Many initiatives have been undertaken, including the following:

- A nationwide mortgage licensing system has been established by the state mortgage regulators through the Conference of State Bank Supervisors (CSBS) to ensure strong licensing standards and enhance supervision for all state-licensed mortgage companies and loan originators. To date, fifteen (15) states are participating in the licensing system and twenty-four (24) states are scheduled to be participating by January 2009. Forty-six (46) states plus the District of Columbia and Puerto Rico have indicated their intent to participate in the licensing system. Additionally, Title V of the Housing and Economic Recovery Act (the Secure and Fair Enforcement for Mortgage Licensing Act) mandates the licensing and registration by the states and the federal banking regulators of all loan originators taking residential loan applications and offering or negotiating terms of residential mortgage loans in the U.S. To implement these federal requirements, the states have drafted model legislation that meets the minimum licensing standards. The model law also contains provisions to improve regulation for safety and soundness and consumer protection. (Policy Statement Recommendation A1)
- Federal supervisory agencies issued guidance on the underwriting of subprime mortgages, and guidance containing model consumer disclosures explaining costs, terms, and risks of these mortgages. State authorities have issued comparable guidance and immediately implemented new examination procedures and training of state examiners to enforce the guidance. (A2)

- Federal and state authorities are reviewing the underwriting standards and management oversight for ensuring compliance with consumer protection laws and regulation at selected non-depository lenders with significant subprime mortgage operations. (A2, A4)
- Additionally, the states adopted the Nationwide Cooperative Protocol for Mortgage Supervision, an agreement coordinating the oversight of mortgage companies operating in multiple jurisdictions, and addressing consumer protection, institution risk and fraudulent practices while minimizing regulatory burden and expense. Through this initiative the states have enhanced re-tooled traditional mortgage examination procedures with technology designed for loan-level review to identify and focus examiner resources on patterns and practices posing the greatest risk. (A2, A4, A5)
- Understanding the need for strong supervisory resources and skills, through CSBS the states have recently instituted a program of mortgage supervision accreditation modeled after the CSBS accreditation for banking departments. (A2, A4)
- The Federal Reserve Board (FRB) revised its rules under the Home Ownership and Equity Protection Act (HOEPA) with respect to certain high-cost loans (HOEPA loans). Under these rules, lenders will be required to verify the income and assets relied upon in making the loan using reliable third-party documentation. This addresses the problem of stated-income loans where the borrower's income on the application is intentionally inflated. (A3)
- The FRB has approved new rules under HOEPA for most higher-priced loans that address abuses related to prepayment penalties, failure to escrow for taxes and insurance, and failure to give adequate consideration to borrowers' ability to repay. (A3)
- The FRB also prohibited the coercion of property appraisers, a form of fraud, in connection with most home-secured loans. (A3)
- The FRB has implemented changes to Truth in Lending Act (TILA) rules to address concerns about incomplete or misleading mortgage loan advertisements and solicitations and to require lenders to provide mortgage disclosures more quickly. (A3)
- The FRB is reviewing TILA rules and is testing potential types of disclosures with consumer focus groups. (A3)
- A number of joint collaborative law enforcement and prosecutorial efforts, including "Operation Malicious Mortgage" and the President's Corporate Fraud Task Force, are pursuing mortgage-related securities fraud and mortgage fraud schemes, including lending fraud, foreclosure rescue scams, and mortgage-related bankruptcy schemes. Several state and regional mortgage fraud task forces also were formed and are pursuing such fraud. (A5)

B. Improvements to Investors' Contributions to Market Discipline

The PWG made several recommendations for improving investors' contributions to market discipline, including:

- Overseers of institutional investors (for example, the Department of Labor for private pension funds; state treasurers for public pension funds; and the Securities and Exchange Commission (SEC) for money market funds) should require investors (and their asset managers) to obtain from sponsors and underwriters of securitized credits access to better information about the risk characteristics of such credits, including information about the underlying asset pools, on an initial and ongoing basis;
- Overseers should ensure that these investors (and their asset managers) develop an independent view of the risk characteristics of the instruments in their portfolios, rather than rely solely on credit ratings; and
- The PWG will engage the private sector to create a committee to develop best practices regarding disclosure to investors in securitized credits, including ABS and CDOs of ABS.

Many initiatives have been undertaken, including the following:

Risk disclosures by market participants

- The Senior Supervisors Group (SSG), in which the FRB, Federal Reserve Bank of New York (FRBNY), Office of the Comptroller of the Currency (OCC), and SEC participate, released a report on "Leading-Practice Disclosures for Selected Exposures" in April 2008. The FRB, SEC, and OCC subsequently sent letters to firms encouraging them to review and, as appropriate, enhance disclosures in line with the SSG report. The report highlighted some practices for making informative and effective disclosure for instruments such as collateralized debt obligations (CDOs), residential mortgage-backed securities (RMBS), commercial mortgage-backed securities (CMBS), other special purpose entities (SPEs), and leveraged finance. Some of the disclosure items highlighted included size, exposure, credit issues, and collateral. (B1, B4)
- The SEC staff in March 2008 sent to certain public companies and made public a letter identifying a number of disclosure issues related to the Financial Accounting Standards Board's (FASB) Statement of Financial Accounting Standards No. 157 (FAS 157) on "Fair Value Measurements," liquidity, and asset-backed securities valuation for the public companies to consider in preparing their "Management's Discussion and Analysis" section of their quarterly reports. (B9, E8)
- In September 2008, the SEC staff sent to certain public companies and made public another letter identifying a number of disclosure issues related to providing clearer and more transparent disclosure regarding FAS 157 fair value measurements. (B9, E8)

- The SEC staff in December 2007 made public and sent a letter to certain public companies involved with non-consolidated conduits, structured investment vehicles (SIVs), and CDOs that identified disclosure issues for the public companies to consider in preparing their “Management’s Discussion and Analysis” section of their quarterly reports. The staff letter identified a number of items associated with off-balance-sheet entities for public companies to consider, including asset categories and lives, funding, write-downs, downgrades, liquidity facilities, support, and potential impact of consolidation. (B4, B9, E7)
- In June 2008, the SEC proposed several amendments to the conflict of interest rules that apply to nationally recognized statistical rating organizations (NRSROs), including disclosure requirements for assets underlying structured finance products. These disclosures would enable market participants to conduct independent assessments of structured finance products, and enable other credit rating agencies to determine unsolicited credit ratings. This could help address rating shopping by exposing an NRSRO whose ratings methodologies were less conservative in order to gain business. It also could mitigate the impact of rating shopping, since NRSROs not hired to rate a deal could nonetheless issue a credit rating. (B3)
- The staff of the SEC formed a subprime working group in spring 2007 to coordinate investigations and is working closely with banking regulators. The SEC staff has initiated over four dozen subprime-related investigations. Areas under investigation include: whether mortgage lenders properly accounted for the loans in their portfolios and whether they established appropriate loan loss reserves; the roles of the various parties involved in the securitization process in connection with the sale of mortgage-backed securities (MBS) and collateralized debt obligations (CDOs), including whether lenders adequately disclosed the risk profiles of underlying loans, whether they valued their portfolios appropriately, and whether they made adequate risk disclosures to investors; and whether investment banks and broker-dealers defrauded retail customers by making false representations or putting investors into unsuitable mortgage-backed investments. (A4, A5, B1, B4)
- The August 2008 report of the Counterparty Risk Management Policy Group III (CRMPG III), titled “Containing Systemic Risk: The Road to Reform,” recommended:
 - specific documentation and disclosure practices for high-risk complex financial instruments (including asset-backed high-risk complex financial instruments) as industry best practices. These documents include discussion of economic assumptions giving rise to expected returns, as well as rigorous scenario analysis and stress tests. The report also recommends a “financial health” warning, prominently indicating that the presence of the identified characteristics and risks give rise to the potential for significant loss over the life of the instrument. (B4)
 - enhanced due diligence processes, particularly with regard to high-risk complex asset-backed securitizations, including: enhanced efforts by underwriters and placement agents to adhere to existing diligence standards; required statistically valid sampling techniques to assess the quality of assets in a securitization; and disclosure to investors of due diligence results. (B4)

- A group led by the American Securitization Forum (ASF) has developed a template for information that should be disclosed to investors in residential mortgage-backed securities offerings. The industry already has a template for the disclosure of critical information to asset backed commercial paper investors that is being rapidly adopted by industry participants. Further recommendations from this broad group of industry participants are expected later this year. (B7, B8)

Independent assessment of risk by investors

- As discussed below, the SEC has proposed amending five rules under the Investment Company Act of 1940 and the Investment Advisers Act of 1940 that rely on the ratings of nationally recognized statistical rating organizations (NRSROs). The proposed amendments are designed to address concerns that the reference to NRSRO ratings in Commission rules might have contributed to an undue reliance on credit ratings by market participants. (B2, B5, B6)
- As noted below, other supervisors have reviewed the use of credit ratings in legislation, regulations, and supervisory guidance and are implementing changes to ensure that investors develop an independent view of the risk characteristics of the instruments in their portfolios, rather than relying solely on credit ratings. (B2, B5, B6)
- The SEC staff examined a number of money market funds to determine, among other things, the extent to which money market funds were able to obtain sufficient information from sponsors and underwriters of securitized pools, including structured investment vehicles (SIVs), to evaluate the risks attendant to investment in the pools. The money market fund advisers examined felt they had adequate access to information about the risk characteristics of the assets underlying SIVs. (B1, B2, B4)
- The CRMPG III's report also recommended establishing standards of sophistication for all market participants in high-risk complex financial instruments, guided by the principle that participants should be capable of assessing and managing the risk of their positions in a manner consistent with their needs and objectives. (B4)
- As part of its ongoing responsibility to assist employee benefit plan fiduciaries in complying with the prudence requirements of the Employee Retirement Income Security Act (ERISA), the Department of Labor (DOL) in 1996 issued guidance addressing the fiduciary considerations attendant to investment decisions involving derivatives and complex financial instruments. The guidance explained that, in considering such investments, fiduciaries should secure from sellers sufficient information to allow an independent analysis of the credit risk and market risk being undertaken by the plan, and that fiduciaries should determine whether they possess the requisite expertise, knowledge, and information to understand and analyze the nature of the risks and conduct stress simulations that would take into account abnormal markets. When utilizing outside investment managers, the fiduciary should consider whether such managers have the personnel and expertise to invest in and monitor investment activities in the complex financial instruments. DOL also made clear

that employee benefit plan fiduciaries making such investments are expected to have the documentation necessary to support their investment decision. (B1, B2)

- The DOL will consider the feasibility of developing additional guidance on a variety of issues affecting plan investments in structured financial products, derivatives, and mortgage-backed certificates. Such guidance should update the 1996 guidance and offer more specific guidance regarding the requirements for fiduciary investment in these financial products. (B1, B2)
- The DOL currently has various enforcement initiatives underway that focus on the fiduciary duties attendant to selection, monitoring, valuation, and reporting of alternative investments, such as investments in limited partnerships, hedge funds, private equity funds, and structured financial products. (B1)
- The New York State Insurance Department (NYSID) is establishing evaluation criteria to use in its audit and examination program to assess insurance companies' risk management practices, including an assessment of the information that insurers receive as investors, the due diligence they afford their investments, and the degree of their reliance on credit ratings. In addition to regulating insurance companies, NYSID has oversight of the New York State Public Retirement Systems, and is developing new pension regulations, including minimum investment standards for the Systems. (B1, B2, B5, B6)
- The National Association of Insurance Commissioners (NAIC) is enhancing the information that all state regulators receive on insurance companies' investments, including structured products, through insurers' financial statement filings. This enhanced information requirement requires insurance companies to obtain information from sponsors and underwriters. NAIC also is working to identify and model risks that are not reflected in credit ratings, and is providing an alternative to credit rating agencies in determining credit quality. (B1, B2, B5, B6)

Accounting and disclosure standards for off-balance sheet entities

- The SEC staff asked the Financial Accounting Standards Board (FASB) to complete revisions of accounting standards related to consolidation and securitization. FASB issued draft standards in September 2008 for public comment by November 14, 2008, and has scheduled a roundtable for the fourth quarter. The International Accounting Standards Board (IASB) is conducting a series of roundtables the first of which took place in September 2008, and plans to issue a draft consolidation standard in the fourth quarter of 2008, and issue a final standard in the second half of 2009. FASB and IASB are coordinating their respective efforts and in September 2008 published an update to their Memorandum of Understanding (MOU) with a plan for completion of joint projects. (E11)
- The SEC held a public roundtable in August 2008 on the performance of International Financial Reporting Standards (IFRS) and U.S. Generally Accepted Accounting Principles (GAAP) during the period of market turmoil. The panels included investors, issuers, auditors, and other parties, and discussed how the two sets of standards dealt with the key

accounting issues, including off-balance sheet entities and fair value, during the market pressures. As noted above, FASB and IASB published an update to their MOU that included progress towards convergence, and IASB expedited its discussions with standard setters and set 2011 as a target date to complete joint projects towards convergence. (E8)

- NYSID plans to evaluate the impact of non-regulated affiliates of insurance companies and to improve the transparency of some investment-related activities of regulated companies, such as securities lending. Enhanced disclosure of risks by financial guaranty insurance companies (FGIs) will be required under proposed new rules. (B9)

Valuation

- On September 30, SEC and FASB staff provided joint clarification on the most urgent fair value measurement issues in the current environment. On October 3, FASB proposed additional interpretative guidance on fair value measurement for financial assets in markets that are not active. (E8)
- The SEC held a public roundtable on fair value accounting standards in July 2008. The panels focused on fair value accounting issues from both the perspectives of larger financial institutions and the needs of their investors, and all public companies, including small public companies, and the needs of their investors. Panelists discussed topics related to the benefits and potential challenges associated with existing fair value accounting and auditing standards. (E8)
- IASB issued a draft report in September 2008 on fair value measurement and disclosure for financial instruments in markets that are no longer active. Public comments were due by October 3, 2008, and IASB expects to publish an exposure draft in mid-2009. Broader questions related to fair value measurement are being dealt with in a separate IASB project on measurement, complexity, and comparability issues. IASB published for public comment a discussion paper in March 2008, with comments due by September 19, 2008. IASB will decide later in 2008 whether to add the project to its agenda. (E8)
- Effective July 2008, an insurance company that owns a downgraded municipal bond, but believes that the credit of the municipality is higher than that of the financial guarantor, can opt to have the NAIC Securities Valuation Office (SVO) conduct a credit assessment of the municipality and apply the credit quality designation determined by the SVO to the security. The NAIC has pledged to continue to use the resources of the SVO to assist regulators in dealing with disruptions in the capital markets. (E9)
- The CRMPG III report also recommended that large integrated financial intermediaries should provide clients with timely and relevant information about a transaction beyond the disclosures in the initial sale documents. In particular, when a counterparty requests a valuation of a high-risk complex financial instrument, the report recommends specific parameters for the provision of that valuation and provision of the basis upon which the valuation was made. Further, the report recommends that following trade execution, the

intermediary should make reasonable efforts to keep the counterparty informed of material developments regarding the performance of key positions. (B4)

C. Reforms to the Rating Agencies' Process for and Practices regarding Structured Credit and Other Securitized Credit Products

The PWG made many recommendations for reforming the ratings processes for and practices regarding structured credit and other securitized credit products, including:

- Credit rating agencies (CRAs) should disclose what qualitative reviews they perform on originators of assets that collateralize ABS rated by the CRA and should require underwriters of ABS to represent the level and scope of due diligence performed on the underlying assets;
- The CRAs should reform their ratings processes for structured credit products to ensure integrity and transparency. The PWG welcomes the steps already taken by the CRAs, and particularly encourages the CRAs to:
 - enforce policies and procedures that manage conflicts of interest, including implementing changes suggested by the SEC's broad review of conflict of interest issues;
 - publish sufficient information about the assumptions underlying their credit rating methodologies, so that users of credit ratings can understand how a particular credit rating was determined;
 - make changes to the credit rating process that would clearly differentiate ratings for structured products from ratings for corporate and municipal securities;
 - make ratings performance measures for structured credit products and other ABS readily available to the public in a manner that facilitates comparisons across products and credit ratings;
 - work with investors to provide the information investors need to make informed decisions about risk, including measures of the uncertainty associated with ratings and of potential ratings volatility; and
 - ensure that adequate personnel and financial resources are allocated to monitoring and updating ratings.
- The PWG will facilitate formation of a private-sector group (with representatives of investors, issuers, underwriters, and CRAs) to develop recommendations for further steps that the issuers, underwriters, CRAs, and policymakers could take to ensure the integrity and transparency of ratings, and to foster appropriate use of ratings in risk assessment;
- PWG member agencies will reinforce steps taken by the CRAs through revisions to supervisory policy and regulation, including regulatory capital requirements that use ratings; and
- The PWG will revisit the need for changes to CRA oversight if the reforms adopted by the CRAs are not sufficient to ensure the integrity and transparency of ratings.

Much progress has been made, including the following:

- In July 2008, the SEC released findings from staff examinations of three major credit rating agencies that found significant weaknesses in ratings practices and the need for remedial action by the firms to provide meaningful ratings and the necessary levels of disclosure to investors.
 - The examinations found that rating agencies struggled significantly with the increase in the number and complexity of subprime RMBS and CDO deals since 2002.
 - The examinations uncovered that none of the rating agencies examined had specific written comprehensive procedures for rating RMBS and CDOs.
 - Significant aspects of the rating process were not always disclosed or even documented by the firms, and conflicts of interest were not always managed appropriately.
 - The report summarized generally the remedial actions that credit rating agencies are expected to take as a result of the examinations.

- In June and July of 2008, the SEC proposed a three-part set of comprehensive reforms to regulate the conflicts of interests, disclosures, internal policies, and business practices of credit rating agencies. The SEC is reviewing the public comments received.
 - The first set of proposed rules addressed conflicts of interest in the credit ratings industry and would require new disclosures designed to increase the transparency and accountability of credit ratings agencies. (C2, C3)
 - The second set of proposed rules would require credit rating agencies to differentiate the ratings they issue on structured products from those they issue on bonds through the use of different symbols or by issuing a report disclosing the differences. (C2)
 - The third part of the SEC's proposed rules would clarify for investors the limits and purposes of credit ratings and ensure that the role assigned to ratings in SEC rules is consistent with the objectives of having investors make an independent judgment of credit risks. (B2, B5, B6, E10)
 - These proposed rules would:
 - address conflicts of interest by prohibiting credit rating agencies from rating products they structure; (C2)
 - require the public disclosure of the information a credit rating agency uses to determine a rating on a structured product, including information on the underlying assets; (C2)
 - require public disclosure of ratings histories and ratings performance measures; (C2)
 - specify disclosure of the way that rating agencies rely on third-party due diligence, how frequently credit ratings are reviewed, whether different models are used for surveillance than for initial ratings, and whether changes made to models are applied retroactively to existing ratings; (C1, C2)
 - require the differentiation of ratings for structured products from ratings for corporate and municipal securities through the use of different symbols or by issuing a report disclosing the differences between ratings of structured products and other securities; (C2) and
 - remove references to NRSROs from SEC rules and forms. (E10)

- In May 2008, the International Organization of Securities Commissions (IOSCO) published its final report containing amendments to its “Code of Conduct Fundamentals for Credit Rating Agencies.” (C4) Changes included issues related to:
 - quality and integrity of the rating process: objective review; rigorous ongoing review of methodologies and models; quality of information; knowledgeable and experienced employees; new product review function; appropriateness of methodologies and models; prohibition on design of rated structured finance products; and adequate resources for monitoring and updating;
 - independence and avoidance of conflicts of interest: review of former employees’ work; review of remuneration policies and practices; disclosure of significant contributors to revenue; public disclosure of information to allow independent analysis and discourage ratings shopping; and definition of ancillary business;
 - responsibilities to investors and issuers: education of investors on meaning and limits of ratings; disclosure of ratings performance; disclosure of the basis/sensitivity of a rating on a structured finance product; differentiation of structure finance product ratings; and disclosure of the principal rating methodology; and
 - disclosure of code of conduct: publication by credit rating agency of its: code of conduct; methodology description; and historical performance.

- A group with representatives of all stakeholders led by the Securities Industry and Financial Markets Association (SIFMA) in July 2008 issued recommendations to ensure the integrity and transparency of ratings and to foster appropriate use of ratings in risk assessment. Its recommendations included disclosure by credit rating agencies of rating methodologies, due diligence on underlying assets, surveillance procedures, performance data, and conflicts of interest; and investor understanding of the limits and use of ratings as one of many inputs into their own independent analyses. (C5)

- US supervisors reviewed whether the inclusion of requirements related to credit ratings in rules and forms had, in effect, placed an "official seal of approval" on ratings that adversely affected the quality of due diligence and investment analysis. Supervisors inventoried the use of credit ratings in legislation, regulations, and supervisory guidance and are implementing changes to ensure that investors develop an independent view of the risk characteristics of the instruments in their portfolios, rather than relying solely on credit ratings. (C6)

D. Strengthening of Global Financial Institutions’ Risk Management Practices

The PWG made many recommendations to strengthen global financial institutions’ risk management practices, including:

- Global financial institutions should promptly identify and address any weaknesses in risk management practices that the turmoil has revealed;

- The PWG will support formation of a private-sector group to reassess implementation of the Counterparty Risk Management Policy Group II’s (CRMPG II) existing guiding principles and recommendations regarding risk management, risk monitoring, and transparency, and to

modify or develop new principles and recommendations as necessary to incorporate lessons from the recent turmoil, including lessons regarding valuation practices;

- Supervisors of global financial institutions should closely monitor the firms' efforts to address risk management weaknesses, taking action if necessary to ensure that weaknesses are addressed;
- U.S. banking regulators and the SEC should promptly assess current guidance and develop common guidance to address the risk management weaknesses revealed by the recent market turmoil, including improvements to:
 - management information systems, including procedures that ensure aggregation of exposures across all business lines and ensure rigorous valuations of instruments and exposures;
 - concentration risk management, liquidity risk management, stress testing and other risk management practices that are necessary to ensure that liquidity and capital cushions are sufficiently robust to absorb extreme system-wide shocks; and
 - governance of the risk management and control framework, including the development of, and adherence to, practices that address incentive problems in compensation policies.
- U.S. authorities should encourage other supervisors of global firms to make complementary efforts to develop guidance along the same lines.

Much progress has been made, including the following efforts:

- Supervisors are establishing a template for benchmarking firms against the risk management practices included in the report issued by the Senior Supervisors Group (SSG) and the CRMPG III recommendations. U.S. supervisors will conduct a comprehensive benchmarking exercise, reviewing individual firm self-assessments as well as firm performance against the broader set of issues identified in the supervisory template. Supervisors will then make an assessment across the industry of the extent to which firms have responded to the weaknesses identified by the turmoil in credit markets. This assessment will focus on identifying issues for which industry progress has not been satisfactory. Finally, U.S. banking supervisors plan to enhance existing guidance to re-emphasize fundamental risk management principles, geared specifically to those issues revealed by the market turmoil. (D1, D4)
- Supervisors have taken action, as appropriate, to address identified deficiencies at individual firms. Supervisors continue to monitor firms' efforts to address risk management weaknesses identified by the market disruption, and have used their supervisory authority to require firms to implement promptly corrective measures to address identified weaknesses. Such corrective actions include addressing weaknesses related to model validation, price verification processes, risk governance/management, and risk systems. Firms have responded positively by strengthening governance processes and improving risk management systems. However, given the ongoing nature of the market disruption, supervisors expect continued improvement in risk management. (D1, D3, D4, D5)

- Firms have engaged in self-assessment exercises and have begun the process of benchmarking their performance against lessons learned, including those highlighted in relevant public- and private-sector guidance. Firms have taken aggressive actions to correct risk management deficiencies, strengthen corporate governance, and reduce risk. These actions include:
 - management changes to strengthen the quality of corporate risk governance;
 - external reviews of risk management processes to identify gaps and inconsistencies with industry sound practices;
 - changes in VaR methodologies to ensure comprehensive risk measurement;
 - strengthening of liquidity risk management, including more thorough contingency planning;
 - improvements to credit underwriting to ensure compliance with regulatory standards regarding capacity to repay;
 - better coordination between managers of market, counterparty credit, and operational risks to improve firm-wide considerations of risk profiles;
 - improvements to risk-related management information systems to ensure timely and accurate risk reporting;
 - adjustments to risk limit structures to provide appropriate controls around risk-taking activities;
 - implementation of counterparty close-out procedures to reduce contagion implications if a significant market participant should fail; and
 - tightening of policies and procedures for leveraged loan commitments and CDO warehouses to appropriately manage pipeline risks. (D1)

- NYSID is creating evaluation criteria to assess enterprise-wide risk management functions, including their robustness, independence, aggregation of all risks across the organization, and adherence to strong operational and financial reporting controls. The assessments will begin in the fourth quarter of 2008, and any weaknesses will be communicated to the company for immediate remediation and will be closely monitored by the NYSID. An evaluation of this function also is being incorporated into examination procedures. (D1, D3)

- The NAIC's examination guidance has incorporated a risk-focused surveillance framework to place more emphasis on risks and risk management in the financial solvency oversight of the insurance industry. The revised framework will be phased in through 2009 and will be required starting in 2010 from all states seeking NAIC accreditation. Riskier companies and riskier processes will receive a higher level of supervision. (D1, D3)

- US insurance regulators currently participate in a number of information sharing arrangements with their counterparts in other jurisdictions and are participating in supervisory colleges for financial conglomerates and insurance groups with significant international activity. The NAIC is working towards improving communication among insurance and other financial regulators within the U.S., as well as regulators abroad. The NAIC has a process that identifies the lead state primarily responsible for coordination of regulation of companies whose insurance subsidiaries operate in several states. The NYSID communicates directly with the Federal Reserve on issues with a material impact on the insurance sector,

especially when the impact potentially could reach to other sectors of the financial markets. (D5)

- The CRMPG III was formed and issued its report titled “Containing Systemic Risk: The Road to Reform” in August 2008. (D2)
 - The group identified the primary causes of the market turmoil as the abundance of global liquidity, the mispricing of credit risk due to competitive factors, increased complexity of finance, speed and breadth of contagion unlike prior periods of financial instability, and incentives that produced patterns of behavior and allocations of resources that are in conflict with the goal of financial stability.
 - The report emphasizes five “core precepts” upon which the management and supervision of large integrated financial intermediaries must rest: (1) corporate governance; (2) risk monitoring; (3) estimating risk appetite; (4) focusing on contagion; and (5) enhanced oversight.
 - CRMPG III made a number of recommendations related to standards for accounting consolidation, high-risk complex instruments, risk monitoring and risk management, enhanced credit market resiliency, and emerging issues.

E. Enhancements to Prudential Regulatory Policies

The PWG made many recommendations to enhance prudential regulatory policies, including:

- Regulators should adopt policies that provide incentives for financial institutions to hold capital and liquidity cushions (that are forward looking and adjust appropriately through peaks and valleys of the credit cycle) commensurate with firm-wide exposure (both on and off-balance sheet) to severe adverse market events.
- Regulators should enhance guidance related to pipeline risk management for firms that use an originate-to-distribute model.
- The Basel Committee on Banking Supervision (BCBS) should promptly complete the work it has initiated to update the Committee’s 2000 guidance on liquidity management, including the sound practice guidelines to be followed by regulated financial institutions as well as the oversight principles for supervisors.
- The BCBS and IOSCO should review capital requirements for ABS CDOs and other re-securitizations and for off-balance sheet commitments, with a view toward increasing requirements on exposures that have been the source of recent losses to firms.
- Regulators should require financial institutions to make more detailed and comprehensive disclosures of off-balance sheet commitments, including commitments to support ABCP conduits and other off-balance sheet vehicles.
- Regulators should encourage financial institutions to improve the quality of disclosures about fair value estimates for complex and other illiquid instruments, including descriptions of

valuation methodologies and information regarding the degree of uncertainty associated with such estimates.

- Regulators should review the current use of ratings in regulation and supervisory rules. At a minimum, regulators should distinguish, as appropriate, between ratings of structured credit products and ratings of corporate and municipal bonds in regulatory and supervisory policies; and
- Authorities should encourage FASB to evaluate the role of accounting standards in the current market turmoil. This evaluation should include an assessment of the need for further modifications to accounting standards related to consolidation and securitization, with the goal of improving transparency and the operation of U.S. standards in the short-term. Additionally, authorities should encourage FASB and IASB to achieve more rapid convergence of accounting standards for consolidation of ABCP conduits and other off-balance sheet vehicles.

Many initiatives are underway, including the following:

- In July 2008, U.S. agencies issued final Basel Pillar 2 guidance to provide incentives for financial institutions to hold capital cushions (both forward looking and adjusting appropriately through peaks and valleys of the credit cycle) commensurate with firm-wide exposure (both on- and off-balance sheet) to severe adverse market events. This guidance instructed that: (1) banks' internal capital adequacy assessment processes (ICAAPs) should assess material risks across the entire bank as well as the potential impact of broader systemic events; (2) banks' capital should remain adequate over time to account for changes in their strategic direction, evolving economic conditions, and volatility in the financial environment; and (3) banks should incorporate liquidity risk in these assessments. This guidance followed a number of reviews of institutions' internal assessments of capital adequacy since the 1999 guidance to banks to ensure that their capital is sufficient to support the full range of their underlying risk positions, both on-and off-balance sheet, and to hold a capital cushion to provide for a wide range of unexpected events. (E1)
- Recently-issued U.S. Basel Pillar 2 guidance also describes the need for banks to account for the potential impact on capital adequacy of risks other than credit, market, or operational risks. These other risks could include reputation or strategic risk, which could arise from conduit and asset management businesses. In the area of reputational risk, the guidance indicated that banks should: (1) understand and identify the linkage between capital adequacy and the damage to its reputation; and (2) in taking account of that linkage, assess risks associated with on- and off-balance sheet exposures and activities, affiliates, subsidiaries, counterparties, clients, or other third parties. The BCBS will issue supplemental Pillar 2 guidance addressing, among other risk management items, the management of off-balance sheet exposures, including risks related to securitization and reputation risk. A proposal is expected to be issued for comment in the first quarter of 2009. (E5)
- To address needed improvements in exposure aggregation, valuation, concentration and liquidity risk management, stress testing, and liquidity and capital cushions, the

supplementary guidance also will cover: (1) oversight of firm-wide risks; (2) management of risk concentrations; (3) management of off-balance sheet exposures; (4) stress testing for risk management and capital planning; and (5) management of valuation and liquidity risks. A proposal is expected to be issued for comment in the first quarter of 2009. (E1, E5, E6, E7)

- Under the supervisory review process of Pillar 2, the U.S. agencies will ensure that each bank meets the process and system requirements of the Advanced Internal Ratings Based Approach to Basel II, including the conservatism of estimates of losses from defaults during a downturn and the robustness of banks' stress tests. As described in the July 2008 Interagency Statement "U.S. Implementation of Basel II Advanced Approaches Framework: Qualification Process," supervisors are currently reviewing firms' models, underlying processes and systems, data, validation, and oversight and control mechanisms in preparation for the qualification process for the advanced approaches rule. (E6)
- Given the weak controls over balance sheet growth at some firms and the resulting liquidity pressures, the BCBS updated the Committee's 2000 guidance on liquidity management, including the sound practice guidelines to be followed by regulated financial institutions as well as the oversight principles for supervisors. The committee issued a final guidance in mid-September 2008. (E3)
- Supplemental Pillar 2 guidance to be issued by the BCBS also will address warehouse/pipeline risk for firms that use an originate-to-distribute model. The Federal Reserve has undertaken analysis of CMBS warehouse exposures across a subset of banks. Following this work, U.S. banking supervisors will continue to monitor financial institutions with large CMBS warehouse exposures and continue to review their guidance and recommend revisions as appropriate. Supervisors remain focused on firms' management of illiquid assets and the adequacy of their exposure measurement and control framework. (E2)
- The BCBS in July 2008 published a consultative document on guidelines for computing capital for incremental risk in the trading book, with comments due by October 15, 2008. The proposed guidelines cover risks related to default, credit migration, credit and equity spreads, and require banks to model these risks at a 99.9 percent soundness standard over the one-year capital horizon. The BCBS is seeking to align the capital charges for illiquid trading book positions with those held in the banking book. The guidelines are expected to be finalized by the end of 2008. (E4)
- With respect to capital requirements for ABS CDOs, other resecuritizations, and off-balance sheet commitments, particularly the relationship between external credit ratings and capital charges, the BCBS Pillar 1 group has addressed resecuritizations under the internal ratings-based (IRB) approach and capital treatment of ABCP conduit liquidity facilities under standardized and IRB approaches. The BCBS will propose: (1) raising risk weights for resecuritizations; (2) extending treatment for such exposures kept in the bank's trading account before the introduction of an incremental risk charge; and (3) raising the credit conversion factor from 20 percent to 50 percent for short-term liquidity facilities. The proposal also will include operational criteria for credit analysis of securitization exposures. (E4)

- The Senior Supervisors Group (SSG) released a report on “Leading-Practice Disclosures for Selected Exposures” in April 2008 to encourage financial institutions to improve their internal reporting and make more detailed and comprehensive disclosures of off-balance sheet commitments, including commitments to support ABCP conduits and other off-balance sheet vehicles. Joint letters from the FRB/OCC/SEC subsequently were sent to firms encouraging them to review and, as appropriate, enhance disclosures in line with the SSG report. The BCBS Pillar 3 group also will address disclosures of off-balance sheet vehicle sponsorship and ABCP conduit liquidity facilities. (E7, E8)
- With respect to encouraging financial institutions to improve the quality of disclosures about fair value estimates for complex and other illiquid instruments, including descriptions of valuation methodologies and information regarding degree of uncertainty associated with such estimates, the joint agency letters noted above included issues related to high-risk instruments, credit valuation adjustments for CDOs for specific counterparties, and sensitivity of valuation to key assumptions and inputs for CDOs, sub-prime, and Alt-A instruments. The BCBS Pillar 3 group also is addressing disclosure of securitization valuations. (E8)
- With respect to insurance companies, fair value of all investments currently is disclosed in filings, and NAIC is working to further enhance information provided. NYSID has proposed through NAIC improving disclosure of the pricing source used for valuation, and improving the transparency of insurance companies’ derivatives positions, including their purposes and hedge effectiveness. (E8)
- As noted above, supervisors reviewed the use of credit ratings in legislation, regulations, and supervisory guidance to ensure that investors develop an independent view of the risk characteristics of the instruments in their portfolios, rather than relying solely on credit ratings, and appreciate the different risk characteristics of different types of instruments. As noted, the SEC proposed a set of rule changes that would require NRSROs to differentiate ratings on structured products from those on bonds either through the use of different symbols or by issuing a report disclosing the differences between ratings of structured products and other securities. The SEC also included reforms to the use of credit ratings in its own regulatory framework. U.S. supervisors continue to conduct a stocktaking of the use of credit ratings in federal statutes, rules, regulations, and supervisory guidance. This effort also will serve as an input into a Joint Forum stocktaking project on the use of credit ratings that is scheduled to be completed by year-end 2008. However, it should be noted that a significant use of credit ratings by supervisors is contained in the Basel Capital Accord, where short-run changes are unlikely. (E10, C2, C6)
- With respect to evaluating the role of accounting standards in the current market turmoil, including modifications related to consolidation and securitization, improvements to transparency, and convergence of standards for consolidation of ABCP conduits and other off-balance sheet vehicles, the SEC has asked FASB to complete revisions of accounting standards related to consolidation and securitization. Under the latest proposal: (1) the consolidation determination for variable interest entities (VIEs) will move from a

quantitative to a primarily qualitative assessment approach and (2) the concept of qualifying special purpose entities (QSPEs) will be eliminated. FASB issued draft standards in September 2008 and will hold a roundtable in the fourth quarter. IASB plans to issue a draft consolidation standard in the fourth quarter of 2008 and a final standard in the second half of 2009. FASB and IASB are coordinating their respective efforts. (E11)

- The FRB, FRBNY, OCC, and SEC are active participants in the SSG's supervisory information exchange and will continue this work. (D5)
- Federal financial institution supervisors currently participate in several colleges that meet regularly and are working with other supervisors. In particular, the SEC, FRB, and OCC are participating in the development of supervisory colleges in an FSF working group. The federal banking supervisors also have participated in ad hoc colleges for Basel II topics. (D5)
- State insurance commissioners are reviewing the appropriateness of capital requirements and risk management practices for financial guarantors in light of changes in the firms' business lines and new activities. In particular, NYSID has proposed changes to strengthen its supervision process, including draft state legislation and revised regulations to update oversight of financial guaranty insurers. The items proposed include an increase in required capital and reserves, a tightening of risk limits, reassessment of risk management standards, additional reporting requirements, and a curtailment of the ability of insurers to guarantee certain types of structured products such as ABS CDOs and collateralized debt obligation squared (CDO²) instruments and certain credit default swaps (CDS). (E9)
- The NAIC has moved to a risk-focused examination approach for use on all insurers by all state insurance regulators to help regulators better identify key risk areas, such as risk modeling by FGIs. Enhanced focus in this area, as well as the proposed more stringent capital and reporting requirements, should ensure improved oversight of FGIs' modeling. (E9)

F. Enhancements to the Infrastructure for OTC Derivatives Markets

The PWG noted that while the infrastructure of the financial markets had coped quite well with heightened price volatility and surging trading volumes, the PWG believed that the supervisors of OTC derivatives dealers, working together under the leadership of the Federal Reserve Bank of New York, should insist on further enhancements to the infrastructure for the OTC derivatives markets.

The PWG made several recommendations to enhance the OTC derivative market infrastructure, including:

- Supervisors should insist that the industry promptly set ambitious standards for the accuracy and timeliness of trade data submission and the timeliness of resolutions of trade matching errors for OTC derivatives.

- Supervisors should urge the industry to amend standard credit derivative trade documentation to provide for cash settlement of obligations stemming from a credit event in accordance with the terms of the cash settlement protocol that has been developed but not yet incorporated into standard documentation; and
- Supervisors should ask the industry to develop a longer-term plan for an integrated operational infrastructure supporting OTC derivatives that:
 - captures all significant processing events over the entire lifecycle of trades;
 - delivers operational reliability and scalability;
 - maximizes the efficiencies obtainable from automation and electronic processing platforms by promoting standardization and interoperability of infrastructure components;
 - enhances participants' ability to manage counterparty risk through netting and collateral agreements by promoting portfolio reconciliation and
 - accurate valuation of trades;
 - addresses all major asset classes and product types; and
 - encompasses the buy side as well as the dealer community.

Much progress has been made, including the following:

- In a letter to regulators in March 2008, major dealers set standards for the accuracy and timeliness of trade data submission for CDS and the timeliness of resolving errors. In a July 2008 letter to regulators, major industry participants strengthened these standards and outlined their near-term approach for other performance enhancements across all asset classes, including: reducing confirmation backlogs, automating key processes such as novations, and continuing to standardize and automate new products. The industry also stated that later in 2008 it would provide longer-term strategic plans to improve the infrastructure, with the ultimate goals of confirming transactions on trade date and eliminating material processing backlogs. (F1)
- The International Swaps and Derivatives Association has committed to achieving greater certainty in credit event management. It will publish by year-end 2008 standardized documentation establishing an auction-based mechanism for the settlement of obligations in credit default swaps following a credit event. The documentation initially will cover defaults and failure-to-pay events, and later will be expanded to cover restructuring events and monoline insurer defaults. (F2)
- In addition to the operational improvements noted above, market participants are undertaking other steps to improve risk management in OTC derivatives processing, including, (i) developing a robust and prudently managed central clearing facility for credit derivatives; (ii) implementing best practices for collateral management, including performing weekly portfolio reconciliation; (iii) maximizing the use of multilateral trade termination services; and (iv) executing an implementation plan aimed at educating buy-side firms about efforts to improve the OTC derivatives infrastructure. (F3)

Areas for Further Effort

Notwithstanding the substantial progress that has occurred in implementing its recommendations, the PWG believes that further effort is still warranted in each of the areas in which it made recommendations.

- The Federal Reserve has approved new rules to address abuses in the mortgage origination process, and new legislation creates a licensing system for some parties in this process. But the success of these steps ultimately depends upon market participants' compliance and effective oversight by state and federal authorities.
- Initial steps, such as the American Securitization Forum (ASF) RMBS template and the CRMPG III recommendations for disclosure best practices for complex financial instruments, have been taken to improve the information available to investors in securitized credits, so that they can more effectively contribute to market discipline. The PWG believes, however, that more remains to be done towards implementation of recommendations, and that investors should make greater efforts to use information vigilantly and to develop an independent view of the risk of investments in their portfolios. The PWG also believes that the success of some of these measures will depend on whether these proposals are accepted by the industry as best practices.
 - A joint securitization project being undertaken by ASF, ESF (European Securitization Forum), and SIFMA expects to issue recommended market standards to: increase and enhance initial and ongoing reporting for RMBS transactions; standardize due diligence and quality assurance practices for RMBS and enhance related disclosures; strengthen and standardize representations and warranties and repurchase mechanisms for RMBS transactions; and expand and improve the independent, third-party valuation infrastructure for securitization and structured finance products.
 - Also, additional markets, such as the CDO market, may need further review. To that end, the ASF has indicated that if the CDO market begins to emerge again, it will undertake a project to develop best practices for CDO disclosure.
- The SEC has proposed a series of reforms to regulate the conflicts of interests, disclosures, internal policies, and business practices of credit rating agencies registered as NRSROs and is evaluating comments on the proposed reforms. The PWG will not be able to evaluate the effectiveness of the reforms in ensuring the integrity and transparency of ratings until the SEC issues final rules and those rules have time to take effect.
- Global financial institutions are identifying the gaps in their risk management practices; firms must dedicate sufficient resources to addressing the weaknesses that are identified.
- Prudential supervisors have made substantial efforts to identify weaknesses in firms' risk management practices and to enhance guidance and improve regulations where needed. The PWG believes that authorities must monitor firms' progress in implementing guidance to ensure that the benefits of various reforms are realized.
- Participants in OTC derivatives markets have made commitments to significantly reform the clearing and settlement processes. Substantial progress has been made already, and the PWG is expecting the industry to fulfill the remaining goals.

Conclusion

While much progress has been made, these efforts are works-in-progress. Implementation of recommendations must continue in order to address weaknesses in global financial markets, institutions, and regulatory policies, consistent with the broader goals of mitigating systemic risk, helping to restore investor confidence, and facilitating economic growth. The PWG will continue to monitor progress closely and make further recommendations where necessary. The PWG will continue to work internationally through the FSF to address remaining issues.

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