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SENIOR SUPERVISORS GROUP

March 6, 2008

Mr. Mario Draghi, Chairman
Financial Stability Forum
Bank for International Settlements
Centralbahnplatz 2
CH-4002 Basel
Switzerland

Dear Mr. Draghi:

On behalf of the Senior Supervisors Group, I am writing to convey a report that assesses which risk management practices worked well, and which did not, at a sample of major global financial services organizations during the recent period of market turmoil. This report, *Observations on Risk Management Practices during the Recent Market Turbulence*, summarizes the results of a review that we undertook this past autumn of firms' practices. It also reflects the results of a roundtable discussion that participating supervisory agencies held with industry representatives on February 19 at the Federal Reserve Bank of New York.

A few caveats are necessary when reviewing this report. First, while the analysis covered eleven of the largest banking and securities firms (and the roundtable included representatives of five additional firms), it did not cover the universe of all major firms active in the relevant markets. Second, the observations reflect supervisory judgments based primarily on detailed discussions with these firms, supplemented with information drawn from ongoing supervisory work. Finally and most importantly, the analysis was completed *prior to the conclusion* of the period of market turmoil.

Subject to these caveats, the report identifies a number of risk management practices that may be associated with negative or positive performance to date.

The predominant source of losses for firms in the survey through year-end 2007 was the firms' concentrated exposure to securitizations of U.S. subprime mortgage-related credit. In particular, some firms made strategic decisions to retain large exposures to super-senior tranches of collateralized debt obligations that far exceeded the firms' understanding of the risks inherent in such instruments, and failed to take appropriate steps to control or mitigate those risks. Such firms have taken major losses on these holdings, with substantial implications for their earnings performance and capital positions.

Another risk management challenge concerned firms' understanding and control over their potential balance sheet growth and liquidity needs. For example, some firms failed to price properly the risk that exposures to certain off-balance-sheet vehicles might need to be funded on the balance sheet precisely when it became difficult or expensive to raise such funds externally. Likewise, some firms found that they could not syndicate their holdings of leveraged loans because of reduced investor appetite for those assets and that they could not cancel their commitments to fund those loans. The resulting effects on the balance sheets of major firms from these sources have been substantial, although the impact on capital ratios has been significantly less than the effect from the write-downs on their exposures to securitizations of subprime mortgage-related credit.

Firms that avoided such problems demonstrated a comprehensive approach to viewing firm-wide exposures and risk, sharing quantitative and qualitative information more effectively across the firm and engaging in more effective dialogue across the management team. Senior managers in such firms also exercised critical judgment and discipline in how they valued its holdings of complex or potentially illiquid securities both before and after the onset of the

market turmoil. They had more adaptive (rather than static) risk measurement processes and systems that could rapidly alter underlying assumptions to reflect current circumstances; management also relied on a wide range of risk measures to gather more information and different perspectives on the same risk exposures and employed more effective stress testing with more use of scenario analysis.

In addition, management of better performing firms typically enforced more active controls over the consolidated organization's balance sheet, liquidity, and capital, often aligning treasury functions more closely with risk management processes, incorporating information from all businesses into global liquidity planning, including actual and contingent liquidity risk.

Using the observations of the report to set expectations, primary supervisors are critically evaluating the efforts of the individual firms they supervise to address weaknesses in risk management practices that emerged during the period of market turmoil. Each supervisor is ensuring that its firms are making appropriate changes in risk management practices, including addressing deficiencies in senior management oversight, in the use of risk measurement techniques, in stress testing, and in contingency funding planning.

Finally, our observations help to define an agenda for strengthening supervisory oversight of relevant areas. In particular, we have identified the following areas relevant to this agenda.

First, we will use the results of our review to support the efforts of the Basel Committee on Banking Supervision to strengthen the efficacy and robustness of the Basel II capital framework by:

- reviewing the framework to enhance the incentives for firms to develop more forward-looking approaches to risk measures (beyond capital measures) that fully incorporate expert judgment on exposures, limits, reserves, and capital; and
- ensuring that the framework sets sufficiently high standards for what constitutes risk transfer, increases capital charges for certain securitized assets and asset-backed commercial paper liquidity facilities, and provides sufficient scope for addressing implicit support and reputational risks.

Second, our observations support the need to strengthen the management of liquidity risk, and we will continue to work directly through the appropriate international forums (for example, the Basel Committee, International Organization of Securities Commissions, and the Joint Forum) on both planned and ongoing work in this regard.

Third, based on our shared observations from this review, individual national supervisors will review and strengthen, as appropriate, existing guidance on risk management practices, valuation practices, and the controls over both.

Fourth and finally, we will support efforts in the appropriate forums to address issues that may benefit from discussion among market participants, supervisors, and other key players (such as accountants). One such issue relates to the quality and timeliness of public disclosures made by financial services firms and the question whether improving disclosure practices would reduce uncertainty about the scale of potential losses associated with problematic exposures. Another may be to discuss the appropriate accounting and disclosure treatments of exposures to off-balance-sheet vehicles. A third may be to consider the challenges in managing incentive problems created by compensation practices.

We are simultaneously releasing the report publicly to inform the broader industry of the results of our review and to identify areas of practice where industry attention is necessary.

Sincerely,



William L. Rutledge
Chairman