

The Report of the Financial Stability Forum: Incremental but Difficult Recommendations

May 12, 2008

On April 7, 2008, the Financial Stability Forum¹ released its "Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience" (the "Report"). Because of their different approaches, it is interesting to compare the Report with the Treasury Department's "Blueprint for a Modernized Financial Regulatory Structure" (the "Blueprint"), which was released on March 31. The Blueprint focuses largely on ways in which it contends the financial regulatory system in the United States could be restructured to become more effective. It does this by evaluating different regulatory styles, choosing one (a style that organizes regulatory institutions by the types of objectives they would pursue) and then proposing regulatory structures for the United States that could correspond to or implement the virtues of the chosen style.

The Report, on the other hand, generally makes recommendations for alleviating specific perceived weaknesses of the financial system. It does not, however, contend that one particular type of regulatory system or one particular institution within a national regulatory system might be more effective than another in implementing the recommendations. The areas as to which the Report makes proposals are the following:

- Oversight of capital, liquidity and risk management;
- Transparency and valuation;
- The role and use of credit ratings;
- The authorities' responsiveness to risks; and
- Dealing with stress in the financial system.

This choice of areas for improvement is based in part on a particular understanding of the factors responsible for the current or recent turmoil in the financial markets. The Report describes these factors roughly as follows: Low risk premiums, financial technology and

¹ The member institutions of the Financial Stability Forum are Reserve Bank of Australia, Canadian Department of Finance, Bank of Canada, Canadian Office of the Superintendent of Financial Institutions, French Ministry of the Economy, Finance and Industry, Banque de France, French Autorité des Marchés Financiers, German Federal Ministry of Finance, Deutsche Bundesbank, German BaFin, Hong Kong Monetary Authority, Italian Ministry of the Economy and Finance, Banca d'Italia, Italian CONSOB, Japanese Ministry of Finance, Bank of Japan, Japanese Financial Services Agency, De Nederlandsche Bank, Monetary Authority of Singapore, Swiss National Bank, H M Treasury, Bank of England, Financial Services Authority, U.S. Department of the Treasury, Board of Governors of the Federal Reserve System, Securities and Exchange Commission, International Monetary Fund, World Bank, Bank for International Settlements, Organisation for Economic Co-operation and Development, Basel Committee on Banking Supervision, International Accounting Standards Board, International Association of Insurance Supervisors, International Organization of Securities Commissions, Committee on Payment and Settlement Systems, Committee on the Global Financial System and European Central Bank.

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the availability of credit enhancement led to a dramatic increase in offerings of complex structured products. This increase was furthered, in the case of banks, by accounting and risk-based capital incentives that resulted in the creation of large numbers of vehicles with maturity and liquidity mismatches and of pools of underlying assets that were hard to evaluate. The manner in which the vehicles were structured caused many banks to misjudge the nature and extent of their implicit commitments to the vehicles. These events were accompanied by a loosening of credit standards. As the US housing market weakened, leveraged holders of products backed by subprime mortgages were confronted with margin calls. Significant downgrades accelerated the process. Investors in asset-backed commercial paper began to refuse to roll over their holdings, forcing bank sponsors to assume responsibility for that paper and redirect their liquidity toward fulfilling that responsibility. This put pressure on the interbank and other lending markets, driving up rates. Increased risk premiums brought some markets to a standstill, making it difficult for institutions to value their holdings of the affected assets. As valuation losses increased, capital cushions shrank, leading to a further tightening of lending conditions.

The proposals in the Report for improving the financial system assume the approximate correctness of the historical analysis set forth above. If this analysis were later to prove incorrect or to contain improper emphases, the proposals may not resolve the current or similar crises, even if they otherwise appear sensible. In addition, the fundamental approach of the Report to this historical analysis also bears on the ultimate success of the Report's proposals. Under this approach, "[a]uthorities should not pre-empt or hinder market-driven adjustments, but should monitor them and add discipline where needed."² In other words, the role of a regulator is that of a modulator of the market, rather than that of the market's creator or its overlord.

Authorities must be proactive in strengthening the financial system. They must do all they can to identify emerging problems so as to be able to take prompt appropriate action to mitigate them. Given the difficulty in foreseeing and preventing specific threats to the financial system, a major focus of efforts must be to ensure that the core of the system is resilient when markets come under stress.³

The immediately preceding sentence seems crucial as an expression of the approach set out in the Report. However, nothing in the Report explicitly describes what constitutes the "core of the system," nor does it clarify what a resilient system is or how one can be constructed or recognized. Conceivably, one aspect of the current turmoil is that the core of the system may have changed or shifted, given the nature and scope of the new financial actors in the system. If it has, then prescriptions that might have worked for the

² Report, p. 10.

³ Report, p. 11.

old core might or might not work for the new, and what it takes or means to be "resilient" might have changed as well. For these purposes, "resilient" presumably means "is capable of continuing to function in more or less the manner in which it functioned before being put under stress." Such an understanding of resilience makes it doubly important to identify the core, so that the right aspects of the system retain their resilience. It could be disappointing to find out that what was thought of as heart surgery turned out to be nothing more than putting a cast on an extremity, or *vice versa*.

Capital, Liquidity and Risk

As might be expected, among the proposals in the area of capital, liquidity and risk are the following: Increasing capital requirements for (i) some complex structured products, (ii) default and event risk in trading books, and (iii) liquidity facilities associated with off-balance sheet conduits; strengthening risk management to better identify, test and manage risk; reviewing, and if necessary improving, all aspects of over-the-counter derivatives, including procedures relating to settlement, legal evaluation and ongoing operations; and better supervising and managing liquidity risk.

The Report states that the implementation of the Basel II capital requirements should overcome some of the inadequacies that contributed to the current turmoil; however, it also expresses the view that further improvements may be necessary. In particular, the Report singles out as problematic re-securitization structures, which pool and re-tranche debt that has already been securitized. For such securities the capital requirements will be raised "to reflect their higher default sensitivity to changes in macroeconomic conditions relative to highly rated ABSs of untranching underlying exposures."⁴ In addition, capital requirements will be raised for instruments that are marked to market, since the Financial Stability Forum has concluded that the current turmoil has shown that "market risk capital measures do not fully capture the credit risk of these products."⁵ Furthermore, capital requirements will be modified to reflect the risk of liquidity commitments, particularly those that were previously entitled to lighter treatment because of their apparently shorter maturities.

The recognition of additional risk (or types of risk) in re-securitized structures in effect makes the general point that re-packaging existing, known risks can create new, previously unknown risks that are difficult to recognize. The failure to have recognized this point may be a variant of the so-called fallacy of composition, the belief that what is true for an individual is true for an entire group, or it may reflect more complex dependencies. Once the issue is recognized, the question becomes how best to institutionalize responsibility for preventing recurrences. Under the framework suggested in the Treasury Blueprint, it is difficult to decide whose regulatory objective it should be

⁴ Report, p. 14.

⁵ Id.

to recognize and counter risks of this kind. Products that expose parties to this type of risk, and most likely others as well, implicate both market stability and prudence, which the Blueprint assigns as objectives to two separate regulators. Given their complexity and the difficulty purchasers might have in understanding them, such products would probably also fall within the purview of the regulator to which the Blueprint assigns the objective of overseeing business conduct. The current turmoil has shown that it is not just individual consumers who can misunderstand the products they buy. In any event, the Report simply treats the additional risk of repackaged products as an analytical problem, while the Blueprint would treat it as a question of institutional structure. A high percentage of the products and practices that currently seem problematic also seem to raise the most issues concerning the allocation of institutional responsibility for them. Conceivably, the primary characteristic of a practice or product likely to cause serious and widespread problems is that responsibility for it should be allocated to each of the three regulators proposed by the Blueprint. This characteristic could be used as a diagnostic even if no changes are made in the institutional structure of the US financial regulatory system. It could also be used as an indicator of what types of institutional reform (if any) are most needed. In any event, it suggests that a tripartite division of regulatory responsibility may work only for less contentious issues.

Going beyond Basel II, the Report then makes a recommendation regarding the role of monoline insurers and financial guarantors, stating that "[a]uthorities should ensure that the capital buffers for [such entities] are commensurate with their role in the financial system."⁶ As the Report elaborates on this recommendation, however, it creates the impression that it is proposing the re-evaluation of almost every aspect of the structure and role of these institutions. For example, in addition to capital, the explanatory paragraph mentions "other regulatory arrangements," "risk management," "internal models" and "guidance for regulated firms doing business with monolines and guarantors, including as part of the management of counterparty and concentration risk."⁷ No mention is made of structural methods for preventing the spread of contagion from one type of guaranteed or insured risk to another. Although other companies, such as CIT, reportedly have also suffered from adding subprime exposure to their traditional business activities, those companies did not serve as last-resort sources of financial strength. It is interesting to speculate (for analytical purposes) what the effect would have been on the extent and seriousness of the current turmoil if the subprime risks and the more typical municipal risks had been insured or guaranteed by separate entities, each with its own capital base. The reference in the Blueprint to the possibility of a federal insurance regulator has no necessary relevance to these issues or to the recommendations in the Report, except to the extent the federal regulator takes responsibility for all monoline insurers and financial guarantors, which has not been proposed.

⁶ Report, p. 15.

⁷ Id.

After its brief treatment of monolines and financial guarantors, the Report proceeds to discuss liquidity management. The areas for which guidance is promised include the measurement of liquidity risk, the testing of an institution's ability to maintain adequate liquidity, and the role of supervisors, managers and markets in dealing with liquidity risk. These measures are important, according to the Report, because "[d]uring the turmoil, it became apparent that financial institutions' funding arrangements often had not planned for sustained system-wide stress in funding markets, and did not address the links between funding, market liquidity and credit risk."⁸ Two related issues are not mentioned, the first being any trade-offs between caution, the ability to perform the market functions to which the various market participants have become accustomed, and the possibility that it might be more efficient in some circumstances to bail out market participants than to impose too many liquidity controls. The second issue is in effect the reverse: helping institutions deal more adeptly with excesses of liquidity generated by the monetary and fiscal policies of their own governments (and regulators). To give one completely hypothetical example: What would have been the consequences if banking and other regulations had required, in response to the housing bubble in the United States, that the down payments for a mortgage loan be increased in some proportion to the apparent level of excess liquidity or disproportionate price increases for housing?⁹ While such a regulation would conceivably have protected banks from some portion of the exposures with which they are now confronted, it would probably also have run counter to monetary policy at the time. This mixture of potential issues is another example of a situation or circumstance that could implicate each of the three regulators proposed by the Blueprint.

The last recommendations of the Report regarding capital, liquidity and risk call for greater supervisory efforts to improve risk management, "sharpen banks' control of tail risks and mitigate the buildup of excessive exposures and risk concentrations."¹⁰ As part of this effort, supervisors will be expected to require improved data collection and reporting of off-balance sheet exposures and better testing of the likely effects of different stresses on these exposures. In addition, supervisors will suggest procedures that reduce reliance on credit rating agencies in connection with the management of securitization exposures and that improve the management of the risks associated with having highly leveraged counterparties, such as hedge funds.¹¹ Motivation for these suggested changes in behavior is to come, in part, from adjustments in compensation practices to reward long- as opposed to short-term profitability.¹² Finally, operational and related risk is to be reduced by settling derivatives in cash, rather than through physical delivery, and by improving trading and settlement procedures.

⁸ Report, p. 16.

⁹ In "Liquidity, Monetary Policy, and Financial Cycles," Current Issues in Economics and Finance (Federal Reserve Bank of New York, January/February 2008), p. 1, Tobias Adrian and Hyun Song Shin report that "institutions increase their leverage during booms and reduce it during downturns."

¹⁰ Report, p. 17.

¹¹ Report, p. 19.

¹² Report, p. 20.

Most of these proposals seem obvious, but one raises some potentially important issues. Reducing the role of credit rating agencies (or their ratings) in the management of investments in securitizations would appear to undercut the role of ratings in the process of determining desirable levels of capital. In turn, banks would presumably need more sophisticated systems and staff, and better methods of valuation would need to be developed. If that happened, what would the role of credit rating agencies be? What should happen if a bank's system and procedures produce results substantially different from those reflected in public ratings? Should it matter if those differences increased or reduced a bank's apparent need for capital or liquidity, or if the bank sold interests in the relevant securitizations to the public, as opposed to only a few institutions? Clearly, some seemingly innocuous proposals could have enormous systemic consequences, including effects on the increasingly popular notion that some entities, such as credit rating agencies, function as "gate-keepers" for investors.

Transparency and Valuation

To increase transparency and improve valuation of balance-sheet items, financial institutions are encouraged to fortify their risk disclosure in their mid-2008 reports, using the practices identified in the Report, with further suggestions to come. The responsible authorities are urged to improve and standardize reporting for off-balance sheet vehicles and improve procedures for performing valuations when markets fail. Disclosure about securitized products and the assets underlying them should be increased.

The Report treats inadequate disclosure as one cause of lack of confidence in the market and, therefore, of reduced liquidity. It is difficult to tell whether this is an accurate characterization or just a plausible working assumption. Disclosure is likely to be effective in maintaining confidence if it reflects aspects of markets or products that have a known analytical significance and if the disclosure is not catastrophically frightening. Conceivably, the problem with disclosure during the early stages of the current turmoil was the lack of understanding of what should be disclosed in the first place and of which facts might be most relevant. Even if there was significant theoretical awareness of what should be disclosed, that does not mean the awareness was sufficiently widespread and commonly understood to form the basis of a disclosure program. In addition, it is hard to believe that complete and insightful disclosure of a catastrophic situation would maintain confidence and liquidity just because it was good disclosure. Perhaps improved disclosure is most useful in crises that derive from a lack of understanding but are ultimately manageable. Nevertheless, the point remains that disclosure requires a prior understanding and presumably cannot consist solely in the multiplication of pages or screens full of data.

For example, the Report asserts the need for a discussion both of total exposure and of exposure before and after hedging. In the current turmoil, however, one of the points at issue has been what constitutes exposure and what can be an effective hedge. Although

the aspects of exposure that are listed in the Report as worth identifying and disclosing are certainly indicative (in some sense) and useful, they don't necessarily reveal by themselves what the possible outcomes are. That kind of revelation requires the kind of prior analysis and understanding that may not have been sufficiently widespread prior to and in the early stages of the current turmoil. This point seems to be recognized in part in the Report's medium-term recommendations. After stating that the list of disclosure items relates to the areas of market concern during the current turmoil,¹³ the Report goes on to state that "future risk disclosures should focus on similar underlying principles, although the particular areas for additional disclosures will depend on market conditions at the time."¹⁴ That, however, is exactly what is at issue: How should one come to recognize either the market conditions at the time or the disclosures that would be relevant. Knowing those things is more likely to be a matter of insight than simple data collection and distribution.

In any event, the Report promises future guidance about the kinds of disclosure that are relevant to some of the apparent causes of the current turmoil. The additional disclosure would include information about re-securitization, obligations to off-balance sheet vehicles, liquidity commitments to asset-backed commercial paper conduits and valuation methods.

Along with increased disclosure, the Report recommends improved and internationally more uniform accounting standards for off-balance sheet vehicles. The principal purpose of any such changes in accounting standards should, according to the Report, be the determination of the exposure or risk remaining for the sponsor of an off-balance sheet vehicle. Whatever decisions are made about accounting standards in this area could potentially affect the ability or willingness of attorneys to opine that a true sale of assets has taken place and also raise issues about the proper treatment of off-balance sheet vehicles in the insolvency of either the vehicles or their sponsors. In addition to these efforts to perfect existing mechanisms for the regulation of off-balance sheet vehicles, it also seems likely that more fundamental questions about the role, structure and purpose of such vehicles will be asked. To the extent that such vehicles themselves act as on-going, small financial institutions, as opposed to unit investment trusts, there may well be modest efforts to regulate them as such. Re-drawing the tranches in such vehicles and imposing additional requirements on liquidity facilities may already amount to a form of capital regulation.

Once again, the question of regulatory responsibility for such issues should be asked. Off-balance sheet vehicles are by definition devices and efforts by banks and other financial institutions to utilize and affect markets. The accounting methods employed to characterize their financial effects on their sponsors serve as measures of the financial

¹³ Report, p. 24.

¹⁴ Id.

prudence of those sponsors. Furthermore, disclosure of information about the asset composition and balance-sheet and income-statement effects of off-balance sheet vehicles is an important aspect of the business conduct of the participants in the market for creating and selling interests in such vehicles. As a consequence, the accounting and disclosure methods that are chosen in response to the current turmoil will implicate all three major objectives pursued by the regulators discussed in the Blueprint. Conversely, an inadequately structured regulatory system may not be capable of implementing the improvements promised by the Report in a maximally effective manner. More importantly, many vehicles of the type discussed in the Report may have no regulator. What will happen to the market if some vehicles are subjected to significant, indirect regulation and others are not is an issue that the Report and the Blueprint do not discuss.

The Report's treatment of transparency and valuation concludes with an extended discussion of initiatives to improve valuation. Procedures or techniques to arrive at valuations have become increasingly crucial as more financial institutions participate in more types of trading markets and offer products that are priced on or derivatively with respect to such markets. In addition, if collateral is required for such transactions it must also be priced. Furthermore, if the prices of the products or the collateral have (by virtue of the way in which accounting principles operate) effects on the overall financial health of the parties, these effects might themselves trigger changes in other prices or in the demand for collateral. As a result of the perceived need for accurate valuations and the prompt tracking of the effects of changes in valuations, there has been increased discussion in recent years about how to be sure that valuations are available and accurate. Generally, finding a price in an active, fair market is preferred, which raises the issue of what to do if the market is either unfair or non-existent. In such conditions not only single products or investments are affected, but also entire enterprises with substantial market-valued exposures. The absence of valuations often signals the absence of adequate liquidity, as well. If liquidity is inadequate, the values of at least some products will fall because there is no demand for them. This is true regardless of whether the lack of liquidity results from an actual lack of funds or from an unwillingness to use funds that are in fact available in principle. In other words, liquidity and valuation relate analytically to confidence.

Part of this Report's recipe for improving confidence is improving disclosure about "valuations, valuation methodologies, price verification processes and the uncertainty associated with valuations."¹⁵ In addition, institutions should better integrate concern with valuation into their overall governance processes (including audit) and develop better valuation procedures. These improved procedures should "apply critical expert judgment and discipline in . . . valu[ing] holdings of complex or illiquid instruments (avoiding undue reliance on ratings and consensus pricing services."¹⁶ Avoiding undue reliance on

¹⁵ Report, p. 28.

¹⁶ *Id.*

ratings and developing skills in valuing illiquid instruments will presumably require an even broader and deeper spread of the technical expertise necessary to accomplish these goals, as well as the cultivation of a willingness to allow technical expertise to affect strategic judgment. A reduced reliance on ratings by institutions could also make ratings into even more of a marketing device than they already are, further reducing their supposed gatekeeper role and demanding further attention to ratings and rating agencies by the regulator(s) responsible for supervising the business conduct of financial institutions.

Despite any improvements in valuation methodology that may result from the efforts of (the members of) the Financial Stability Forum, establishing or attributing values of traded products in an illiquid market will likely remain a difficult problem. This problem may be remedied in part if the products to be valued are based on underlyings that can themselves be valued and if trustworthy models exist for transforming the values of the underlyings to the reasonable equivalent of a market value. Such a modeled value is, however, not just a potential substitute for a market value; it also raises the more general issue of the relationship in theory and practice between investments held for trading and those held to maturity. It also suggests that consideration be given to how and whether circuit breakers should (or should not) be used in situations of market turmoil. Although they implicitly underlie discussions of valuation and liquidity and of the originate-to-sell system for mortgages, neither of these fundamental questions seems to have received much explicit focus in current discussions of regulatory reform, which by and large have concentrated on incremental improvements in methodology or institutional structure. This is not surprising, since the daily life of a financial institution cannot orient itself around the point at which the system collapses. On the other hand, in analogy to the way secured lending orients itself around the consequences of bankruptcy, it would be interesting to see what kind of regulatory system would result from taking as the fundamental analytical starting point either the use of circuit breakers at a time of systemic failure or an understanding of the dynamics of the relationship between trading and holding. In effect, these questions exemplify the current structural transition in which the US banking system finds itself.

One of the Report's proposals for improving transparency about valuations (as opposed to improving the valuation process itself) is that originators and issuers of securitized products should both more fully disclose their "underwriting standards for the underlying assets"¹⁷ and "make available to investors and [rating agencies] the results of their own due diligence."¹⁸ The Report makes no effort to describe what it means by the results of such diligence. A wide range of interpretations is possible, ranging from all facts or presumed facts to all analyses of the data to all prognostications, modeled or otherwise, relating to a particular pool. To the extent all diligence results are made available, it

¹⁷ Report, p. 30.

¹⁸ Id.

becomes somewhat unclear what other disclosure obligations the various relevant parties might have.

Credit Ratings

After attributing some degree of responsibility for the current turmoil to the rating agencies, the Report makes a number of recommendations. Rating agencies should adopt the revised IOSCO Code of Conduct Fundamentals for Credit Rating Agencies. The ratings on structured products should be distinguished from other ratings and provide more information. Regulators should consider changing the role played by ratings in the financial system.

The Report suggests that credit rating agencies were both directly and indirectly responsible for the current turmoil in the markets. Directly, because of a "precipitous decline in confidence in ratings of structured credit products."¹⁹ The precipitousness of that decline in confidence is blamed in part on the precipitousness of the decline in the ratings themselves. Indirectly, because of concern that the original, high ratings might have resulted from conflicts of interest purportedly inherent in the structure of the rating process. In particular, the Report perceives the so-called "issuer-pays model" of credit rating to be subject to greater conflicts of interest in connection with structured products than in connection with corporate debt. This allegedly results from the fact that the products are structured in the first place and that the structuring is carried out on the basis of (sometimes paid) advice from the rating agencies themselves. The Report identifies other weaknesses as well: inadequate data, inadequate models and inadequate attention to a decline in underwriting quality.²⁰

The Report recommends not only improvements in the areas just discussed, but also in the understanding and explanation of how ratings for structured products differ from those for traditional corporate debt. This difference purportedly results from the fact that ratings for structured products are based on models and are largely assumption-driven while those for corporate debt are not. Clearly, this cannot be the case. Even the most ordinary corporate debt ratings are based on models of some sort, namely, on an understanding of the way certain types of data tend to be explanatorily related (or at least correlated) with certain types of future behavior. In other words, the fundamental difference between ratings for structured products and those for ordinary corporate debt must derive, at least in part, from differences in the nature of the models used for each and not from the presence or absence of a model *per se*. Conceivably, some of the difference could derive from the differences in the ways aspects of the two types of products correlate with other aspects of the economy. The Report touches on the

¹⁹ Report, p. 32.

²⁰ Report, p. 33.

behavioral differences between the products when it describes how highly-rated tranches of structured products can create such great losses.

But when an economy-wide event occurs that influences the creditworthiness of many assets at once, correlated defaults in the asset pool eliminate much of the benefit of diversification. This gives a strong "cliff" effect to the ratings of structured products: while structured products have more stable ratings than corporate bonds during times of overall economic and financial calm, they have a higher risk of a severe downgrade than corporate bonds during difficult conditions.²¹

In this way, as well, structured products to some extent resemble small financial institutions, particularly those with a large number of customers exposed to similar problems. One example would be banks in farming regions with a large exposure to loans secured by farm land.

To remedy these inadequacies the Report suggests not only better processes for coming up with ratings but also better disclosure to investors about how structured products and their ratings behave.²² In addition, the rating agencies should obtain better data, which they should analyze more critically,²³ and investors should learn more about how structured products differ from ordinary corporate debt.²⁴ Finally,

[a]uthorities should check that the roles that they have assigned to ratings in regulations and supervisory rules are consistent with the objectives of having investors make independent judgment of risks and perform their own due diligence, and that they do not induce uncritical reliance on credit ratings as a substitute for that independent evaluation.²⁵

This series of recommendations seems to say that everyone needs to understand securitized products better and to make this understanding second nature. As noted above, one consequence of this approach may be the need for larger, more sophisticated staffs at financial institutions that sponsor or deal in such products. If, however, ratings cannot serve as clear indicators of creditworthiness, the only investors these recommendations can have in mind are other large financial institutions and a very small number of sophisticated individuals. There are unlikely to be others who can "perform their own due diligence." Such an attitude of extreme caution could also be taken to impose greater burdens on investment advisers and brokers, since if ordinary investments

²¹ Report, p. 35.

²² *Id.*

²³ Report, p. 36.

²⁴ Report, p. 37.

²⁵ Report, p. 38.

require substantial explanation, the dangerously complicated must require explanations that are even more substantial to a currently unknown degree. This leads to fairly strange consequences: Rating agencies will have to do a better job of analysis and provide more information, but the burden of analysis and judgment will be shifted at the same time from the agencies to the recipients of their skilled advice and information. This calls the role of the rating agencies into question and imposes substantial costs on other market participants.

Responsiveness to Risk

In order to achieve adequate results in real time, regulators, says the Report, will need to be more responsive to risk. One way to achieve this result would be to establish a college of supervisors for each large, global financial institution. Such a college would organize the scattered international supervisors of such institution for the purpose of sharing information about its performance and making recommendations as to practices that should be implemented to better manage the risks to which it is exposed. Each college would in effect funnel the results of other collaborative endeavors of supervisors into the institutions that, because of their size and exposures, at least appear to be the most worthy of attention. Whether size best signals the value of such special attention is, however, unclear. Although the largest institutions might be the best places to start in the absence of other information, what regulators presumably need is a measure of an institution's centrality, salience or connectedness in whatever network is most relevant for a particular type of product. Deploying forces around all large institutions might have the advantage of not signaling that any particular one of them is suffering from problems, but addressing real problems may require a sharper focus. Different kinds of products may well be associated with different networks and require concentration on different institutions and on different aspects of those institutions. To take an oversimplified example: It wasn't always the largest railroad that exercised disproportionate market power. Sometimes it was the one that controlled a particular link at a major railroad junction.

Stress in the Financial System

Central banks and other regulators will need to find better ways of cooperating, according to the Report. This will be necessary not only to assist in the kind of regulatory improvements discussed earlier in the Report but also to handle the different liquidity needs that have become apparent in the course of the current situation. Among the needs that have become more apparent are the need for greater flexibility in providing liquidity to the system and the need for greater speed in reacting to systemic crises. Although the Report mentions these needs, it does not discuss their origin. In all likelihood, they derive in part from the increased variety of significant financial institutions and from the speed with which trading takes place. At a time when there were fewer significant financial institutions and these varied within a narrower range, the ways in which liquidity could or

needed to be provided to the system could presumably be more limited without losing their effectiveness. Different kinds of financial institutions, however, have different kinds of assets that can serve as collateral for loans and are enmeshed in different kinds of trading and other networks that operate and react with differing speeds (and therefore require different kinds of reaction time and awareness).

Among the other central bank issues discussed by the Report is how to inject liquidity without stigmatizing the borrower or signaling that the borrower is failing, especially when the liquidity is needed for purposes that appear to be transitory as opposed to mortal. The methods proposed for accomplishing this result include establishing clearly separate facilities for "purely frictional"²⁶ needs, better educating bank leadership about obtaining liquidity, better insuring the anonymity of borrowers, and structuring auction facilities in a way that prevents clear deductions about the actual borrowers, their needs or their specific circumstances. Presumably, if liquidity can be injected often enough in ways that are not immediately followed by a catastrophe and that do not impose an unacceptably high cost on the central banks, borrowing from central banks might become more a sign of systemic adjustment than an indicator of total failure. This would also lessen stigma, which might lessen the need for anonymity. Although anonymity certainly plays a useful role in preventing unnecessary panic, it may be worthwhile to point out that everywhere else in the recommendations of the Report the need for greater amounts of ever more precise information about institutions is stressed. A certain amount of tension thus exists among the Report's different recommendations in regard to information.

Most of the suggestions in the Report about central bank operations would probably fit best into the Blueprint's discussion of market stability. This may not necessarily be true in all respects, however. The tension mentioned above in regard to the provision of information implicates aspects of prudential regulation and business conduct, as well. Public companies are already required to disclose various material events, and questions can certainly arise about the propriety of continued ordinary-course dealings with customers if an institution has reason to believe that its liquidity needs or balance-sheet weaknesses could subject its customers to heightened risk.

The Report closes with additional, very general recommendations about improving the way regulators deal with weak banks, strengthening deposit insurance and increasing international cooperation. It says nothing about the treatment of institutions that no one currently regulates, regardless of whether they are potentially subject to national regulation (such as much of the mortgage industry in the United States) or are situated outside the jurisdiction of nations that tend to impose the most regulation.

²⁶ Report, p. 47.

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