

## The Business of Systemic Risk: The Report of the Counterparty Risk Management Policy Group III

August 26, 2008

On August 6, 2008 the Counterparty Risk Management Policy Group III (the "Group") published its report entitled "Containing Systemic Risk: The Road to Reform" (the "Report"). The stated intention of the Report is to recommend "steps that must be taken by the private sector to reduce the frequency and/or severity of future financial shocks while recognizing that such future shocks are inevitable..."<sup>1</sup> The recommended steps are based in part on a particular understanding of the causes of the current financial crisis, which the Report summarizes as follows: excessive liquidity, accompanied by a mispricing of credit risk; increased transaction speed and complexity; a rapid transmission of complexity-induced contagion, probably as a result of the nature of certain investment vehicles and abetted by an increase in risk aversion, a high degree of leverage and inadequate ability to mitigate risk; and patterns of behavior "not always consistent with the basic goal of financial stability."<sup>2</sup>

It is a fundamental contention of the Report that, despite the fact that the current financial crisis has its roots in "collective human behavior,"<sup>3</sup> government regulation is not enough.<sup>4</sup> Consequently, the Report is a sustained argument for the proposition that what is needed "is a form of private initiative that will complement official oversight in encouraging industry-wide practices that will help mitigate systemic risk."<sup>5</sup> What the exact purpose of this effort to complement regulation might be, however, remains ultimately unclear in the Report.

The Report does not claim that the private sector should be given a chance to fix itself before the regulators step in, nor does it argue that government will only make things worse if it tries to restructure the financial system. It does not assert that only private initiative really understands financial institutions or that the market will rectify itself. One possible reading of the Report is that large financial firms can fix most things themselves, but need government in spots in order to render certain solutions enforceable and to punish those who might try to interfere with the restructured system rather than submitting to it. The Report's purpose was presumably not, however, to set forth a new theory of financial regulation, but to make specific recommendations. This it does at great length.

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<sup>1</sup> Report, p. 1.

<sup>2</sup> Report, p. 5.

<sup>3</sup> Report, p. 7.

<sup>4</sup> "...official oversight is not a substitute for the effective management of financial institutions." Id.

<sup>5</sup> Id.

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In making its specific recommendations, the Report states that they represent a specific articulation of "relatively single, readily understandable, and forward-looking core precepts..."<sup>6</sup> The precepts are:

- The Basics of Corporate Governance
- The Basics of Risk Monitoring
- The Basics of Estimating Risk Appetite
- Focusing on Contagion
- Enhanced Oversight<sup>7</sup>

The meaning of the first two precepts can easily be intuited. Corporate governance ensures that risk management is not left to the specialists. In addition, it "foster[s] the incentives that will properly balance commercial success and disciplined behavior over the cycle while ensuring the true decision-making independence of key control personnel from business unit personnel."<sup>8</sup> Risk monitoring requires awareness and tracking of perceived risks in real time, both in general and with respect to each individual (institutional) counterparty, and digestible reporting of this awareness to senior management.

What it means to "estimate risk appetite" is somewhat less easy to intuit, in large part, perhaps, because the Report does not clearly distinguish appetite for risk from the measurement of risk. In addition, the Report fails to distinguish between quantitative measurements of risk levels and changes in the slope or shape of the curves plotted by the values of the specific risk levels (*i.e.*, in the sensitivity of the response of various values to changes in other values). It seems fair to say, however, that "estimating risk appetite" refers to the coordinated establishment of a company policy on taking or avoiding risk as a part of – and result of – an ongoing process of establishing the nature and behavior of the relevant risks.

Focusing on contagion appears to be less a separate precept than a specialized application of the process of establishing risk appetite. After describing contagion as arising most often from "(1) credit concentrations; (2) broad-based maturity mismatches; (3) excessive leverage either in balance-sheet terms or in the form of leverage that is embedded in individual classes of financial instruments; and (4) the illusion of market liquidity or the belief that such liquidity will always be present..."<sup>9</sup> the Report recommends brainstorming sessions "aimed at identifying potential contagion 'hot spots' and analyzing how such 'hot spots' might play out in the future."<sup>10</sup> In other words, establishing risk appetite requires consideration of worst-case scenarios. By their nature, such scenarios tend to be seriously

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<sup>6</sup> Report, p. 8.

<sup>7</sup> Report, pp. 9-14.

<sup>8</sup> Report, p. 10.

<sup>9</sup> Report, p. 12.

<sup>10</sup> Id.

non-linear, i.e. not predictable by plotting ordinary trends into the future, and therefore require speculative anticipation.

Enhanced oversight refers to the suggestion of the Report that the highest-level supervisory body of a large regulated financial institution (e.g., the board of directors of a US corporation) should meet at least annually with "highest-level officials" of the institution's regulator to discuss "the condition of the institution with emphasis on high-level commentary bearing on the underlying stability of the institution and its capacity to absorb periods of adversity."<sup>11</sup> Such meetings should at least indicate to each party the seriousness with which the other takes the issues being discussed. Although the Report does not make this point explicitly, such meetings might be more effective if each party brought along some specialists capable of discussing certain relevant matters in more detail, so that the meetings would not dwell only on atmospherics. The Report itself could be taken to imply this point, but the relevant reference seems to be concerned more with identifying the applicable management level in different countries. The precept that encourages enhanced oversight seems to assume that supervisors and the supervised will have antithetical expectations. It is interesting to speculate whether this would have been true if such meetings had regularly taken place in the US at the time when it was official policy to encourage credit by maintaining historically low interest rates.

After articulating its five precepts, the Report lists its recommendations and then motivates them at length. The recommendations are numerous,<sup>12</sup> fairly specific and, in their totality, fairly complex. For that reason, it may be more interesting for analytical purposes to focus on some of the apparent underlying assumptions and possible consequences of the precepts, rather than enumerating the recommendations and setting out the motivation for each. First, however, it may be worthwhile to discuss something that does not appear in the list of recommendations.

In its discussion of the causes of the current financial crises, the Report, it will be recalled, blames in part "patterns of behavior...that were not always consistent with the basic goal of financial stability."<sup>13</sup> In the paragraph that discusses these patterns of behavior, the Report takes a position on the compensation of "senior and executive management."<sup>14</sup> Such compensation, says the Report, "should be (1) based heavily on the performance of the firm as a whole and (2) heavily stock-based with such stock-based compensation vesting over an extended period of time."<sup>15</sup> The Report also takes the position that incentives at other levels in a firm "should help to balance business imperatives by ensuring that the resource base and the recognition/reward system for the support and control functions are such that critical tasks, such as risk monitoring and price verifica-

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<sup>11</sup> Report, p. 14.

<sup>12</sup> Just setting out the recommendations consumes 20 pages, single-spaced.

<sup>13</sup> See footnote 2 above.

<sup>14</sup> Report, p. 5.

<sup>15</sup> Id.

tion, are performed in a manner that protects the financial integrity and professional reputation of the institution."<sup>16</sup>

The approach to compensation that these views appear to reflect may not necessarily match the approach behind the more specific recommendations regarding risk management. It is difficult to be certain, since compensation issues are not as thoroughly articulated or motivated as other recommendations of the Report; however, the Report seems to be of the view that compensating senior management with substantial equity and insisting that the equity vest over a moderately long period of time will align the interests of senior management with the needs of the large, integrated financial interactions that are the focus of the Report. Indeed, there is presumably some alignment by virtue of longer-term vesting, since this may well reward the development of respect for the potential riskiness of certain investments and strategies. On the other hand, it is less clear that the emphasis on compensation in stock, as opposed to cash, necessarily matches the Report's rationale for enhanced risk management practices. The Report repeatedly stresses the importance of involving top management in the development, review and adjustment of their firm's risk management practices. It is at least conceivable that such involvement might justify compensating senior management, at least in part, in the manner recommended by the Report for risk management specialists. At the very least, the emphasis of the Report on the risk management role of senior management makes it important to think through in more detail the basic understanding of what senior management of large, integrated financial intermediaries is being compensated for and how this relates to the manner (and not necessarily the amount) of such compensation.

One theme of the recommendations that is named, but not analyzed, is the focus on large, integrated financial intermediaries. The assumption behind this focus appears to be the conviction that such institutions are engaged in a form of financial intermediation that requires special attention. Judging by the content of the Report's recommendations, the need for special attention is thought by the Group to derive from both the large size and the integrated nature of such institutions. Nevertheless, a financial institution of any size whatsoever whose business depends on understanding, taking and hedging complex risks would seem well-advised to consider seriously the Report's recommendations, even if it is an insignificant start-up. The large size of the institutions that are the Report's focus presumably makes them of greater interest or concern to regulators, since their business volume is a more significant percentage of total financial transaction volume and they are probably linked to more participants in the financial network than smaller firms are. From such a perspective it probably makes sense to contemplate, as the Report does, a closer and more symbiotic relationship between large, integrated financial intermediaries and their regulators, especially insofar as those regulators are responsible for the safety and effectiveness of the entire financial system and not just of the individual participants.

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<sup>16</sup> Id.

What is less clear – because it is largely taken as a given by the Report – is what this kind of market stratification or grouping might mean for the financial services market and its regulators. Under Basel II, as applied in the US, it is already contemplated that the largest institutions<sup>17</sup> with at least \$10 billion in consolidated non-US assets will be required to apply an internal ratings-based approach in calculating their capital requirements. The few banks that satisfy this test control substantially more than a majority of US banking assets. Other banks that have the required infrastructure for determining their capital needs will be permitted (as opposed to required) to apply an internal ratings-based approach. The largest US securities organizations already calculate their capital under Basel II as a result of their decision to be regulated as “consolidated supervised entities” by the Securities and Exchange Commission, a regulatory status that simplifies their treatment under European Union law. US securities laws also contain other examples of differential treatment based on size.

Nevertheless, to the extent that the Report’s recommendations do not just reflect the pride in their own prowess of the institutions that assisted in its preparation, they seem to represent something more than practical suggestions for the technical improvement of risk management. This “something more” can perhaps be called an awareness of the central, specialized and (conceivably) qualitatively different role that certain firms arguably play in comparison to the role played by most others. If they do in fact play such a special role, it will be important both for the firms and their regulators to develop a more thorough and explicit understanding of that role in order to better structure the financial system and to work out even better risk management techniques.

One facet of this special role as embodied in the Report itself may be the emphasis placed on the same-day settlement of credit-derivative transactions and the improvement of valuation techniques and procedures for settling defaults that occur in derivatives transactions. It is clear from the recommendations of the Report that the technical facilitation of credit-derivative transactions is largely a matter for the large firms, and that less active or smaller firms can make do with less capable systems. This amounts to a two-fold claim, namely that the market in such investment vehicles consists in substantial part in the trades and relationships effected and maintained by large, integrated financial intermediaries and that the safety of that system depends on how the large firms operate.

If, as implied by the Report, the risk management needs and capabilities of large, integrated financial intermediaries distinguish them significantly from other participants in the financial markets, then perhaps the risk management tasks of the large, integrated firms are even more different from those of other firms than the Report suggests. The risks to which all participants in the market are subject, assuming they are fairly evenly distributed, seem likely to be easier to estimate, manage and control than risks that are

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<sup>17</sup> Institutions with more than \$250 billion in consolidated assets, excluding the assets of insurance subsidiaries.

concentrated in the hands of the few largest participants. Such concentrated risks are likely to be more difficult to manage by virtue of their concentration alone (a factor that seems to have played a role in the current financial crisis). In addition, they are likely to be of a more complex character, as well. Such greater complexity could arise, for example, by virtue of the inter-relationships among the concentrated risks or because the largest market participants are the only ones with the knowledge and the capital to engage in very complicated transactions. If this intuition is correct, the risk management task of large, integrated financial intermediaries will go beyond evaluating the risk exposure of counterparties (as recommended by the Report), something which is itself difficult enough in some circumstances and might require the modeling of significant portions of the financial markets. Any such special requirements of the risk management task of large, integrated financial institutions will raise the question of what these special requirements consist in and what regulatory response, if any, might be appropriate. For example, are the Basel II rules for qualifying institutions sufficient, or does the structural aspect of the risk concentrated by large, integrated financial intermediaries require other types of analysis and resolution? What would it mean if the large, integrated financial intermediaries were not just larger than their competitors, but were also in some way essentially different?

One kind of likely difference seems reasonably clear. The very size and limited number of the large, integrated financial intermediaries to whom the Report is addressed suggest that their business activities put them at structurally crucial nodes in the systems that provide and facilitate market and funding liquidity. For this reason, the extensive coverage of liquidity issues in the Report is essential not only for the institutions to which the Report's advice is addressed, but also to the regulators of such institutions and to the general public.

A related, potential consequence of the Report's recommendations follows from its frequent references to the need for all levels of management to understand, respect and be involved in the risk management efforts of their firm. The recommended degree of management involvement, the extensive, detailed procedures recommended to large, integrated financial intermediaries, the enormous data collection and modeling operations that are treated as vital for such intermediaries, and the occasional suggestion that some products should not even be sold to anyone but customers with serious modeling capabilities all suggest that, quite possibly, risk management should no longer be treated as a compliance mechanism for the firms addressed by the Report. Instead, the Report could perhaps be read as a cautiously phrased description (using language already familiar to readers of the Report) of a type of financial intermediary whose entire business simply is risk management, rather than an intermediary whose "real" business is supervised and constrained by risk management techniques and staff. This conception may not be unusual in more specialized contexts, but it could indicate a significant transformation of the financial system if it became part of the self-understanding of its largest participants and of the public understanding of such participants.

Conceiving of certain financial intermediaries in this way could have a number of consequences, including the following:

- The allocation of funds within such an organization (including executive and non-executive compensation) would be guided by a different understanding of the relative importance of various activities;
- At least rhetorically and perhaps substantively, the business focus of the organization would be on explaining and exploiting its knowledge and management of risk, rather than on the use of risk management to protect its “real” business;
- Risk management functions would more clearly sort out into those intended to check for honesty and accuracy, those intended for self-presentation and those intended as means of gaining business advantage; and
- Regulators would need to think about risk management not only as a means of protecting the safety and soundness of the institutions they regulate, but also as an activity or product line and as a source of potential structural changes in the financial systems (financial sectors of the economy) that they oversee.

For more traditional financial intermediaries, the role of risk management as a defensive mechanism would be retained.

If there are, in fact, such new types of financial intermediary slipping out of their chrysalis, their metamorphosis could have interesting effects on accounting, the rating of securities and disclosure, as well. Historically, accounting has developed differing techniques for representing the financial situation of a company depending on whether the investments of greatest concern at the time were debt (as at the time when railroad financing was dominant in the US, leading to a focus on solvency) or equity (when the stock markets became more central, leading to a focus on cash flows and income). The firms at which the Report’s recommendations are directed are more like extraordinarily complicated derivatives or securitization vehicles than they are like issuers of ordinary debt or equity. While perhaps all firms can be modeled using derivatives and other notions from finance theory, large, integrated financial intermediaries with powerful risk management capabilities come close to being intentionally structured as direct instantiations of such ideas. It seems quite possible that standard accounting practices will ultimately prove inadequate in their present form for the relatively brief and insightful characterization of such intermediaries, although notes and narrative descriptions in their financial statements and periodic reports can obscure this inadequacy for a while. For example, increasingly the types of information requested by those interested in the health of complicated companies resemble those that are necessary to model those companies and calculate predictions rather than those that were historically developed to provide a revealing and indicative snapshot of a company’s financial state.

For similar reasons, the ratings of such intermediaries may well, in the long run, have to be prepared differently, and be distinguished, from the kinds of ratings currently assigned

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to them, as has happened to the ratings for asset-backed securities. In addition, although Standard & Poor's is planning to introduce a separate ratings component that reflects the risk management capabilities of companies, such a separate component may be inadequate as a representation of the actual circumstances of the large intermediaries to which the Report is addressed. It may, however, adequately reflect the efforts of smaller, less complicated companies for which risk management is still not at the core of their business.

Finally, disclosure for the entities at which the Report is directed may need to be reconceived. Currently, for most publicly held companies, disclosure of a relatively small number of financial indicators is thought of as adequately making their financial condition apparent, provided some narrative is added about some components of those indicators and trends in their development. However, as is implicit in the Report, and as has been discussed in the last few paragraphs, the financial condition of some companies, and especially of large, integrated financial intermediaries, can increasingly only be understood as a dynamic model. While there may turn out to be indicators of how these models and companies will develop, it could also be the case that such indicators are not much more useful than weather forecasts for next month – and for similar reasons. Disclosure regimes for risk management have been encouraged (parts of Basel II provide an example), but these regimes best fit companies for which risk management is only protective gear for the rest of the business. Insightful, believable disclosure for companies whose business has become indistinguishable from risk management does not yet seem to exist.

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