MEMO# 22313

March 10, 2008

Senior Supervisors Group Issues Report on Risk Management Practices During the Recent Market Turbulence

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TO: SEC RULES MEMBERS No. 23-08
FIXED-INCOME ADVISORY COMMITTEE No. 7-08
MONEY MARKET FUNDS ADVISORY COMMITTEE No. 3-08
MUNICIPAL SECURITIES ADVISORY COMMITTEE No. 10-08
INST. MONEY MARKET FUNDS ADVISORY COMMITTEE No. 4-08
RISK MANAGEMENT ADVISORY COMMITTEE No. 3-08 RE: SENIOR SUPERVISORS GROUP ISSUES REPORT ON RISK MANAGEMENT PRACTICES DURING THE RECENT MARKET TURBULENCE

On March 6, the Senior Supervisors Group issued a joint report assessing risk management practices among a sample of eleven major global financial services organizations. [1] The Senior Supervisors Group is comprised of seven supervisory agencies from five countries, including the French Banking Commission, the German Federal Financial Supervisory Authority, the Swiss Federal Banking Commission, the U.K. Financial Services Authority and, in the United States, the Office of the Comptroller of the Currency, the Securities and Exchange Commission, and the Federal Reserve. At the behest of the Financial Stability Forum, the report was undertaken to evaluate the effectiveness of current risk management practices during the recent period of market turmoil. [2] It reflects the results of a review by the supervisory agencies (through questionnaires and meetings with senior management) as well as a roundtable discussion held with industry representatives.

The report explains that the supervisory agencies focused on practices related to the following:

- The role of senior management oversight in assessing and responding to the changing risk landscape;
- The effectiveness of market and credit risk management practices in understanding and managing the risks in retained or traded exposures as well as in counterparty exposures, in valuing complex and increasingly illiquid products, and in limiting or hedging exposures to credit and market risk; and
- The effectiveness of each firm's liquidity risk management practices in assessing its vulnerability to that risk in a stressed environment and in taking appropriate action.

The report concludes that the primary source of losses for financial services firms through year-end 2007 was the firms' concentrated exposure to securitizations of U.S. subprime mortgage-related credit, particularly in businesses involved in the warehousing, structuring, and trading of collateralized debt obligations ("CDOs") backed by such credits. The report found important differences in firms' approaches to risk management practices and specific business lines. Specifically, the report found that some firms made strategic decisions to retain large exposures to super-senior tranches of CDOs that far exceeded the firms' understanding of the risks inherent in such securities, and failed to take necessary steps to control or mitigate those risks. It also found that firms' lacked a complete understanding and control over their potential balance sheet growth and liquidity needs. In addition, the report stated that firms were more vulnerable to a prolonged disruption in market liquidity than they expected.

The report noted that, "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." Further, these firms enforced more active controls over the consolidated organization's balance sheet, liquidity, and capital. The report found that firms that avoided significant losses reduced risk through active and early decisions to reduce or exit businesses that were likely to be affected by the changing environment.

The report stated that the supervisory agencies are using the observations in the report to set expectations for and address weaknesses at the firms. The report also stated that the supervisory agencies have used their findings to define an agenda for strengthening supervisory oversight in relevant areas of their supervisory programs. In particular, they intend to focus on the Basel II capital framework, strengthened management of liquidity risk, and strengthened guidance on risk management practices, valuation practices, and the controls over both. In addition, the supervisory agencies will support efforts to address issues that may benefit from discussion among market participants, supervisors, and other key players (e.g., the quality and timeliness of public disclosures to reduce uncertainty about the scale of potential losses associated with problematic exposures).

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endnotes

[1] Senior Supervisors Group, Observations on Risk Management Practices during the Recent Market Turbulence, March 6, 2008. The report may be found at http://www.sec.gov/news/press/2008/report030608.pdf.

[2] The report specifies that the review period concludes with the 2007 year end, so the report should be viewed as an interim assessment of the key risk management practices that have affected major firms' ability to weather the current market turbulence.
