Press Points for Chapter 2:
Structured Finance: Issues of Valuation and Disclosure
Global Financial Stability Report (GFSR), April 2008

Key points

- **Weaknesses in the valuation and disclosure of structured finance products have contributed to the depth and duration of the current financial crisis, resulting in a severe funding and confidence crisis.**

- **In many cases, investors underestimated the risks underlying these complex structured products, foregoing adequate due diligence and relying disproportionately on credit rating agency assessments.**

- **The perimeter of risk for financial institutions (i.e., the risk assessment of an institution's activities) did not adequately account for their exposures to off-balance sheet entities, such as structured investment vehicles or commercial paper conduits.**

- **Policy proposals should aim to strengthen the weaknesses and gaps in accounting and regulatory frameworks, without inhibiting financial innovation and smoothly functioning markets.**

The financial crisis beginning in late July 2007 brought to the surface the underlying weaknesses in the new complex structured finance products and the supporting market, business models, and regulatory environments. The crisis resulted in substantial uncertainty about the accounting valuations of financial assets; the exposure of financial institutions, including from off-balance sheet risks; and consequent protracted uncertainty about counterparties and the strength of their balance sheets.

The chapter focuses on two key factors contributing to the financial turmoil. First, it examines the valuation and accounting practices for structured finance products. Second, it discusses the business and regulatory incentives that prompted the fast growth of these products, framed in the context of financial institutions' risk management practices. In addition, because of the substantial influence of credit rating agencies in the rating and structuring of these products, the chapter examines the methodologies for constructing these ratings.

The chapter finds gaps and potential weaknesses in each of these areas. First, recent experience has shown that the application of the fair value accounting framework can cause prices to fall further when there are thresholds (either self-imposed by financial institutions or by regulation) that require sales of assets when fair-values fall below the threshold. Second, financial institutions set up legal entities, such as structured investment vehicles (SIVs) and commercial paper conduits, off their balance sheet and failed to address the associated risks. It turned out that the perimeter of bank risk consolidation was evidently too narrow for the risks to be properly assessed as they remained intransparent to investors and regulators. The Basel II capital accord addresses many of these regulatory shortcomings, but some gaps still remain. Further, the pro-cyclicality of both fair value accounting triggers and Basel II capital requirements could reinforce each other, thereby exacerbating a downturn in the economy.

Several policy implications, as well as suggestions for private initiatives, arise from the chapter, some of which are already under consideration. **For the private sector:**

- **The standardization of some securitized finance products** could facilitate investors' understanding of risks and promote liquidity through the development of a secondary market. Standardization could also facilitate the development of a clearinghouse that would mutualize counterparty risks associated with these types of over-the-counter products.

- In addition to **a differentiated rating system for structured credit products**, rating agencies should provide investors with more analytical information regarding the potential sensitivity of ratings.

- **Transparency at product origination is needed**, which should include sufficient and easily understood information that enables investors to better understand the product's risks, including underlying assets, valuation assumptions and sensitivity to changes.

- **Financial institutions that retain risks to off-balance sheet entities should disclose aggregate information on a regular and timely basis,** including the quantity and sensitivity to credit, market and liquidity risks, and the changes to these risk exposures over time.

In the area of public policy:

- **Weaknesses in the implementation of fair value accounting results should be addressed.** Decision rules that trigger compulsory sales when fair value goes below some threshold will need to be examined. The extent to which such fair value "triggers" are either encouraged or mandated in regulation and supervisory guidance would need to be re-evaluated.

- **Further refinement and careful implementation of Basel II would reduce gaps in the framework.** The chapter proposes greater emphasis on Pillar III on market monitoring and the provision of reliable information to investors and supervisors; and enhanced guidance within Pillar II for supervisors on the transfer of credit risk off of balance sheets, and within Pillar I for a review of risk weights for contingent credit lines.