market breakdowns. Lastly, the authorities could encourage better pricing and public disclosure of contingent liquidity risk.

A second key area where progress should be made is compensation systems. Systems based on immediately measurable results also reinforce procyclicality, and encourage excessive risk taking in pursuit of high returns, often with insufficient attention to risk. Financial institutions should be encouraged to better align compensation with longer-term objectives – eg by delinking bonuses from annual results through deferrals and clawbacks. Also performance metrics should be better aligned with firm risk management systems. Compensation schemes and results should also be made more transparent, to bring more market discipline to bear.

A third area for improvement is information. Many investors in securitization products did not exercise appropriate due diligence, and relied too heavily on rating agencies for their risk assessments. In many cases, this was because sufficient information was not available, or because there was too much information to process and synthesize. Hence, securitizers should improve the availability and the usefulness of the information and tools that investors need to do their own risk assessments. Authorities should press the credit rating agencies to continue to improve their internal governance practices to reduce their special incentive conflicts. Also, given that, by design, structured credit products can suffer more severe, multiple-notch downgrades relative to corporate or sovereign bonds, a differentiated rating scale would help make these differences more explicit.[3]

A fourth area for improvement is the securitization process itself. Products should be simplified and standardized to increase transparency as well as market participants' understanding of the risks, thus facilitating the development of liquid secondary markets. Although there will always likely be types of investors that will demand bespoke complex products, securitization trade associations and securities regulators could encourage that these be structured, at least partially, from standardized building blocks.

A fifth area for improvement is an expansion of the regulatory perimeter, to ensure that the supervisors and regulators are capturing all systemically important institutions with their regulatory tools and framework, to avoid arbitrage. This will help to ensure that the distortion of incentives from longer intermediation chains no longer fall outside the regulatory net, and hence the radar screen of supervisors.

And finally, I would suggest that we need to change or update the crisis management frameworks that we have in place to deal with the risks from securitization. This topic covers a host of different issues, including how we structure the lender of last resort function and access to emergency liquidity, eligible collateral, what sort of haircuts to apply, but also more complex topics such as the deposit insurance arrangements in place in the presence of securitization – do we need to reconsider coverage limits, the types of institutions covered and how the schemes are funded? And what about resolution frameworks for financial institutions – do we need to broaden the powers of regulators, and what legal complications do lengthened intermediation chains pose for the prompt resolution of failing institutions?

To conclude, I would like to close with reference to the implications of the paper for monetary policy. What has become clear from the present crisis is that the short-term policy rate is important for financial stability, and regulation should take this into account. But monetary policy may also amplify procyclical risk taking. For example, interest rates that are too low for too long may encourage excessive leverage and over-indebtedness. Perhaps central banks should consider applying policy tools more symmetrically over the cycle and, in particular,

[3] Meanwhile, it is a promising development that rating agencies are now providing investors with more analytical information regarding potential rating volatility. This additional analytic information, typically in the form of a score or index, provides investors with a useful quantification of the increased downgrade risk.