



THE FSF'S AGENDA FOR FINANCIAL REFORM

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As discussion continues of the changes in financial systems and regulation required by the turbulence that began in mid-2007, major features of the likely shape of reform have emerged. At the same time representatives of the financial sector have mounted the battlements in an effort to influence the reform and to defend the sector's control of its members' remuneration.

The most complete multilateral statement of the reform agenda from countries with major financial centers is contained in the April document of the Financial Stability Forum (FSF), Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience. Publication of the Report has coincided with reform initiatives in the United States and the United Kingdom.

[As this article went to press, the Basel-based Committee on the Global Financial System, which consists of the G10 central banks and the Central Bank of Luxembourg, issued reports containing its inputs to the FSF Report on two subjects (discussed below), "Ratings in structured finance: what went wrong and what can be done to address shortcomings" and "Central bank operations in response to the financial market turmoil".]

In many ways an exemplary document, the FSF Report contains a wide-ranging set of policy recommendations with brief explanations of the problems being targeted and of the ways in which the recommendations can contribute to their solution. The shortcomings of the Report reflect the limited membership of the FSF and the parameters within which such a group has to work.

The FSF consists of representatives of the Ministries of Finance, central banks and financial regulators of 12 economies (Australia, Canada, France, Germany, Hong Kong, Italy, Japan, Netherlands, Singapore, Switzerland, United Kingdom, and United States), of multilateral institutions (IMF, World Bank, Bank for International Settlements, and OECD), of some more specialized international bodies (Basel Committee on Banking Supervision, International Association of Insurance Supervisors, International Organization of Securities Commissions, Committee on Payment and Settlement Systems, and Committee on the Global Financial System), and of the European Central Bank. The principle objectives of the FSF are coordination and information pooling for the purpose of surveillance of global financial stability. Such a remit is conducive to realism concerning the steps required to meet problems identified by the FSF but within parameters imposed by need for consensus among its membership.

These parameters are evident in the FSF Report's introductory statement concerning areas for policy action: "Authorities should not pre-empt or hinder market-driven adjustments, but should monitor them and add discipline where needed". The preamble contains no parallel reference to the breakdown of market mechanisms underlying recent financial turbulence which raise questions as to the healing capacity of these mechanisms even after implementation of the Report's recommendations.

These recommendations come under five headings: (1) strengthened prudential oversight of capital, liquidity and risk management; (2) enhancing transparency and valuation; (3) changes in the role and uses of credit ratings; (4) strengthening the authorities' responsiveness to risk; and (5) robust arrangements for dealing with stress in the financial system.

BASEL 2

The FSF Report urges speedy implementation of Basel 2. The core of Basel 1 and Basel 2 consists of rules for minimum levels of banks' regulatory capital corresponding to their exposures to the risks associated with their lending and other operations. The capital consists of equity and other financial instruments with the properties of being available to support a bank during threats to its solvency but carrying costs higher than other categories of funding. Basel 1, which was agreed in 1988, lacked

rules concerning the capital required for securitization exposures, i.e. exposures to securities backed by assets such as mortgages which have been a major cause of the current turbulence. This shortcoming was one of the main reasons for the decision to replace Basel 1 with a new agreement.

As a result Basel 2 not only contains rules for banks' allocation of capital to securitization exposures but also specifies the conditions to be met by banks if the removal from their balance sheets of such exposures to "special purpose vehicles" established for the purpose is reduce or - even better from the point of view of their capital costs –eliminate the corresponding capital requirements.

Despite its emphasis on the urgency of implementation the Report acknowledges that Basel 2 may need to be strengthened in the light of weaknesses in banks' risk management highlighted by the credit crisis. Supervisors are to monitor the adequacy of banks' capital levels and risk management once Basel 2 is in place. If they judge increases in these levels to be necessary, they should implement them through their discretionary powers of supervisory review under Pillar 2 of Basel 2.

The Basel Committee on Banking Supervision will also issue revised rules for banks' securitization exposures. The Basel 2 rules offer different options for setting minimum capital levels designed to accommodate differences in the structuring of securitization exposures. Most of these options accord a role to the ratings of credit rating agencies.

Revision of the rules for securitization exposures will reflect experience since last summer This showed that credit ratings often underestimate the risks of securitization exposures. Moreover the experience demonstrated the need for more rigorous rules for the allocation of capital to banks' residual commitments to support ABCP conduits, a form of securitization arranged or sponsored by banks that involves off-balance-sheet special purpose vehicles whose assets are backed by short-term commercial paper held by investors other than the banks themselves.

The rules of Basel 2 are also to be strengthened to counter opportunities for regulatory arbitrage through shifts of items between different parts of banks' portfolios. Such opportunities are due to the lower capital requirements for the credit risk of assets held in banks' trading as opposed to their banking books. Trading books consist of positions in financial instruments and commodities held either with trading intent or to hedge other items in the trading book. Recent experience has shown that the credit risk of assets of the positions can be underestimated under existing rules).

The FSF Report acknowledges the need to step up the monitoring of the procyclicality of bank lending. Basel 2 is designed to bring rules for regulatory capital more closely into line with banks' own procedures for assessing risks. However, these procedures often generate procyclical fluctuations in banks' lending which are capable of accentuating booms and recessions. Mitigation of procyclicality under Basel 2 is to be achieved by guidelines under which banks would set capital requirements on the basis of data averaging variations in creditworthiness over the economic cycle. However, as the FSF acknowledges, this may prove inadequate.

The FSF Report fails to draw attention to the measures taken by the Spanish authorities to deal with securitization exposures and procyclicality as meriting regulators' special attention.

Under securitization Spanish banks are required to consolidate special purpose vehicles in their accounting. This eliminates the incentive to transfer securitized assets to such vehicles, and has protected the banks and the Spanish economy from exposure to the risks associated with the "originate to distribute" model of securitization prevalent during recent years in the United States and the United Kingdom.

To offset procyclicality, the Spanish authorities have set rules for dynamic provisioning under which a protective cushion of additional loss reserves built up by banks in good times is available to be drawn down in bad times. These rules have been drafted in a way which conforms with International Financial Reporting Standards concerning loan loss reserves. [On Spanish measures in both areas see Miguel Fernandez Ordonez, Governor of the Bank of Spain, "Turbulence in the world markets – a Spanish view (five lessons and some homework)", address at the Circulo Financiero, 14 May 2008.]

LIQUIDITY RISK

Historically banks' liquidity management focused on holding cash and other liquid assets adequate to meet withdrawals by customers. With the growth of interbank and money markets the ways in which banks can access liquidity have greatly expanded. But so has the complexity of managing liquidity risks.

As the Institute of International Finance, a Washington-based organization of major banks, put it in a recent report, an appropriate strategy for the management of funding liquidity risk must now take "into consideration...business models and legal structures (e.g. mix of foreign branches versus foreign subsidiaries), complexity (the breadth and diversity of markets/products, geographies, and legal entities), key lines of business, home and host regulatory requirements and environments, marketplaces, and risk materiality in the context of firm-wide risk management strategy and appetite" [Institute of International Finance, Inc., Principles of Liquidity Risk Management, 2007, p.20].

Regulators now classify liquidity risk under three headings: (1) funding mismatch risk, i.e. the risk that the firm will not have sufficient funds to meet its normal obligations; (2) market liquidity risk, i.e. the risk that the firm will not be able to convert assets to cash or to access financing on reasonable terms (owing to a lack of buyers or uncertainty over valuation); and (3) contingent liquidity risk which results from difficulties in meeting obligations due to firm-specific or market-wide unexpected events. All three categories of liquidity risk have been features of current turbulence but the third has attracted special attention owing to its importance in connection with securitization exposures. Banks have faced the contingent liquidity risk of having to reconcentrate on their balance sheets liquidity and credit risks from the off-balance-sheet ABCP conduits (described above) originally created or sponsored by them for which short-term funding from investors subsequently dried up.

The FSF Report's recommendations concerning liquidity risk focus on strengthened supervision and internal control. Under the latter the emphasis is on more rigorous stress testing, a tool used to evaluate through computer simulation the potential impact of an event or movement in a set of financial indicators. According to the Report the stress testing should be linked more closely to banks' contingency funding plans.[The Basel Committee on Banking Supervision has issued a draft for consultation, Principles for Sound Liquidity Risk Management and Supervision, summarized in SUNS 6498, 17 June. 2008.]

Regarding the relationship between the management of liquidity risk and Basel 2 the FSF Report's recommendations refer mainly to Pillar 2 (supervisory review) and Pillar 3 (disclosure). The recommendations do not include increases in regulatory capital specifically to cover liquidity risks. This is unsurprising in view of the lack of regulatory consensus on a basis for such increases

Not including such a recommendation also accords with the position of major banks expressed in the report of the Institute of International Finance on the management of liquidity risk already mentioned: "Liquidity regulations should be based on qualitative (Pillar 2) risk-management guidance, not specific quantitative (Pillar 1) requirements. ...Quantitative legal entity

requirements...may impinge on the ability to manage liquidity on a group-wide basis” (owing to the diversity of required and available liquidity and of legal rules in different countries) [Principles of Liquidity Risk Management, pp. 40-41].

The strengthened defenses of financial firms will be tested during periods of illiquidity in future financial crises which, regardless of the implementation of the FSF Report’s recommendations, can be expected to continue to recur periodically.

BANKERS’ REMUNERATION

What is widely considered to be the outlandishly high remuneration of executives of the financial sector is generating a political backlash. In the FSF Report’s characterization, “One of the striking features of recent events has been firms’ sizeable payouts to staff in areas in which the firms have subsequently incurred very large losses as risks materialized. Compensation arrangements often encouraged disproportionate risk-taking with insufficient regard to longer-term risks.” The Report’s recommendation is that compensation models should be aligned with long-term, firm-wide profitability, and that regulators and supervisors should work with market participants to mitigate risks due to inappropriate incentive structures.

In the Interim Report of the IIF Committee on Market Best Practices of April 2008, the bankers represented by the Institute of International Finance acknowledge the same distortions as those in the FSF Report but wish to retain control over the reform of compensation models: “There is a strong sense that externally mandated compensation policies would be at odds with the need to forge competitive, efficient firms that serve the interests of consumer and corporate clients”. The IIF’s lukewarm mea culpa may fail to ward off pressures for external intervention in the determination of executive compensation not only in the financial sector but also in other large non-financial firms.

OTHER ISSUES UNDER STRENGTHENED PRUDENTIAL OVERSIGHT

The FSF Report draws attention to longstanding regulatory concerns over weaknesses in the settlement, legal and operational infrastructure of the markets in over-the-counter (OTC) derivatives. An idea of the volume of activity requiring internal controls is given by a 2002 Survey of ISDA, an industry group which was established in the mid-1980s to promote a dealing market in derivatives and whose major achievement is the development of standardized documentation for derivatives contracts. On a weekly basis the average large dealer entered into 1,900 transactions and made over 22,000 settlements involving OTC derivatives. These already substantial figures will have increased since 2002, and with them the scale of the arrangements needed to control them.

TRANSPARENCY AND VALUATION

Enhancing transparency is a standard recommendation in official reports concerning the functioning of financial markets. Disclosure requirements for these markets vary according to the regulatory status of the financial firm and the category of transaction. Notoriously opaque are many OTC derivatives transactions, the assets and liabilities of special purpose vehicles established in connection with securitization, and firms subject to only limited regulatory oversight such as many hedge funds.

As background to its recommendations the FSF was able to draw upon the findings of an April 2008 survey (Leading-Practice Disclosures for Selected Exposures) of 15 major banks and five securities firms conducted by a Senior Supervisors Group from France, Germany, Switzerland, the United Kingdom and the United States. Most of these firms did disclose the overall scale of their involvement in and exposure to different forms of securitization. But disclosure by different category

of exposure was spottier, as was that concerning valuation methods used by the financial firms, their hedging, and the sensitivity of valuation to changes in their assumptions about market conditions.

Many of the recommendations in the FSF Report on disclosure are directed at shortcomings revealed by the credit crisis. There is special emphasis on enhanced disclosure on the part of all those involved in the different stages of the securitization process: originators, arrangers, distributors, managers and credit rating agencies. The Report notes that during the crisis arrangers often withheld from investors and credit rating agencies the results of their due diligence concerning the assets underlying securitizations.

The FSF Report's observations on valuation have come at a time of continuing controversy within the accounting profession concerning the appropriate way to value financial instruments. Under current United States rules which serve as the basis of international standards various alternatives are available for valuing these instruments.

In the case of many derivatives, subject to the fulfillment of certain conditions, firms can use hedge accounting under which gains and losses from derivatives offset losses and gains of similar magnitude during the same accounting period on the items hedged, thus minimizing the effects on the firm's income statement. Except in the case of items held on the balance sheet at amortized cost less provisions for losses (a category which typically includes loans which are not available for sale), other financial instruments are measured at fair value.

The fair value of a financial instrument is an estimate of the price at which it could be traded between willing parties, and thus reflects current expectations concerning the instrument's cash flows and market prices. Fair values are estimated either from observed market prices or through the use of a valuation model. In the case of instruments designated as held for trading unrealized gains and losses are recognized in the income statement in the period when they occur, although this period may precede that of their realization through sale.

Controversy concerning fair value applies especially to transactions or periods for which market prices are difficult to identify because the markets are inactive or non-existent, as they have been for many financial instruments during the credit crisis. The procedures used for valuation in such circumstances (often described as mark-to-model as opposed to mark-to-market) are subject to criticism owing to doubts about the validity of the estimates so obtained and to the uncertainty which they introduce into figures for earnings. Another March 2008 report of the Senior Supervisors Group mentioned earlier (Observations on Risk Management Practices during the Recent Market Turbulence) emphasized its survey-based finding that in financial firms which had performed better in 2007 rigorous internal processes for the valuation of complex and potentially illiquid securities had been installed as part of risk management.

The FSF Report's recommendations in this area are for the strengthening of accounting and disclosure rules and of audit guidance on the part of international standard setters such as the International Accounting Standards Board (IASB) as well as of internal controls by financial firms. Attention is drawn by the FSF to the work on valuation currently ongoing in the IASB but, perhaps understandably, there is no reference to the ongoing discord in the accounting profession and to criticisms of rules on fair value among policy makers concerned with their effects in practice.

ROLE AND USE OF CREDIT RATINGS

As the FSF Report puts it, "One of the important triggers of the current turmoil was the precipitous decline in confidence in ratings of structured credit products. After assigning high ratings to [such

products] between 2004 and 2007, and thus contributing to the phenomenal growth of subprime lending, since mid-2007 CRAs [credit rating agencies] have announced an inordinate number of rapid multi-notch downgrades of these instruments”.

The performance of CRAs in the rating of structured credit products based on securitizations is widely regarded as characterized by several shortcomings. With respect to rating methods these shortcomings involve both the modeling of credit risks and due diligence in the assessment of the credit quality of the assets backing structured credit products. According to the FSF, failings in due diligence included missing clear signs of fraud in the loan files of a significant fraction of defaulting subprime mortgages. Moreover the issuer-pays model used to set payments to CRAs for the rating of structured credit products is particularly susceptible to conflicts of interest owing to the scope of the advisory role which CRAs often also assume.

Many of the recommendations of the FSF Report concern strengthening CRAs’ internal processes for producing ratings and their arrangements for avoiding conflicts of interest. The FSF expresses tentative support for a separate system of symbols for ratings of structured credit products to distinguish them from traditional ratings of corporate bonds.

The FSF Report also noted that the International Organization of Securities Commission (IOSCO) was due to issue a revised version of its Code of Conduct Fundamentals for Credit Rating Agencies by mid-2008. This is now available [Technical Committee of the International Organization of Securities Commissions, Code of Conduct Fundamentals for Credit Rating Agencies, Revised May 2008]. Predictably there is considerable convergence between the contents of the FSF Report concerning CRAs and the more comprehensive recommendations of IOSCO.

What remains to be seen is how the recommendations will be implemented: whether the policy choice will be reliance on voluntary implementation by the CRAs themselves or whether statutory backing for at least some of the recommendations will be forthcoming from individual countries or the EU. Moody’s, one of the three major global agencies, and many asset managers have already expressed opposition to the recommendation of a separate system of rating symbols for structured credit products.

Interestingly the FSF Report acknowledges the possibility of some regulatory responsibility for over-reliance on credit ratings in assessments of creditworthiness. Official recognition of ratings in regulation and supervision is capable of encouraging over-reliance by investors. (Such recognition is evident in ratings’ important role in the assignment of minimum capital requirements for securitization exposures in Basel 2.) Stocktaking of this issue is promised by the FSF, though no indication is given of “the transitional implications of any changes to regulations and supervisory rules” which may be proposed.

AUTHORITIES’ RESPONSIVENESS TO RISK

The FSF Report’s emphasis is on reinforcing supervisory capacity and arrangements for information exchange and other cross-border cooperation among regulators and supervisors.

The recurrence in official reports of recommendations on cross-border information exchange and other cooperation among supervisors reflects continuing problems associated with this apparently humdrum subject due to differences in languages, cultures and legal frameworks. According to the Italian finance minister during much of the recent period, “in the EU, the recent financial turbulence was a revealing test. While, in the monetary field, the European Central Bank (ECB) has acted quickly and decisively, the supervisory function has been almost absent: no effective sharing of evidence,

not even special meetings to form a common assessment of the events and upcoming risks” [Tommaso Padoa-Schioppa, “Better supervision is key to stability”, *The Banker*, April 2008].

In its recommendation concerning the need for supervisors to have requisite resources and expertise to oversee the risks associated with financial innovation the FSF would appear to be acknowledging the difficulties which such innovation has posed for supervision and which have not always been handled in a satisfactory manner .

The FSF also concedes the only limited success which regulators and supervisors had during the years preceding the current market turmoil in focusing the attention of participants in financial markets on weaknesses in their functioning. In some cases this lack of success has been due to understatement and excessive caution – a point not made by the FSF. An often cited example is the April 2007 edition of the IMF’s Global Financial Report which forecast that investors in highly rated tranches of mortgage-backed securities were most unlikely to face losses.

Two recommendations under authorities’ responsiveness to risk are especially worthy of note.

The first is for the establishment of international colleges of supervisors for the largest global financial firms. This would help to give a more systematic character to the cross-border supervisory cooperation required for the operations of such firms. It would also facilitate the cooperation in dealing with weak banks which is also a major topic of the FSF Report.

The second is related to strengthening the capacity of policy makers to handle the seizing-up of financial markets in periods of illiquidity. The FSF recommends that large banks be required to inform central banks of their contingency plans for managing liquidity risks.

ROBUST ARRANGEMENTS FOR STRESS

The FSF’s recommendations under this heading cover (1) monetary policy and lender-of-last-resort operations and (2) arrangements for dealing with weak banks.

Under the first heading the FSF’s recommendations include the establishment of swap lines among central banks as part of arrangements for the provision of liquidity in different currencies during times of stress. Swap arrangements have long been among the policy tools deployed by governments during foreign exchange crises. What is more novel in the FSF recommendations would be the formalization of standing cross-border swap facilities designed to enable central banks to provide liquidity in different currencies to international banks during periods of stress, in effect setting up swap lines which would be part of central banks’ lender-of-last-resort arrangements.

The difficulties faced by some major international banks during the credit crisis have undoubtedly rendered more real for regulators the specter of the insolvency of a major international bank or financial conglomerate. Development of an international consensus concerning the rights and responsibilities of parties in different countries in such a situation is a longstanding issue under international financial codes and standards. The problem is being considered by a working group of the Basel Committee on Banking Supervision which aims to produce an initial internal report by November 2008.

(In the second part of the article the author looks at policy actions so far in areas covered by the FSF Report and provides a preliminary evaluation of major features of the Report.)

POLICY ACTIONS SO FAR

In a short June 2008 report to the G8 finance ministers, Update on the Implementation of the FSF’s Recommendations, the FSF takes an upbeat line, noting that conditions in financial markets are calmer, and that financial institutions have raised substantial amounts of capital and improved their

liquidity positions, while also reducing leverage. However, the Update avoids specifying how far this characterization is generally applicable among firms in the financial sector. The review of progress focuses on ongoing work and on initiatives in the form of proposals in major areas rather than on implementation –predictably since these are still early days.

In the United Kingdom, in the light of an internal audit of failings in its performance as a supervisor during the funding crisis of the bank, Northern Rock, the Financial Services Authority has put forward a programme for strengthening the rigour, range and depth of its supervision. Somewhat more controversially the government has proposed as part of a blueprint for the Bank of England the establishment of a committee to oversee financial stability. This appears to be an attempt to upgrade financial stability in the Bank's deliberations where it has previously tended to be overshadowed by the focus on monetary policy.

In the United States the President's Working Group on Financial Markets, an interagency body of the Treasury, the Federal Reserve, the Securities and Exchange Commission and the Commodity Futures Trading Commission, issued in March 2008 a Policy Statement on Financial Market Developments which covered ground similar to that in the FSF Report, and made recommendations on the mortgage origination process, investors' contribution to market discipline, the credit rating agencies, financial firms' risk management, prudential regulation and the infrastructure for derivatives markets. These recommendations have a thrust similar to those of the FSF Report but one specifically adapted to United States financial markets.

The same month witnessed the publication of the United States Treasury's Blueprint for Financial Regulatory Reform which was the outcome of a process begun in early 2007 but which attracted special attention owing to the coincidence of its release with continuing financial turbulence. The Blueprint would rationalize the existing system of multiple regulatory agencies under three headings, overall market stability, prudential regulation of firms, and business conduct (consumer protection through rules for disclosures, business practices and licensing, etc.). The Blueprint has been criticized for the central role which it assigns to the Federal Reserve in the supervision of financial stability despite the Fed's failure to gauge or control the risks of credit expansion during the period leading up to current turbulence. Action on the Blueprint is unlikely during the current Bush Administration.

TOWARDS A PRELIMINARY ASSESSMENT

The success of the recommendations in the FSF Report will depend on the ways in which they are incorporated in national regulatory rules, and in the actual practice of supervisors and of those responsible for financial firms' internal controls. But certain points bearing on the likelihood of the eventual emergence of more healthy financial sectors are worth making.

The FSF's recommendations depend crucially on good risk management within financial firms. This accords with a trend towards the increased emphasis on such dependence now characteristic of financial regulation. The rules enunciated by international bodies concerning banks' risk management are generally well conceived, though they sometimes lag developments in firms' practices. But well conceived rules achieve their objectives only if properly implemented and enforced.

However, recent experience suggests that firms' own internal auditing and due diligence cannot necessarily be relied on. This proved especially the case during the recent boom in which representations of those responsible for banks' internal controls could be, and apparently often were, overridden as part of drives to achieve rapid increases in profits. Such overriding often reflected the relative weights in managerial deliberations of those who contribute directly to firms'

short-term profits (and who are the recipients of huge remuneration) and those responsible for the proper functioning of internal controls (who are typically much less generously rewarded). Even when problems due to lax implementation of internal controls are eventually identified by a bank's external auditors, irreversible damage may already have taken place with all which this implies for the value and reputation of the firm, not to mention in some cases for the financial sector more broadly

Among ideas mooted (but not in the FSF Report) for dealing with shortcomings in the implementation at firm level of internal controls is an upgrading of the professional competence of banks' boards of non-executive directors. Boards would include more members with hands-on experience of banking. However, to be effective, such directors would have to invest substantial amounts of time in their responsibilities for vetting banks' internal controls and would have to face the same problems in indentifying shortcomings as the risk managers already in place. Arrangements facilitating careers which combined periods in bank risk management, bank auditing , and supervision might also help here. Such arrangements would require élite status and pay to match for the supervisors involved.

Financial firms' incentives systems, which have an important bearing on the effectiveness of internal controls, are partially, but arguably insufficiently, addressed in the FSF Report. The sheer scale of rewards in the financial sector can assure recipients (as well as their heirs) a luxurious life style after in some cases only a fairly brief career. Measures more stringent than the somewhat loosely defined alignment of compensation models with long-term, firm-wide profitability proposed by the FSF will probably be needed to overcome the distorting influence of inordinate pay packages.

The issue of excessive remuneration is closely related to more general ones of the corporate governance of financial firms, where corporate governance overlaps financial ethics. Conspicuous features of behaviour in the financial sector during the period leading to current turbulence have been failures by those working for financial firms to observe the requirements of fiduciary duty (which can be defined as the exercise of that degree of judgment which men of experience, prudence, discretion and intelligence exercise in the management of their own affairs, not for speculation but for investment, considering the probable safety of their capital as well as the probable income to be derived).

Such failures have been evident in the derivatives business and in subprime lending and securitization. The omission of explicit reference to breakdowns in corporate governance and financial ethics in the FSF Report does not mean that they were not important influences on many of the shortcomings identified, rather that these were subjects concerning whose appropriateness for inclusion it would have been difficult to achieve a consensus among the FSF's membership.

The overriding priority attributed in the new climate of corporate governance to the maximization of shareholder value (which is usually equivalent to the maximization of short-term profits) is felt throughout the different levels of financial firms. Its contribution to high-profile management failures is illustrated in the revealing report of UBS on its risk management and internal controls [Shareholder Report on UBS's Write-Downs, 18 April 2008] UBS explains the way in which growth orientation led to "an asymmetric focus in Investment Bank Senior Management Meetings on revenue and P&L, especially when compared to discussions on risk issues".

Elevated growth objectives are now wired into financial sectors not only at firm but also at industry level. It is not uncommon for industry associations, and even governments, to set targets for their countries' financial sectors which are determined by the objectives of becoming regional financial centers or even of competing with major existing international financial centers. The danger is that

pursuit of these objectives will be at the expense of the traditional features of good banking, namely proper assessment and pricing of banking risks and good management of relations with customers.

PLUS CELA CHANGE

In consideration of the implications of current financial turbulence and of the recommendations of the FSF Report for the design and reform of financial systems for countries other than FSF members it is worth stepping back and looking at a longer swath of history.

The events leading to the United States banking debacle of 1929-1933 had significant likenesses to the developments which preceded the current turbulence. Of special interest here are banks' relationships in that period with their securities affiliates as analogues of the shadow, unregulated banking system associated with recent securitization.

As part of 1931 hearings a subcommittee of the Senate Committee on Banking and Currency under the chairmanship of Senator Carter Glass, basing itself on an analysis of the performance of 14 bank securities affiliates, listed various ways in which the operations of such an affiliate could, and often did, affect the position of the affiliated bank. These included the following: (1) "very prevalent" borrowing by the affiliate from the bank; (2) the purchase of securities by the bank to relieve the affiliate of excess holdings; (3) more liberal lending by the bank to customers on issues sponsored by the securities affiliate in order to support their distribution; (4) making of unwise commitments by the bank, in the knowledge that in case of need they could be shifted to affiliates and thus removed from the bank's condition statement; and (5) in reliance upon the resources of the parent bank in case of need, the tendency of securities affiliates to assume commitments less cautiously than private investment bankers. [These features of the subcommittee's findings are taken from the more comprehensive list in William Upshaw, "Bank affiliates and their regulation", Part 1, Federal Reserve Bank of Richmond Monthly Review, March 1973.]

The potential of this system to transfer instability between different entities of a bank holding company and the opportunities which the system provided for conflicts of interest were important parts of the motivation for the US Banking Act of 1933 (Glass-Steagall) which was designed to achieve substantial separation of commercial and investment banking. Through regulatory actions from the 1970s onwards the restrictions of the Act were gradually made more flexible before being repealed in the Gramm, Leach, Bliley Act of 1999.

The broader point which should emerge from this historical reference is not that other countries should adopt their own versions of Glass-Steagall. Rather the reference serves to highlight that the legal framework governing the separation or the degree of permissible integration of commercial and investment banking is a matter of policy choice and system design. There is nothing inevitable about evolution towards a model of the financial sector where the commanding heights are occupied by large financial conglomerates. Nor, in the light of the failings of such conglomerates thoroughly exposed during the financial turbulence, does there seem to be any necessary reason for the objectives of policy towards the financial sector to include progress towards this model.

The backlash for which these financial conglomerates will have been largely responsible may lead to the establishment in countries with major financial centers of behemoth regulators to supervise them. The question for developing countries is whether they want in their jurisdictions either financial firms which have the potential to become behemoths or the behemoth regulators which such institutions may eventually require.

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