

SUPERVISING RISK-TAKING IN WORLD FINANCIAL MARKETS

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ABSTRACT

A major international financial policy objective in both developed and developing is to strengthen the capacity of individual countries and of the international financial system as a whole to control financial instability and limit the number and extent of financial crises. A great deal remains to be done, if the stimulus from recent crises is to be fully reflected in better risk management by financial institutions and in improved supervision on a global scale. In the past, recovery from financial crises has usually blunted reform efforts and the lessons have had to be painfully re-learned. For a more effective containment of the financial crises, it will require a major extension of the public monitoring effort on a global scale and the embedding of more and better incentives for risk-mitigation into the system.

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SUPERVISING RISK-TAKING IN WORLD FINANCIAL MARKETS

1. INTRODUCTION

Financial crises at the national level, mostly involving systemic bank collapses, have long been a feature of the world, sometimes spilling over into international crises (Kindleberger, 1996). The past two decades have seen major financial crises in many industrial and developing countries, and in 1997-1998 a number of hitherto very successful Asian countries have seen dramatic losses in confidence. Substantial problems of financial market credibility appeared moreover since the 2000. This paper puts forward some ideas regarding the role that financial supervisors, especially through their international groupings, should play in strengthening the international financial architecture. This means the setting up of new institutions and the changing the mandate of existing institutions (Drage and Mann, 1999).

A major policy objective of international policy makers – in G7 and other industrial countries, in developing countries, and in the international agencies such as the IMF and World Bank – is to strengthen the capacity of individual countries and of the international system as a whole, to limit the number and extent of financial crises. The issues involved in managing crises better – such as sorting out failing banks, the terms of private sector involvement in rescue packages, IMF conditionality – are the subject of extensive work elsewhere, for example the G22 report on international financial crises, and the report by the IMF Managing Director on progress in strengthening the international financial architecture. The two sets of issues – prevention and cure – are of course related, since the way in which each crisis is managed sends out powerful signals for the future.

The thesis of this paper is that the standard-setting role, of financial supervisors in particular, needs to be complemented by a much stronger emphasis on compliance, by firms and by supervisors themselves, with standards. The first big step is an independent assessment of compliance with standards, and this work is underway in a few countries. The second step, just beginning, should be publication of these assessments, so that they are available to all who participate in financial markets. The third step should be making use of these public assessments in building in more incentives for compliance.

These three steps pose big challenges to the supervisors and their international groupings (the standard-setters), and to the IMF and the World Bank (the compliance officers): they have all begun to work together much more closely. A new high level committee, the Financial Stability Forum, offers an opportunity to bring together the key players and provide political impetus. The changes in financial architecture are modest; but the significant changes that are taking place within institutions and between them amount to extensive plumbing work.

Carrying these changes through will require much effort, more resources, and (what has been lacking) a determination to press on well after the crises have turned into recovery. The need to reduce financial and systemic risks is very clear from the heavy costs incurred in recent years.

2. COSTS OF FINANCIAL CRISES

There is a growing volume of work on the very high costs of financial, mainly banking, crises. These include both direct economic costs and indirect costs due to contagion effect. More specifically, direct costs include taxpayer costs (bailout cost), depositor cost (risk of lost savings), creditor cost (unpaid debts), shareholders cost (lost equity), employee cost (lost jobs) and government cost (increased deficit). Further, due to contagion effects, local financial crises spread out in a global scale and exert a much wider impact. This was certainly the case with the global financial crisis in 2007 which essentially started in the sub-prime segment of the US housing market but whose contagion effects were far reaching. The chain of reaction was initiated by problems in the US sub-prime mortgage markets and spread to mortgage companies to lenders & home builders to financial markets to the US economy to the global economy.

Financial crises eventually feed through into the real economy and usually cause a fall in business investment that takes on the following forms: (a) higher cost of credit – commercial banks become more risk averse and may raise interest rates on higher risk loans; (b) falling asset prices weaken bank balance sheets and constrain the volume of lending to the private sector; (c) a desire to maintain higher liquidity causes a fall in lending to new and small businesses which can hamper entrepreneurial activity; (d) the fall in asset prices causes a fall in consumer spending / aggregate demand and economic confidence – businesses less likely to invest when spare capacity is growing; and (e) a fall in share prices hits the ability of listed companies to raise extra capital to fund their investment plans.

The following table 1 shows estimated costs to the taxpayer – usually met by bond issues – of some of the crises of the last twenty years. The costs are very rough and ready, and take account of direct costs to governments: to the extent that cost recoveries take place in the future, the costs will be less; but there may well be so far unrevealed costs of bad loans and extra indirect costs, for example when governments provide guarantees or monopoly privileges to banks or where there are unmeasured burdens from the effects of crises in widening interest rate spreads. Losses of output and real income, while less than the costs to governments, and even more difficult to measure, have usually been large. These figures, which are not fully comparable across countries, are taken from World Bank studies by Klingebiel (1999) and IMF studies by Balino (1999) and others. This table includes rough estimates of the cost of recent crises in Asia. More recently, the US Treasury Department, in an April 2012 assessment, estimated the total lost household wealth due to the crisis at \$19.2 trillion. But this figure doesn't take into account long-term effects of homeowners who may be less socially mobile and therefore it therefore contributes less to the economy over time.

Further, table 2 shows the impact of crises on share prices. Peak to trough losses vary considerably. During the recent crisis the loss in the US markets was 48% and in the UK was 44%.

Another feature of the past two years has been the greatly increased volatility in some financial markets. Houseman (1999) shows that for recent years the extent of volatility in capital flows to emerging markets and in spreads on emerging market bonds over US T-bills was very high. These reflect mainly the Mexican crises of late '94 early '95, the Asian and Russian crises of 1997-98, and the

more general flight to quality in 1998, including the near panic at the time of the LTCM affair.

Table 1. Costs of financial crises in selective cases

Country	Years	Cost (% GDP)
Argentina	1980-82	55
Chile	1981-83	41
Cote d'Ivoire	1988-91	25
Finland	1991-93	8
Indonesia	1997-99	45
Korea	1997-99	15
Thailand	1997-99	40
Sweden	1991	6
United States (S&L)	1984-91	3
Israel	1977-93	30
US subprime	2007-08	13

Source: Klingebiel (1999); author's calculation

Table 2. Impact of financial crises on share prices

Year	Crisis	Peak to Trough Loss			Crisis Type			
		UK	US	Asset Bubble	Sovereign Crisis	Currency Crisis	Inflation Crisis	Banking Crisis
1720	South Sea Bubble	80%	-	x				x
1825	The Country Banking Crisis	43%	3%	x	x			x
1845	Railway Mania Bubble UK	9%	5%	x	x			
1857	Railroad Mania Bubble US	13%	23%	x				x
1866	Collapse of Overend and Gurney	7%	6%					x
1873	Long Depression	33%	47%		x			x
1890	Baring Bank Crisis	9%	42%	x		x		x
1907	US 'Bankers' Panic'	19%	26%	x				x
1929	Wall Street Crash	52%	85%	x		x		x
1983	Latin American Debt Crisis	5%	20%		x	x	x	x
1987	Black Monday	31%	30%					x
1997	Asian Crisis	12%	6%	x	x	x	x	x
2008	Great Financial Crisis	44%	48%	x	x			x

Source: <http://www.risk.jbs.cam.ac.uk>

3. THE (IN)EFFICIENCY OF MARKETS

These developments have raised in a dramatic way the long debated issue of how far the observed volatility in these financial markets is a function of the real risks inherent in this lending, and rational expectations of change; and how far a consequence of inherently unstable financial markets, or of markets distorted by

mistaken incentives for lenders and borrowers. At the risk of oversimplifying, it may be helpful to identify three, not mutually exclusive, views:

First, there are those who believe in inherent instabilities in financial markets: for example, from their short-term outlook e.g. because of incentive systems arising from bonuses; because of externalities, such as the neglect by individual institutions of systemic risk (Eatwell and Taylor, 1999); or because of multiple equilibriums (Shin, 1999).

Second, there are those who believe that financial markets can work well, but not if the incentives are wrong, as suggested by Wolf (1999); or absent co-ordination of creditors, as proposed by Haldane (1999). Factors which can encourage financial institutions to take on too much risk, with the occasional panic when reality takes hold, include:

- Excessive safety nets at the national level, including too extensive guarantees to depositors, and a reluctance promptly to take action against failing banks; this is seen as leading to banks' risk taking being partly underwritten by the authorities (moral hazard);
- Excessive safety nets at the international level, arising from large country rescue packages, which can allow banks to enjoy returns higher than justified by the risks;
- Incentives, e.g. in the 1988 Basel Capital Accord, that are seen to unduly encourage short-term capital flows¹.

Third, there are those who believe that the volatility in emerging markets is a reflection of the inherent risks involved in often unstable environments, where little confidence can be held in future financial stability, as in the recent book by Friedman (1999). Major fault lines, whether related to macro policy (e.g. pegged exchange rates) or to the frailty of the financial system, are seen as the main cause of the high volatility. Most recent work in the international community of policy makers has focused on addressing both the second and third issue by:

- re-examining the role of domestic and international safety nets, including the functions and lending policies of the IMF; reducing or eliminating the "short term bias", as one element in the proposed revision to the 1988 Basel Capital Accord² and improving deposit insurance arrangements and consumer compensation schemes;
- helping individual countries put in place a greater degree of financial stability at the macro level; building up defenses (e.g. external reserves); and improving the robustness of the financial sector, e.g. through better supervision and more market discipline.

Not much has been done about the first issue.

¹ The 1988 Capital Accord says that banks' claims on all other banks should attract a capital charge of 1.6% provided the claim is for less than a year; and of 8% if the claim is both more than a year and on a bank whose government is not a member of the OECD. This five-fold increase in the capital charge is believed to have increased the proportion of short-term bank finance in capital flows to Asian countries in the 1990s. See, for example, a paper by Governor Meyer. A study by a Basel group of supervisors led by Bonte found that the evidence was not conclusive.

² The new Capital Adequacy Framework, Basel Committee, June 1999, available on the BIS website, provides two options for risk weighting of banks, one of which would eliminate altogether any incentive to make loans short-term, and the other would reduce the incentive. There is clearly more work to be done in this area.

4. THE CHARACTER AND STRUCTURE OF SUPERVISORS

At national levels, financial supervision evolved largely in response to events. In the Anglo-Saxon countries, for example, statutes on insurance date back to previous centuries, with insurance supervision in broadly its existing form being just a few decades old. The growth of financial systems, in size and sophistication, with many different markets and instruments, led to increasing involvement by public policy agencies, both as providers of safety nets and various forms of consumer protection and, as a corollary, as supervisors³ not only of banks and insurance companies but also of securities markets and investment business. Today, the objectives given to supervisors now include, broadly speaking, maintaining confidence and order in financial markets, protecting the consumer, raising consumer awareness, and combating market abuse. The broadening of supervisory objectives, together with the rapid development of financial markets and the breaking down of distinctions between different institutions, have led to organizational shifts in supervision in many countries, increasingly concentrated in a single institution (see the FSA in the UK as well as the developments in other European countries, e.g. Sweden and the Netherlands).

At the international level, there are three main supervisory groupings: The Basel Committee on Banking Supervision was formed in 1975; IOSCO (the International Organization of Securities Commissions) in its present form dates from 1990; and IAIS (the International Association of Insurance Supervisors) in 1994. The Basel Committee has members from 12 countries, and observers from the European Commission, the ECB and the BIS Financial Stability Institute, whereas IOSCO and IAIS have worldwide membership (see Table 3).

Table 3. Supervisory Collective Institutions

COLLECTIVE INSTITUTION	CORE PRINCIPLES	SECRETARIAT STAFF	COUNTRY MEMBERSHIP
Basel Committee	Yes	15	12
IOSCO	Yes	6	91
IAIS	Yes	5	80

Each of these bodies provides a forum for supervisors to get to know each other, exchange information, and set standards. All seek to operate by “consensus”: only the IAIS has formal voting rules. None have formal powers to censure let alone impose sanctions on members, but are able to exert, with variable success, informal peer pressure. In each of the groupings the effective decision making bodies (the Basel Committee and the Technical Committees of IOSCO and IAIS) are made up of a relatively small number of countries. Outreach to the rest of the world is done through a wide (but not totally comprehensive) membership, in the

³ It is convenient to use “supervision” for all the work of overseeing financial institutions; and to use “regulation” for the narrower process of setting rules, whether by supervisors collectively (as in Basel or IOSCO) or by law. In practice, supervisory groupings – national and international – invariably deal with both.

case of IOSCO and IAIS, and partially by the Basel Committee, including through a Liaison Group with selected supervisors from round the world. Another characteristic of these groupings is that they each have a small dedicated secretariat, so that much of the work is done by the members and their staffs – unlike, for example, the international financial institutions.

A little-publicized, but operationally very important, aspect of cooperation between supervisors is the growing practice of bilateral / multilateral meetings to exchange information. Most of this activity takes place within the framework of Memoranda of Understanding: these define in broad terms the subject matter and circumstances of information exchange, from the standpoint of home and host supervisors. While this exchange is mostly concerned with firms' ongoing business, the contacts and trust built up are helpful if crises occur and information is sought at very short notice.

5. SETTING OF STANDARDS

The Basel, IOSCO and IAIS websites show the extent of work done in recent years on setting standards, both for supervisors and for those supervised. These standards relate to principles of supervision (the “Core Principles” of Basel and IOSCO), to rules of disclosure by firms, to risk management, to minimum capital standards and so on. Standards relevant to supervision are also set by the international accounting and auditing bodies (IASB, IFAC and IAPC) and by the OECD for corporate governance. Accounting standards, especially those relating to disclosure about financial instruments and risks (IAS 32 and the proposed IAS 39), are particularly important, and controversial, for financial firms and supervisors. Checking compliance by firms with these standards is a matter for supervisors in individual countries. The need for compliance with accounting standards also features in the Basel Committee's Core Principles of Banking Supervision and in many of IOSCO's objectives.

Supervisors are well aware that their work has to be applied in the context of particular economies and their institutions, and within the established policy framework. Supervisors should also be one of the participants in the development of relevant policies and legislation. The Basel Committee have defined (in the rubric for the Core Principles, available on the BIS website) the following preconditions for effective supervision in banking, investment and insurance business:

- A reasonably stable macro-economic environment;
- A well-developed public legislative and institutional infrastructure, including accounting rules;
- Effective market discipline, through greater transparency and disclosure, and the avoidance, as far as possible, of uncertain/implicit government guarantees;
- Procedures for efficient resolution of problems in financial institutions;
- Appropriate safety nets, that place emphasis on the disciplinary role of competition.

The need for competition, particularly foreign competition, in financial services is another important requirement for a healthy financial sector. It is worth noting that most countries in Latin America, following extensive banking crises in the 1980s, had opened up their financial systems (and strengthened supervision); whereas many countries in Asia made it difficult for foreign competition to enter, thus

closing off one important transmission mechanism for good management and new techniques to strengthen the domestic financial sector. In Asia, it is ironic that the open trading policies so successfully pursued by many countries in manufactures, and which were celebrated in the so-called East Asia miracle, were not followed in financial services. Reform programmes in these countries now put a welcome emphasis on opening up trade in financial services and cross-border establishment of firms.

Where these pre-conditions are not met in full – for instance, in economies with large macro-economic swings – supervisors are increasingly ready to apply more stringent tests e.g. higher minimum capital standards.⁴ Moreover, there is a growing realization that some economic policy choices have major implications for supervisors and their policies; and that the two sets of policies need to be much better integrated. An example is exchange rate policy: The Asian crises, in particular, have led to much questioning of fixed, or semi-fixed, exchange rates; and much discussion of the merits, and stability properties, of other exchange rate regimes. From a supervisory perspective, even more important than the stability properties of a particular regime is the extent to which it allows or encourages hedging by financial institutions. A pegged exchange rate regime, with a political commitment, makes it much more difficult, for supervised firms and their supervisors, to take account of currency risks.⁵ Another example is the excessive reliance on banks in many financial systems, and the need to develop money, bond and equity markets much more fully: this could reduce corporate leverage, improve corporate governance and by reducing reliance on bank financing make the system more resilient to shocks.

Rapid developments in financial markets, together with the impact of financial crises, are leading to new and revised rules in many areas. The Asian crises have provided a major stimulus to this work. This paper will consider three main areas of standard-setting work amongst supervisors: core principles of supervision; minimum capital; and disclosure, particularly with regard to highly leveraged institutions.

5.1 Core Principles

The Basel Committee developed its Core Principles of Banking Supervision in 1997, as part of its outreach to supervisors outside the G10 and in response to the many banking crises in the previous 20 years. The work was given a big impetus by the Asian and other crises. Twenty five basic principles⁶ were laid down, applicable to supervisors worldwide, (almost) whatever the economic or political systems in each country. The principles were developed in consultation with supervisors round the world; and the Basel Committee set up a Core Principles Liaison Group, bringing together members of the Committee, selected supervisors from non-G-10 countries (including a number of developing countries), together with staff from the IMF and World Bank.

⁴ Higher capital requirements, as a supervisory reaction to the absence of some of the pre-conditions, are generally a lot better than nothing; but putting in place the right policy framework, so that the pre-conditions are met, is best.

⁵ On the difficulties of pegged exchange rates, including prudential supervision of foreign currency exposures, and on the need to reduce the dependency on banks within the financial system, see the Balino et al (1999) IMF study “Lessons from Asia”.

⁶ As an example, Core Principle 1(1) says “An effective system of banking supervision will have clear responsibilities and objectives for each agency involved in the supervision of banking organisations”.

IOSCO's thirty Objectives and Principles of Securities Regulation aim to achieve three objectives: the protection of investors; ensuring that markets are fair, efficient and transparent; and the reduction of systemic risk. They were agreed by the membership and published in September 1998. Their focus is on the key issues of concern to supervisors, with detail on best practices when setting up supervisory systems and approaches. The regulator, firms, markets, enforcement, and international co-operation are all covered. The "Insurance Supervisory Principles", agreed by the IAIS membership in 1997, identify key issues fundamental to effective insurance supervision. The Principles set out areas in which the insurance supervisor should have authority or control, and form the basis from which more detailed standards are being developed. The Principles are complemented by the Insurance Concordat which covers the particular problems involved in the supervision of international insurers and insurance groups and their cross-border operations.

5.2 Minimum capital requirements

Minimum capital requirements for banks have been a cornerstone of the Basel Committee's work since the mid-1980s, and led to higher capital being held by nearly all international banks. The Committee's June 1999 Consultative Paper aimed to produce a new Capital Accord, so as to increase the safety of individual banks and of banking systems; and to relate capital charges more closely to the risks run by banks – taking account of developments in financial markets and in risk management by banks. Three pillars have been identified for the capital framework:

- Minimum capital requirements;
- A supervisory review of capital adequacy; this includes the need for supervisors to have the powers (which exist and are used in some Anglo-Saxon countries) to set capital for individual banks above the minimum, and for supervisors to encourage banks to develop their own risk-based assessments of the capital they need;
- Market discipline, including disclosure by financial institutions.

In effect, the Committee wants to look at bank capital from the perspectives of the supervisors, the banks and the markets.

5.3 Disclosure by individual firms

The third key area of standard-setting currently being re-examined is that of disclosure by individual firms. Firms which analyze creditworthiness of other firms before doing business as counterparties, the output of rating agencies, media comment and analysis – all this enhancement of market discipline (the combat of market abuse) is now part of the financial infrastructure in many countries, and is regarded by many supervisors as the second most important element (after risk management in financial firms) in making for the safety of the financial system. Increasing the extent of compulsory disclosure by financial institutions, especially by larger firms and those quoted on stock exchanges, could provide more information, more frequently, on: measures (ex ante and ex post) of credit, market and other risks and of capital (regulatory, actual, and economic). Proposals to extend disclosure by firms are now being considered in a number of different official bodies. One issue, not satisfactorily covered in the literature so

far, is why markets – for example, in the case of LTCM counterparties – did not themselves demand greater transparency.

Traditionally, experienced securities supervisors have had a more positive attitude towards disclosure, reflecting concerns about market stability. A main concern of banking supervisors has been to avoid triggering a run on a bank caused by disclosure of adverse information at a difficult time. While that concern remains, most banking supervisors are convinced of the beneficial and timely incentive effects expected to flow from regular disclosure.

The issues of disclosure and market discipline have been prominent in the analysis of, and policy recommendations to deal with, hedge funds and the more general issue of highly leveraged institutions. Several reports (e.g. the official report already published by the Basel Committee, the Bruckheimer report, and the report by the President's Working Group on Financial Markets) stress the lack of transparency of the funds, together with the willingness of many counterparties to waive normal risk management rules. More definitive answers to the problems of high leverage are being sought by the Financial Stability Forum (see below).

Proposals to strengthen market discipline also include requiring the compulsory issue of subordinated debt by banks, the market price of such debt then being regarded as a useful indicator of the banks' overall riskiness. Argentina has put in place such a measure: it will be useful to see an evaluation after experience has been gained. Also relevant is evidence from rates on other instruments such as CDs. An altogether more radical proposal by Calorimis (1998) would, at least in part, substitute for banking supervision through the movement of spreads on subordinated debt. There is evidence from work by the Chicago Federal Reserve Bank that these spreads contain some useful information about the creditworthiness of banks; but it would be a big step, as yet untested, to use the evidence from such spreads as a major determinant of supervisory actions. Enhanced disclosure by financial firms, with the aim of increasing market discipline, is the subject of a working group under Peter Fisher (NY Fed). This group is undertaking a pilot exercise on disclosure, among banks, hedge funds, finance and insurance companies and securities brokers, and has issued recommendations to cover an enhanced disclosure regime and incentives for ensuring firms' full participation. The Fisher group's proposals were reported to the Financial Stability Forum and the international supervisory groupings, who looked at the costs and the benefits of disclosure, and the need for more informative as well as more extensive disclosure. These developments have the potential to reinforce significantly the role of market discipline in contributing to better risk management, to a safer financial system and to a more efficient allocation of capital.

Greater transparency by governments and supervisors is also being developed, relating to both the process of supervision and its results. Individual country supervisors now publish all major policy proposals in a consultative form; and more generally the IMF's Code of Good Practices on Transparency in Monetary and Financial Policies sets out desirable behavior by governments and supervisors. The IMF is developing examples from all round the world of good transparency practices. Supervisors, especially bank supervisors, are also considering how far their assessments of individual institutions, or of groups of institutions, or of financial sectors, should be published. There are suggestions by e.g. Flannery (1998) that supervisors which possess information on individual institutions additional to that contained in market signals should publish it. Practices vary, for example about disclosure of supervisors' actions to discipline

banks, or of regulatory capital ratios; but few supervisors disclose their overall assessments of banks' riskiness: this could prejudice supervisors' ability to get early information on, and get the bank to take early steps to counter, deficiencies in management or risk control systems.

6. COMPLIANCE TO STANDARDS

Setting rules, principles, standards, codes, guidance has become a major task for the supervisors, as indicated by the rapidly increasing number and size of papers on the Basel, IOSCO and IAIS websites. But these worthy tomes need to do more than sit on shelves and gather dust. "Setting standards is the first step: maintaining them is the hard part", was an apt lecture title by Charles Goodhart. Compliance is used both in the sense of firms complying with the supervisors' standards; and in the sense of supervisors complying with international standards (such as core principles of supervision). In practice, the second sense embraces the first. The traditional approach to compliance was to assume that all members of a particular club, such as Basel or IOSCO, would comply with the club's own rules; that supervisors would bring to colleagues' attention their own experiences of interpreting the rules; and that the tour de table and informal contacts would provide a kind of peer review. This traditional approach broke down either when some members did not apply the rules (for example, the financial crises in the 1990s) or when there were marked inconsistencies in the way countries applied the rules (e.g. the different treatment of special purpose vehicles in calculating minimum capital requirements for banks) There was also a problem of applying the rules worldwide: IOSCO has a very wide membership (91 countries), but a small secretariat and no political will to enforce rules amongst all members. IAIS, with 80 members, is in a similar position, and inhibited by its members' relative unfamiliarity with collective action. The Basel Committee has tried to go beyond its own very limited membership through informal contacts with supervisors worldwide, and its growing willingness to assume a leadership role – for example in the development of core principles. This outreach to a worldwide audience will need to be demonstrated again on the new capital adequacy framework if that is to be a framework for all, and not simply for internationally active banks in the G10.

The last two years have seen a growing, but far from complete, acceptance by supervisors and by the international financial community generally that the standard setting role of the international supervisory bodies needs to be complemented by arrangements for assessing compliance with standards. Peer review has been tried by both Basel and IOSCO. This brought to bear the expert judgment of experienced supervisors, but was abandoned after several trials. The results were disappointing; partly because of a reluctance to commit the necessary resources and to provide the necessary confidentiality, but also because a willingness to pass judgment on the arrangements in colleagues' jurisdiction could inhibit the good bilateral relations between supervisors needed to pass supervisory information both ways.

Instead, the necessary expertise, resources and willingness to pass judgment on compliance with many of these standards are being put together by the IMF and World Bank. The IMF has a worldwide responsibility for economic surveillance, which has only recently been extended to cover financial sectors in depth. Both the IMF and the World Bank have lending programmes designed to help

countries recover from or avoid financial crises. Both the Breton Woods institutions have expanded their financial policy departments, made strenuous efforts to work closely together (following difficulties in a few Asian countries) and liaised with supervisors to draw on expertise from national authorities, especially from G-10 countries, by temporary secondments.

There is a wide gap between the construction of general principles laid down by the supervisors (the Basel, IOSCO and IAIS principles of supervision) and the practical assessment of compliance. To fill this gap, the supervisors and the IMF and World Bank are working closely together: in the case of Basel Core Principles, the Committee has published a methodology manual. For each of the 25 core principles, a set of essential criteria have been formulated, with additional, desirable, criteria. These criteria have been agreed with banking supervisors worldwide, and are being tested in practice, particularly by the IMF but also by the World Bank.

The need for detailed compliance assessments has been shown clearly by the Asian crisis. A familiar example is the way in which the ratings agencies were forced to make downgrades of sovereign ratings in Asia, partly by failing to recognize the vulnerabilities in the financial sectors of many Asian economies. Another example is a 1996 article by Stiglitz and Uy on financial markets in Asia. In the case of banking supervision, arrangements are well advanced for these assessments of compliance; much work lies ahead in the practical application. IOSCO and IAIS are discussing with the IFIs how best to do this work and who should take the lead. The IMF and World Bank are expected to have completed 30 country assessments of compliance with the core principles of banking supervision in 1999, and more are planned. Increasingly, these assessments are being done within a much broader framework, which takes into account other parts of the financial sector, the preconditions for effective supervision, the interlinkages between the financial sector and the macro economy, and the vulnerabilities of the financial sector. This broader framework is the subject of a Financial Sector Assessment Programme (FSAP): this is a joint IMF/World Bank collaboration effort, based on joint teams from the institutions, drawing in supervisors from some national authorities. Some 12 FSAPs were conducted in 1999 and early 2000.

The outcome of these assessments will be available to the authorities in the countries concerned, to the senior management of the International financial institutions and (in some form, which may be very summary, depending on the views of the authorities) to the Boards of the IMF and World Bank. The FSAP is designed to address a number of issues, including the need to focus on and strengthen the early detection and identification of financial sector vulnerabilities, assess observance and implementation of standards, and to develop appropriate policy responses to weaknesses in financial systems. In this context, assessments under the program cover a wide range of issues including the macroeconomic environment; the regulation, supervision, and soundness of the financial system; financial markets; systemic risks in payment systems; as well as the institutional and legal arrangements for crisis management. The FSAP aims also to identify key priorities for financial sector development and improve the design and delivery of technical assistance.

The assessments of compliance could also be done by the private sector, e.g., the big international accounting firms, if they had the necessary supervisory expertise. In principle, this would offer welcome additional resources and

expertise; in practice, national authorities may well be reluctant to open up their books fully, and there would be an issue of who bears the costs.

There is no agreement, as yet, how far to go beyond this. Some governments will no doubt choose to make public a full assessment (save for sensitive information about individual institutions in the country). Other governments see difficulty in the IMF and World Bank combining their role as confidential policy adviser with that of impartial assessor. Squaring this circle involves convincing reluctant governments that it is in their longer term interests to be open about their financial sectors and reform plans. I believe that there should be a strong presumption of publication. Such public assessments of compliance are potentially of considerable value to:

- Supervisors, for example in making judgments about the creditworthiness of firms seeking to set up branches or subsidiaries overseas;
- Supervisors in setting rules e.g. the amount of capital that a bank should hold against a loan to a bank in a jurisdiction, could depend on that government's compliance with core principles of banking supervision, as suggested in the Basel Committee's Consultative Paper on capital;
- Ratings agencies, in assessing the robustness of a country's financial system (the agencies themselves find it difficult to perform adequate compliance assessment because they do not have the same access to confidential information);
- The financial markets generally, including the analytical/research departments of the larger firms, when considering lending and investment decisions;
- The IMF, World Bank and regional development banks: for designing loan programmes to help countries improve their financial systems; and also to help the IMF make a judgment on whether a country fulfils the criteria for the new Contingency Credit Line.

Compliance assessments will be of particular value to national authorities in designing and carrying through programmes to strengthen financial systems. Public assessments, which are seen to be independent and authoritative, will give added credibility to national efforts; and should be rewarded by lower spreads on borrowing by governments, financial firms and others. The full benefits from publication will only be obtained when there is a critical mass of countries agreeing to publish; and if the assessment contains enough detail and judgment for comparable quantitative as well as qualitative conclusions to be drawn.

Some governments, particularly where there are major gaps in the financial sector and in supervision or where plans for improvement are not well advanced or where crises are feared, will not be keen on publication. Incentives for governments to publish include: reinforcing their reform efforts; getting better ratings from the agencies and markets; securing lower risk weights for government and bank borrowing; and enjoying better access to IMF and World Bank loans. Countries that do publish should gain a competitive edge; conversely, the market will in time draw its own conclusions about governments that do not publish. This will put pressure on others, as has happened already with the IMF's Special Data Dissemination Standards, now signed up to by over 50 countries.

Compliance assessments should cover all countries, in principle. In practice, given limited resources, priority should be those vulnerable markets where

governments are keen to bring their financial systems towards international standards. These will often be emerging markets, but also some industrial countries.

Offshore financial centers present particular problems. Supervisory standards vary from non-existent to first class, so there is great diversity. The better regulated centers increasingly see their own self interest as being to achieve full compliance with international regulatory standards; and the Financial Stability Forum, through its Working Group on Offshore Centers, is beginning to give a strong push in this direction, and devising incentives for compliance.

7. INCENTIVES FOR COMPLIANCE

Putting in place greater financial stability, at national and international levels, requires more effective incentives, and some institutional changes. At the level of the financial firm, incentives to manage risk come first from the firm's own profit motive; secondly from the pressure of competitive market forces on firms that are perceived not to manage risk well; and thirdly from the rules and practices set by the supervisors. All of those are conditioned by the economic and institutional environment set by public authorities. Much of the debate about financial stability, crisis prevention, and international financial architecture is about generating more and better incentives for firms, markets and government agencies (including supervisors). This paper has identified the following ways of improving incentives:

- Better market discipline through enhanced disclosure by firms;
- Where national markets are very limited in size in many emerging markets, better market discipline through more competition, especially by opening up domestic financial services to competition through removing barriers to trade and barriers to the establishment of foreign firms;
- A closer relationship between firms' capital and risk;
- Greater use of risk-based incentives by supervisors, for example imposing more or less intrusive supervisory efforts (which can be charged to the firm) depending on the effectiveness of a firm's risk management;
- Lower capital requirements for firms/banks headquartered in jurisdictions which comply with core principles of supervision, and on exposures to governments which subscribe to the IMF's data standards;
- Better access to IMF and World Bank loans by countries which comply with standards;
- Better market ratings and lower borrowing spreads for governments which comply with transparency and other codes;
- Other market and regulatory sanctions on firms, governments and jurisdictions (including offshore centers) that do not comply with enhanced disclosure or other standards (and maybe are making few efforts to comply).

A beginning has been made in a number of these areas. But it will be a big task to carry them through to a state of the world in which these incentives are material for internationally active banks and other financial institutions, and for most jurisdictions which aspire to meet international standards. Specifically, it will require: long-term commitments by governments, supervisors and international agencies; closer co-operation between all these players; extra expert resources; and the right institutional arrangements.

8. INSTITUTIONS FOR SUPERVISING COMPLIANCE

The debate about international financial architecture has spawned a wide variety of institutional proposals, well summarized in Eichengreen (1999). These include the empty promise of a new Breton Woods and far-reaching ideas for an international authority with the power to regulate all cross-border business (Eatwell and Taylor, 2000).

For the reasons given by Eichengreen, an evolutionary, pragmatic approach has easily won the day. Essentially, it is far quicker, cheaper and more effective, at the international level, to adapt existing institutions than to set up new ones.

It is easy to underestimate the scale of evolutionary change in institutions (a “business as usual” sign is much more common than “under new management”). Indeed, from the perspective of supervisors, there has been much change over the past 2-3 years. A rather incomplete list follows:

- Much more outreach by banking supervisors, above all to supervisors in non-G-10 countries and in emerging markets;
- Increasing acceptance by all supervisors that core principles of supervision, applicable in all countries of the world, are needed;
- Increasing acceptance of the need for external monitoring of compliance with principles;
- Willingness to work closely with the IFIs as the monitors;
- willingness by supervisors to work more closely with each other, across borders – through a greatly expanded network of bilateral, trilateral etc, contacts – and across the sectors of banking, securities and insurance – where the Joint Forum is the main international grouping⁷;
- A much greater willingness by the supervisors to consult widely on policy changes;
- Willingness by the Breton Woods institutions to take on the role of monitors; to put together the necessary resources; and to integrate financial sector surveillance and reconstruction much more closely into general surveillance and programmes;
- A desire by the international financial community to consider more carefully the threats to financial stability, to put in place better incentives for avoiding such crises, and to bring together the key government officials, supervisors, central banks and the IFIs, through the new Financial Stability Forum.

9. THE FINANCIAL STABILITY FORUM / BOARD

The FSF first met in April 1999, following a proposal by the UK Chancellor Gordon Brown in 1998, and a report to G7 Finance Ministers in February 1999 by the then Bundesbank President Hans Tietmayer. The FSF brings together, for the first time, supervisors and their international groupings, central bankers (including the ECB), and finance ministries, together with the IMF, World Bank, OECD and

⁷ The Joint Forum consists of banking, securities and insurance supervisors from the Basel Committee, IOSCO and IAIS, mostly from G10 countries. For details of the papers, see the BIS website. Issues covered so far include problems (such as lead co-ordination, capital adequacy and information exchange) of supervising financial conglomerates. The work of the Forum is currently being extended to cover more general cross-sectoral issues, such as the different capital requirements across sectors.

the BIS. Representation, initially only the G7, now extends to Australia, Netherlands, Hong Kong and Singapore.

The aims of the Forum are:

- To assess vulnerabilities affecting the international financial system;
- To identify and oversee action needed to address these vulnerabilities;
- To improve co-ordination and information exchange among the various authorities responsible for financial stability;
- To strengthen the development and implementation of international standards.

The Forum has issued reports since 2000 on: highly leveraged institutions; offshore centers; and on capital flows. Further work is planned on: implementing standards; insurance; safety nets and internet issues. The reports are intended to contain practical recommendations, which will be for others – national bodies, supervisory groupings, international agencies, etc to carry out. The Forum, with a secretariat – in Basel and Washington – of about six people, is not itself an executive agency, but has the potential to give some impetus to the work of others. The place of the Forum in the international financial and institutional architecture can be seen from table 4. This shows in broad terms the institutions and countries that are members of the FSF and of other groups, especially the (renamed) International Monetary and Financial Committee. Compared with the IMFC, the Forum brings in supervisory and other groupings, but involves fewer countries. Pressure to expand further the country coverage of the Forum has to take account of its already large size (42 members) but also, and much more importantly, the need to bring into decision making processes key developing countries, without whose consent most of the Forum's agenda will not be realized.

Table 4. Supervisory Collective Institutions

Basel Committee	IOSCO	IAIS
↓	← ↓	← ↓
G7 / G10	Other industrial countries	Developing countries
↓	↓	↓
→	IMF, Development banks	←
↑←	Financial Stability Forum	→↑

Note: the shaded area shows the area of FSF influence. The arrows indicate directions of authority.

10. THE EUROPEAN CASE

The many issues involved in improving financial supervision in Europe – across borders, across sectors and institutionally – are receiving increasing attention. See, for example, recent talks on the role of the 4-level Lamfalussy Process for bringing about a single European financial market by 2006. It is beyond the scope of this paper to cover these issues, but is worth noting the already extensive European Union-wide system: legally enforceable directives, central institutions (including the Commission), and an increasing amount of informal exchange

between supervisors. Future developments in Europe will be an important test of how far national institutions, common laws and standards, and much informal cooperation can evolve to meet the developing challenges to financial supervision – especially from firms that are cross-border and cross-sectoral.

This framework needs to develop in some important ways, for example to ensure effective lead supervision for all financial conglomerates in Europe; to bring about closer links between the supervisory agencies (and EU groupings) covering the banking, securities and insurance sectors; and to achieve greater harmonization of the rules governing financial institutions in the different sectors. If the European framework develops in this way, then the setting up of European-wide supervisory institutions should not be necessary. A contrary view has been expressed by Ruding.

11. CURRENT SITUATION AND EPILOGUE

The global financial and economic crisis led to a wide-ranging debate on the structure and functioning of the international monetary and financial system. The agreements reached by the G20 leaders and the steps taken by the IMF in recent years are described below (see ECB, 2014).

Following their first meeting in November 2008 in Washington DC, the Heads of State or Government of the G20 members met in April 2009 in London for their second summit. They (a) called for action in the areas of financial regulation and macroeconomic policies; (b) underlined their commitment to open markets and free trade; (c) agreed on steps to fund and reform the international financial institutions; and (d) agreed that the Financial Stability Forum be expanded, given a strengthened mandate and re-established with a stronger institutional basis and enhanced capacity as the Financial Stability Board (FSB).

At their Pittsburgh summit in September 2009, the G20 leaders: (a) confirmed their continued commitment to international cooperation in dealing with the global policy challenges. Underlining the role that the G20 has played in shaping the responses to the global financial crisis, leaders designated the G20 to be the premier forum for our international economic cooperation; (b) launched the G20 Framework for Strong, Sustainable and Balanced Growth, which aims to help manage the transition from crisis response to a strong, sustainable and balanced pattern of global growth, as well as to address some of the global imbalances that contributed to the financial crisis. The Framework entails a process of mutual assessment of how national and regional policies and policy frameworks of G20 members fit together and whether they are consistent with the objectives of strong, sustainable and balanced growth. G20 members have set out their policy frameworks in an agreed template, with the EU Presidency, the Eurogroup, the European Commission and the ECB submitting a common contribution from the euro area and the European Union. Building on its expertise in bilateral and multilateral surveillance, the IMF will assist G20 members in this mutual assessment process, drawing on input from other international organizations, including the FSB on financial policies; and (c) noted the substantial progress that has been made in the various areas of regulation and supervision, but acknowledged that far more needs to be done. Building on the G20 Ministers and Governors' Declaration on Further Steps to Strengthen the International Financial System, further work is spelt out in four key domains (building high-quality capital and mitigating pro-cyclicality; reforming compensation practices; improving OTC

derivatives markets; addressing cross-border resolutions and systemically important financial institutions). Moreover, there was a commitment for all major G20 financial centers to have adopted the Basel II capital framework by 2011.

Convening in Toronto in June 2010 for their fourth summit, G20 leaders: (a) followed up on the commitments made at their previous meeting in Pittsburgh and completed the first stage of the mutual assessment process of the G20 Framework. They agreed on a number of concrete commitments, e.g. by advanced deficit countries to take actions to boost national savings and by surplus economies to undertake reforms to reduce their reliance on external demand and focus more on domestic sources of growth. Emerging surplus economies committed to undertake reforms to strengthen social safety nets to help reduce precautionary savings and stimulate private spending and to enhance exchange rate flexibility to reflect underlying economic fundamentals. Furthermore, all G20 members pledged to embark on structural reforms to stimulate economic growth. (b) recalled the substantial progress that had been made in such areas as prudential oversight, improving risk management and promoting transparency to strengthen the global financial system. At the same time, they acknowledged that more work was required to achieve the commitments made at the last three summits and identified four pillars of the G20 financial regulatory reform agenda (a new capital framework, effective supervision, addressing systemically important financial institutions (SIFIs), and transparent international assessments and peer reviews).

At their fifth summit in Seoul in November 2010, G20 leaders: (a) agreed on the Seoul Action Plan with concrete policy commitments to make progress towards meeting the objectives of the G20 Framework; (b) endorsed the outcomes of a number of important work streams that had been reached in preparation for this summit, notably a reform of IMF quotas and governance as well as key building blocks for transforming the financial system by addressing the root causes of the crisis, including the work of the Basel Committee; (b) showed awareness that the G20 also had to address issues concerning the large, non-represented group of developing and low-income countries.

At their Cannes Summit on 3-4 November 2011 the G20 leaders reaffirmed their commitment to work together and coordinate their respective policies. The leaders: (a) reached agreement on the Cannes Action Plan for Growth and Jobs, setting out country-specific short- and medium-term policy measures, to place the global economy on a stronger, more sustainable and balanced growth path; (b) adopted measures to strengthen the resilience of the international monetary system. They endorsed the agreement by their finance ministers and central bank governors on i) coherent conclusions to guide the management of capital flows, ii) common principles for cooperation between the IMF and Regional Financial Arrangements, and iii) an action plan for local currency bond markets. Moreover, the leaders supported the IMF in putting forward a new Precautionary and Liquidity Line to provide on a case-by-case basis flexible short-term liquidity to countries with strong policies and fundamentals facing exogenous shocks; and (c) made further progress on financial sector reform. The leaders endorsed the implementation of an integrated set of policy measures to address the risks to the global financial system from SIFIs, and the timeline for implementation of these measures. Specific measures focus on G-SIFIs, which will be subject to strengthened supervision, a new international standard for resolution regimes as well as additional capital requirements. They also called on jurisdictions to meet their commitment to implement fully and consistently the Basel II framework as

well as the Basel II-5 additional requirements and the Basel III capital and liquidity standards.

At the same time, the IMF continued to support the global response to the financial crisis with strengthened surveillance and policy advice as well as with financial support to its member countries.

As a follow-up to the commitment made by G20 leaders at their London summit in April 2009 to increase the resources available to international financial institutions, the reformed and expanded New Arrangements to Borrow (NAB) became effective in March 2011. Participation in the NAB was extended from 26 to 40 members, and the overall amount of these credit lines to the IMF increased from SDR 34 billion to SDR 369.9 billion. Most bilateral borrowing and note purchase agreements signed since 2009 between the IMF and its member countries, in the amount of SDR 196 billion, are to be incorporated over time into the NAB.

In November 2011 the IMF agreed to further amend its lending instruments to respond to the liquidity needs of countries with strong fundamentals that are affected by contagion. In this context, it was decided to increase the flexibility of the Precautionary Credit Line created in August 2010 by allowing it to be used by members with actual balance of payments needs and by enabling six-month arrangements in addition to the existing options of one and two-year arrangements. Given these changes, the Precautionary Credit Line was renamed the Precautionary and Liquidity Line.

The G20 and the IMF Executive Board also exchanged views in 2011 on the composition of the currency basket that determines the value of the SDR. It was affirmed that the composition of the basket should continue to reflect the relative role of currencies in the global trading and financial system, and that the principles guiding SDR valuation, including stability in terms of major currencies, remained valid, though there is to be further clarification of the criteria for admission to the basket. In the current four-currency SDR basket, the contribution of the euro was set on 1 January 2011 at 42.3 euro cents which represented 37.4%.

One of the core activities of the IMF, surveillance, underwent its regular triennial review in 2011. This exercise considered lessons for surveillance emerging from the global financial crisis and took stock of the progress made since 2008 (including the new spill over reports mentioned above, and the implementation of the 2007 Decision on Bilateral Surveillance over Members' Policies). This focus made it a particularly rigorous and comprehensive review. It was agreed that the surveillance framework should be more integrated, even-handed and effective so that it can better identify and address risks, including spill over risks, to economic and financial stability. An action plan put forward by the Managing Director of the IMF will guide the way forward on the six key aspects identified for further improvement, namely: i) interconnections; ii) risk assessments; iii) financial stability; iv) external stability; v) the legal framework; and vi) engagement with and adherence to IMF policy recommendations.

A great deal remains to be done, if the stimulus from recent crises is to be fully reflected in better risk management by financial institutions and in improved supervision on a global scale. In the past, recovery from financial crises has usually blunted reform efforts and the lessons have had to be painfully re-learned. For a more effective containment of the financial crises, it will require a major extension of the public monitoring effort on a global scale and the embedding of more and better incentives for risk-mitigation into the system.

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NOTES

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