



FINANCIAL SECTOR ISSUES

In different ways, two features of recent financial sector developments provide an opportunity for reflection on the role of senior management in maintaining wider financial stability. The banking cycle has reached a critical point for key strategic decisions about credit risk and its pricing. And recent irregularities in two fund management firms have underlined the importance of effective management controls and a culture of compliance. Below, we discuss these two issues and the way in which current regulatory thinking is developing in relation to management accountability. We also look at recent developments in UK payments systems, where progress is being made in reducing systemic risk.

A new credit cycle

The half-yearly results of the major clearing banks remain one of the main indicators of the performance of the UK financial sector. The most recent figures suggest that the banks are in good shape. They are strongly capitalised and, on that basis, well placed to expand their lending. But it is just at this point in the cycle that an over-expansion of lending can create problems for the future.

There are two distinct elements in the banking cycle. On the one hand, banks' fortunes are connected to the wider economy. When the economy is buoyant, there is strong demand for loans and borrowers are less likely to default. Conversely, in a recession, demand for credit is weaker and the value of a loan book is likely to be reduced by an increasing proportion of bad debts.

Banks can exacerbate this underlying cyclical pattern through their lending and pricing decisions. It has often been the case that, in periods

of economic growth, banks have concentrated on expansion of the balance sheet. With a combination of optimism about the economic future and competitive pressure to maintain market share, rigorous credit assessment often takes second place. This leads to imprudent loans being booked during the upturn, so that subsequent problems are more severe than they need be.

The latest set of clearing bank results suggests that just such a critical stage in the banking cycle has been reached. The economic upturn in the United Kingdom has been under way for some time. On top of that, bad debt provisions, in many cases against loans made before the previous downturn, have progressively declined so that we are now probably at the bottom of the provisioning cycle.

The challenge for senior management is clear. Their institutions have the means and the business case to expand their lending. But new business is worth booking only if it is good business. When expansion is the priority and the economic climate is favourable, the warnings of the credit assessment function will often appear unduly obstructive.

In the United States, for example, where the banking cycle is somewhat further advanced, bad debt write-offs on loans to individuals have already begun to rise despite a

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continuing recovery. It is up to senior management to ensure that credit officers are not ignored in the rush for new business.

'Riskless' business?

The UK group Robert Fleming was fined recently and ordered to pay compensation for the actions of a fund manager working for Jardine Fleming Investment Management, a Hong Kong associate. A few days later, trading was suspended in three collective investment schemes managed by Morgan Grenfell Asset Management. These two events are important for those with responsibility for the protection of investors, depositors and markets; they also raise a number of more general issues which are relevant to the whole financial sector.

First, the cases again illustrate the need for directors of firms to ensure that their compliance and internal monitoring systems are set up to a sufficiently robust standard and operate properly. Individual employees of financial firms are often given considerable discretion to act on behalf of their firms, and to deal in sums of money which, if lost, could be material to the firm and to its depositors or investors.

Regulators have a role in monitoring firms to ensure that controls are adequate. But this does not remove the responsibility of the senior management of financial firms to ensure that failures of systems and controls do not occur. The trustees or other parties charged with looking after collective investment schemes

must also satisfy themselves about the systems of the fund management firm.

Second, these cases underline the extent to which functional and national boundaries are being eroded in the financial industry. The Jardine Fleming case involved the Hong Kong associate of a UK financial group, while the Morgan Grenfell case involved the fund management subsidiary of a UK group (owned by a German bank) which had invested on markets regulated by the Securities and Exchange Commission in the United States.

In such cases, effective regulation requires there to be clear division of responsibilities between regulators and well established arrangements for sharing information across jurisdictions. This is discussed in greater detail in the article on 'International Regulatory Co-operation' on pages 44-50.

Third, these problems grew up in an area of financial activity which is regarded as less risky than conventional banking or securities business. As fund management does not usually involve a firm in taking proprietary positions, regulatory capital requirements are typically small for this kind of business. However, this does not mean that these kinds of businesses are free of operational or legal risks.

The large value of funds under management may mean that, in cases of fraud or negligence, there is a risk of losses on a scale much larger than the financial resources of the fund manager itself.

Last, the two cases show that when firms are members of larger groups, the market standing and good name of an entire financial group can be put at risk by the activities of one part. In the case of Morgan Grenfell, Deutsche Bank decided that the potential loss of reputation was significant enough to make it worthwhile to commit to cover investors' losses.

This 'reputational risk', which can arise in respect of agency activities as well as an institution's proprietary business, can lead to substantial calls on capital.

Individual accountability

The Securities and Futures Authority recently issued a consultative document which proposes that the senior executive officers of financial institutions should be required to ensure that all employees act to avoid serious damage to the firm. Penalties could be imposed on senior management for general control inadequacies rather than specific failures of day-to-day management.

This proposal can be seen as part of a wider discussion on the personal accountability of the senior management of financial institutions. The Bank of England, for example, recently wrote to all banks to require that their key supervisory returns be signed by a director. It is a general feature of financial regulation that the directors — and, more widely, 'controllers' and senior managers — of an authorised institution should be 'fit and proper' for the particular position they hold.

Under the Financial Services Act, this is reflected in a direct authorisation of individuals; under the Banking Act the requirement is indirect, but the authorisation of a bank may be withheld if one or more of its directors or senior staff is judged to be unsuitable. None of these arrangements imposes direct and specific accountability on staff; such direct accountability is, however, already a feature of the regimes in New Zealand and Canada.

Objections have been made to the principle of increasing the potential sanctions on the senior management of companies. Since modern firms tend to be complicated, it is not always realistic to expect a director to be aware of everything that is going on. If the regulatory approach were to move too far in the direction of punishing senior management for the consequences of actions of their employees, it could become more difficult to persuade able people to become directors.

However, there are good reasons why individual responsibility is particularly important in the financial sector. The balance sheets of financial institutions can change rapidly and it is, therefore, difficult to keep investors and creditors up to date. The scope for unscrupulous or negligent managers to take advantage of their creditors and investors tends to be greater.

Increasing the accountability of directors gives them a greater incentive to prevent malpractice in their firms and strengthens market discipline. In modern institutions, it is

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often only the management of a firm that will be able to spot breaches, so their role is central to maintaining the soundness of institutions.

The trade-off between giving the proper incentives to company directors and not placing on them an unreasonable liability which few will accept is well known. Although there are currently no plans beyond the current SFA consultation document to alter the terms of that trade-off, it is a question in which regulators have good reason to be interested.

Payments and settlements

The United Kingdom implemented a new real-time gross settlement (RTGS) system in April. This provided an immediate benefit in reducing risk in the high-value inter-bank funds transfer mechanism; it also provides a building block for further improvements in the United Kingdom's payment and settlement systems.

The immediate benefit of RTGS was in removing the credit risk that a settlement bank incurred on other banks in the system. Previously, settlement banks would send each other payment messages through CHAPS (the Clearing House Automated Payment System) but the obligations would be settled only at the close of business. If a settlement bank failed during the course of a day, the recipient could not rely on the funds being paid.

The debit positions run by some banks during the working day were very large and so the exposures were a significant concern.

In the new system, payments are settled on a transaction by transaction basis in real-time across accounts at the Bank of England. Funds are, therefore, final on receipt and settlement banks are not exposed to the risk of the failure of their counterparties in the settlement system. Similar systems have been, or are being, developed in all European Union countries. It is planned to link these systems together to create a trans-European real-time gross settlement system for euros (TARGET). This should bring these benefits to those high-value cross-border transactions in euros which are put through the system.

The benefits of the RTGS system can also be extended by linking it to the securities transfer systems. This will enable the real-time movement of title to securities to be synchronised with the real-time movement of final funds. This is known as 'delivery versus payment'. That this should be the next step was the main conclusion of an internal group established by the Bank to review the strategic requirements for payment and settlement arrangements in consultation with representatives of UK financial markets.

The Bank has now established a small group with the Association of Payment and Clearing Services and other market representatives to agree on the broad design of delivery versus payment systems and to prepare for the more detailed design work.

The largest settlement risk, in terms of the sums involved, is in foreign exchange. A report by the

G-10 group of central banks in March set out a three-part strategy to reduce these risks.

Progress can be made by individual banks tightening their procedures for monitoring and controlling the extent of their exposures to individual counterparties. But RTGS systems are an important component of the overall strategy for reducing risk. They ensure that payments are made both in real-time and with finality, which makes it easier to assess when an exposure has been extinguished.

This is an important feature both for individual institutions and for collective settlement arrangements. Indeed, netting schemes, as well as mechanisms such as the continuous linked settlement scheme proposed by a group of banks called the Group of 20, operate to tight deadlines and need finality of payment at precise times of the day. In due course, it may also be possible to link RTGS systems in different countries and currencies to provide a direct form of 'payment versus payment' allowing for the safe exchange of value in the foreign exchange market. ■

'Prudence'