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ABOUT THE AUTHOR

Paul Blustein, senior visiting fellow at CIGI, is a journalist who covered global economic issues during much of his career as a newspaper reporter and has written three books that focus on international economic institutions. The first, which chronicled the emerging markets crises of the late 1990s, was *The Chastening: Inside the Crisis that Rocked the Global Financial System and Humbled the IMF* (PublicAffairs, 2001); the second was *And the Money Kept Rolling In (And Out): Wall Street, the IMF, and the Bankrupting of Argentina* (PublicAffairs, 2005); the third was *Misadventures of the Most Favored Nations: Clashing Egos, Inflated Ambitions and the Great Shambles of the World Trade System* (PublicAffairs, 2009). A graduate of the University of Wisconsin, Blustein also attended Oxford University as a Rhodes Scholar, receiving an M.A. in philosophy, politics and economics. He spent nearly 20 years as a staff writer for *The Washington Post*, including a posting as a correspondent in Tokyo, and before that he worked at *The Wall Street Journal* and *Forbes Magazine*. Among the prizes he has won for his work is the Gerald Loeb Award, which recognizes distinguished business and economic journalism. He lives in Kamakura, Japan, and in addition to his CIGI affiliation he is a nonresident fellow in the Global Economy and Development Program at the Brookings Institution.

ACKNOWLEDGEMENTS

This is the second of two papers I have written for CIGI chronicling the inner workings of important international institutions prior to the global financial crisis. As I wrote in the acknowledgements for the first paper, journalists like me don't usually produce work like this. No mass-circulation media organization would likely publish an article that goes into such detail about a group as obscure as the Financial Stability Forum. At the same time, journalistic narratives of this sort — with anecdotes and other story-telling devices that have long been my stock-in-trade — aren't the typical products of scholars either.

The idea that I should produce these papers was the inspiration of Tom Bernes, who until May 2012 was CIGI's executive director and now holds the title of distinguished fellow. I was looking for a way to get support for a book I had been researching about the role played by international institutions in the global financial crisis; Tom imaginatively came up with the concept of my writing research papers for CIGI that would delve deeply into certain issues involving those institutions. With help from Eric Helleiner, holder of the CIGI chair in international political economy at the Balsillie School of International Affairs in Waterloo, Ontario, we decided on topics that would be suitable for such papers. Tom and Eric provided enormously helpful guidance throughout my research process, including a meeting in June 2011 when CIGI generously hosted me for a fruitful discussion of my preliminary findings with colleagues and graduate students. And once I had finished a first draft of this paper, Eric — together with Jim Haley, who joined CIGI as director of the global economy program in early 2012 — conferred even more extensive assistance in the form of insightful feedback and suggestions for how the paper ought to be improved. Tom, Eric and Jim bear no responsibility for any errors or shortcomings in the paper, of course. But their support and encouragement was invaluable, and I am especially grateful for the friendly spirit in which they gave it.

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This paper, though, is a CIGI project. In addition to Tom, Eric and Jim, I owe a particular debt of gratitude to Neve Peric, CIGI's former vice president of operations, who handled some crucial administrative tasks with adroitness and good humour; and two editors — Carol Bonnett and Jennifer Goyder — who expertly fixed countless passages and got the paper ready for prime time. For their warm welcome, and the honour of their association, I thank all of my CIGI colleagues.

Paul Blustein

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EXECUTIVE SUMMARY

This paper provides the first detailed look inside the operations of the Financial Stability Forum (FSF), a little-known and secretive institution created shortly after the emerging-market crises of the late 1990s. Although other institutions have come under intense scrutiny and criticism since the eruption of the global financial crisis in 2007, the FSF has gotten much less attention than it deserves. Its primary aim was to coordinate efforts in preventing and mitigating future crises, and its members included top-ranking officials from the finance ministries, central banks and regulatory agencies of the world's richest countries. Moreover, the FSF's successor body, the Financial Stability Board (FSB) — whose name reflects the two bodies' many similarities — was established at a summit of world leaders in April 2009, amid solemn promises that the leaders were putting in place the mechanisms necessary to ensure the safety and soundness of the global financial system.

The paper is based on interviews with scores of policy makers who worked on the FSF in various capacities, and on thousands of pages of previously undisclosed documents, mostly notes, minutes and confidential summaries of the FSF's meetings. The story that unfolds illuminates the failure of regulators to keep pace with the globalization of the financial system — a failing that underscores the magnitude of the challenges facing the international community today. FSF members were not blind to, or blasé about, the forces that were menacing global prosperity; records indicate that they spotted, tracked and discussed a number of these factors. But the paper shows, with far greater specificity and authority than has been possible to date, how slow the FSF was at discerning the financial system's fragility and at directing preventive and preparatory action. It also reveals how sluggish the FSF was at grasping the severity of the crisis at the outset. Another important aspect of the crisis — the impact it had on the power and influence of the United States — also features prominently in the narrative. US officials exhibited extraordinary hubris in their dealings with the FSF, especially in its early days, when they saw it as a vehicle for fostering US-style financial policies in other countries, while stymying initiatives that might affect Washington's own policies and practices.

Although most of the paper is devoted to past events, its purpose is to help inform the debate about international financial regulation, in particular, the FSB. The insight into the FSF's inner workings that the paper affords should deepen skepticism about whether the FSB, as currently constituted, can achieve the goals that the international community has set for it.

ACRONYMS

BIS	Bank for International Settlements
BRIC	Brazil, Russia, India and China
CDOs	collateralized debt obligations
EWE	Early Warning Exercise
FSAP	Financial Sector Assessment Program
FSA	Financial Services Authority
FSB	Financial Stability Board
FSF	Financial Stability Forum
G7	Group of Seven
G20	Group of 20
IAIS	International Association of Insurance Supervisors
IIF	Institute of International Finance
IMF	International Monetary Fund
IOSCO	International Organization of Securities Commissions
ROSC	Reports on the Observance of Standards and Codes
WTO	World Trade Organization

INTRODUCTION

In the wake of the global financial crisis that erupted in 2007, major public agencies and institutions responsible for economic and financial policy have undergone extensive scrutiny — little of it flattering. Journalists, scholars, commissions and oversight bodies have produced countless books, articles, studies and reports exposing policy makers' failures, both before and during the crisis. Seemingly, every official body worthy of critical assessment has been targeted; the most prominent include the Federal Reserve System, the US Treasury, the US Securities and Exchange Commission, the International Monetary Fund (IMF) and the Basel Committee on Banking Supervision.

One body, however, has largely escaped notice: the Financial Stability Forum (FSF), which was created shortly after the emerging market crises of the late 1990s, and based in Basel, Switzerland. The FSF merits much more attention than it has received, given that its primary aim was to coordinate efforts among policy makers in preventing and mitigating future crises, and given that its members included top-ranking officials from the finance ministries, central banks and regulatory agencies of the world's richest countries. Moreover, its successor body, the Financial Stability Board (FSB) — whose name reflects the two bodies' many similarities — was established at the Group of 20 (G20) summit in London in April 2009, amid solemn promises that the world's leaders were putting in place the mechanisms necessary to ensure the safety and soundness of the global financial system.

This paper provides the first detailed look inside the operations of the FSF, from its creation in 1999 to its replacement by the FSB. Up to now, an in-depth account of the FSF's activities has not been available. In the generally secretive world of international economic organizations, the FSF was at the non-transparent end of the spectrum, refusing to even disclose the attendees at its twice-annual meetings, beyond listing their countries and institutions; after most meetings, the FSF's website gave only cursory, anodyne accounts of the discussion. This has made it difficult for scholars and other outside observers to evaluate its activities and draw conclusions about how the FSB might improve on its predecessor's record. As Andrew Baker wrote in 2010: "The problem with making assertions about the institutional nature of the FSF/FSB is that they are largely based on anecdotal evidence. No systematic comprehensive studies of the FSF/FSB as an institution exist and most of us have only an anecdotal appreciation of what goes on behind closed doors at FSF meetings and the full range of institutional and social dynamics at work" (Baker, 2010).

Rectifying that deficiency in public knowledge, or at least going a substantial way toward that goal, is the chief purpose of this paper. It is based on interviews with scores of policy makers who worked on the FSF in various capacities, and on thousands of pages of previously undisclosed documents, mostly notes, minutes and confidential summaries of the Forum's meetings. This wealth of information affords a lengthy tale with instructive value that goes well beyond satisfying curiosity about what the FSF was doing all those years.

Regulatory breakdowns and lapses are an oft-cited cause of the financial crisis, and the FSF's story illuminates the international side of that problem. It is about the failure of regulators to keep pace with the globalization of the financial system — their inability to understand the transmission of risk across borders and oceans, and their lack of planning for the coordinated measures that would be necessary to deal with a global crisis. These failings underscore the magnitude of the challenges facing the international community today, as it struggles to create rules and apparatuses for managing a system that has shown itself capable of massively destructive instability. The world needs regulations that are designed to keep the system safe from the greatest sources of vulnerability. At the same time, regulation must be sufficiently well-coordinated to ensure that banks and other financial firms cannot simply shift operations — and risks — to lighter-touch jurisdictions. The FSF's record does not inspire confidence that global bodies can effectively fulfill such complex and politically tricky missions.

Another important aspect of the crisis — the impact it had on the power and influence of the United States — also features prominently in the narrative. The hubris that US officials sometimes exhibited in their dealings with the FSF is both sobering and galling to behold in light of subsequent events. Especially in the forum's early days, the officials saw it as a vehicle for fostering policies and practices in developing countries that would conform more closely to those of the advanced world, and the United States in particular. At the same time, the officials stymied any FSF initiative smacking of international influence over, or even monitoring of, US policy. Comeuppance came, of course, once the outbreak of the crisis brought glaring flaws in the US model to the fore. The emerging powers made it clear that the FSF's membership arrangement — which gave seats at the table only to rich countries — was untenable. No longer would emerging economies accept the role of "rule takers" while allowing Washington and its wealthy allies to be "rule makers."

Previous critiques of the FSF have described its performance as disappointing, in view of the goals envisioned for it.[1] Apt though such assessments may be, the evidence supporting them has been paltry, commensurate with the meager amount of information disseminated to the public. The material presented herein lays bare,

1 One leading example is the discussion of the FSF in Howard Davies and David Green (2008). *Global Financial Regulation: The Essential Guide.* Polity.

with far greater specificity and authority than has been possible to date, how slow the FSF was at discerning the financial system's fragility, and at directing preventive and preparatory action.

A prime example is the FSF's meeting on March 29, 2007. At that meeting, which took place in Frankfurt, 40 policy makers from around the world gathered as signs of strain in the US housing market were growing increasingly manifest. A report issued a few days earlier showed foreclosures had reached record levels in the fourth quarter of 2006, and although most of them were concentrated among subprime borrowers, default rates were increasing on better-quality loans as well. "Crisis Looms in Mortgages," warned a March 11, 2007 headline in The New York Times; two dozen mortgage lenders had gone bankrupt or closed their doors in previous weeks, and one of the biggest, California-based New Century, was reportedly on the verge of filing for bankruptcy protection.[2] For the FSF, determining whether these sorts of developments presented a serious threat to the global financial system was the top item on its agenda that day.

The answer FSF members received, from Randall Kroszner, a governor of the Federal Reserve Board, was soothing. According to confidential minutes of the meeting, Kroszner acknowledged that delinquency rates on certain types of subprime housing loans had risen sharply in 2006, but he said it was "important to recognize that the market segment affected, variable rate subprime mortgages, only constitutes seven to eight percent of the overall US mortgage stock." Although prices for some securities backed by subprime mortgages had plummeted, "the secondary market liquidity for these securities has not dried up," the document quotes Kroszner as telling the others, "and there has been little evidence of spillover into other market segments."

It is not surprising that Kroszner would have offered such a sanguine assessment of the problems in US housing and the potential for them to adversely affect other parts of the financial system. His private comments to the FSF were consistent with what other US policy makers, including Federal Reserve Chairman Ben Bernanke, were saying at that time. More noteworthy, however, is that his reassurances drew little if any challenge from others; the confidential document summarizing the meeting includes no indication that anyone voiced a contrary opinion.

"Nobody around that table said, 'This is not believable,'" recalled one former FSF member who was interviewed on condition of anonymity. "We basically sat there and formed our own views." And that, he added, was fairly typical of FSF meetings, especially during the years before the global financial crisis erupted in the late summer of 2007. "There was great defensiveness, and excessive politeness. It was interesting to talk to clever, thoughtful people about subjects that were my daily bread and butter. But it wasn't something in which you went away thinking, 'I've got a real sense there's a problem developing, so now I'm going to do this or that differently.' I don't think that in the pre-crisis period I ever got that sense from the FSF."

This does not mean that FSF members were blind to, or blasé about, the forces building inside financial markets and institutions that were threatening global prosperity. Records of their meetings show they had spotted, tracked and discussed a number of these factors. But for a variety of reasons, which will become clearer as this narrative unfolds, they spent a great deal of time on issues that turned out not to matter much, and failed to respond with sufficient alacrity to ones that turned out to matter a lot.

Moreover, once markets displayed early symptoms of the crisis, the FSF was again sluggish at grasping its severity — as evinced by documentary material revealing how the "worst-case scenarios" that members privately discussed became progressively more pessimistic. The FSF has generally drawn much higher marks for how it performed after the crisis was fully underway, thanks to a report it issued in the spring of 2008 that helped set the agenda for much of the G20's subsequent action. But this perception of the FSF, as rising to the occasion during the crisis, fails to take into account an embarrassing episode that came two weeks after the bankruptcy of Lehman Brothers, which was never reported. The group had to effectively abort a meeting for lack of attendees, despite the hopes of its chairman that it would assume a new role in coordinating countries' crisis responses.

One reason to recount the FSF's history is to help hold it and its members accountable. To be sure, the FSF was hardly a major culprit in causing the crisis; nor was its failure to act a major factor in making the crisis possible. But there is a legitimate public interest in exploring why and how this body failed to deliver what was expected of it. The FSF does not deserve to be more shielded from this sort of accountability than, say, the Federal Reserve's Open Market Committee, whose meeting transcripts are released to the public after five years.

More important than looking back, though, are the forward-looking implications that may help inform the debate about international financial regulation, in particular, the FSB. Having been called by US Treasury Secretary Tim Geithner "in effect, a fourth pillar" of the international global economic architecture (along with the IMF, World Bank and World Trade Organization [WTO]), the FSB has already achieved a much higher profile than the FSF. The stated presumption among policy makers is that the new

2 See Gretchen Morgenson (2007). "Crisis Looms in Mortgages." *The New York Times*. March 11; see also Vikas Bajaj (2007). "Bad Loans Put Wall St. in a Swoon." *The New York Times* March 14; and Bajaj and Julie Creswell (2007). "Lender Said to Be Weighing a Bankruptcy Filing Soon." *The New York Times*. March 28.

body offers much better promise of recognizing where the financial system is in greatest need of shoring up, and that it has better tools to ensure that its views are acted upon. But there is widespread recognition that achieving the FSB's ambitious objectives won't be easy. In a book of essays published in 2010, *The Financial Stability Board: An Effective Fourth Pillar of Global Economic Governance?*, scholars admonished that the FSB would need to have a "loud whistle, and the authority, expertise and support of its members to blow the whistle, even if the offender is a powerful country." They also said it would have to engage in "ruthless truth-telling," "provide unpalatable messages," show itself "capable of leaning against the wind," and "voice concerns about unsustainable financial booms" (Griffith-Jones, Helleiner and Woods, 2010).

The new insight into the FSF's inner workings that this research affords will deepen skepticism about whether the FSB can do the sorts of things the authors in the report identified as necessary. It will also, it is hoped, help in gauging where greater ambition or fresh approaches might be desirable. The official community insists, of course, that the FSB differs substantially from the FSF, not only in its much broader membership, but in other major enhancements over the preceding arrangement. Policy makers tout the FSB's more systematized method of detecting vulnerabilities, its peer reviews of member countries, the "Early Warning Exercise " (EWE) it conducts jointly with the IMF and the clout the group wields by dint of its close links with the G20.

Yet aspirations for the FSF were also lofty at the time of its emergence, and its ties to major powers formidable. Before delving into what it did and didn't do, a brief look at its formative period is in order.

BIRTH OF A "CLUB OF CLUBS"

Bureaucratic turf battles and bruising clashes over global governance materialize in any effort to create a new international body. The establishment of the FSF in the late 1990s was no exception, as witnessed by a confrontation that took place between two titans of international economic policy. One was Andrew Crockett, then general manager of the Bank for International Settlements (BIS), who had just been named to chair the fledgling FSF; the other was Stanley Fischer, then first deputy managing director of the IMF. Though both men were renowned for their geniality, the appointment of Crockett as the FSF's first chairman infuriated Fischer, who believed that the new body's responsibilities properly belonged within the IMF's purview, and he laced into Crockett when they met at an Aspen, Colorado conference. "It was the most acrimonious conversation I've ever had with Stan," Crockett recalled in an interview. "He told me it was unacceptable, that I was behaving badly in agreeing [to chair the FSF]. He's a very good friend of mine, and that's the only friction-filled conversation I've ever had with him."

Personalities aside, Fischer's outburst was based on a reasonable question: Why was it necessary to form this separate group? The IMF had a long-standing mandate to conduct surveillance over the global economy, and it had the virtue of legitimacy, with membership that included nearly all of the world's countries. Moreover, the Fund had led the international response to the crises that had struck in emerging market countries such as Thailand, Indonesia, South Korea, Russia and Brazil in the 1990s, which were widely blamed — particularly in Washington's high official circles — on shortcomings in those countries' governance and financial systems. So the Fund considered itself well positioned to make judgments about what sort of reforms in emerging markets would make the world safer from crises. But officials of the Group of Seven (G7) major industrialized countries, while broadly sharing the view that reform in emerging markets was the key to financial stability, were loath to confer new authority on the IMF. The Fund's handling of the crises had shown it to be much less savvy about problems in banking systems than it was about tax and budget matters. Another important reason for G7 officials' chariness of the Fund was its powerful staff and sometimes-unpredictable executive board, which were not always fully amenable to G7 control.

Among the most radical ideas, championed by Gordon Brown, then British chancellor of the exchequer, was the creation of a global regulator with vast new powers over international finance. That idea got little traction elsewhere, least of all the United States. Still, the influential officials in the Clinton administration's Treasury department were interested in bringing some coherence to the panoply of international standard-setting organizations — such as the Basel Committee, the International Organization of Securities Commissions (IOSCO), and the International Association of Insurance Supervisors (IAIS) — which had been issuing standards in scattershot, disjointed fashion at various times in previous decades. Equally important, Treasury officials were keen to see finance ministries gain more input and intelligence regarding international regulatory issues, because the crises of the 1990s had vividly shown the potential for financial turbulence to spread on a global scale. Central bankers met regularly at the BIS, and bank regulators through the Basel Committee; yet finance ministries were the ones who would be stuck with the bill — and their political masters would be held to account — if a crisis leapt to their countries' shores from abroad.

That was the backdrop for the proposal to create the FSF, drafted by Hans Tietmeyer, the outgoing president of the Deutsche Bundesbank, who accepted a request from the G7 finance ministers and central bank governors to devise a plan. After consulting extensively with fellow policy makers, Tietmeyer proposed a group that would include top officials from 16 international bodies — both standard setters and international financial institutions such as the IMF and BIS — plus officials from the finance ministries, central banks and chief regulatory agencies of major countries. Although all of these international bodies and national authorities were constantly gathering data and looking for danger signs in certain segments of the international system, "none has the breadth of information or the capacity to formulate a complete assessment of evolving risks," Tietmeyer wrote. Importantly, his report envisioned that one principal aim of this new group would be "overcoming the separate treatment of micro-prudential and macro-prudential issues" — that is, monitoring financial risks not just by assessing the soundness of individual institutions, but examining broader forces that might be leading the entire system in an unstable direction. This was one of the first consequential uses of the term "macro-prudential" to describe the approach that regulators and supervisors should take; following the crisis of 2007–2009, it would become widely recognized as an essential focus of policy, but at the time of Tietmeyer's report it had just started coming into vogue.

The new group would not have formal standing or legal power of the sort held by the IMF. Rather, in a world where the G7 was the supreme club, the FSF was a "club of clubs" (Drezner, 2007). An earlier proposal for such a group had envisioned the inclusion of emerging market countries, and Paul Martin, then Canada's finance minister, fought vigorously to expand the membership to at least the countries in the G20, which was at the time also getting underway at the ministerial level. But others in the G7 — in particular the United States — wanted to keep the national memberships to themselves, with perhaps a few additional seats for others from similarly advanced jurisdictions. (The Tietmeyer report suggested a "small number" of additional countries could join, and in 1999 invitations went to Australia, the Netherlands, Hong Kong and Singapore, although they were not given the three seats each that G7 countries got. Switzerland received an invitation in 2007.) In another important decision aimed at maintaining a firm G7 grip on policy levers, the FSF secretariat was limited to a handful of people — at most 7.5 full-time equivalents — with most staffers on temporary secondment from government agencies and international bodies, including the IMF and World Bank, except for the secretary general, a Norwegian named Svein Andresen who had worked for Crockett at the BIS.

The secretariat's small size has long been a source of head-scratching among observers who feared the FSF was bereft of necessary staff. It looks to have been a penny-wise and pound-foolish arrangement, especially after the global financial crisis, and it is sometimes attributed to G7 parsimony. But in fact, staffers' salaries came from the BIS,which earns hefty profits for its central bank shareholders. According to Crockett, the BIS would have been willing to fund a substantially bigger payroll if it had been asked. The real motivation, Crockett explained, was the G7's desire to avoid ceding control to an independent, IMF-like bureaucracy. Instead, the large staffs of the member countries' own economic agencies, and those of the international institutions that were also on the FSF, could provide extra brainpower, number-crunching expertise and analytical capacity as the need arose.

In Crockett's words: "The idea was to get the G7 together. They fondly imagined at that time that crises would only happen in the emerging world, and they would be well-placed to identify and manage risks coming from elsewhere."

THE GOOD, THE BAD AND THE UGLY

On April 14, 1999, the day of the FSF's inaugural meeting in Washington, , an op-ed published in the *Financial Times* reflected the hope that the body might succeed where the IMF had failed at surveilling the financial system. "We need to look for trouble more systematically than before," stated the op-ed written by Howard Davies, who, as executive chairman of Britain's Financial Services Authority (FSA), was a prominent FSF member. "It is easy to forget the dramatic market volatility of 1997, and the near-meltdown of last September [the crisis involving the Long-Term Capital Management hedge fund]. So now, before the memories fade, is precisely the time to begin planning our response to the next crisis" (Davis, 1999).

With the aim of ensuring that the FSF would become something more than just a talk shop, and possibly even make a splash on the international policy making scene, Crockett exercised the prerogative of the chair at that first meeting to present a proposal. He suggested the creation of three working groups to study and offer recommendations concerning specific problems that were sources of worry. The work of two of these groups — one on capital flows, and another on hedge funds — proved of little consequence. But one of the groups did have an impact, which is worth a brief discussion because of what it reveals about international governance —namely, the importance of enforcement power and credible threats in changing countries' behaviour.

This working group, chaired by Canada's Superintendent of Financial Institutions, John Palmer, focused on offshore financial centres — many of them small island countries in the Caribbean, Mediterranean and Pacific — that it lumped into categories labelled Group I, Group II and Group III,[3] jokingly dubbed "the good, the bad and the ugly." At issue was the quality of the centres' financial supervisory and regulatory authorities; the ones that failed to adhere to international standards "constitute weak links in the supervision of an increasingly integrated financial system" by enabling market participants to engage in activities that wouldn't be allowed elsewhere, the group's report concluded (FSF, 2000a). (Other problems often associated with offshore centres — tax evasion and money laundering — did not fall under the FSF's purview, so those issues were left to other bodies.) The 25 "ugly" jurisdictions in Group III, which included the Bahamas, the Cayman Islands, Gibraltar, Macau and Panama, faced the prospect of grave sanctions if they continued doing business as usual. "In extreme cases," the report warned, the world's richest countries "could *restrict or even prohibit financial transactions* with counterparties located in problematic" centres (emphasis in original). Since the FSF didn't have the staff to monitor the centres' conduct, that job went to the IMF.

Some FSF members voiced skepticism about whether this issue merited so much effort. Offshore centres had not been implicated in creating systemic financial problems, as the working group's report acknowledged. "Is it really a threat?" queried Larry Meyer, a governor at the Fed, according to notes of one early FSF meeting. European representatives, however, were adamant in pressing for a full-scale review and disclosure of the worst offenders when the lists were drawn up. "There are some hard-nosed sinners who need harsh treatment," said Jochem Sanio, Germany's chief bank regulator, a sentiment echoed by Jean Lemierre, the director of the French Treasury, who told his fellow FSF members that the list of non-complying jurisdictions "should be published immediately. Waiting and watching is a compromise, and possibly a dangerous one."

Despite resentment and fury over having been named, shamed and threatened, many of the targeted jurisdictions hastened to clean up their acts. The Bahamas, for example, retained highly regarded former US and UK officials to help improve Bahamian regulatory policies and operations. The overall improvement was marked enough that the FSF withdrew its list of the good, bad and the ugly in 2005. Whether or not this made a major difference to the safety and soundness of the global financial system, it clearly showed the FSF's capacity for exercising clout over individual countries when it could brandish sanctions. The FSF, to be sure, had no formal enforcement power of its own, but the group's wealthy and powerful members could use its findings to justify taking collective action against certain countries that were deemed "hard-nosed sinners."

This power proved effective when the "sinners" in question were relatively small and weak. It was not so easy with bigger ones.

"UPGRADING" EMERGING ECONOMIES

"Our challenge is to get the systemically important developing countries to 'upgrade,'" Tim Geithner, then the Treasury under secretary for international affairs, said at an FSF meeting on September 7, 2000, according to notes of the session. "Otherwise we are vulnerable to another crisis."

The subject Geithner was addressing was, in essence, the FSF's main *raison d'etre* at that point — inducing changes in the policies of emerging market nations. The formerly high-flying economies of East and Southeast Asia, many of which were recuperating from crises and recession, still had a long way to go in opening up and revamping their relationship-based, often corrupt, financial systems. Countries in Latin America and other emerging regions were grappling with similar issues. The United States, by contrast, was in the midst of a long boom that was widely perceived to prove the superiority of the American way, from its rule of law to its shareholder-oriented corporate governance to its reliance on vibrant securities markets for funding the growth of its industries. Across the Atlantic, the United Kingdom was enjoying a similar renaissance that likewise seemed to showcase the advantages of neo-liberal economic policies.

To further the goal of "upgrading" emerging economies, an FSF task force combed through the various standards issued by international bodies and selected a dozen that it deemed to be of the highest priority. Promulgated in April 2000 as the "Twelve Key Standards for Sound Financial Systems," they included IMF principles on transparency in monetary and fiscal policies, the Basel Committee's core rules on banking supervision, IOSCO's standards on securities regulation and others, on issues ranging from accounting to bankruptcy. The implicit message from the FSF to the developing world was: Transform your domestic systems in accord with these principles, and you can be rich like us.

It was far from clear, though, how much success the FSF would have in getting governments in developing regions to embrace these principles. After all, the FSF hadn't accorded those countries any say over the content, and it

3 Group I jurisdictions were "generally viewed as co-operative, with a high quality of supervision, which largely adhere to international standards." Group II jurisdictions were "generally seen as having procedures for supervision and cooperation in place, but where actual performance falls below international standards, and there is substantial room for improvement." Group III jurisdictions were "generally seen as having a low quality of supervision, and/or being non-co-operative with onshore supervisors, and with little or no attempt being made to adhere to international standards." These assessments were based mainly on a survey of supervisors in major financial centres (FSF, 2000a).

had no practical way of coercing them; in this case, FSF members had no stomach for using the threat to block access to their financial markets, as they had done with the offshore financial centres. With the backing of the G7, monitoring countries' compliance with these standards was assigned to the IMF and World Bank, which would send teams of financial specialists every few years to each member country under new initiatives, the Financial Sector Assessment Program (FSAP) and Reports on the Observance of Standards and Codes (ROSC), to prepare lengthy reports aimed at evaluating the strength of banking systems, as well as their regulatory and supervisory structures. But there was no penalty for failing to comply — indeed, participation in FSAPs and ROSCs was voluntary, and even if a country submitted to monitoring it could bar publication of the results, in whole or in part. The developing countries, using their clout on the IMF and World Bank boards, had made sure of that.

This was the context in which Geithner made his comments in September 2000. If the FSF standards were to be taken seriously, "enforcement" would probably have to depend on financial markets — that is, investors would bid up the securities of countries that complied, and sell off the securities of those that did not. "The problem is, markets are not paying attention to the standards," Geithner groused. "It's difficult to impose IMF conditionality *ex ante*." (In other words, there is no way to make a country conform to the policies the Fund would require if, hypothetically speaking, the country was receiving an emergency loan.) Indeed, a report distributed by the FSF at that meeting showed that "most market participants are not very familiar" with the standards (FSF, 2000b). This was a source of frustration not only to Geithner, but other participants in the meeting, including Annette Nazareth, director of the Division of Market Regulation at the Securities and Exchange Commission. "We need to market the standards — show how it is in everyone's interest to use them," she said. The FSF later did so, distributing about 10,000 booklets to market participants and officials.[4]

The ultimate effectiveness of the "Twelve Key Standards" exercise is difficult to assess. In the end, it may have been the FSF's most important accomplishment, because, in some cases at least, emerging market countries took the standards to heart when IMF and World Bank teams came to conduct FSAPs and ROSCs.[5] Some observers even credit this factor as the main reason emerging markets weathered the crisis better than advanced countries.[6] But there are grounds for skepticism about this claim, notably a scholarly study that analyzed the process of reform in several Southeast Asian countries and found much evidence of "mock compliance" with the standards (Walter, 2008). A judgment on which of these views is right is beyond the scope of this paper.

This much is certain: The United States made sure it would not be subjected to the kind of monitoring and direction from abroad that it wanted other countries to accept. Until after the global crisis hit, Washington refused to undergo an FSAP;[7] Federal Reserve Board Chairman Alan Greenspan, was, by all accounts, the one most adamantly opposed, on the grounds that it would be pointless and burdensome to spend a lot of time with an IMF team looking at shortcomings of the US regulatory system that were already well known. (Several other major countries, including China, Indonesia and Argentina, likewise declined.)

Furthermore, particularly after President George W. Bush came to power, US representatives on the FSF took a dim view of Crockett's effort to turn the FSF into more of an action-oriented body. Largely for that reason, the FSF did not form any new working groups after the three mentioned above finished their reports. The Bush administration was not eager to empower the FSF — partly because the forum was a Clinton-era creation, but more importantly because Bush officials wanted to avoid any semblance of giving influence over US financial policy to an international group. Entreaties from Europeans for the FSF to consider more international monitoring and possibly even regulating hedge funds, credit ratings

4 See FSF (2001). *Final Report of the Follow-Up Group on Incentives to Foster Implementation of Standards*. September. Available at: www.financialstabilityboard.org/publications/r_0109a.pdf.

5 The IMF's Independent Evaluation Office, in a mixed evaluation of FSAPs, said it had "identified a wide range of cases in which significant changes did take place subsequent to the FSAP and in which there is some evidence that the FSAP was at least a contributory factor...The most commonly identified value-added of the FSAP was as an independent, expert 'second opinion' on the financial system and reform plans. In a number of cases, this contribution increased the credibility of reform initiatives...But there were also a number of missed opportunities where the FSAP did not, for various reasons, lead to timely changes to forestall problems. The most dramatic example was in the Dominican Republic where a banking crisis broke out less than a year after the FSAP." See IMF Independent Evaluation Office (2006). "Report on the Evaluation of the Financial Sector Assessment Program." January 5. Available at: www.imf.org/external/np/ieo/2006/fsap/eng/pdf/report.pdf.

6 See C. Fred Bergsten (2009). "A Blueprint for Global Leadership in the 21st Century." Speech to the Global Human Resources Forum, Seoul, November 4.

7 Edwin M. Truman, who was assistant secretary of the Treasury for international affairs in the Clinton administration, contends that the United States initially agreed to an FSAP, but later changed its mind when President Bush came to office. See Edwin Truman (2009). "The International Monetary Fund and Regulatory Changes." Working Paper, WP 09-16. Peterson Institute for International Economics. December.

agencies and insurance companies, therefore came to naught. Randal Quarles, who, as assistant secretary of the Treasury for international affairs, participated in a number of FSF meetings, said in an interview that he personally would have preferred giving the FSF "more of an athletic role," but he explained:

> It was generally the US view that as much as possible, [the FSF] should be a communications forum, so it wouldn't take steps that might limit our freedom of action, where we might have to say to some constituency in the United States, "Well, we promised the Indonesians" — or worse, the French. It would be counterproductive if Congress thought there was somebody out there who had obtained commitments or claims on the US government. So for all those reasons, it was part of the relatively conscious, if not loudly articulated, view of the United States that these should be bodies principally for communication, as opposed to decisions. Better to have a discussion, see what people want, and see if we can achieve it, rather than bind to doing things.

So the FSF was to be little more than a talk shop after all, at least during the period that led up to the crisis. What, then, does the record show about the quality of the group's discourse?

"MOUTHING THE WORDS OF GREENSPAN"

Inflated US housing prices, reckless purchases of risky mortgage securities, conflict-of-interest-riddled credit rating agencies, pro-cyclical regulations, too-big-to-fail banks, complex investment models with hidden pitfalls — all of these phenomena and more came up for discussion at FSF meetings. Indeed, close scrutiny of meeting notes and minutes reveals numerous instances in which members piped up with observations and worries that, in retrospect, are almost eerily prescient.

As far back as the September 1999 FSF meeting, for example, Nout Wellink, the Dutch central bank chief who chaired the Basel Committee on Banking Supervision, ruminated on the risks engendered by the increasingly prevalent view among his country's banks that they must expand or succumb to takeovers. "Are we creating banks that are too big to run, too big to supervise, too big to fail?" Wellink asked.

In a discussion about the US economy, Jürgen Stark, vice president of the Bundesbank, wondered aloud, "Is there a housing bubble under way?"— and while that question might seem unremarkable, it was uttered at an FSF meeting in March 2002. About a year later, Alastair Clark of the Bank of England fretted about how banks were off-loading mortgages to investors who might not understand what they were getting into. "Where has the credit risk gone?" Clark demanded, adding that although one group of international regulators had prepared a report on the issue, "the market is changing very fast. The real problem is that we really need full information on credit risk — who has it?...And another problem is that those who buy the risk may know less than those who offered the credit." Likewise, Michel Prada, France's chief securities regulator, informed his fellow FSF members at a March 2007 meeting that a study of credit rating agencies showed that they were growing increasingly dependent on fees from rating structured products such as collateralized debt obligations (CDOs). Prada noted that IOSCO, whose technical committee he chaired, had previously studied the potential for conflict of interest at credit rating agencies by focusing on their ratings of individual borrowers; perhaps, in light of the rating agencies' newer and more lucrative line of revenue, further examination was merited he said — a sentiment others agreed with. (By the next FSF meeting, Prada was able to report that IOSCO had responded by duly establishing a task force.)

To help organize and focus the discussion about such matters at FSF meetings, the FSF secretariat established a "High-level Vulnerabilities Working Group," consisting mainly of senior staffers from central banks and regulatory agencies (in other words, the top aides to the principals who attended the body's plenary sessions). It included a number of public servants esteemed for their expertise; among them were Vincent Reinhart from the Federal Reserve, Paul Tucker from the Bank of England, Claudio Borio from the BIS, John Sloan (who, though Canadian, was then working for the UK's FSA), Garry Schinasi from the IMF and the FSF's own Svein Andresen. The vulnerabilities working group met before each FSF meeting to scan the financial horizon for threats and consider scenarios that would help the forum's members identify the system's biggest potential weaknesses. Based partly on the working group's discussion, the secretariat prepared a document for distribution to all FSF members prior to each meeting — documents which, like the meeting discussions themselves, contain nuggets of insight into the dangers and problems that would eventually materialize. For example, the note distributed to FSF members prior to the September 2005 meeting foresaw one of the most disastrous results of value-at-risk models and other complex methods used by large financial institutions. "To the extent that the signals from...models...lead [large banks] to implement similar strategies to contain risks, this could result in a 'rush for the exit' and amplify credit movements," the note observed.

As these snippets from FSF meetings and documents suggest, the group was aware of, and discussed, a number of the problems that today are recognized as major causes and accelerants of the crisis. Yet, as became evident later, the concerns expressed about these problems did not even come close to matching the seriousness of the situation. There are several reasons for the FSF's shortcomings in this regard.

First, alarmist sentiment would generally run afoul of the FSF's most powerful member country, the United States. Although by no means alone in playing down the risks to the financial system, American representatives on the FSF tended to be the most steeped in the pro-market ethos — that is, the view that the innovations and new financial instruments devised by market participants were making the system not only more efficient at allocating capital, but less prone to cataclysms. Crockett recalled one particularly striking conversation he had on the sidelines of an FSF meeting with the then under secretary of the US Treasury for international affairs: "John Taylor, who's also a good friend, said to me, 'Look, the Forum is writing all these things about problems [in the global financial system, such as hedge funds and offshore financial centers]. Can't we write about things that are going well?' Of course, many things *were* going quite well. But the purpose of the Forum was to spot the rocks ahead instead of saying, 'it's all smooth blue sea.'" (In an email exchange, Taylor corroborated Crockett's account, though with this caveat: "I recommended to Andrew that 'the FSF should write both about the problems and about what is going well.' [The words 'both' and 'and' are key parts of my point.] The point was that you learn from policy successes as well as policy failures.")

As has been amply documented elsewhere, the most influential bastion of the pro-market perspective during the lead-up to the crisis was the US Federal Reserve, with Alan Greenspan as chairman. The Fed's view was essentially the antithesis of those who worried about the need for macro-prudential policies; rather than fretting about the tendency of financial markets to generate unsustainable booms followed by devastating busts, Fed officials believed that the self-interest of market participants would lead them to avoid taking the kinds of risky positions that could bring down their institutions. In a remarkably candid interview, former Fed Governor Laurence Meyer acknowledged that, during his time on the FSF, he was much too cavalier in dismissing the concerns of European members, especially the French, about the unknown risks of financial instruments such as derivatives and how they might exacerbate market turbulence during periods of stress: "To my utter regret, I responded by simply mouthing the words of Greenspan — that banks are different, they're subject to the safety net, and as a result they have to be supervised, but other parts of the financial system that are not subject to the safety net operate with a lot of market discipline. So we should just let those markets evolve on their own."

The Fed's vice chairman, Roger Ferguson, succeeded Crockett as FSF chairman in 2003. Although Ferguson was well liked for both the good humour and conscientiousness with which he ran FSF meetings, some members have said it was a bad idea, especially in retrospect, to give the chair to an official from such a large stakeholder in the system. I could find no evidence in my research that Ferguson showed any overt favouritism toward one party or another, nor did I find evidence that he used the powers of the chair to intensify examination of problems in the US system. A revealing anecdote about his general attitude may be the sardonic name — "Merry Sunshine" — that he gave Bill White, the chief economist of the BIS. White and his deputy, Claudio Borio, were among the most prominent advocates of macro-prudential-oriented policies; White's repeated warnings about the dangers of a crash meant that he was one of the few policy makers to emerge from the crisis with a vastly enhanced reputation.

It would be unfair, however, to pin all of the blame for the FSF's failings on the complacency of its American participants. More fundamental weaknesses kept the forum from galvanizing itself to what in hindsight would have been an appropriate level of concern. Many of the attendees considered FSF meetings to be a chore; some of the phrases they used in interviews include "boring... pointless...unmemorable...lot of hot air...everyone checking their watches." Such perceptions were widely shared despite efforts that Crockett made at the outset to liven up the meetings; he decreed that members must refrain from reading prepared statements and should address each other by first names. He also opened each segment of the meetings by posing provocative questions about the next topic on the agenda.

A paradox underlaid the FSF's lack of urgency: Each meeting considered a wide variety of potential dangers, many of which appeared worrisome at the time, but eventually proved financially inconsequential or at least not systemically damaging. These included avian flu, Argentina's debt default and Brazil's close brush with default in 2002, the woes afflicting the Doha Round, geopolitical events such as the September 11 attacks and the invasion of Iraq, the potential for the US fiscal deficit and current account imbalance to generate a US dollar collapse, and banking problems in Japan and China. Searching widely for possible triggers of global financial panic was a big part of the FSF's duty, so it should not be faulted for doing so. But after attending several meetings where such issues were aired, especially during periods when financial markets were continuing to manifest signs of ebullience, officials understandably came to regard the gatherings as repetitive and lacking clear direction for policy. Votes were never taken on matters of substance; the group operated by consensus.

A related phenomenon was the mantra-like similarity of the conclusions reached from one meeting to the next.

"Members noted that conditions were generally benign, but...continuing developments...could over time lead to strains in financial markets," the FSF stated after its September 2005 meeting in London — wording very close to that which it had issued on other occasions.[8]

At many of their meetings, FSF members devoted considerable time to a subject of potentially immense importance but little glamour — the activities of international standard-setting bodies. This was a touchy subject since groups such as IOSCO and the Basel Committee are traditionally protective of their independence and resistant to anything resembling political interference. In some cases, having a top standard setter at FSF meetings helped generate cooperative interaction — for example, Michel Prada's acknowledgement, noted above, that IOSCO needed to update its scrutiny of credit rating agencies' conflicts of interest, in light of their increasing reliance on fees from structured products. In other cases, such as insurance, standard setters responded more grudgingly. FSF members pressed the IAIS for detailed information on the extent to which the insurance industry was taking on the risks that banks were laying off. "There is a shortfall in data and we should try to fill it," Howard Davies fumed at a March 2003 FSF meeting. But the response was slow and inadequate, FSF members recalled.

To get a better sense of what FSF meetings were like during the pre-crisis period, it is worth examining in detail one meeting, an account of which follows in the next section. This account is based both on the confidential minutes prepared by the FSF secretariat as well as the sketchy notes taken by a person who attended. The meeting offers an illustrative case study because it took place about a year before the crisis began to erupt. In the note circulated by the FSF secretariat prior to this meeting, one sentence stands out as heralding — albeit in understated terms — what was to come: "There are indications that the benign conditions of recent years may be approaching a turning point."

AN ILLUSTRATIVE MEETING

The FSF meeting in Paris on September 6, 2006 marked the start of a new era: Mario Draghi was taking over as the forum's chairman from Roger Ferguson, who had left the Fed. Much has been written about the rise of "Super Mario" since he became president of the European Central Bank in November 2011 — how the orphaned teenager from Rome won a scholarship to the Massachusetts Institute of Technology, advised successive Italian governments as an economics professor, held the position of director general at the Italian Treasury for a decade, and spent three years at Goldman Sachs before becoming governor of the Bank of Italy in 2005. In his introductory remarks to the group he now chaired, Draghi showcased his skills at agenda setting. He "acknowledg[ed] the achievements of his predecessors in establishing the reputation of the FSF," the confidential meeting summary states; he then spelled out how his stewardship might differ from previous chairmen. He said he wanted "to focus [the FSF's] work on specific operational issues and practical ways in which risks could be mitigated, while avoiding spending time on macroeconomic issues in which the forum had no comparative advantage over other groupings."

For all the energy and clarity of purpose Draghi might have brought to the table, though, this meeting, like previous ones, did not achieve any conceptual breakthroughs about the problems that were mounting beneath the financial system's seemingly placid surface. Comments from members ranged from ones expressing moderately deep concern to ones that, with the benefit of hindsight, manifest relative nonchalance about a wide variety of issues. Perhaps most interesting, as we shall see, was a trenchant criticism by one member about the futility of the whole exercise.

As usual, members received a note from the secretariat prior to arriving; the note started with a review and analysis of the previous six months' developments, including illustrative charts. To set the agenda and stimulate discussion among FSF members when they got together on September 6, the note's second and main section, titled "Potential areas of vulnerability," enumerated several sources of concern, with the following equivocal overview: "The list of prominent vulnerabilities is broadly unchanged since the FSF's previous meeting. However, the changing macroeconomic environment may have increased both the probability that one or more of these vulnerabilities would be worsened, and the impact that they might have on financial stability should they crystallize."

Turning first to housing markets and household indebtedness, the secretariat's note cited "clear signs of a significant cooling" in US home prices and evidence that a substantial number of American homeowners faced higher mortgage payments as the rates on their adjustable-rate mortgages rose. "Although...increases in mortgage payments...will be spread out over a number of years, so that the impact on the household sector as a whole is likely to be gradual, these issues warrant continued close attention," the note said. "Stress tests conducted by supervisory authorities and central banks...suggest that financial institutions are resilient to shocks to their mortgage portfolio. However, structural changes...make it difficult to apply past patterns to present portfolios."

The note then elaborated on a list of potential vulnerabilities. First were private equity and leveraged buyouts, followed by global imbalances and overheating of the Chinese economy. Then, in a section titled "Possible

8 See: www.financialstabilityboard.org/meetings/pm_050908.htm.

areas for consideration by FSF members," the secretariat cautioned: "A scenario in which troubles at one or more large institutions spread to others in the system, although unlikely, continues to be a possibility." Among the "possible triggers" that might lead to such an eventuality were macroeconomic events (that is, a significant slowdown in growth or acceleration in inflation) geopolitical events and "other shocks" such as "the failure of international trade talks or a worsening of global current account imbalances [that] could lead to an increase in protectionist pressures." The upshot: "Any of these shocks would be likely to have an impact on several of the vulnerabilities identified above. A worsening of one or more vulnerabilities could in turn raise the materiality of others."

This meaty array of issues formed the basis for the discussion that followed Draghi's opening comments. As in previous meetings, the bullish attitude that prevailed among investors worldwide evoked some anxiety. Xavier Musca, director general of the French Treasury, was outspoken on this point, fretting that "risks are underpriced." A weakening of the US economy could coincide with a disorderly unwinding of global imbalances; moreover, "financial markets are changing rapidly, with huge interconnections" that were poorly understood, in Musca's view. "Better interaction among regulators," and "crisis management war games" were needed, he concluded.

Turning to housing, Fed Governor Susan Bies acknowledged that in some parts of the United States "market prices are not sustainable," but she pointed out that, in general, "price rises are slowing — not falling." Although delinquency rates on mortgage payments were increasing, the interest rates on many adjustable-rate mortgages would not rise for another couple of years, "so we have some leeway." Overall, she said, "the strength of the labour market should offset any setbacks in the housing market."

Members from other countries followed with observations about their own regional and national housing markets. Lucas Papademos, vice president of the European Central Bank, worried (sensibly, as events would later show) about the "currency mismatches" in central European countries, where many borrowers had taken out mortgages in euros and Swiss francs that they would be unable to repay if foreign exchange rates shifted significantly. "The subsidiaries of key [European] banks could be hit," he noted. Callum McCarthy, chairman of Britain's FSA, opined that most of the UK's big banks were in sound shape; "the broader question is how households will react" should home prices falter. Echoing that sentiment was the Netherlands' Nout Wellink, who said, "Excessive mortgage lending will affect households, but not the banking system except through reputational risk."

A discussion ensued about the increased use of "exotic" mortgages and the securitization of the mortgage market in the United States. According to the meeting summary, FSF members generally felt that "to the extent [mortgage-backed] securities have been sold to other investors, banks' exposure should be limited. However, risk managers are still developing techniques to price and model these exotic instruments." Moreover, "these products are not always well understood by consumers and expose them to 'payment shock.'"

So far, this account of the meeting underscores that FSF members were well aware of the problems that would fuel the crisis — but (with the arguable exception of Musca) they not very concerned about them. The remainder of the meeting was devoted mainly to other worries raised in the secretariat's note, which didn't end up contributing much to the crisis. These included private equity and leveraged buyouts ("Members expressed concern that banks involved in private equity activity may be taking on sizable risks," according to the summary), and the potential for a "hard landing" in China. Regarding global imbalances, "some members assigned a low probability to a disorderly adjustment...others expressed greater concern." Items on the agenda for the last portion of the meeting included reports and stock-taking on various matters including avian flu, offshore financial centres, and international accounting and auditing issues.

In hindsight, one intervention appears to have been more on point than most — an exhortation by Geithner, then president of the New York Federal Reserve Bank, that "the principal task for authorities is to strengthen the cushions that will make the financial system more resilient in times of stress." According to notes of the meeting, Geithner pointed out that "large financial institutions have off-balance-sheet risk equal to about 50 percent of what they have on-balance sheet," and although "core institutions are much larger and better managed" than others, regulators "must look at [the likelihood of] 'tail events.'" He argued, "stress testing has improved but it is not good enough." No longer was Geithner focused on "upgrading" emerging market countries, as he had been six years earlier.

Small wonder, though, that the outgoing governor of the Reserve Bank of Australia — who was attending his last FSF meeting before his retirement — expressed dissatisfaction with his experience on the body. "At the end of the meeting, Ian Macfarlane noted that the secretariat's background notes and members' discussions about vulnerabilities have identified a number of different areas of concern over the years," the meeting summary states, "but it was not always clear how useful those discussions had proved to be."

One additional aspect of the September 2006 meeting deserves attention — a presentation to the FSF by a group of bankers and other executives from the Institute of

International Finance (IIF), the Washington-based group that represents global lending and investment firms. The group, led by IIF Managing Director Charles Dallara, also included top officials from UBS, Citigroup, BNP Paribas, Allied Irish Bank and Morgan Stanley. The purpose of their presentation, according to the minutes of the meeting, was to seek a "strategic dialogue on the overall interaction between regulators and industry," because of their "increasing concern" about the "burdens of financial services regulation and enforcement, including possibly inconsistent treatment across jurisdictions [and] excessive detail in regulations."

This episode raises one of the most politically explosive issues to emerge from the crisis — whether "capture" by the private sector blinded regulators to practices that ultimately proved to be the financial system's undoing. The FSF's meeting with such a powerful lobbying group could be interpreted as emblematic of a broader tendency among public officials involved in financial issues to become overly cozy with, protective of and sympathetic to, the banking and securities industry, rather than maintain a fittingly adversarial degree of distance. In fact, the September 2006 meeting was not the only one that took place between the FSF and private sector representatives; the group's records show the first had taken place in 2004.

But whatever capture may have occurred at the national level, the FSF reacted to the IIF's presentation with remarkable aloofness, combined with self-conscious concern about its propriety. The following comes from the meeting summary:

> Almost all members felt that the FSF is not the most appropriate body to engage in such a dialogue [as that requested by the IIF], particularly since certain of the issues raised by the IIF were the responsibility of national legislators, enforcement officials or regulatory authorities. Internationally, in many cases...[an] individual sector's standard-setting body would be more appropriate...At the same time, the IIF cannot be the sole private sector body to engage in such a dialogue, because it is not sufficiently representative of all private stakeholders, including smaller financial institutions or consumer groups...Some members made the further point that meeting regularly with the IIF would set a difficult precedent, as other bodies might seek a similar level of access to FSF meetings.

COMING UP SHORT ON CROSS-BORDER FAILURES

Although the FSF didn't see the crisis coming, it could have taken action to prepare for unexpected catastrophes in markets or at major financial institutions; however, on this score, the body delivered too little, too late. The issue of strengthening the capacity of authorities in different countries to coordinate in the event of collapse at an international financial institution is one of the most salient examples of where the FSF came up short.

As early as 2000, participants in FSF meetings raised concerns about the need for rules and systems regarding the cross-border resolution of financial institutions on the verge of failure. "Would it be wise to be better prepared by thinking in advance?" Crockett asked at the September 7, 2000 meeting. "Most of those who would be drawn in are around this table and they could usefully exchange views here." His suggestion drew a hearty endorsement from Germany's chief regulator, Jochen Sanio, who said, "We need a 'script' for dealing with the bankruptcy of a large and complex international bank."

The problem is one of the thorniest in global regulation. Among major countries, wide disparities exist in their bankruptcy codes and procedures for handling failing financial institutions, and there are no detailed international agreements on how authority would be apportioned in a crisis at a big institution or who would bear responsibility for providing public funding should that prove necessary.

A confidential report drafted in 2001 at the behest of the FSF and a number of other international bodies outlined a long list of obstacles that would impede the orderly wind-down of a financial conglomerate with a variety of businesses in different jurisdictions. The report didn't even attempt to offer a comprehensive set of rules; the best it could do was make recommendations for how supervisors should maintain up-to-date information about the far-flung activities of institutions under their purview, "develop regular contacts" and "effect ongoing dialogue" with their foreign counterparts, and prepare contingency plans for a crisis, in part by familiarizing themselves with the legal systems in other countries, especially those governing insolvency.[9] FSF members remained worried enough about the issue to ask for a follow-up appraisal in 2005, and the secretariat responded with a brief report stating, "there has been progress in contingency planning," including the formation of "colleges of supervisors" from around the globe who would meet to discuss issues concerning a few of the largest individual institutions. "However, work

9 The report remained secret for many years, but was recently disclosed as the result of a lawsuit involving the Lehman Brothers bankruptcy, and is available at: www.scribd.com/doc/42414020/Defendant-Federal-Reserve-Docum-Production-Lehman-Part-II-summer-2008-heavy-redactions-Lawsuit-3.

remains ongoing and most of the arrangements remain untested in practice," the report said.

One FSF member remained particularly anxious about the need for better preparation — John Gieve, deputy governor of the Bank of England. Partly at his urging, the FSF and the British authorities jointly held a workshop on the issue in London on November 13-14, 2006, with Gieve delivering a speech on the first day in which he said:

> In its first seven years, much of the FSF's focus has been on the identification and assessment of risks in a rapidly changing financial system; it has played a valuable role in building a common understanding among authorities and among market participants of what the risks are and how they can be reduced. However, that level of progress has been less apparent on putting in place arrangements for handling and resolving cross-border crises. Overall, I do not know anyone who believes we have established either the common approach to crises or the practical machinery which would enable us to handle a complex cross-border failure with confidence.[10]

Gieve argued that the discussion needed to move from general principles — which might prove inapposite or too inflexible in a crisis — to specific case studies. His favoured approach was what he called "table-top exercises," in which small groups of regulators and supervisors from various countries would get together to discuss how they would handle the failure of particular major institutions with operations in their jurisdictions — and thereby gain some insight into the concrete problems that would be most likely to arise. This idea was somewhat more focused than the "college of supervisors" concept, since it wouldn't include every supervisory authority in which a large bank or investment firm had operations, just the ones that would be confronting the most consequential decisions in the event that the firm was going belly up.

Gieve asked the question, "What role could the FSF play in promoting these kinds of bilateral or small multilateral discussions?" and answered it "As we all know, it is not the role of the FSF to manage cross-border crises. But my view is that the FSF *does* have a role in this area. To me, it seems the ideal group to draw out the common messages and lessons that may emerge from these interest group discussions, and to establish a common framework for handling crises, which will be of use both to its members and more widely."

Gieve's proposal for active FSF involvement got a cool response, according to a report on the conference delivered confidentially by the secretariat to the FSF at its next meeting: "Reactions from FSF members and workshop participants since the workshop have suggested that, in practice, such discussions and exercises are best conducted by those with specific technical expertise and responsibility in this area rather than by the FSF itself."

Despite the FSF's reluctance to foster and encourage the exercises he envisioned, Gieve maintained that they should take place. He reckoned that it would be most fruitful to start with such talks among American, British, Swiss and Dutch authorities, given the size of their financial sectors. But, as he recalled in an interview: "There was no real appetite on the US side to get into discussing particular examples. We were offering to put HSBC or Barclays on the table, with real balance sheets, and maybe in return, they would do Citi or Lehman. But that never got off the ground."

Later, the FSF would embrace Gieve's approach — although only after the crisis was well underway.

A SUPER-ELITE CLUB

Boredom ceased to be a problem for FSF meetings, members recall, starting with the meeting in late September 2007. The convulsions that struck financial markets in August 2007, and especially the run by depositors on the British bank Northern Rock, had jolted the guardians of global finance into recognizing that something was seriously amiss in the financial system. And the FSF found itself at the centre of the official response.

After years of restraining the FSF from acting decisively, the US Treasury decided that the body ought to assume the task of drafting a plan to deal with the various fragilities and structural problems the nascent crisis was exposing. The Americans' change of heart was partly attributable to the belief that "this was more than just a US problem, so we needed to deal with it in a global way," recalled Clay Lowery, who was then assistant secretary for international affairs at the US Treasury. But another important reason was that the Bush administration hoped to deflect the heated denunciations coming from Europe, where blame was being heaped on the US financial system. "We didn't want to be on the back foot, and the best way to not be on the back foot is to be on the front foot by proposing an action-oriented agenda," Lowery said. Accordingly, two Treasury under secretaries, David McCormick and Robert Steel, co-authored an op-ed published in the *Financial Times* on September 12, 2007, declaring that despite calls for immediate regulatory action, "US economic decision makers are committed to work multilaterally to put these events in perspective, examine the root causes and respond in a thoughtful and timely fashion." The G7, they

10 Available at: www.bankofengland.co.uk/publications/Documents/speeches/2006/speech290.pdf.

announced, would assign this job to the FSF (McCormick and Steel, 2007).

It was both a chastened and energized group of FSF members that convened at the New York Federal Reserve Bank in September 2007. According to the minutes, Callum McCarthy of the UK's FSA set the tone by noting that "the major issue for banks was facing up to off balance sheet liabilities that they (and their supervisors) had collectively ignored." BIS General Manager Malcolm Knight summed up worries raised at recent meetings about the weaknesses in financial markets that were becoming apparent: "The structured finance market had not held up well when market conditions became adverse...the scenarios adopted in stress testing had not taken sufficient account of the dynamic interaction of risks underlying structured finance products."

This does not mean that the FSF was finally getting ahead of the curve; on the contrary, considerable evidence suggests that, at this point, the body was still underestimating the depth of the trouble that lay ahead. The assessment of vulnerabilities in the financial system prepared by the FSF secretariat, for example, contained an elaborate analysis of the turbulence that had occurred during the summer, but with the benefit of hindsight, its assessment of the future was sadly deficient. "It may be useful to review a number of ongoing risks, how they might evolve, and what a worst-case scenario might be," the document said, and then, after that sensible suggestion, it continued, "The most likely scenario going forward is for losses to continue, but without threatening core financial institutions. However, a downside risk is that a core financial institution encounters severe financial distress." As we shall see, the "worst-case scenario" envisioned by the secretariat would be a good bit worse at the FSF's next meeting six months later, shortly after the collapse of Bear Stearns.

Still, even if the FSF didn't fully appreciate how bad the situation might get at the September 2007 meeting, it accepted the G7's request with alacrity — no one more so than its chairman. This was, in a sense, a moment Draghi had been preparing for all his life, although he could hardly have imagined how many more moments like it were coming.

Draghi proposed, to general agreement, the establishment of a "small, agile, senior group" — in effect, one super-elite club within another — to prepare the broad outline of a response to the crisis that the G7 wanted. (The FSF publicly announced the formation of the body, which was dubbed the Working Group on Market and Institutional Resilience.) Finance ministry officials were deliberately kept out in favour of the central bankers, regulators and chiefs of international standard-setting bodies and committees, who were deemed more likely to have the necessary expertise. Finance ministry officials, most agreed, would likely be prone to engaging in political bickering with their counterparts, possibly wrecking the chances of producing a consensus document; moreover, if a finance ministry representative from one country was included, all would insist on joining.

By all accounts, meetings of the Working Group were far more stimulating and productive than those of the full FSF had been; its high-powered members[11] recall spirited discussions about what had caused the crisis and what ought to be done about it. The confidential information I have obtained about the Working Group's meetings is sparse and of little use, but the group's decisions about what to report and recommend to the G7 are not secret — they were released publicly in April 2008.[12]

At the time, the report was widely perceived as offering a searing indictment of the financial system's flaws as well as fairly ambitious proposals for how to correct them.[13] It excoriated banks and other financial institutions for inaccurately assessing or even properly understanding the risks they were taking; it accused the US subprime sector of "unsound...and in some cases fraudulent" practices; it blasted credit rating agencies for "weaknesses in rating models, inadequate due diligence...and insufficient attention to conflicts of interest." And though it aimed most of the blame at the private sector, it also offered a mea culpa of sorts: "Public authorities recognized some of the underlying vulnerabilities but failed to take effective countervailing action, partly because they may have overestimated the strength and resilience of the financial system."

The report's 67 recommendations spanned a host of areas, ranging from strengthening the capital and liquidity of big financial firms to changing the rules for credit rating agencies to preparing supervisors for a big bankruptcy. Most involved tasks that various international bodies, central banks, supervisors and private firms were expected

11 In addition to Mario Draghi, Jochem Sanio, Tim Geithner, Malcolm Knight, Lucas Papademos, John Gieve, Michael Prada, Callum McCarthy and Nout Wellink, who have already been mentioned, members included: Julie Dickson, Canada's Superintendent of Financial Institutions; Donald Kohn, Vice Chairman of the US Federal Reserve; John Dugan, US Comptroller of the Currency; Jaime Caruana, Director of the IMF's Monetary and Capital Markets Department; Jean-Pierre Landau, Deputy Governor of the Banque de France; Hermann Remsperger, Member of the Bundesbank Executive Board; Takafumi Sato, Commissioner of Japan's Financial Services Agency; Philipp Hildebrand, Vice Chairman of the Swiss National Bank; Christopher Cox, Chairman of the US Securities and Exchange Commission; and John Smith, Board Member of the International Accounting Standards Board.

12 See FSF (2008). *Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience*. April 7. Available at: www.financialstabilityboard.org/publications/r_0804.pdf.

13 See Larry Elliott (2008). "Policymakers Join Forces to Repair Battered Markets." *The Guardian*. April 14; Tara Perkins and Kevin Carmichael (2008). "More Rules? No Thanks, Banks Say." *The Globe and Mail*. April 10; Chris Giles and Krishna Guha (2008). "Banks' Self-regulation Plan Shunned." *Financial Times*. April 13.

to achieve, in many cases by specific deadlines. Especially remarkable were proposals that issued directions to standard setters, in ways they had never been directed before. For example, shocked at how the triple-A ratings on many CDOs had grossly misrepresented the actual risks, the report's authors urged that such products should be rated using a different system than the one used on corporate bonds. This went considerably further than IOSCO's own task force, which had only recommended that credit rating agencies "study" whether to change their systems. As for the Basel Committee, the weaknesses of the Basel II bank capital rules that had come to light prompted the writers of the report to declare that the Committee — some of whose members sat on the FSF — must also take action. Specifically, the Basel Committee issued proposals in 2008 to raise the amount of capital banks would be required to hold if they invested in "certain complex structured credit products such as CDOs of asset-based securities."

Many of the recommendations, however, were vague, reflecting both a lack of consensus and deference to the authorities who had responsibility for the issue in question. For example, the report stated that the Basel Committee "will continue to update the risk parameters and other provisions of the Basel II framework," and "The financial industry should align compensation models with long-term, firm-wide profitability."

Better late than never, the report also incorporated John Gieve's idea about strengthening cross-border cooperation to prepare for the wind-down of a multinational bank or other financial conglomerate. (This was no coincidence; Gieve was on the Working Group and headed the subcommittee responsible for the matter.) "For the largest cross-border financial firms, the most directly involved supervisors and central banks should establish a small group to address specific cross-border crisis management planning issues," the report said. "It should hold its first meeting before end-2008" — a deadline obviously set in blissful ignorance of how much cross-border cooperation would be needed in the autumn of that year, when various disparities in legal systems and failures to coordinate, in particular exacerbated the Lehman debacle.

The deeper the financial system sank in the months following the spring 2008 release of the FSF Working Group's report, the less cutting-edge the report looked. "It was a good document in April this year; does it look adequate given the scale of what has occurred?" Adair Turner, the UK's new FSA chairman, said in a *Financial Times* interview published in mid-October 2008, a month after the bankruptcy of Lehman Brothers. "In April of this year everybody knew that something pretty big had happened to the world's financial system. What we had no idea, bluntly, was how extreme it was going to be" (*Financial Times*, 2008).

Yet the extremity of what might happen was evidently starting to dawn on the FSF when it formally approved the Working Group report at a meeting in Rome on March 28-29, 2008. At that meeting, the FSF was already contemplating the need for much more radical options than those contained in the report, for obvious reasons: Two weeks earlier, the US authorities had been forced to rescue Bear Stearns from collapse.

THE WORST-CASE SCENARIO GETS WORSE

"The process of adjustment to the financial turbulence that started last summer is proving to be far more protracted, and more damaging to the real economy, than had been expected six months ago," admitted the secretariat's note on vulnerabilities, circulated ahead of the March 2008 meeting.

No longer was the direst scenario "a core financial institution encounter[ing] severe financial distress," as it had been at the September 2007 meeting. According to the March 2008 note, "heightened gridlock in primary and secondary financial market activity" was one of the distinctly plausible paths that the world might take. "In a worst-case scenario, credit flows could decelerate rapidly and asset values fall sharply throughout the financial system, spurring a self-reinforcing flight to safety," the note said. "Illiquidity, and the threat of insolvency, would spread to a widening circle of financial institutions." Also conceivable were "institutional failures," the note continued. "A worst-case scenario would be the distress or insolvency of one or more large and complex financial institutions. The sharp and speedy decline in Bear Stearns's liquid assets, which fell from $18 billion to $2 billion in a matter of days, illustrates the precariousness of balance sheet liquidity, especially for institutions that rely on overnight wholesale funding markets."

Despite the extensive measures that governments had already taken — monetary and fiscal stimulus, steps by central banks to promote market liquidity, actions to prop up individual institutions and initiatives to bolster the US housing sector — "financial systems remain extremely fragile," the note concluded. "There is a strong risk that conditions will not improve by themselves, and may indeed get substantially worse before they get better."

This was where the radical policy ideas came in — some of which were later adopted in one form or another. "Authorities may need to consider whether to take a more proactive approach," the note warned. "It is important to consider options that will lay the groundwork for responses ahead of time rather than under the pressure of fast-moving events." As befits a multilateral body, the note argued: "Coordinated international initiatives may enjoy a greater public profile and garner more political support than measures taken on a piecemeal basis by different countries," and it enumerated several for the FSF's consideration:

- Coordinated lending to systemically important institutions. This might be desirable because providing liquidity support to individual firms would only raise questions about others; therefore, lending could "encompass a broad range of institutions, regardless of their liquidity or capital status."
- Coordinated recapitalization of systemically important institutions: This alternative might be preferable because, "with solvency having started to replace liquidity as the primary perceived risk to systemic stability, the effectiveness of further moves to provide official-sector credit to financial institutions would not be clear." Although public funds might help recapitalize individual firms, "[i]n a worst-case scenario of more widespread doubts about solvency in the financial system, one option could be to consider a broader effort to bolster capital simultaneously in a number of institutions," perhaps involving "cross-border cooperation."
- Further efforts to move illiquid assets off balance sheets: Ideally, governments would mobilize "consortia of private buyers" for such assets, but authorities might have to use guarantees to "facilitate" the purchases. "A more radical approach might be a government-sponsored or publicly funded facility to buy the assets, and then sell them off slowly as markets recover."

At the Rome meeting, much of the discussion was devoted to putting finishing touches on the Working Group report before its submission to the G7. But the FSF also spent time mulling over the policy options listed in the secretariat's note, as well as the worrisome change in fortunes that necessitated their consideration. Notably, Fed Governor Randy Kroszner offered a considerably more sober forecast about US prospects — and the impact of the housing market — than he had a year earlier in Frankfurt. "[T]he central scenario was one of very low growth for a couple of quarters, possibly until 2009, although downside risks to this forecast remained," Kroszner was quoted as saying in the meeting summary prepared by the FSF secretariat. Falling house prices were negatively affecting wealth and confidence, while banks were hoarding cash to protect their balance sheets. The upshot, Kroszner acknowledged, was "a negative market dynamic, where deterioration in the financial system would lead to less lending by banks, falling consumption and investment, deterioration in macroeconomic conditions and in turn a further worsening of financial sector conditions."

Even by the FSF's low standards of transparency, the information released after the meeting was extraordinarily disparate from what the members had discussed — and the secretariat's note had stated — about the global situation and the possibility of more drastic policy action. The press release summed up the meeting's conclusions thusly: "The financial system faces a number of significant near-term challenges. With many securitisation markets effectively closed, assets are accumulating on bank balance sheets. Together with valuation losses on mortgages and other assets, this is straining capital positions and contributing to tightening credit conditions. Hoarding of liquidity and counterparty concerns are leading to a shortening of the maturity of banks' funding profiles and causing severe strains in interbank and other lending markets" (FSF, 2008).

Nonetheless, the public got an unprecedented glimpse into the FSF's deliberations, thanks to a *Financial Times* scoop based on a leaked copy of an "options paper" showing many of the various policy actions listed in the secretariat's note. "Stability Forum Begins to Think the Unthinkable" was the newspaper's headline (Giles, 2008). The leak prompted Draghi to send an indignant email to FSF members, saying, "We all understand that this is especially sensitive material that was not to be made public...[the leak] jeopardizes the mutual trust on which the quality and candor of our background documentation and of our discussions themselves rely. I trust that such a violation of trust will not happen again."

FIASCO IN AMSTERDAM

Given the large number of people who attended the FSF's semi-annual meetings, the importance of the jobs they held and the distance they had to travel, meetings were scheduled well in advance. The risk in doing so, of course, was that unforeseen events would render the chosen date seriously inconvenient for many members. Never was that truer than the meeting held in Amsterdam on Monday, September 29, 2008, which proved to be the FSF's greatest fiasco.

In the days prior to the meeting, frantic efforts to contain the global reverberations of the Lehman bankruptcy consumed the time and energy of officials in nearly all of the world's major capitals. The British authorities — haunted by memories of the run on Northern Rock — were scrambling over the weekend of September 27-28 to prevent the collapse of Bradford & Bingley, a Yorkshire-based mortgage lender. Similar situations were unfolding that weekend in Germany, where the government was negotiating a bailout for Hypo Real Estate, and in the Benelux countries (Belgium, the Netherlands and Luxembourg), where Fortis Bank was on the brink. In the United States, administration and Fed officials were furiously lobbying members of Congress in the hopes of securing quick passage of the Troubled Assets Recovery Program (or TARP) bill, and also working intensively to line up aid for stricken giants such as Morgan Stanley.

Late on Saturday, September 27, Svein Andresen of the FSF secretariat sent an email to all members, saying: "Owing to conditions, a number of members have indicated they will not be able to join this FSF meeting." The email explained that, although FSF members would meet as planned on Monday morning with private sector representatives, Draghi would adjourn the gathering earlier than scheduled, after a "vulnerabilities discussion" on Monday afternoon, with plans to resume it in the second week of October during the IMF-World Bank meetings in Washington, which many members would presumably be attending. A conference call was also scheduled for October 1.

By the time the email landed, some members were already on their way to Amsterdam. Among them was Kathleen Casey, a commissioner of the US Securities and Exchange Commission, who, upon landing at Schiphol airport on Sunday morning, turned on her BlackBerry to find Andresen's email in her inbox. Realizing that the meeting would probably be a waste of time, and that staying would divert her from urgent tasks back home, Casey did not even leave the airport; she booked a flight and flew immediately back to Washington.

Despite giving no details about what had just occurred, the press release issued after the FSF had met was appropriately terse — a single sentence, in fact: "The FSF plenary meeting took place in Amsterdam on 29 September 2008" (FSB, 2008).

The officials who skipped the Amsterdam meeting had compelling reasons for doing so, of course, and could not be expected to put the FSF ahead of their domestic responsibilities. But the episode was a low point in a period marked by many failures in international cooperation. By coincidence, it came on the same day as one of the most notorious examples of such failures — Ireland's unilateral decision to guarantee all the liabilities of its banks, which stunned policy makers in other countries, who feared they might be obliged to followed suit.

Draghi, for one, took to heart the idea that if any international body ought to be trying to foster better coordination during periods of severe financial strain, it was the one he chaired. Although top officials such as deputy finance ministers and deputy central bank governors in major capitals were in daily contact by telephone and email during this period, Draghi told the Amsterdam meeting he supported "creating a communication network among national financial authorities to enhance information exchange," in response to a suggestion by one member who complained that some governments had been launching important initiatives without informing their colleagues abroad. He "tasked the [FSF] secretariat to make the needed arrangements," according to an email sent by Andresen to FSF members a couple of days later. And during the morning session with private sector representatives, Draghi "emphasized that, as this crisis worsens, there is a growing danger that countries will push ahead with reforms in different directions, which will be disruptive to globally integrated markets," according to a summary of the meeting, which was also sent to members. "Market participants concurred and noted the importance of globally coordinated responses to the crisis, and that the mission of the FSF, which can support the needed coordination of actions, was key."

Months later, Draghi would say in an interview that the FSF had indeed assumed an important role in crisis coordination. "Initially, when this crisis started, the FSF was given a mandate to produce recommendations for the reconstruction of the financial system so that people would feel confident that these problems would not happen again. Our focus was on the medium-term perspective," the *Financial Times* quoted him as saying. "But then when we had the Lehmans [collapse], that changed everything. We started to have a focus on crisis management issues, in terms of trying to get consistency between national responses" (Tett, 2009).

The Amsterdam meeting was obviously not a shining illustration of the FSF asserting itself in crisis coordination, and a number of people who served on the FSF at the time profess they are unable to recall the body playing an active part in that regard. But the FSF was indeed moving toward gaining a broader remit — and other sorts of fortification as well.

OPENING THE CLUB DOORS

In the fall of 2008, a message was conveyed to Draghi that went something like this: "You are welcome to speak at the meeting — provided you do so in your capacity as governor of the Bank of Italy, not in your capacity as chairman of the FSF." This was a telling sign that the FSF would have to change with the times.

The meeting in question was that of G20 finance ministers and central bank governors, scheduled for November 8-9, 2008 in Sao Paulo, Brazil. Draghi wanted to make some special FSF-related remarks to the group, and asked the Brazilian officials for permission. But the idea grated on the Brazilians; after all, the FSF was a body from which they and other emerging powers were excluded. So they told him that, as governor of the central bank of a G20 member country, he could of course exercise his speaking privileges — as long as it was clear he wasn't wearing his FSF hat.

Up to that point, the FSF had used an "outreach" approach to show that it was taking into account the views from countries outside its membership. Under a system that Crockett initiated, the forum held a meeting at least once a year in Asia, Latin America, Eastern Europe or Africa, and invited top officials from the finance ministries, central banks and regulatory agencies of a couple of dozen non-member countries. These meetings were often well attended, and some evidence suggests they generated useful discussions.

Productive as such meetings might have been, however, they were no substitute for a true seat at the FSF table. Frustration was rising among officials from non-member countries, especially the BRICs (Brazil, Russia, India and China), as the episode involving Draghi's speaking engagement in Brazil attested. In the fall of 2008, some of those countries were finally in a position to demand membership in the FSF as well as other bodies such as the standard setters. The Bush administration's decision to call a summit of G20 leaders gave the BRICs the opportunity to press their case — and Draghi received the message loud and clear. Two days before the November 15 summit in Washington, he issued a public statement saying, "We strongly support the call to broaden the FSF's membership to include key emerging market economies and will be working to rapidly achieve that objective." The summit declaration echoed that position: "The Financial Stability Forum (FSF) must expand urgently to a broader membership of emerging economies..." (G20, 2008).

Spirited debate ensued in the weeks and months following the summit about how far expansion would go, as the likely point for deciding the issue — the London G20 Summit scheduled for early April 2009 — was looming. According to people who were involved in the discussions, some on the FSF vehemently opposed letting too many developing country representatives in, especially ones from countries whose governments scorned orthodox economic policies, such as Argentina. They feared that making the body even bigger could severely impair its effectiveness. But the BRICs were not about to settle for second-class citizenship. Well aware that each G7 country had three representatives on the FSF, the Brazilians insisted that they would accept nothing less than parity with the G7 — which meant the same would have to apply to the other BRICs.

The BRICs were successful. Each country would get three seats, though other developing countries in the G20 would get fewer. Not that this mattered much in practical terms; the number of seats a country has in a group such as the FSF is not nearly as crucial to its influence as the importance of its economy or the ability of its representatives to present their views persuasively. Putting the BRICs on equal footing with the G7 sent a potent signal that the FSF was going to change in more than just symbolic ways. With the United States then in the greatest need of "upgrading," power would be dispersed much more widely than it had been before.

CONCLUSIONS AND POLICY IMPLICATIONS

Anyone with a penchant for devil's advocacy could make the argument that the FSF should have been abolished at the London G20 Summit, with no successor body created. If they had been so inclined, the leaders might have acknowledged, with regret, that the FSF had proven incapable of fulfilling its mission of spotting vulnerabilities in the global financial system, so continuing to maintain this sort of group would no longer serve much useful purpose and might interfere with more productive approaches.

Such a decision would have been awkward, to say the least, especially since Tim Geithner, who had attended so many FSF meetings, was now the US Treasury secretary. It also would have been unfair. The FSF's failings in recognizing vulnerabilities were essentially the same as those of many other policy-making bodies. In addition, the forum had made a valuable contribution to global public policy with the reports that it had prepared after the outbreak of the crisis. The April 2008 report may not have been as bold as it should have been, but it set an international agenda for both standard setters and national governments that the G20 has largely followed. If that was as far as policy makers in the various major countries were prepared to go at the time, there was probably no better way of assembling their best minds and generating their best recommendations than doing so within the small committee that Draghi formed. The world certainly needed a report of that nature at the time it was issued.

It also would have been foolish to abandon the FSF concept altogether. When a venture in international cooperation fails, that doesn't necessarily mean that the countries involved are completely incapable of working together on the issue in question in a mutually beneficial way. It may mean that they need a more robust cooperative arrangement — in other words, they need to try again, only harder. That should be the first option under consideration. Even if it doesn't work, it's preferable, in most cases, to the alternative of just giving up.

At the London G20 Summit, the G20 did try again, creating the FSB — a bigger, stronger, better-designed and better-equipped version of the FSF, expanding its membership (to include all G20 members), giving it a broader mandate and greater power that might have served the FSF well had it also had those attributes all along.

Like the FSF, the FSB is a network — consisting of finance ministry officials, central bankers, financial regulators, standard setters and international organization officials — that operates by consensus. The FSB also shares the informal nature of the FSF in that it lacks any treaty basis; it cannot independently impose sanctions on a country, although its members can collectively take action against a wayward state. But FSB membership entails obligations that never applied during the FSF era, most notably the requirement for member nations to undergo peer reviews of their financial systems as well as FSAPs. (The United States finally underwent its FSAP in the fall of 2009, with the results published in July 2010.) The FSB also has considerably greater influence over standard setters than its predecessor, and it has a bigger secretariat, with about two dozen staffers. Moreover, it has adopted a tough procedure — replete with the threat of sanctions — for surveilling all countries to ensure they are complying with basic international financial standards. The question is whether all those enhancements suffice or whether underneath them the FSB is essentially the same body it was before and, therefore, unlikely to be any more successful. Considering the FSB's chief advances over the FSF can, in turn, provide answers.

BETTER PROCESSES, BUT WILL TRUTH-TELLING BE RUTHLESS?

The FSB uses a more organized, systematic and muscular process for discerning the greatest weaknesses in the global financial system, determining appropriate responses, and inducing countries to change their practices. The product of considerable brainstorming among Draghi, Andresen and others in Basel during the lead-up to the London summit, this process involves dividing the body into committees, which allows participants to stay focused on specific responsibilities, and using peer reviews to prod countries toward fixing their problem areas.

The job of identifying risks in the financial system and prioritizing these risks in terms of degree of concern goes to the Standing Committee on Assessment of Vulnerabilities, which meets four times a year. Once this committee has decided that a "material vulnerability" is in urgent need of policy attention, another panel called the Standing Committee on Supervisory and Regulatory Cooperation goes into action to determine a policy response, possibly directing standard setters to reflect on whether new standards are in order. Underpinning these activities are clear orders from the G20 for the FSB to focus on macro-prudential issues.[14]

Well reasoned as this may sound, it is important to remember that the FSF also commenced with an exhortation to take macro-prudential issues into greater consideration, and it too had a process for assessing and prioritizing risks — the High-level Vulnerabilities Working Group. Yet, despite the expertise from around the world on which it drew, the FSF failed at gauging the depth of the financial system's problems, even after the crisis began to unfold in 2007. Expectations for the new risk-spotting approach should, therefore, be dampened accordingly.[15]

Much more promising, in terms of potential impact, are the new powers vested in a third panel, the Standing Committee on Standards Implementation, which monitors what countries are doing to shore up their financial systems. This committee's chief responsibility is overseeing the two kinds of peer reviews that the FSB conducts — country reviews of individual members and "thematic" reviews that assess the compliance of all members with particular agreed policies, such as those on compensation or mortgage underwriting. In a context such as the FSB, peer reviews could theoretically have great force; a country that was named and shamed for infirmities in its financial system would have reason to worry about investors becoming reluctant to buy its securities.

A new handbook on the peer review process[16] shows the intriguing possibilities of the reviews — as well as their limitations. When a member country comes up for review, which is supposed to take place every five years or so, a small team of experts, selected mainly from other FSB members' government agencies, drafts a report on that country for submission to the Standing Committee. The report isn't supposed to be a comprehensive examination of the country's financial system, because that is what FSAPs are for; rather, the peer review is intended to focus largely on whether the country is implementing recommendations contained in its FSAP. The peer review can also focus on other matters — although only when the team has "agreed in advance with the reviewed jurisdiction," according to the handbook. As a "general principle," the team isn't supposed to visit the country, relying instead on responses to detailed questionnaires, and its report is supposed to be descriptive, without resorting to "grades," in part because ROSCs already use a grading system. After the Standing

14 For example, a G20 working group issued a statement in the spring of 2009 saying that "regulators, supervisors, and central bankers [should] supplement strong microprudential regulation with a macroprudential overlay to more effectively monitor and address the build-up of risks arising from excess liquidity, leverage, risk-taking and systemic concentrations that have the potential to cause financial instability." This statement was included in G20 Working Group 1 (2009). "Enhancing Sound Regulation and Strengthening Transparency." Final Report. March 25.

15 The same goes for the EWE that the FSF's Standing Committee on Vulnerabilities conducts on a joint basis with a team from the IMF staff. The EWE has a heavy focus on tail risks — that is, vulnerabilities that may pose the imminent threat of a severe crisis — and is presented twice a year, in confidence, to the full FSB and the IMF's ministerial steering committee. Although the potential value of such an activity shouldn't be discounted entirely, an IMF document explaining the EWE provides little grounds for concluding that it will be significantly more effective than either the FSF or the IMF were in their pre-crisis surveillance. The paper is full of sensible caveats, for example, "[A]ny early warning exercise is certain to face challenges in generating 'hits' rather than 'misses.' Indeed, in a complex global economy, there is almost no limit to the range of conceivable risks, and IMF staff are under no illusions that the EWE could capture all those to which policy makers should remain alert" IMF (2010). "The IMF-FSB Early Warning Exercise: Design and Methodological Toolkit." September. Available at: www.imf.org/external/np/pp/eng/2010/090110.pdf.

16 *Handbook on FSB Peer Reviews*, December 2011, available at: www.financialstabilityboard.org/publications/r_120201.pdf.

Committee considers the report for possible modifications — with representatives present from the country under review — the report goes to the full FSB plenary, which has the power of approval over the report. Similarly, for thematic reviews, teams of experts (again, from FSB member countries and organizations) prepare reports assessing whether member countries are successfully implementing certain regulatory or supervisory policies, these reports also go to the plenary for approval after consideration by the Standing Committee.

To address one obvious hole in this process — the possibility that a country could, singlehandedly, veto approval of its own review or some other review that it didn't like — the FSB handbook made it clear that this shouldn't be countenanced: "Plenary decisions are taken by consensus. Consensus is not synonymous with unanimity. Rather, for the purpose of peer reviews, consensus is understood to mean that the views of all members are considered and compromises are sought, but that no single jurisdiction can block a decision supported by a clear majority."

For that impressive assertion of its right to speak plainly over the objections of individual member countries, the FSB deserves kudos. It is, however, worth recalling the comment from one FSF member about the "great defensiveness and excessive politeness" that characterized much of the forum's colloquy. That is precisely why widespread skepticism has greeted the creation of the FSB's peer reviews: international groupings are notorious for conducting peer reviews with kid gloves, because members know that harsh treatment toward others will invite the same on themselves. The requirement for expert teams to obtain permission from the countries they're reviewing before examining topics outside of the FSAP, may be a troubling sign that FSB member nations want to keep peer reviewers from engaging in the loud whistle-blowing, ruthless truth-telling and unpalatable message-sending referred to earlier as hallmarks of effective surveillance. Little evidence of a proclivity for such outspokenness has surfaced in the handful of peer reviews conducted by the FSB so far.

Even more stringent than naming-and-shaming is the enforcement contemplated in another FSB initiative aimed at "global adherence to international cooperation and information exchange standards." Also overseen by the Standing Committee on Standards Implementation, this initiative is redolent of the FSF's measures against offshore financial centres — one major difference is that it applies to virtually all the world's countries instead of just a few dozen small ones. Under this initiative, small groups of experts assess whether a country is complying with certain basic standards spelled out by groups such as the Basel Committee and IOSCO, particularly those that are essential to international cooperation and information exchange. The penalties for "non-cooperative jurisdictions" are potentially severe — the FSB could ask supervisory agencies to impose higher capital requirements on financial institutions operating in such jurisdictions, or restrict transactions with counterparties located in them.

However, the standards that countries must meet to "pass" this "test" are relatively narrow in scope, and initial evidence suggests that the bar countries must hurdle to avoid threat of sanctions won't be very high. The first review of 61 "priority" countries listed only two — Venezuela and the deposed Libyan regime — as being in clear danger of suffering sanctions, mainly due to their refusal to engage with the FSB (FSB, 2011).

BETTER REPRESENTATION, BUT STILL A SELF-ANOINTED GROUP

The FSB is far more representative of the world's economies than the FSF was and — despite the FSB's larger number of members — it may be even more efficiently run. With members hailing from countries that cover about 80 percent of the world's population, never again will this body serve as a means for a small club of the rich to tell the rest of the world's countries how to conduct their financial affairs. Although, by all accounts, representatives from the advanced countries still tend to be the most influential members in shaping initiatives and decisions, the developing country representatives effectively hold veto rights. This inclusiveness bestows a degree of authority on the FSB that its predecessor could not claim.

Remarkably, fears that the expanded membership would make the FSB too cumbersome appear to have been misplaced, thanks to the ingenious reorganization conceived and executed by Draghi in the spring of 2009. Faced with the necessity of welcoming a large number of developing country members, which meant increasing the number of people around the table from about 42 to more than 70, he established a steering committee in addition to the three standing committees. Although the FSB still meets in full plenary session twice a year, the more compact steering committee (which currently has 41 members) meets considerably more often, sometimes through conference calls.

As desirable and skillfully handled as the membership expansion has been, however, it still leaves the FSB with one of the same big problems that the FSF had — a lack of legitimacy. The FSB may be a bigger club, but it's still self-anointed, and non-member countries wishing to provide input must continue to settle for an informal outreach process based on "regional consultative groups," which meet periodically with FSB members. The FSB is effectively browbeating non-members to adopt its standards on international cooperation and information exchange, but those non-members will be justified in saying that they are being put in the same "rule-taker" position as the Brazils of the world were prior to the London G20 Summit.

MORE ACTION-ORIENTED, BUT STILL CONSTRAINED BY SOVEREIGN GOVERNMENTS

Whereas the FSF was hamstrung for years by the US desire to keep it largely as a talk shop, the FSB can already claim responsibility, or at least partial responsibility, for some major, concrete achievements. This is attributable, in large part, to its leadership role in the standard-setting realm bestowed by the G20. The FSB's charter envisions that it will "undertake joint strategic reviews" of the standard setters "to ensure that their work is timely, coordinated, focused on priorities and addressing gaps." It also states that: "the standard-setting bodies will report to the FSB on their work," though with the caveat that "this process should not undermine the independence of the standard-setting process" (FSB, 2009).

The most significant results concern rules for international banks and other giant multinational financial firms. With the FSB riding herd (and the G20 leaders providing even higher-level exhortation), the Basel Committee produced its revised rules for global banks, known as Basel III, much faster than it did with previous similar undertakings. Basel III sets tougher standards for the quantity and quality of capital that banks must hold to cushion themselves against downturns; it also includes "counter-cyclical" rules aimed at forcing banks to accumulate more capital during boom periods (a reflection of the new importance attached to macro-prudential considerations). And the FSB added its own major contribution to this endeavour by selecting 29 "globally systemic international financial institutions" that would be subject to special requirements because they are so big and interconnected that their collapse is deemed unacceptable. The special requirements include holding extra capital above and beyond that mandated for ordinary international banks, and the writing of "living wills," so that regulators can figure out how to break them up and sell them off piecemeal in a hurry if severe trouble hits.

Other important developments in which the FSB has played a major role include the establishment of colleges of supervisors for many big multinational banks; and requirements for many derivative financial instruments to be traded on organized exchanges with central clearing systems, instead of in private, over-the-counter exchanges between financial institutions. This latter reform is aimed at addressing one of the major problems that undermined confidence during the crisis — worries about whether financial institutions dealing in derivatives could depend on their counterparties to honour the contracts.

Putting such measures in place is no mean feat, but the first major concern that arises is whether they are proportionate to the dimensions of the financial system's weaknesses, as revealed by the crisis. Skepticism abounds about whether the capital requirements for large institutions were set sufficiently high, whether living wills will be workable in a financial emergency and whether the derivatives rules are free enough of loopholes to prevent the continuation of risky trading in unregulated over-the-counter markets. A second major concern is whether countries will wholeheartedly enact the legislation and implement the regulation necessary to effectuate all of these measures. The FSB's chief tool for inducing compliance is peer reviews, which may be no match for the pressure that private interests can bring to bear to keep their rules and enforcement as lax as possible. Considerable evidence suggests that governments are already succumbing to such pressure; a recent *Financial Times* article on regulatory disharmony reported examples of coordination eroding in nearly every segment of the financial industry. According to the article, "Even on bank capital, the one big success story, unity is breaking down as European Union, UK and US authorities accuse one another of watering down or delaying the tougher standards" (Masters, 2012).

The FSB, in other words, is constrained by the will of the sovereign countries that constitute its membership, and its lack of authority to bring them to heel. In that crucial respect, it is no different from the FSF. This is an important reason to temper enthusiasm about what its new chairman, Bank of Canada Governor Mark Carney, can accomplish. It is hard to imagine a more impressive combination of credentials and talents than those which Carney brings to the job — the tough-guy image befitting a former Harvard hockey goalie, the brainpower of an Oxford D.Phil. in economics and the credibility of a central banker from a country whose financial system sailed through the crisis relatively unscathed. He has already manifested an admirable propensity for bluntness and readiness to overcome the resistance of powerful financiers to stricter regulation. But even a superb leader — and the FSF had those, too — cannot compensate for the constitutional debilities of the body he or she heads.

Those debilities exist because of the G20's collective choices. If G20 members wanted a considerably more powerful and effective FSB, they presumably would have established it. Suppose, though, that they did want such a thing — what could they do? To end this paper, I will offer two suggestions, with no illusions as to their political practicality.

APPLY "THE GOOD, BAD AND UGLY" TO THE BIG AND SMALL ALIKE

First, the FSB could borrow from one of the FSF's clearest successes during the pre-crisis period — its "good, bad and ugly" designations (or, as they were more formally known, Group I, Group II and Group III) used on offshore financial centres. These categorizations, it will be recalled, were backed by an implicit threat of sanctions; if an "ugly"

(Group III) offshore centre failed to change its ways, firms based there could have suffered some loss of access in the markets of FSF members. (As just noted, the same sorts of leverage are now envisioned under the initiative to promote global adherence to certain standards.) In theory, FSB peer reviews of its members' financial systems could pack a similar punch — but only if they were as free from political influence as possible; free, that is, from "excessive defensiveness and great politeness." Although the FSB has taken a constructive step toward increasing the likelihood of candid reviews by specifying that individual members don't have veto rights all by themselves, it is unlikely to go far enough.

A more radical approach would be better suited to the task. The FSB could convene panels of outside experts to pass judgment on countries' financial systems and decide which designation — Group I, II or III — should apply, based on mutually agreed criteria regarding the characteristics of each group. This process would be somewhat similar to the dispute settlement system of the WTO, in which independent tribunals resolve disagreements between countries over alleged violations of trade rules. The WTO's tribunals command considerable esteem for their objectivity and fairness, and by employing a similar system, the FSB's country reviews might attain a comparable degree of respect.[17] Of course, even WTO panels are subject to being overruled by the body's membership. Unaccountable, unelected technocrats cannot run global affairs without some political oversight. The FSB could, therefore, have the power to reject a panel's finding — but only if a supermajority of members voted to do so.

These reviews would not involve surveillance of a country's entire financial system; the FSB sensibly wants its peer reviews to avoid duplicating FSAPs. Rather, they would be aimed at identifying and highlighting particular trouble spots, especially those of macro-prudential concern. If initial investigation indicated that a country's FSAP had properly identified all significant areas of vulnerability, the panel could limit its assessment to the issue of whether the country was implementing the FSAP recommendations. But if the panel perceived that issues outside the scope of the FSAP merited scrutiny, it could delve into those topics without being obliged to secure the permission of the country's authorities. Moreover — and this is another important difference from the FSB's current peer review process — the panel would use a grading system, for the simple reason that grades, albeit crude, are the most straightforward and effective way to conduct international surveillance with loud whistle-blowing, ruthless truth-telling and unpalatable message-sending.

17 Panels might also be used to resolve disputes among countries, as in the WTO — if, for example, one country believed that another was luring financial business away by administering excessively lax standards.

A "good, bad and ugly" approach was deemed suitable for the likes of the Bahamas — so why not for countries with much more important financial systems? Under this approach, a country found to be in Group III might be required to undergo another review process within a much shorter period than others — say 18 months. And if repeatedly placed in Group III, such a country might be subject to sanctions of some kind. One appropriate sanction for this sort of regulatory and supervisory failure would be a requirement to make the country's banks hold some additional capital. But other, more or less severe measures might also make sense. Perhaps the sanctions element wouldn't be necessary; the threat of being named-and-shamed with a Group III designation might well be sufficient to induce the necessary reforms. In any case, only a thoroughly depoliticized body, such as a panel of outsiders, could brandish such a threat credibly.

This proposal is similar to an even more radical one put forward by Barry Eichengreen, who suggested the creation of a World Financial Organization that would set broad principles for financial supervision and use panels to determine whether countries were in compliance, with non-compliers subject to possible exclusion from the financial markets of others (Eichengreen, 2009). As Eric Helleiner has noted, Eichengreen's proposal "raises many difficult questions about the criteria by which panels might be selected and the relationship among these panels and the FSB's expert teams, the [Standing Committee on Standards Implementation] and the peer review process." The same, I must admit, goes for my proposal.[18]

ONE COUNTRY, ONE MEMBER

Another way of instilling greater potency in the FSB would be to change the kinds of people around the table. This sort of modification is, admittedly, subject to ridicule as "technocratic tweaking" (Beattie, 2012). Tweaks can sometimes go unexpectedly far. Shifting the FSB to a system of dedicated members — one per country at most — is one such idea.

Instead of major countries sending three representatives, under this proposal they would send just one, whose full-time job (or at least chief responsibility) would be to serve on the FSB. Such a person would consult closely with all

18 See Eric Helleiner (2010). *The Financial Stability Board and International Standards*. CIGI G20 Papers, No. 1. June. Waterloo: CIGI. In response to Helleiner's questions, I acknowledge their difficulty, but offer the following answer: First, the panels should essentially replace the expert teams. Especially in the case of thematic peer reviews, the expert teams are too biased anyway, coming as they do from FSB member governments that have a stake in how they are rated in the reviews. The Standing Committee on Standards Implementation would exercise oversight over the whole process, including selection of impartial panellists. The Standing Committee would also have the right to issue its own dissenting report to the plenary if it disagreed with the panel. The plenary, as noted above, would have the final say, but could only overrule the panel based on a supermajority vote.

relevant agencies — finance ministry, central bank, bank and securities regulators — in his or her capital, before and after attending FSB meetings and while working on FSB issues. A report by six distinguished experts, including Andrew Crockett, made a similar proposal for each country to be represented by one official chosen from among the three agencies. Explaining the problem with multiple representation, the report said: "Not only does this add to the numbers around the table and thus inhibit discussion; it dilutes responsibility" (Brunnermeier et al., 2009).

True enough, but the debacle at the FSF's Amsterdam meeting presents a much more compelling reason to shift to a system in which countries' representatives would be one person, with a multi-agency affiliation and a singular focus on the FSB. The world needs a body of people guaranteed to show up at an international meeting under circumstances such as those in late September 2008. The global financial system, already in dire straits at that point, nearly came even more unstuck because of the lack of communication between capitals. Space does not permit a comprehensive account; to cite one example, the US and UK Treasuries were unable to ascertain for several days whether German authorities were following Ireland's lead by issuing a blanket guarantee on the liabilities of German banks. Of course, top international officials of the major finance ministries and central banks were in close touch by phone and email — as they would have to be in any future crisis of similar magnitude. But a more formal and well-defined international network should also be available, to ensure that countries can be aware of what others are doing and properly consider the international implications of any action they might take. The FSB is the obvious body for such a role, and its members should never again be too distracted by their domestic responsibilities to attend a meeting at a juncture when global coordination is on the verge of breaking down.

A corollary of both the ideas proposed here — the peer reviews with the "good, bad and ugly" grading system assessed by independent panels, and the representation of countries with single, dedicated participants — is that the FSB should become much more formal and legitimized. The FSB chairmanship should be a full-time job, the body should have a considerably larger budget and staff and virtually all countries should be invited to join (with less developed nations obviously subject to less stringent obligations than G20 members). To be sure, universal membership would raise more difficult trade-offs between legitimacy and effectiveness; the FSB would be much the worse if it were to resemble the United Nations General Assembly. But such a problem could, hopefully, be finessed by resorting to a system in which FSB members would represent constituencies of countries, as is the case on the IMF and World Bank boards. These ideas for bestowing greater formality and legitimacy on the FSB have been proposed elsewhere, and they would serve the body well.

The proposals advanced above will no doubt strike some readers as overkill or underkill or be otherwise misconceived. Their advisability, or lack thereof, is by no means the main point of this paper.

Governing a world of globalized capital requires formidable international institutions; the story of the FSF shows how lamentably short it fell of that standard during its existence. It would be comforting to believe that the lessons of this story have been fully incorporated into present-day policy — but that could prove a costly delusion.

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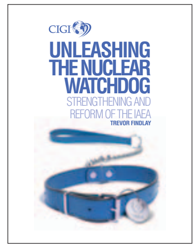

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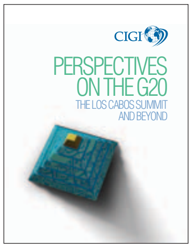

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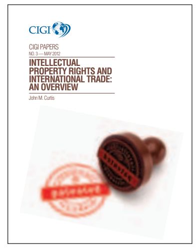

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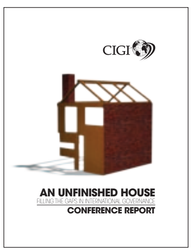

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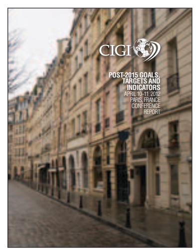

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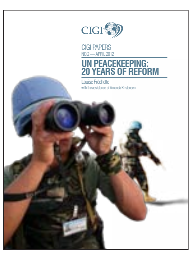

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