HEINRICH BÖLL STIFTUNG
NORTH AMERICA
ECONOMIC GOVERNANCE

Issue #2

G20 Fundamentals

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December 2012

The G20's Record in Disciplining the Financial Sector

This article assesses the G20's performance against its seven commitments to reform the financial sector. The Financial Stability Board (FSB) has significant responsibility for carrying out the mandates of the G20 in this sector.

1. Financial Institutions which are "too big to fail"

Since 2008, governments have mobilized public support (i.e., taxpayers' money) to bail out financial institutions which had become "too-big-to-fail." That is, the bankruptcy of these institutions could wreak havoc on the provision of vital banking services and negatively impact whole economies. In the absence of policy tools to wind down these financial institutions in an orderly way, governments have felt forced to prop them up or face certain disaster.

The G20 committed to strengthening supervisory and regulatory oversight of the "systemically important financial institutions" (SIFIs)– a term that refers to firms that are "too big to fail. They also agreed that SIFIs should develop plans for: a) orderly winding down ("resolution") in case of emergency, b) winding down cross-border firms, and c) reducing firms' excessive risk-taking, especially through requiring them to hold more capital.

Progress assessment **:**

As a result of mergers and acquisitions that took place in response to the crisis both in the United States and Europe, the financial sector is more concentrated than it was before 2008, with firms becoming bigger and more interconnected. The Financial Stability Board (FSB) has identified less than 30 firms that it defines as SIFIs, but these firms have not yet filed their plans for winding down in case of crisis. The FSB has also issued guidelines for how to implement resolution systems when financial institutions fail. Although all countries are expected to adopt these guidelines, few have begun to do so. Currently, analysts agree that there is nothing to stop governments from bailing out financial firms which collapse in the future.

Importantly, the G20 explored the financial transaction tax (FTT), which could help reduce financial risk-taking, but to date, there is no agreement to adopt the FTT on a coordinated basis.

2. Derivatives

The derivatives markets had reached the staggering size of more than USD 600 trillion before the crisis. A majority of the transactions in this market were conducted in opaque and non-transparent ways, and without the posting of collateral. As a result, the exposure and vulnerability of financial institutions and the financial sector, as a whole, increased to a dangerous extent. At the same time, there were few controls to prevent the use of derivatives to speculate on prices of commodities, such as oil or food staples. This speculation has led to higher and more volatile commodity prices.

To increase transparency, the G20 made a commitment that all "standardized" derivatives would be traded on public exchanges and centrally-cleared. Central clearing would allow the "netting out" of the exposures among different firms. Clearing houses would also enforce the posting of adequate collateral for such transactions. When derivatives could not be "standardized" (to allow for public trading and clearing), trades would still have to be reported to authorities. Finally, the G20 also encouraged "position limits" on traders –an important device to ensure traders cannot engage in large transactions for purely speculative purposes.

Progress assessment :

The 2012 deadline for these reforms will be missed in most countries. Even where reforms are implemented, many derivatives that are traded bilaterally (between two financial institutions) will not be subjected to the new rules. This is because banks claim (often with little justification) that such derivatives should be exempt from the rules because they cannot be standardized.

Only a few countries adopted rules that impose "position limits" on traders and at levels not significant enough to change the dynamics that lead to price volatility. The trading of derivatives continues to obscure the real risk exposure of banks and can highly distort the "weighting" of risks for the purpose of determining capital reserve requirements. The agreed reforms do not prevent banks from profit-taking or enjoying the implicit subsidy to their operations derived from mixing deposit-taking (which is government-guaranteed) with risky derivative transactions (which should not be government-guaranteed).

3. Bank capital requirements

Regulators are in charge of setting and monitoring requirements regarding the amount and type of capital reserves which banks must hold in order to absorb any risks that arise from lending and other transactions. Since the 1970s, regulators in different countries have coordinated such requirements on the basis of an international agreement, the "Basel Agreement." However, the Basel Agreement did not prevent banks from profiteering by making increasingly risky transactions with inadequate capital backing.

The G20 committed to a reform of the Basel Agreement in order to require banks to hold larger capital cushions to absorb losses in case of crisis. Some reforms to the Basel Agreement were effectively approved which would raise the level of equity that banks must hold. (Equity is the most loss-absorbing type of capital.) The reforms also require banks to hold reserves to counteract bad times (a "countercyclical buffer"), limit their leverage (debt-to-equity ratios) and protect a certain level of liquid (cashable) assets over time. Finally, banks considered "systemically important" were also required to hold an extra capital, as a cushion.

Progress assessment:

Most of the reforms of the Basel Agreement have yet to enter into effect – as they have long phase-in periods. Also, only some countries are reforming and these reforms are often piecemeal. The new version of the Basel Agreement, even while requiring that banks hold more capital, still allows banks to report risks based on subjective internal models, which tend to minimize the quality of capital buffers, as experience has shown. The extra capital charges on systemically important banks are too small to have any impact on the growth and complexity of the institutions – factors that make them riskier and harder to regulate.

4. Credit rating agencies

Credit rating agencies (CRAs) were responsible for grossly underestimating the risks attached to certain assets (such as Collateralized Debt Obligations and Mortgage-Backed Securities). Many investors – including managers of pension funds – invested in these assets because they trusted their high ratings. Legislation authorized these investors to consider an asset "safe" when it obtained a high rating by a CRA. When assets proved riskier than anticipated, the CRAs were able to deflect any accountability by claiming that their ratings were mere "opinions" based on erroneous mathematical models. However, CRAs were subject to conflicts of interest because they were rating the assets issued by the same institutions that paid them to determine such rating (something termed the "issuer-pays" model). They were also under pressure to give high ratings to assets in order to compete with other rating agencies.

The G20 committed to a stronger regulation and oversight of credit rating agencies on the basis of an existing (2008) Code of Conduct designed to improve governance and transparency of the agencies, including prevention of conflicts of interest. It also pledged to diminish the regulatory and legal requirements for investors to rely on the opinions of credit rating agencies for evaluating the risk of their assets.

Progress assessment:

Governance of CRAs: In 2009, at the behest of the G20, the International Organization of Securities Commissions (IOSCO) reported that CRAs were largely implementing the Code of Conduct and then, reports on compliance ceased to be issued. But, the Code of Conduct does not provide a meaningful alternative to the "issuer pays" model which was at the basis of failures in rating.

Alternatives to CRAs: The G20 stressed that investors must reduce their reliance on CRAs and agreed to a "roadmap" to achieve that goal. Historically, the legal and regulatory reforms prescribed by the "roadmap" have proven difficult to implement, especially for complex products. This perpetuates a dangerous situation since most investors simply lack the capacity to judge the creditworthiness of such products.

Exemption from Liability of CRAs: The G20 never challenged the status of the CRAs – that is, their privileged position (exemption from liability for negligence or lack of due diligence) compared with other sources of expert opinion, such as accountants or investment banks. Such a privileged position is not appropriate given the great impact CRAs have on the market.

5. Shadow banking system

The "shadow banking system" refers to the world of financial agents that operate in a bank-like manner, this is, intermediating funds between savers, investors and borrowers, but without being subject to as high a level of oversight as banks are. The shadow banking system is comprised of investment banks, finance companies, money market funds, some hedge funds, special purpose entities and conduits, among other vehicles. In 2011, the system held about USD 67 trillion, according to the Financial Times, which is equivalent to about a quarter of the financial assets in 25 major jurisdictions. The crisis highlighted the fact that entities operating in the "shadow banking system" can generate risks that ultimately impact the formal banking system and can lead to bail-outs of unregulated shadow banking firms as well as regulated financial institutions.

The G20 has only recently focused on the danger posed by a growing shadow banking system. Now, it has acknowledged that new regulations could drive risky activities into the unregulated world of shadow banking unless bold steps are taken to strengthen the regulation and oversight of this system.

Progress assessment:

It is too early to judge the outcomes of the G20's work on shadow banking. The G20 has commissioned the FSB to conduct studies regarding data gaps and the risks posed by a range of shadow banking activities and entities, including securitization, money market funds and repos. Does the G20 have the necessary consensus to address the risks created by the system? This is unclear. There are early indications that the G20 is seeking a "balanced" approach – that is, it will address some risks, but avoid regulations that could inhibit "innovation" in the shadow banking system. Such thinking is problematic, as many apparent "innovations" are deliberately designed in a complex way in order to mask risk. They, thereby, deceive consumers and endanger the economy.

6. Financial transparency, bank secrecy and tax havens

The integrity of financial markets was highly compromised by opacity and lack of transparency. Tax evasion and avoidance thrived, enabled by a web of jurisdictions with inadequate accounting rules and bank secrecy laws. Illicit financial flows reach near USD 2 trillion, according to some estimates.

The G20 pledged to take action against "non-cooperative" jurisdictions, which are unwilling to implement requirements for "exchange of information" about financial transactions – and end bank secrecy. They also set out to assess the performance of countries against standards for "exchange of information."

The G20 has promoted adherence to the Multilateral Convention on Mutual Administrative Assistance and committed to lead by example in adopting automatic exchange of information practices. This is a big step forward because, if information is exchanged automatically, wrong-doing will be easier to detect.

They have also encouraged support of efforts of developing countries to combat transfer pricing by transnational corporations (TNCs). For accounting purposes, a transfer price is the price assigned to the cross-border provision of goods and services between related companies (e.g. parent and affiliate of the same transnational conglomerate). By inaccurately pricing these transfers, global companies manipulate the location of profits and losses in order to reduce tax payments. Through such means, countries are deprived of tremendous amounts of revenue that rightfully belong to their citizens.

Progress assessment:

Transparency: The Global Forum on Transparency and Exchange of Information for Tax Matters was established with a Secretariat at the Organization for Economic Cooperation and Development (OECD) which conducts peer reviews of countries' standards for the exchange of information. Out of 79 peer reviews conducted to date, it appears that 32 countries lack some essential elements for the effective exchange of information.

The G20 set the "bar" (or the level of requirements for a jurisdiction to be listed as "non-cooperative") too low. The Multilateral Convention contains significant loopholes so, even if adopted, it will not be a panacea.

Transfer Pricing by Transnational Corporations: Measures to combat transfer pricing fall short of an adequate regime to regulate financial flows world-wide, such as a global agreement to reform accounting rules and require country-by-country reporting on the part of companies. Country-by-country reporting requires that companies report profits, payments of taxes and salaries and other revenue and expenses in a disaggregated way for each country in which they operate, rather than on a globally consolidated basis as is the case now.

7. Reform of the International Monetary Fund (IMF)

The IMF failed to see the risks looming in the financial system before the crisis. Even if it had it seen the risks, it may have been powerless to do much about them. The institution lacks "teeth" to enforce policy prescriptions - especially on the Group of 7 (G7) member countries which significantly control its governance. Indeed, its governance is largely based on arcane Western conventions that have prevailed since the post-World War II founding of the institution.

Even worse, many borrowing countries felt (and still feel) that IMF policy prescriptions are "bad medicine" that fail to balance the need for austerity and fiscal discipline, on the one hand, with the need for growth and employment, on the other. These countries felt stigmatized when submitting to the IMF and inconvenienced by the need to "jump through hoops" to obtain IMF financing. Finally, it was widely recognized that the IMF lacked adequate capitalization to deal with crises of great magnitude.

The G20 committed to: a) a significant increase in IMF lending resources, b) the reform and streamlining of lending mechanisms; c) the reform of the IMF's governance and mandate; and d) more objective surveillance (i.e., review) of member country policies.

Progress assessment:

At the behest of the G20, IMF members initially raised the institutions' capacity to lend to approximately USD 875 billion and, then, an additional USD 450 billion. But conditions to consolidate some of these increases, currently in the form of bilateral lines of credit by members, into capital, have yet to be met.

Critics contend that the IMF was given a "free ride" – that is, considerable resources without the mandate for the deep institutional reforms needed to ensure the responsible use of these resources. For instance:

- Governance reforms have been completely inadequate. The voting share of developing countries in the institution have seen a small increase, but deeper reforms (i.e., to the quota formula) are being avoided by powerful countries. Only deep structural change through an overhaul of the anachronistic variables used for allocating capital and voting power can give emerging and developing economies their fair share of power.
- Leadership traditions are unchanged. In 2011, a French woman was chosen as the Managing Director of the IMF. By this action, the IMF re-affirmed its out-dated tradition by which the leader of the institution is always a European.
- Problematic process and quality of lending. Although the IMF streamlined some lending mechanisms, critics claim that these measures were insufficient to remove stigma for applicants. Also, the IMF still tends to require borrowing countries to implement excessively contractionary policies. We need an IMF that balances the growth and employment imperative with the need for fiscal prudence.

To safeguard the international financial and economic system from future crises, the G20 will need to improve its effectiveness.

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