THE G20 FINANCIAL REFORM AGENDA AFTER FIVE YEARS

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INTRODUCTION

The key phase of empowerment of the Group of Twenty (G20) in the area of financial regulation started with the group's mid-November 2008 Washington summit[1], which was novel in terms of format, focus and ambition. First, financial regulatory discussions, which had until then been mainly the preserve of the United States, Europe, and Japan (plus Australia and Canada) were taken up by a grouping in which emerging market economies represented half of the members. Second, financial regulation was pushed to the forefront of the global economic cooperation agenda at the level of political principals, which had until then been mainly focused on trade and macroeconomic policy. Third, the G20 committed to seek an unprecedented level of cross-border consistency in their efforts on financial reform, a policy area that previously was seen as belonging predominantly to the national level of responsibility.

The G20 financial reform agenda has since gone through a cycle of hype, disappointment and cynicism. At the time of the first three summit meetings (Washington in November 2008, London in April 2009 and Pittsburgh in September 2009), some leaders, including France's Nicolas Sarkozy and the United Kingdom's Gordon Brown, developed a rhetoric that suggested a supranational decision-making role for the G20, as opposed to a coordinating role for decisions made by individual jurisdictions. The London summit declaration supported this rhetoric by including phrases such as *"a global crisis requires a global solution"* and *"prosperity is indivisible"*. However, as the sense of globally-shared and immediate danger that prevailed in 2008-09 later dissipated, scepticism took hold. Recent G20 meetings have been described as "*High-Church liturgy of a religion in which nobody believes any longer*"[2].

Half a decade after the initiation of this reform effort, this Policy Contribution takes stock of the G20's financial reform achievements and challenges. Inevitably, the picture is mixed. First, and in spite of the occaaen

1. The G20 was formed in 1999 in the wake of the Asian financial crisis of 1997-98. Its members are Argentina, Australia, Brazil, Canada, China, the European Union, France, Germany, India, Indonesia, Italy, Japan, the Republic of Korea, Mexico, Russia, Saudi Arabia, South Africa, Turkey, the United Kingdom and the United States. Until November 2008, G20 meetings were held at the level of finance ministers and central bank governors, not heads of state and/or government.

2. Author's conversation with a senior European economic policymaker, April 2014.

capital (or in the Basel jargon, 'loss absorbency') requirements; and additional disclosure obligations for banks. On the other hand, entities or activities that until 2008 were mostly outside of the scope of regulators were made subject to a comprehensive regulatory framework, eg over-the-counter (OTC) derivatives, executive compensation, credit rating agencies, hedge funds, 'shadow banking' (ie entities and activities that are not regulated as banks but present bank-like systemic risk profiles) and, more recently, financial benchmarks (following the uncovering of fraud in the setting of LIBOR, the London Interbank Offered Rate, and other similar reference rates).

Among the coordination items, two stand out. First, the G20 attempted to force global accounting harmonisation, by calling repeatedly for *"international accounting bodies"* (widely understood to refer primarily to the International Accounting Standards Board (IASB) and to the US Financial Accounting Standards Board, or FASB) to *"achieve a single set of high-quality, global accounting standards"*. Second, the G20 started an ambitious effort, which is still ongoing, to address the coordination issues that might arise in the resolution of complex financial institutions, including banks, whose activities are scattered across several jurisdictions. Also in this category, the G20 has paid special attention to the question of whether the special features of emerging markets and developing economies were adequately addressed in the global financial regulatory agenda.

Finally, the items on observing the financial system are generally referred to under the umbrella label of 'data gaps' in the G20 and FSB jargon. While this expression suggests an aim limited to plugging holes in the existing statistical and financial surveillance apparatus, it actually also covers an ambitious and unprecedented effort to build global sets of data, the interrogation of which might be relevant for the assessment of systemic risk. This is specifically attempted in two key areas: large banks, with the creation of an 'international data hub' of non-public bank-level information within the Bank for International Settlements (BIS); and derivatives markets, with the requirement to report all OTC derivatives transactions to 'trade repositories' and the aim to aggregate the corresponding data at the global level.

Unsurprisingly, the G20 agenda has evolved over time and successive summits. Some items have lost prominence, either because most of the desired work was considered achieved (eg capital standards with the finalisation of Basel III), or, on the contrary, because the initial ambition has proven difficult or impossible to fulfil (eg global accounting harmonisation). Other items have gained prominence over time, some of them following changing political circumstances in influential jurisdictions, or the realisation of possible unintended consequences of earlier initiatives. Specifically, since 2012 the FSB has explicitly referred to *"ending too-big-to-fail (TBTF)"* as one of its main objectives, an ambition that was not formulated in such explicit and ambitious terms in prior documents. The issue of how the financial system may foster long-term investment has also moved up the G20 agenda in recent years.

ACHIEVEMENTS AND CHALLENGES

The scattered nature and complexity of the G20 financial reform agenda make it difficult to summarise its execution. The following non-exhaustive list focuses on the items deemed by the author as most significant.

- Bank capital and leverage: Basel III unquestionably marks an improvement over its predecessor, the Basel II capital accord of 2004, which is now widely seen as inadequate and a contributor to the crisis in Europe. The definition of capital, or characterisation of instruments that are sufficiently loss-absorbing to be treated as equity for regulatory purposes, has been considerably tightened; minimum ratios have been increased; some risks and assets that could have been placed off-balance sheet under previous conventions can no longer be; and the introduction of a leverage ratio, which existed before the crisis in the United States but not in other jurisdictions, creates a check against the possibility of risk-weighting calculations being gamed by banks. Additional, so-called 'macroprudential' capital requirements may also be placed either on the most systemically important banks (assessed at the global, regional, or national level), or on all banks at high points of observed financial cycles ('counter-cyclical buffers'). Some observers, mostly in the banking community, consider Basel III too strict, and argue its adoption has contributed to a scarcity of credit, particularly in Europe, and to a migration of risk outside of the regulated banking sector. Others, particularly in academia, see it as too lax, with too-low minimum ratios and too many opportunities for regulatory arbitrage and gaming of the rules. To this author, the capital and leverage provisions of Basel III represent a broadly balanced, ambitious yet practical step towards a better capitalised banking system, and can thus be counted as a policy success.

- Bank liquidity: In comparison to the provisions on capital and leverage, Basel III's requirements on bank liquidity represented a more experimental and unprecedented effort, with a greater potential for unintended economic consequences. With this in mind, the BCBS has set

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covered by what is known as 'pillar 3' of the Basel supervisory framework. In this area, the FSB has identified best practices but has until now remained somewhat reluctant to standardise disclosure requirements for financial stability purposes, which supervisors have tended to delegate to accounting standard setters. The latter habit is questionable, given that financial accounting is primarily about serving the information needs of investors, and the mandate and objectives of accounting standard setters are therefore structurally distinct from those of prudential authorities.

- OTC derivatives: The G20 Pittsburgh summit set an end-2012 deadline for the introduction of major derivatives markets reforms, but the implementation has proven more difficult and protracted than initially envisaged – not least in the EU, the largest single jurisdiction in terms of derivatives trading volumes, where some of the requirements are not yet fully implemented (central clearing) or have started being implemented only recently (mandatory trade reporting since 12 February 2014). The aim of identifying concentrations of risk through systematic reporting of derivatives transactions to trade repositories appears appropriate. However the choices made for its implementation might result in the relevant information remaining fragmented across multiple repositories and jurisdictions in a way that does not allow for global aggregation of data, and might limit the ability of regulators to see the full picture[5]. Separately, the requirement that all OTC derivatives be cleared in central counterparties (CCPs) might bring more transparency, but also implies a concentration of risk in CCPs, with no certainty yet that this risk will be adequately managed. Many of the derivatives market reforms involve significant costs, both in terms of transition and steady state, and it is not yet clear to what extent such costs will be offset by gains in financial stability.

- Resolution of systemically important banks: The FSB has accomplished significant work on how to structure contracts between legal entities in different countries within international banking groups, and minimum requirements of debt on which losses may be imposed on cred-

5. Note: the author is an independent director of the global trade repository arm of DTCC, a financial infrastructure firm that is run on a non-profit basis.

itors in the event of resolution (dubbed 'gone-concern loss absorbing capital', or GLAC). However it remains to be seen how these theoretically compelling arrangements will work in practice, particularly as most jurisdictions outside the United States have limited concrete experience of resolution processes, and many had not even introduced a special resolution regime for banks into their domestic legislation until recently. The FSB's current description of its objective as *"ending TBTF"* may be setting the bar too high. From this perspective the spelling out by the FSB in 2011 of *"key attributes for effective resolution regimes"* was a constructive contribution to a general shift toward such regimes, but it might be a long time before their effectiveness can be actually assessed, depending on the occurrence of future crises.

- <u>Nonbank SIFIs and shadow banking:</u> In line with the pledge made by the G20 at the London summit *"to extend regulation and oversight to all systemically important financial institutions, instruments and markets"*, the FSB has endeavoured to produce specific regulatory frameworks for systemically important insurers, asset managers, financial infrastructures and for a handful of market segments bundled under the imprecise label of 'shadow banking'. While certain market segments such as constant-net-asset-value money-market mutual funds clearly require tighter regulation or perhaps even a ban, there is a distinct risk that the FSB approach in this area would insufficiently take into account the diversity of the financial system and the specific risk profiles of various forms of nonbank financial intermediation. Ironically, a misguided regulatory framework applied to insurers and certain categories of funds might end up defeating the initiative's purpose by making their behaviour more pro-cyclical, and impairing their ability to smooth financial cycles given the long maturity of their liabilities.

- <u>Accounting convergence:</u> On this, the G20 agenda has unambiguously failed. Successive deadlines set by the G20 for the completion of IASB and FASB convergence projects have been conspicuously ignored by the independent accounting standard setters. This does not necessarily imply that no further progress will ever be made toward global accounting harmonisation, including in the United States, even though many observers have grown increasingly sceptical on this count over the last five years. If any such progress is made, however, it is likely to be difficult to attribute it even partially to any momentum created by the G20.

- <u>Institutional developments:</u> While the Asian financial crisis of the late 1990s led to the creation of new institutions or groupings, including the G20 and the FSF, no major new global institutions have been created in the wake of the crisis of 2007-08. The exceptions are limited in purpose, such as the OTC Derivatives Regulators Group (ODRG), at this stage a specialised working party of 11 regulatory agencies in eight jurisdictions rather than a permanent institution, and the Global Legal Entity Identifier Foundation (GLEIF), a new legal entity set up to coordinate the allocation of unique coded labels to all legal entities that enter into certain types of financial transactions, particularly for derivatives trade reporting. However there have been notable institutional developments. In particular, the membership of most global financial authorities and bodies, including the IMF and FSF/FSB, was expanded or rebalanced to better represent large emerging economies, mirroring the shift from G7/G8 to G20 as *"the premier forum for (...) international economic cooperation"* in the words of the Pittsburgh summit declaration. In contrast to previous attitudes, all major economies, including the United States and China, have agreed to submit themselves regularly to the discipline of a financial stability assessment programme (FSAP) of the IMF and the World Bank (the latter only for emerging market economies). The Basel Committee has pioneered an effort to monitor the adoption of its accords across jurisdictions, including in terms of the completeness of compliance and consistency of implementation. Even in the absence of any enforcement authority, this unprecedented effort appears likely to foster more consistent implementation through peer pressure and public identification of noncompliant jurisdictions.

Beyond these specific points, two broader and interrelated concerns are likely to gain increasing attention as the consequences of the G20 financial reform agenda gradually unfold.

First those global institutions that exist lack broad-based acceptance, a weakness that can easily translate into a deficit of authority. Most are set up as voluntary groupings rather than treaty-based institutions, and even those that do have a treaty basis (the BIS, the IMF, the OECD and the World Bank) have no enforceable financial regulatory mandate. The willingness of individual jurisdictions to respect the choices made by these global bodies is therefore essential. However even after the above-mentioned expansion or modification of the membership of several of these organisations, there are still major imbalances in the way different parts of the world are represented, as shown by table 1.

Table 1 suggests a structural over-representation of Europe in the functioning of the institutional system, and a corresponding under-representation of other parts of the world, in particular China. While there may be multiple reasons, not all of them to be blamed on Europe, it creates a risk of widely different levels of commitment to the global reform agenda across different jurisdictions—even though correcting these institutional imbalances might also lead to forms of disengagement by some stakeholders[6]. An area of particular importance is the governance arrangements applying to the FSB, given that body's pivotal role in driving the G20 financial reform agenda. The FSB has initiated a review of the structure of its representation, which is expected to lead to proposals to the G20 later in 2014.

Second, in the absence of strong global financial regulatory institutions, the combination of an ambitious regulatory agenda with the fragmentation of regulatory and supervisory authorities across individual jurisdictions is bound to result in limitations of cross-border financial integration – in spite of the G20's repeated commitment to support *"an open world economy based on market principles"*, as the London summit declaration put it. Even if there is no specific intent to erect barriers, the sheer number of independent centres of decision-making makes it difficult for regulated market participants to maintain a globally integrated approach. For example, the G20 has encouraged individual jurisdictions to create regulatory and supervisory frameworks for credit rating agencies, which until 2008 were unregulated in most countries. As a consequence, there is a tangible risk that over time, divergent regulatory and supervisory approaches could make it increasingly difficult for rating agencies to maintain the global consistency of rating methodologies that has been until now a key feature of their contribution to the functioning of capital markets. Such concerns are aggravated by the behavioural and cognitive bias of national supervisory authorities, which generally perceive more scope for supervisory failure in third countries than within their own geographical remit. As a consequence, they tend to give more weight to the risk of cross-border financial integration creating channels of financial contagion that would contribute to

Table 1 Distribution of selected indicators between regions

	Europe	United States	China*	Rest of Asia-Pacific	Rest of world
GDP					

6. In the context of negotiations over the proposed Transatlantic Trade and Investment Partnership, US Trade Representative Michael Froman was reported as observing that the *"EU often only recognises international standard-setting bodies where EU members cast the bulk of the votes"*; Patrick Henry, 'Regulation Biggest Barrier to Integrated U.S.–EU Trade: Froman', *Bloomberg News*, 30 September 2013.

might prove insufficient to counter the risk of fragmentation of the global financial space highlighted in the previous section. While no analytical consensus exists among economists about the benefits of global financial integration, its reversal could prove severely damaging for global economic integration and growth. To avoid such a development, still more ambitious endeavours might need to be considered in the future.

To foster global buy-in, more policymakers from emerging-market economies should accede to leadership positions in global financial regulatory bodies. Existing or newly formed bodies should be located in Asia, and not exclusively in Europe or the United States as is currently the case[7]. For example, the permanent secretariat of the FSB, which is very limited in size, could be relocated from Basel to Hong Kong, where the BIS already has a representative office for which it has negotiated extensive privileges and immunities for its international staff, or to Singapore. Similarly, the International Forum of Independent Audit Regulators is considering the establishment of a permanent secretariat to support its expanding activities, and might choose to locate it in a major Asian financial centre that could offer sufficient privileges and immunities as well as political stability.

To support global financial integration, an ambitious but circumscribed objective would be to ensure a consistent basis of financial information. Regulated information intermediaries such as credit rating agencies, audit firms and trade repositories play a crucial role, and their supervision at the international level by supranational supervisory authorities might need to be envisaged to deliver this aim. If this sounds utopian, one may recall that similar scepticism greeted the vision of EU-level supervision of individual financial firms before the crisis—but now the European Securities and Markets Authority (ESMA) directly supervises credit rating agencies throughout the EU, and the European Central Bank is expected to supervise most of the euro area's banking system starting in November 2014. Moreover, unlike banks or CCPs, these information intermediaries do not carry significant financial risk, with the consequence that their supervision at the supranational level would not need to involve any meaningful financial risk sharing among the world's governments, beyond the limited cost of operating the supranational authority. It would nevertheless require a treaty, and international legal and judiciary infrastructure, which do not currently exist, at least in the financial area. Innovative hybrid public-private governance arrangements could also be considered, building on a number of precedents of remarkable public policy achievements by non-profit global bodies with a public-interest identity, such as the IASB.

CONCLUSION

The definition and implementation of the G20 financial reform agenda has seen a number of successes. But the global institutional infrastructure on which it is currently predicated is not sufficient to support the vision of a financial system that would be both globally integrated, and adequately regulated over the medium-to-long term. To address this challenge, further institutional change, experimentation and innovation should be considered by G20 policymakers. They should not be afraid of trial and error. If, conversely, they choose to rely exclusively on established institutional and procedural patterns, the risk is that they will eventually reach a point at which they would have to durably renounce the economic and other benefits of an open financial world. The global experiment that started with the Washington, London and Pittsburgh summits still has a long way to go.

7. From this standpoint, the recent establishment of the Global Legal. Entity Identifier Foundation (GLEIF) as a Swiss foundation with a seat in Basel may be viewed as a missed opportunity.