The G20, five years on

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Introduction

Five years ago, the G20 was created almost from scratch in response to the shock provoked by the financial crisis and the fear that it would lead to a global economic slowdown. Decisive policy action at the London and the subsequent G20 meetings led to an impressive re-regulation of the financial sector, above all in the EU and the US. Five years on, the question emerges whether we have succeeded in taming the ‘wild beast of finance’. Following the debates in the developed countries, it seems that much remains to be done to make the financial sector function properly again.

The key element of the G20 was the decision that all systemically important financial institutions, instruments and markets must be adequately supervised. The Financial Stability Board (FSB) was tasked with monitoring adherence, fostering “a race to the top, wherein encouragement from peers motivates all countries and jurisdictions to raise their level of adherence to international financial standards”. FSB member jurisdictions “will lead by example”, it stated, through implementation of the agreed standards, disclosure and peer reviews.

Five years on, a huge regulatory agenda has been pushed through in many jurisdictions. Hence, at first sight, global governance is working, and the G20 managed to become the driving force. This leads to the first question we would like to answer: Is this effectively the case or was the G20 simply the crystallising actor that managed to bring a better global governance structure in place, together with the IMF, the FSB and other bodies? The second question we would like to address is: How effective is the implementation and enforcement? Rules that are not enforced only increase bureaucracy, but the G20 has no supranational power, only peer pressure. Is this system working now? And why did it not work in the past? We will start with a discussion on the re-balancing of financial markets post-crisis, and the prospects towards 2050.

Global rebalancing ongoing

The G20 was in essence a process by which the G-7 asked the rest of the world to participate in a huge cover-up exercise affecting its financial system. The EU-US financial system, which before the crisis accounted for a large slice of total GDP, bank assets, stock market capitalisation and debt securities

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outstanding, fell back on all accounts, while the non-G-7 countries increased their part in the meantime (see Table 1). The EU’s share of global bank assets went down from 52% to 42% from 2006 to 2012, and the US share of global debt securities declined from 41% to 32% in the same period. To re-regulate its financial system, the G-7 asked the rest of the world to do the same, whereas the other countries had not necessarily been as liberal as the G-7, with probably the exception of Canada.
Table 1. Comparative data (GDP, Total domestic bank assets, stock market capitalisation, total debt securities market)

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<tr>
<th>€ bn</th>
<th>World</th>
<th>EU</th>
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<td>GDP (current prices)</td>
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<tr>
<td>2006</td>
<td>39,857</td>
<td>11,765</td>
<td>29.52%</td>
<td>10,671</td>
<td>26.77%</td>
<td>1,018</td>
<td>2.55%</td>
<td>624</td>
<td>1.57%</td>
<td>2,160</td>
<td>5.42%</td>
<td>3,474</td>
<td>8.72%</td>
<td>870</td>
<td>2.18%</td>
<td>723</td>
<td>1.81%</td>
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<td>2012</td>
<td>56,208</td>
<td>12,997</td>
<td>23.12%</td>
<td>12,643</td>
<td>22.49%</td>
<td>1,417</td>
<td>2.52%</td>
<td>1,119</td>
<td>1.99%</td>
<td>6,398</td>
<td>11.38%</td>
<td>4,639</td>
<td>8.25%</td>
<td>1,753</td>
<td>3.12%</td>
<td>1,433</td>
<td>2.55%</td>
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<td>Domestic bank assets</td>
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<tr>
<td>2006</td>
<td>53,804</td>
<td>27,822</td>
<td>51.7%</td>
<td>7,748</td>
<td>14.4%</td>
<td>1,463</td>
<td>2.71%</td>
<td>1,030</td>
<td>1.91%</td>
<td>4,279</td>
<td>7.95%</td>
<td>4,775</td>
<td>8.87%</td>
<td>550</td>
<td>1.02%</td>
<td>547</td>
<td>1.01%</td>
</tr>
<tr>
<td>2012</td>
<td>85,307</td>
<td>35,472</td>
<td>41.60%</td>
<td>10,175</td>
<td>11.90%</td>
<td>2,788</td>
<td>3.26%</td>
<td>2,117</td>
<td>2.48%</td>
<td>16,254</td>
<td>19.05%</td>
<td>7,772</td>
<td>9.11%</td>
<td>1,843</td>
<td>2.16%</td>
<td>1,063</td>
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<td>Stock mkt cap</td>
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<tr>
<td>2006</td>
<td>40,528</td>
<td>10,285</td>
<td>25.4%</td>
<td>14,750</td>
<td>36.4%</td>
<td>1,291</td>
<td>3.18%</td>
<td>832</td>
<td>2.05%</td>
<td>2,172</td>
<td>5.35%</td>
<td>3,642</td>
<td>8.98%</td>
<td>539</td>
<td>1.32%</td>
<td>1,209</td>
<td>2.98%</td>
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<tr>
<td>2012</td>
<td>41,362</td>
<td>8,090</td>
<td>19.60%</td>
<td>14,523</td>
<td>35.10%</td>
<td>1,560</td>
<td>3.77%</td>
<td>1,051</td>
<td>2.54%</td>
<td>4,948</td>
<td>11.96%</td>
<td>2,789</td>
<td>6.74%</td>
<td>930</td>
<td>2.24%</td>
<td>1,893</td>
<td>4.57%</td>
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<td>Debt securities mkt</td>
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<tr>
<td>2006</td>
<td>49,434</td>
<td>17,326</td>
<td>35.04%</td>
<td>20,161</td>
<td>40.78%</td>
<td>1,050</td>
<td>2.12%</td>
<td>702</td>
<td>1.42%</td>
<td>922</td>
<td>1.86%</td>
<td>6,627</td>
<td>13.04%</td>
<td>613</td>
<td>1.24%</td>
<td>267</td>
<td>0.54%</td>
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<tr>
<td>2012</td>
<td>69,334</td>
<td>22,719</td>
<td>32.76%</td>
<td>22,156</td>
<td>31.95%</td>
<td>1,791</td>
<td>2.58%</td>
<td>1,213</td>
<td>1.74%</td>
<td>2,993</td>
<td>4.31%</td>
<td>11,201</td>
<td>16.15%</td>
<td>1,825</td>
<td>2.63%</td>
<td>517</td>
<td>0.74%</td>
</tr>
</tbody>
</table>

Sources: IMF, ECB, WFE, BIS, OSFI (Office of the Superintendent of Financial Institutions), APRA (Australian Prudential Supervisory Authority), CBRC (China Banking Regulatory Commission), BoJ (Bank of Japan), BCB (Central Bank of Brasil) and RBI (Reserve Bank of India).

1 Only domestic credit institutions. When foreign-controlled subsidiaries and/or branches are included, the total is €45 trillion.
2 Hong Kong Exchanges, Shanghai SE and Shenzhen SE.
3 Osaka and Tokyo SE.
4 BM&FBOVESPA (largest exchange in Latin America).
5 BSE India and National Stock Exchange India.
6 Total debt market = Total domestic debt market (all issuers, by residency) + Total international debt market (all issuers, by nationality).
All issuers= general government, financial and non-financial corporations.
It is worth recalling that the G20 is a recent creation in the panoply of international institutions. It was launched in 1999 as a forum for discussion primarily among finance ministers and central bankers, and until the crisis hit, had a more limited agenda. The proposal to discuss the crisis in this forum was initiated by the EU, more in particular by the French President Nicolas Sarkozy who called for the launch of a “new Bretton-Woods” during his tenure at the helm of the French Presidency of the EU Council. While it would be entirely unworkable to tackle this issue in a UN context, the G20 seemed a more appropriate framework, bringing together North and South. Developing countries were the victims of the financial crisis, which in their eyes originated entirely in the Western world. Dealing with these matters in the G-7 (created in 1975), on the other hand, would reactivate the North-South tensions of the 1970s, and it would not contribute to a comprehensive solution.

Hence relying on the G20 was intuitively the right move, and adapted to a rapidly changing world. It is now expected that, under different scenarios, that the EU and the US will jointly account for about 25% of global GDP by 2050, whereas today they account for more than 50%. China should by that time account for 28%, India for 12% (see for example Faure et al., 2010).

**Where are we with the core London G20 commitments?**

The main components of the financial regulatory reform concern: 1) bank capital, 2) central clearing and trading of OTC derivatives, 3) regulation of ratings agents and hedge funds and 4) bank resolution regimes. The follow-up to these commitments has been impressive in the G20 countries (see summary in the annex), indicating that the G20 process effectively worked. The remaining task now is the monitoring of effective implementation and the exercise of peer pressure.

Key to the entire financial regulation programme is **bank capital** and the effective enforcement of the agreed rules. Although the 1988 Basel Accord was a huge step forward, the implementation of the rules left a lot to be desired until recently. Even within the EU, where the rules were implemented in EU directives, meaning they were legally applicable and enforceable in all member states, important differences existed already in the implementation of the definition of capital, and member states were given leeway in the risk weighting of assets. The force of the Accord was watered down in the Basel II agreement, which allowed the risk weighting of assets based upon a standardised external or an internal ratings-based approach. The former was based upon ratings of credit rating agencies, the latter on internal models of credit risk, leaving much discretion to banks in setting their capital levels. The internal models approach created distortions with smaller banks following the standardised approach, leading to calls to set a minimum leverage ratio. These debates led US federal banking agencies to decide not to apply the Basel II standards to the vast majority of smaller local banks, and concerns over the impact of more sophisticated approaches on the effective capital base of large banks caused delays in its application to the latter. Hence the US entered the crisis without Basel II, which seriously undermined the authority of the Basel Committee.

Given the lacklustre performance with Basel II, it is impressive to note that a mere three years after the agreement on Basel III was reached, about 2/3 of the jurisdictions and all of the G20 members have implemented its provisions. Regulatory capital ratios of the large internationally active banks are

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7 The definition of capital could be changed through, for example, the inclusion of minority interests.
increasing and shortfall declining (Basel Committee, 2013b). The Basel Committee started a Regulatory Consistency Assessment Programme (RCAP) to monitor, assess and evaluate the implementation of the new Basel Standards. The RCAP has an impressive schedule of jurisdictional assessments covering all Basel Committee member jurisdictions for the period 2012-15, with formal publication of the reports (on the Basel Committee’s website) and, if necessary, request for rectification of material gaps. For the four jurisdictions covered so far, Japan, Australia, Singapore and China, the Committee requested rectifications in all cases, and up to 90 in the case of China. Preliminary assessments were also carried out for the EU and the US in October 2012. It concluded that the EU was materially non-compliant on two items, the definition of capital and the approach to credit risk in the internal ratings-based approach. The US was materially non-compliant on one item, the securitisation framework.

A key weakness in the Basel III framework, however, is the maintenance of the risk-weighting of assets, above all under the internal ratings-based approach, in the measurement of the regulatory capital. This allows large banks, mostly from the US and Europe, to maintain a huge competitive regulatory edge over mid-sized and smaller banks, mostly in developing countries. To correct for this shortcoming, Basel III foresees a capital conservation buffer, and a surcharge for globally systemically important banks (G-SIBs), but this only marginally restores the level playing field. It would be better to set a minimum leverage ratio, but this will only be binding from 2018 onwards, and is set at a very low level, i.e. 3% (of non-risk-weighted assets). The effective implementation of the leverage ratio is currently the subject of a Basel Committee consultation. Bankers associations already reacted that the ratio would lead to much higher capital for banks’ least-risky assets, such as government bonds, and reduce the demand for such assets, they argue.8

A major problem for supervisors is the erosion of risk-weighted assets under the internal ratings-based approach, and the differences applied by large banks in the risk weights for assets. For large banks, the EU average of risk-weighted assets as a percentage of total assets is 33% and the US average is about 58%, meaning that the other assets require no capital. A review by the Basel Committee found that risk weights for credit risk in the banking book vary significantly across banks, variations that are not supported by differences in underlying assets. Capital ratios vary by as much as 1.5 to 2 percentage points in either direction around the 10% benchmark as a result of different practices (Basel Committee, 2013). The culprits of this situation are EU-based banks, accounting for 41.6% of global bank assets, which can continue to be more or less ‘compliant’ with the Basel framework, while on average being highly leveraged. The average leverage ratio for large euro-area banks is about 3.2%, or 1 percentage point below large US-based banks, even on a comparable IFRS basis (ECB, 2013, p. 39).

A second important element of the London G20 was the obligation for central clearing and trading of OTC derivatives transactions. In addition, it was decided that OTC derivatives contracts should be reported to trade repositories. Before the crisis, the OTC derivatives market was subject to self-regulation, and considered to be non-transparent and open to huge counterparty risks, as was exemplified in the AIG exposures. The global market for OTC derivatives is much more highly concentrated than the exchange-traded side of the market, and controlled for 85-90% by five respectively 6 financial institutions in the US and six in the EU (Valiante 2010, p. 6).

Legislation implementing these commitments has been adopted (or is near adoption) in most jurisdictions, but it is too early to make an assessment whether it is working. The rules have been operational since August 2013 in the US, while primary legislation has been adopted in the EU, but not yet the secondary legislation. Other jurisdictions have also implemented provisions, but none are as liberal as those in the EU and US.

The US rules are called Swap Execution Facility (often abbreviated as "SEF"), a regulated platform for swap-trading that provides pre-trade information (bids and offers) and an execution mechanism for swap transactions among eligible participants. SEF trading will become mandatory (subject to certain exceptions) with respect to "swaps" that are both subject to a centralised clearing. As far as clearing is concerned, the EU rules are part of EMIR (European Market Infrastructure Regulation) and as far as trading is concerned, they are embedded in the amendments to the Markets in Financial Instruments Directive (MiFID II), which is still being negotiated.

A problem issue with central clearing remains the governance and control of central counterparties (CCPs). If inadequately managed, CCPs could become the ‘Fukushima’ of global finance. As they will centralise and net exposures between participants in OTC markets, they may become incapable of meeting liquidity needs of members in periods of financial stress. It is crucial to establish an adequate level of capital, effective rules governing exposure management and margining as well as clear governance and conduct requirements for all members.

The regulation of rating agencies is in place in all jurisdictions. It should be recalled that ratings agencies were in most G20 countries not regulated before the crisis, notwithstanding their central role in capital markets. Even the International Organisation of Securities Commissions (IOSCO) had until mid-2008 called for a self-regulatory code, rather than for statutory regulation. Considering the degree of abuse of ratings, and the fact that the industry is highly concentrated, with two US-based firms controlling more than 80% of the market, and three firms 96% (according to Roland Berger, 2012), regulation and oversight were seen to be essential. This should also allow that new competitors could enter the ratings business, and break the oligopoly.

Policy-makers also decided to reduce the regulatory reliance on ratings, but progress in this direction is more difficult to achieve. Many pieces of regulation carry explicit or implicit references to ratings, and created a captive market for the industry. The most important example is possibly the Basel II external ratings-based approach, which uses ratings of rating agencies to determine the risk weights. This has not been modified in the Basel III framework.

Hedge funds are now also regulated in all G20 countries, with the exception of Brazil. Before the crisis, hedge funds were dealt with in different ways across countries, and no EU regulation existed, for example. The consensus emerged rapidly that the sector needed proper oversight, even if the alternative fund sector claimed not to be the cause of the crisis. Work on this subject is now part of the broader ambition to properly regulate the ‘shadow banking’ sector.

The installation of effective resolution regimes for the banking sector is another important part of the G20 agenda, where much progress has been achieved. The key objective is to tackle too-big-to-fail and moral hazard behaviour by banks. This subject is especially relevant for large cross-border banks, which are especially difficult to unravel, and thus again is most important for the US and the EU. The US has a proper structure in place with the Dodd-Frank Act, while the EU is still finalising its approach, although it is well advanced. But the debate is far from over, given the proposal in the US Congress to reintroduce
the Glass-Steagall Act, or the proposals in several EU member states to separate the different functions in banking (see for example the Vickers and Liikanen proposals).

The most important issue for resolution regimes is to have a clear operational structure and a clear legislative framework. It is evident that these issues are easier to achieve in a single country, such as the US, than in a federation of countries, as in the EU. But the latter seems to be advancing with its structure, and it is most likely to be agreed upon in the coming months, although effective implementation will take some time.

**Conclusion**

The G20 has taken a big step forward towards instituting better global governance and a more aligned global regulatory framework for financial markets. It has been a success also in view of the fact that the problem essentially emanated from Europe and the US. Five years on, the G20 countries have largely delivered on the commitments taken at the London G20. (Better) rules are in place on bank capital, OTC derivatives, ratings agents, hedge funds and bank liquidation. It is now the enforcement of rules that will matter, but a compliance structure has been put in place. Initial data on the implementation of the new Basel III Tier 1 rules are promising.

Some caveats need to be kept in mind, however. The rules on regulatory capital in banking still favour large banks with internal risk models, notwithstanding the capital add-ons. The very low level of risk-weighted assets at a share of total assets in European banking is a reason for concern and grounds for action. The rules on OTC derivatives trading and clearing are only on the verge of implementation; hence it is too early to discuss effectiveness and enforcement.

On the long term, it will be essential for the continuing success of the G20 to maintain the process of peer pressure, as is ongoing with Basel III Regulatory Capital Assessment Programme, for example. This may be more difficult in the other areas discussed above, such as OTC derivatives, as commonly agreed standards are more recent and still being developed.

**References**


Basel Committee (2013b), Basel III Monitoring Report, September


Annex

Follow-up to London G20 commitments re financial regulation

Credit Rating Agencies (CRAs)

➢ In all jurisdictions, stricter registration and supervision regimes for credit rating agencies (CRAs) are in place. In addition, regulatory technical standards, guidelines on disclosure and codes of conduct have been issued by the relevant authorities.

Hedge Funds

➢ In all jurisdictions, except Brazil, stricter authorisation and licensing regimes for hedge funds and their managers are in place. In addition, operational, prudential and reporting requirements have been issued by the relevant authorities.

OTC Derivatives Market Reform

➢ Central clearing. Subject to adoption of further mandatory regulation and phase-in implementation, future market assessments, conditions such as achieving a critical mass of trades and adequate liquidity in certain instruments, voluntary clearing, or capital incentives.
➢ Exchange/platform trading. Few concrete steps have been announced (consultations).
➢ Reporting to trade repositories. Seven jurisdictions have some form of specific reporting obligations in force by end-2013: Australia, Brazil, China, Hong Kong, India, Japan and Singapore. In Canada, market participants are expected to comply as from Q2 2014.

Basel III

➢ Risk-based capital. All eight member jurisdictions have adopted final rules that are legally in force, subject to transitional and phase-in arrangements, except for Canada, which has required banks to meet the capital adequacy requirements (10.5% of their total RWA) on an all-in basis well before the 2019 deadline. Rules on capital buffers are expected to be issued in 2014 by Hong Kong. Rules on capital conservation buffer and countercyclical buffer expected to be issued in 2014-15 by Japan.
➢ G-SIB and D-SIB requirements. In Canada, D-SIBs (the six largest Canadian banks) will be subject to a 1% risk-weighted capital surcharge starting 1 January 2016. Additional supervisory expectations and disclosure obligations are in effect. The specific D-SIB supervisory framework is reviewed in China, where a 1% D-SIB surcharge has been applied to the five largest Chinese banks since 2010. Rules are expected to be issued in 2014 in Hong Kong.
➢ Liquidity Coverage Ratio (LCR). In May 2013, Australia revised its previous draft on liquidity standards. Public consultations began in November in Canada. In Hong Kong, the authorities are undertaking industry consultations on implementation of LCR, with the rules expected in 2014. In India, draft guidelines were issued in February 2012 and final rules are being formulated.
➢ Leverage ratio. Rules on disclosure of leverage ratio are expected to be issued in 2014 in Hong Kong. Guidelines were issued in May 2012 in India and leverage ratio monitoring started from Q3 2013. Rules on disclosure of leverage ratio are expected to be issued in 2014. Canada is
considering alignment of the current assets-to-capital multiple to Basel III leverage requirements. In China, a domestic leverage ratio requirement of 4% has been in effect since 2012.

Resolution Regimes

- Resolution regimes across the member jurisdictions exhibit a broad range of practices in terms of scope, mandates and powers of authorities, treatment of financial contracts in resolution, safeguarding of creditors, funding arrangements, resolvability assessments, recovery and resolution planning (RRP).
- All jurisdictions have designated resolution authorities for both banks and insurers, except for India which has designated a resolution authority only for banks. Only China and Brazil have designated authorities for securities or investment firms. There are no resolution regimes for FMIs (financial market infrastructures).
- The powers assigned to authorities can be exercised without shareholders’ consent in Australia, Canada, China, India and with court approval in Japan. Tools such as establishing and operating a bridge institution or an asset management company are not in place in China or India. A bail-in regime has not been designed yet. A temporary stay on early termination rights can be imposed only in Canada. Both departure from equal treatment of creditors and compensation if losses under resolution are higher than in ordinary insolvency procedure are possible in Australia and Canada. Only Japan has both a resolution fund and a formal mechanism for recovery of public funds in place. The rules on submission of recovery and resolution plans for review/approval vary across all jurisdictions.
- Australia, Brazil and Singapore are in the process of developing further legislation following public consultations. Internal policy discussions are taking place in Canada, Hong Kong and India. In Japan, a report with recommendations on the establishment of an orderly resolution regime for financial institutions has been released. No reform is envisaged in China.

Sources

Financial Stability Board, National/regional responses on Progress in the Implementation of the G20 Recommendations for other priority areas, September 2013
OTC Derivatives Reforms progress report to the G20, September 2013
Basel Committee progress report (August 2013), Peer review report on resolution regimes, April 2013