REGIONAL THINK SEMINAR

SESION 4: FINANCIAL REGULATION

FINANCIAL REGULATION AND THE G 20: IS THERE A GAP IN THE GOVERNANCE STRUCTURE?

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Executive Summary

Strengthening financial regulation has been a major focus of the G20 since the crisis. There has been considerable progress, although it has not been smooth sailing. It is a highly complex industry and a great deal is being done very quickly. The focus is turning to implementation of the new standards. But the process needs to be re-energised.

To date, the G20 has largely endorsed the decisions coming from the FSB. What has been missing has been consideration of 'higher-order' issues, such as: whether the prioritisation of the standards has been appropriate; the type of changes in financial structures that are being sought; progress in meeting objectives, in particular the balance between achieving financial stability and facilitating economic growth; and whether there are unintended consequences. These are issues that justify significant consideration, however the agenda for G20 finance ministers and central bank governors meetings is already crowded.

The extension of financial standards to non-G20 members has also brought into question the legitimacy of the G20 and whether it is sufficiently representative.

To broaden, intensify and re-energise political involvement in international financial regulation, it is proposed that *a Finance Ministers and Central Bank Governors Committee on Financial Regulation* be established. Specific financial regulatory issues would be considered by this committee rather than the G20. The committee would consist of G20 ministers, central bank governors and heads of regulatory agencies along with the non-G20 members of the IMFC as well as Hong Kong. The committee would have a specific charter that would cover not only oversight of the development and implementation of standards but also their overall impact on financial stability and economic growth. It would receive reports from the FSB, IMF and other international organisations. This new committee would meet during the course of the spring and annual meetings of the IMF and replace the G20 finance ministers' meeting that is usually held at that time. In addition to helping to clarify the relationship between the IMFC and G20, the establishment of the committee would free up time on the G20 finance ministers agenda.

The chairs of the new committee would regularly provide reports to G20 leaders.

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Introduction

Strengthening financial sector regulatory arrangements has been a major focus of the G20 since the crisis in 2008. It was at the core of the first leaders meeting in Washington DC in November 2008, and has retained a very prominent place in the communiques of leaders, finance ministers, and central bank governors at all their subsequent meetings. Progress in strengthening financial regulations is often cited as a success of the G20.

The G20 transformed the Financial Stability Forum (FSF) into the Financial Stability Board (FSB) at the London Summit in 2009, expanded its membership to cover all G20 members and has subsequently endorsed an expansion in the size of its secretariat. Since 2008 the FSB has launched a host of wide ranging regulatory reforms aimed at creating 'a more disciplined and less pro-cyclical financial system that better supports balanced sustainable economic growth'.[2]

A striking aspect of this effort has been the close involvement of G20 leaders and ministers. Prior to the crisis, the details of financial regulatory standards were primarily left to 'networks of independent regulators and private industry associations'.[3]

The Governor of the Reserve Bank of Australia, Glenn Stevens, has suggested that 'absent some major new developments, which brings to light some major reform need not hitherto visible , to task the regulatory community and the financial industry with further whole-sale changes from here would risk over-load'[4]. Stevens view is that by 2014, the year that Australia takes the chair of the G20, the focus should squarely be on 'careful and sustained efforts at implementation of the regulatory reforms'. Although he also noted that 'there was always a pretty good chance that the compounding effects of multiple reforms would contain some unexpected and unintended consequences'.

While the focus should appropriately move to implementation, it is also an opportune time, some five years since the crisis, to reflect on what are the lessons from the intense effort to improve financial regulatory standards. There have inevitably been unintended consequences and questions raised as to whether the approach taken was the right one. Without questioning the overall thrust of the efforts to strengthen financial regulation, an issue that should be considered is whether the approaches that have been taken, particularly in regard to accountability, are ensuring optimum outcomes. A specific issue that needs to be considered is the relationship between the FSB and the G20.

The G20's focus on financial regulation

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[2] FSB. Report of the Financial Stability Board to G20 Leaders. 29 September 2009
[3] Starvros Gadinis. *The financial stability board; the new politics of international financial regulation.* FSB New Politics. 10 February 2013.
[4] Glenn Stevens. Address to the Australian Securities and Investments Commission ASIC) Annual Forum. Sydney 26 march 2012

Why did the G20 zero in with great detail on the issue of financial regulation? Prior to the crisis in 2008, financial regulation was an unlikely topic for a leaders' summit, let alone be a prominent part of a leaders' declaration with many pages devoted to such technical aspects as capital and liquidity requirements of banks, the clearing of OTC derivatives or the operations of shadow banks. This was traditionally the realm of financial regulators. As Stavros Gadinis noted, the financial system was thought to be best served by highly sophisticated technocrats protected from the distorting influence of politics.[5]

It is not surprising that the political response to a devastating financial crisis, which in part was the result of poor regulatory supervision, was a strong push to tighten regulatory standards.

While the G20 focused on strengthening international financial standards, the process began before the November 2008 G20 leaders meeting in Washington DC. At their meeting in October 2007, G7 finance ministers requested the FSF to prepare a road map for international regulatory reform. The FSF released a detailed set of recommendations in April 2008. These recommendations were the basis of the G20 push to strengthen financial regulations.

There were only three weeks between the announcement by President Bush in late October 2008 that he had invited G20 leaders to a meeting in Washington DC and the inaugural G20 Leaders Summit in November 2008. The expectations for the Washington G20 Summit were high and the US recognised that more needed to come from summit than good intentions. This was largely achieved. The communique from the Washington Summit conveyed a sense of urgency, with a focused action plan and precise language. This sense of action and precision was achieved by the G20 communique picking-up the detailed recommendations that were in the FSF report to G7 finance ministers.

Hence it served the G20 well to 'adopt' the FSF report at its inaugural summit and make it the feature of its communique. This meant, however, that G20 leaders were associated with the minutiae of financial regulation. But in the long-term, was this approach in the best interests of the G20?

Where are we up to in strengthening international financial standards?

The vast range of work on strengthening the financial regulatory standards is well documented by the FSB. It is, as David Wright from IOSCO commented, very process and timetable driven.[6] The intensity of the work underway is summed up by a comment by Wright that one leading US agency claims there are 182 working groups of various types that they have to attend.

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[5] Stavros Gadinis. *The financial stability board: the new politics of international financial regulation.* FSB New politics February 2013

[6] David Wright, Secretary General of IOSCO. Remarks to the Atlantic Council, Washington DC, 10 December 2012

As Glenn Stevens has pointed out, the emphasis should now be on ‘careful and sustained implementation’. David Lipton, First Managing Director at the IMF, has observed that there has been progress, with most G20 countries starting to implement the Basel 3 capital rules, but there is a long way to go.[7] A particular worry is the delay in the implementation of Basel 3 in the EU and the US. There are also significant differences in banks’ calculations of the Basel 3 metrics. Less progress has been made on reforming the derivatives market, where national authorities have not met the deadlines to implement the reforms because of the many complexities involved. Some banks remain ‘too-big-to-fail’ and while work continues with respect to shadow banking, there remains little consensus on implementation. Lipton notes that ‘ one area particularly troubling to many global stakeholders is the lack of movement towards a single set of global, high quality, principles-based financial reporting standards, which were formally called for by the G20’. Much still needs to be done in the area of financial and regulatory reform.

David Wright has acknowledged the progress that has been made by the FSB, but has identified a number of ‘problems’, including[8]:

- Insufficient prioritization of the many subjects on the agenda;
- Few bodies representing the global community of regulators, with emerging countries under-represented in the global reform process;
- Too many global bodies scrapping for competence or competing in ‘’beauty contests’’ for new regulatory subjects‘ ;
- A domination of central banks and bank regulators in the key global policy committees (including the FSB) leading to the predominance of a policy culture of risk minimization, rather than risk optimization;
- Impact analysis of policies being carried out ex-post, with insufficient consideration of complexities; and
- Insufficient attention on the need to change behaviour, ethics and incentives in firms.

Wright refers to one expert’s assessment of the global reform process as a situation where ‘…enthusiasm is waning; cohesion weakening; political focus drifting; there is a need for re-engergization…’

There will inevitably be tension between financial institutions and the regulators when it comes to efforts to strengthen regulatory standards. While generally recognising the need to improve standards, concern has been expressed by financial institutions over the extent of the new regulations, uncertainty over their detail and scope, along with concerns

[7] David Lipton. First Deputy Managing Director, IMF. Speech on Financial Sector Regulatory Reform to Chartered Financial Analyst Society of Washington, Washington DC, 13 March 2013.
[8] Ibid

whether implementation in the jurisdictions they operate in may be harsher than in other jurisdictions.

How should we assess progress on financial regulation?

As noted previously, a range of concerns have been raised regarding the effort to strengthen the regulation of the financial system following the crisis. It is not surprising that it has not been smooth sailing, because it is a highly complex industry. As Stevens notes, the reforms that seemed so' simple and obvious, so bold and so sweeping in the immediate aftermath of the crisis in 2008', have turned into be harder to implement than first expected.[9] And furthermore, so much is being progressed at the same time.

Andrew Haldane from the Bank of England caused considerable controversy among the banking regulators, although support from many in the industry, with his claim that the regulatory response, particularly the Basel framework of model-based risk-weighting, is just too complex.[10] Haldane argues that just because modern finance is complex, you do not have to have complex regulation. You do not fight complexity with complexity, because that generates uncertainty. According to Haldane, what is required is a regulatory response grounded in simplicity, not complexity. The Basel Committee of Banking Supervision has established a task force to examine possible simplifications to the regulatory standards.

It is to be expected that assessments on the progress of financial regulatory reform have focussed on whether countries are implementing the new standards and meeting the timetable that has been set. However, these are only a means to an end. The ultimate objective is to achieve a safe and stable financial system that intermediates funds between savers and investors and supports investment, trade, employment and overall economic growth. The quest is not only for a stable financial system, but also one that manages risk and supports innovation and generates growth.

It is perhaps not surprising that in the immediate aftermath of a major financial crisis, and an international effort to avoid future crises, there was not an articulated vision of the type of future financial system that was being envisaged. The objective for financial sector reform outlined in the various G20 leaders' communiques has been at a very high level.

In order to assess progress towards establishing a safe and efficient financial system, some guidelines as to type or structure of the system being sought is required in order to serve as a bench mark. The focus should not solely be on whether the new regulatory standards are being implemented. There has to be some basis to determine whether the standards are having their desired effect in restructuring the financial system.

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[9] Ibid

[10] Andrew G Haldane. *The dog and the Frisbee*, Federal Reserve Bank of Kansas City's 36th economic policy symposium, Jackson Hole, Wyoming, 31 August 2012

In the October 2012 Global Financial Stability Report (GFSR), the IMF provided an interim report on progress toward a safer financial system. In doing so, they first outlined what such a system should look like. Some of the desirable features of such a system include one where:

- there less complexity and more transparency, where regulatory authorities and investors understood the location of risks and the way institutions were interconnected;
- institutions were less dependent on leverage and thus less prone to boom and bust cycles;
- institutions had higher and better-quality capital and liquidity buffers to absorb shocks and losses;
- institutions were discouraged from taking advantage of an implicit government guarantee and encouraged properly price all risks;
- similar prudential standards were applied to similar risks to avoid regulatory arbitrage; and,
- systemically important financial institutions could be resolved in an effective and timely way.

The overall assessment by the IMF was that despite improvements along some dimensions in some countries, the structure of intermediation remains largely unchanged. Financial systems are still overly complex, banking assets are concentrated with strong domestic inter-bank linkages, and the too-important-to fail issues remain unresolved. Moreover innovative producers were already being developed to circumvent some new regulation. This assessment has to be qualified with the fact that many of the new standards have still not been implemented.

The GFSR also noted that the positive aspects of recent financial developments should not be lost. For example, while efforts are underway to bring shadow banking into the regulatory net, it needed to be recognised that non-traditional banking and intermediation can benefit market depth and broaden access to finance. In addition, diversifying financial intermediation beyond the traditional form of deposit taking and lending can expand credit and diversify risks. However the risks still needed to be understood, transparent and appropriately priced.

The IMF also pointed out that while some financial structures may be associated with both safety and efficiency, policymakers may also face a trade-off between the safety of financial systems and economic growth. The GFSR posed a fundamental question that has not received much attention in the effort to strengthen financial regulation since the crisis, and that is whether the structural changes occurring in the financial system are not only making it safer but are doing so in a way that is promoting better economic outcomes.

Conclusions about the relationships between differing financial structures and economic outcomes are to date tentative and generally inconclusive. But this is an important area that must be explored, since the structure of financial intermediation is changing and it is important to assess how these changes are impacting economic outcomes. As the IMF notes, if these changes in financial structures are associated with lower growth or increases in economic volatility, there may be a role for government policies to 'tweak' the changes in structures to promote better outcomes.

While no financial system can ensure the best outcomes in all circumstances, the IMF's work has focused on important issues that need to be assessed in considering the overall objectives of the efforts to strengthen financial regulation, and issues that have perhaps not received sufficient attention.

Another important 'structural' issue is whether countries should be concerned about the overall size of the financial sector and how this fit within the efforts to strengthen financial regulation. The experience of Ireland, Iceland and Cyprus clearly demonstrate the problems that can occur when a financial sector which is many multiples the size of the economy gets into trouble. However Stephen Cecchetti from the BIS points out that the evidence suggests that a growing share of financial system in the economy actually slows overall economic growth.[11] In a similar vein, Cecchetti notes that financial globalisation might also only be beneficial up to a point, and the world may have passed that point.

So in addition to focusing on the timelines for the implementation of the new regulatory standards, there are a range of much wider issues regarding the structure of the financial sector and its impact on both stability and economic growth that need to be assessed.

In terms of assessing the impact of financial regulation, as opposed to its implementation, the November 2012 meeting of G 20 finance ministers and central bank governors requested international organisations to provide a report on the factors affecting long-term investment finance, including its availability. The reports were submitted to the February 2013 Meeting of G20 finance ministers and central bank governors, and included input from the FSB on the impact of financial regulatory reforms. [12] The overall conclusion from the FSB was that there was little tangible evidence to suggest that global financial regulatory reforms have significantly contributed to current long-term financing concerns. However implementation was at an early stage and the impact of the reforms needed to be monitored on an ongoing basis. The report did state that 'the regulatory community is vigilant to avoid material unintended consequences and to analyse potential impacts prior to finalisation of the reforms'.

[11] Stephen Cecchetti, *Is globalisation great?* BIS papers No 69 the Future of financial globalisation. Basel Switzerland December 2012

[12] FSB, *financial regulatory factors affecting the availability of long-term investment finance.* Report to G20 finance ministers and central bank governors. 8 February 2013

While it is important that the regulators undertake such assessments, there is the question whether they are best placed to consider the overall impact of the reforms, and in particular the trade-off, as described in the GFSR, between the safety of financial systems and economic growth. In particular, some specific questions include:

- Are the regulators too focused on achieving financial stability at 'any cost'?
- Have the regulators become too process and timetable driven, will they give appropriate attention to assessing whether there are unintended consequences with the reforms?
- To whom is the FSB accountable in terms of ensuring that it is appropriately prioritising its activities and assessing the overall impact of the new standards, both in achieving the desired outcomes and avoiding unintended consequences?

Has the G20 got the right relationship with the FSB?

In terms of questions regarding the accountability of the FSB, the obvious answer may be that the FSB is accountable to the G20. The FSB is a creation of the G20 and the FSB provides a progress report before every G20 finance ministers or leaders meeting.[13] And as noted previously, the communique from the meetings of leaders and finance ministers and central bank governors cover in significant degree detail the FSB's work program. Moreover the new financial reforms are often attributed as originating from the G20.

One positive from the close association between the G20 leaders meetings and the FSB's activities is that it has given high level political momentum to the task of agreeing on new financial standards.

The membership of the FSB is slightly broader than the G20, in that it includes the non-G20 economies of Switzerland, Hong Kong and Singapore. The concern has been expressed from countries that are non-members of the FSB that they are expected to apply financial standards when they are not a member of the body setting them. The FSB's response has been to establish six regional consultative groups.[14] Nevertheless, concerns over the legitimacy of the FSB in attempting to set standards for non-members have impacted on the standing of the G20.

The membership structure of the FSB raises questions whether the G20 is the appropriate political forum for oversighting international efforts at strengthening financial regulation, but there is also the question whether the G20 has in fact been providing the necessary oversight of the FSB's activities. Accountability is a two way processes. The FSB provides

[13] The FSB charter says that 'the FSB will discharge its accountability, beyond its members, through publication of reports and, in particular, through periodical reporting of progress in its work to the Finance ministers and Central Bank Governors of the Group of twenty, and to Heads of State and Governments of the Group of Twenty'.

[14] FSB regional consultative groups cover; Americas, Asia, Commonwealth of Independent States, Europe, Middle east and North Africa, Sub –Saharan Africa

reports to the G20, but has the G20 been appropriately responding to those reports? As noted previously, there are many issues that need to be considered beyond the detail of the new regulatory standards and the timetable for their implementation. Rather than just repeating the detail of the FSB and the Standard Setting Bodies (SSBs) activities in the G20 communiques, G20 Ministers and Governors should have been focusing on the 'higher order' questions such as: the appropriate prioritisation of the new standards; the changes in financial regulatory structures that are being sought by the reforms; progress in meeting the objectives, in particular the balance between financial stability and promoting economic growth; and whether there are unintended consequences. While these are issues that should be considered by the FSB and the SSBs, other players have a very important contribution to make, particularly the IMF.

There is also the question of time. The agenda for G20 finance ministers and central bank governors has been crowded. There is very limited time at G20 meetings for ministers and governors to focus on the issue of financial regulation. It is also not an issue that will attract the attention of leaders.

Proposal: a new ministerial body oversighting international financial regulation.

One option to improve the involvement of ministers and central bank governors in international financial regulation would be to establish a dedicated ministerial committee – the Finance Ministers and Central Bank Governors Committee on Financial Regulation. This committee would have a charter outlining its responsibilities, which would examine not only progress by the FSB and the SSBs in the development and implementation of financial standards and regulation of financial systems, but also the progress in achieving the objectives of achieving stable and efficient financial systems that promote economic growth. The charter of the FSB would be amended to allow the FSB to provide progress reports to this new ministerial committee. In addition, the committee would request regular assessments from the IMF, and possibly other international organisations such as the OECD and the World Bank, on the economic implications of the changes to financial regulation.

The membership of this committee would consist of G20 finance ministers, central bank governors, and/or head of regulatory authorities. To enhance the legitimacy of the FSB's activities, this committee could include not only G20 finance ministers and governors, but also those from non-G20 members of the IMF's International Monetary and Financial Committee (IMFC)[15]. In essence, it would be a combined G20 and IMFC meeting but specifically focused on the issue of financial regulation. The committee could be jointly chaired by the chairs of the FSB and IMFC. The secretariat to the committee would be the FSB secretariat and the IMF staff. Under such an arrangement, Hong Kong would be the only FSB member not represented and could be invited to participate.

[15] The members on the IMFC change depending on constituency arrangements. Currently the non-g20 members on the IMFC are Singapore, UAE, Sweden, Netherlands, Algeria, Gabon and Switzerland.

To avoid adding to the meeting burden of ministers and governors, this new committee could meet at the time of the spring and annual meetings of the IMF. The meeting could replace the FSB finance and ministerial meeting that is usually held before the IMFC meetings. There is currently a significant element of duplication in having a G20 finance ministers meeting immediately before an IMFC meeting. All the members of this new committee should attend the IMF/FSB 'early warning' presentations that are part of the IMFC meetings. This approach would help clarify the relationship between the G20 finance ministers' process and the IMFC. In addition, with this committee focusing on financial regulatory issues, it would free up time at the G20 meetings to focus more on broader economic policy issues.

The joint chairs of the Finance Ministers and Central Bank Governors Committee on Financial Regulation would provide progress reports to G20 leaders.

Conclusion

There is a governance gap in the current structure of international efforts to strengthen financial regulation. Specifically, the accountability arrangements for the FSB. The membership structure of the FSB raises questions whether the G20 is the appropriate political forum for oversighting international financial regulation, but there is also a question whether the G20 has in fact been providing the necessary oversight. There are many issues that need to be considered beyond the detail of the new regulatory standards and the timetable for their implementation. Ministers and governors should be asking 'higher order' questions, including whether the new standards are achieving the right balance between financial stability and promoting growth.

A new *Finance Ministers and Central Bank Governors Committee on Financial Regulation,* which combined members of the G20 and the IMFC, and was serviced by the FSB secretariat and the IMF, would broaden, intensify and re-energise the political involvement in international financial regulation. This would be the main ministerial level committee dealing with international financial regulation. Such a committee would help clarify the relationship between the FSB and the IMFC. And if the committee met at the time of IMFC meetings and replaced the G20 finance ministers meeting that normally takes place at that time, it would reduce duplication between the G20 and IMFC and free-up the agenda of the G20 finance ministers' process to consider other matters.