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Global Financial Regulation: Three Challenges the G20 Must Address

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As G20 leaders prepare for their next meeting in September 2013, this policy memo:

- Identifies three unresolved challenges in global financial governance
- Sets out six principles to guide reform

Global financial regulation needs strengthening

Five years into the global financial crisis we still lack robust institutions and regulations for governing finance at the national, regional and global levels. While reforming the international financial architecture and strengthening financial regulation have been at the top of the global agenda since at least 2008, concrete progress has come slowly. There is a risk that politicians will soon fall prey to financial regulatory reform fatigue, losing the political will to take tough decisions before real changes have been achieved.

This policy memo draws on a series of recent events[3] co-hosted by the Blavatnik School of Government and the Global Economic Governance Programme at the University of Oxford to identify three unresolved challenges in global financial governance. As world leaders prepare for September's G20 meeting in St Petersburg, where financial regulatory reform will once again be high on the agenda, this memo sets out six principles to guide the creation of a safer, more stable global financial architecture.

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3 Key events on which this policy brief is based are: The Blavatnik School's Challenges of Government Conference 2012 and a series of follow-up events which brought economic experts to Oxford for related discussions

Have banks made the 'Great Escape' from new regulation?

In the immediate aftermath of the crisis, there was a consensus amongst shocked publics and politicians around the world that dramatic changes to financial regulatory regimes would be necessary. At the first G20 leaders summit in November 2008, politicians called for strong new measures as part of a wide and ambitious regulatory reform agenda. New international regulatory standards, Basel III, were endorsed by G20 leaders in November 2010.

Despite this flurry of activity on the surface, how much has really changed on the ground? How close are we to obtaining the strong and effective regulations and regulatory institutions we need?

Challenge 1: Developing countries are excluded from the debate

Developing countries are profoundly affected by new rules governing international finance, yet remain severely underrepresented at the negotiating table. The Financial Stability Board, launched in 2009, includes all members of the G20, and is thus considerably more representative than its predecessor. But the vast majority of developing countries are still excluded from the process. While regional consultative groups have been set up to liaise with non-members, in practice non-members have minimal say over the standards, codes and best practices with which they are expected to comply. Similarly, at the IMF, the EU and US continue to stall long-promised reforms which would give developing countries greater representation.

Precious little attention has been paid to how new global financial regulations will affect developing countries. How will new principles and standards affect financial flows to developing countries? Will the new rules aide or constrain developing country governments as they seek to regulate their own financial systems? How can stringency in global standards be balanced with sufficient flexibility to allow countries at dramatically differing levels of financial development to select policies best suited to their needs? There is an urgent need to understand these questions, which - perhaps unsurprisingly given the minimal voice developing countries hold in the global debate - have not yet been adequately addressed.

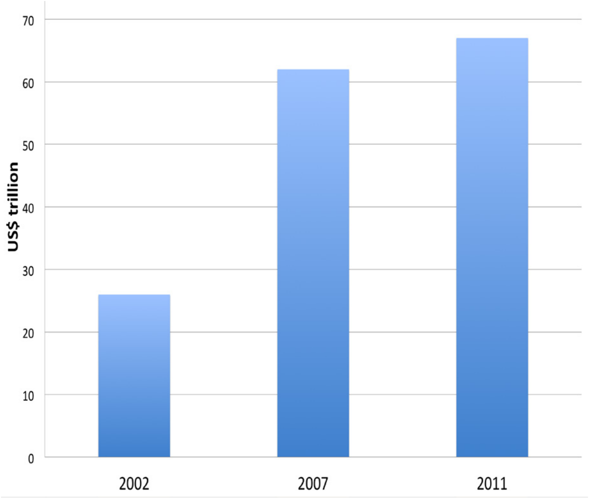
Challenge 2: Regulatory reforms are weak, overly complex, and fragmented

Banking reforms fall short of the dramatic changes many expected back in 2008/2009. Basel III, the cornerstone of new global financial regulations, has major shortcomings. It allows large banks to use their internal models for risk weighting of assets, meaning banks are free to choose models which deliberately lower their capital requirements. Minimum capital ratios are no higher than the ratios held by many financial institutions when they were embroiled in crisis, and the minimum leverage ratios are arguably too low to act as an effective back-stop. It is also overly complex, at 616 pages, up from just 30 pages of rules in the 1980s. Overstretched regulators will struggle to monitor and enforce such a complex set of rules.

Large banks successfully lobby to water-down new regulations. Lobbying by powerful banks is partly to blame for the weaknesses in Basel III, and this dynamic continues. At the beginning of this year, for example, the deadline for banks to meet new liquidity requirements was pushed back from 2015 to 2019, after the pleading of many large international banks. Government officials must ensure that the crucial implementation phase of the regulatory process is not open to capture from private financial interests, who have large enough profits at stake to motivate devoting considerable energy and resources to influencing the process.

Disagreements among Governments result in fragmentation. Large banks are not the only actors thwarting effective policy: national governments are wary of ceding autonomy to international rules and are pursuing their own, often very distinct regulatory agendas. A fragmented system opens up the door for regulatory arbitrage, and is ill-suited to regulating global banks. While there is a strong case for decentralisation so that governments retain discretion, effective cooperation is vital.

Growth of shadow banking



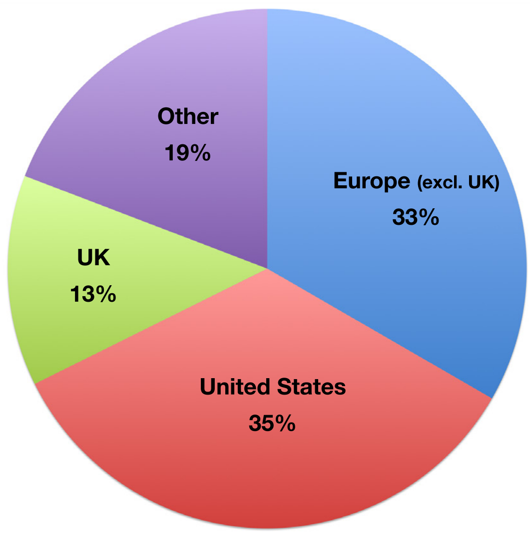
Source: FSB Global Shadow Banking Monitoring Report 2012

Challenge 3: Thorny issues not being addressed

While the reform agenda has focused largely on banks, other problematic aspects of international financial regulation have to date been neglected, partially because there is less consensus on necessary solutions. Yet the G20 cannot afford to keep these issues on the back-burner:

Large parts of the financial system remain unregulated. The 'shadow banking' sector – comprising all financing outside of traditional banking channels, including finance companies, hedge funds, money market mutual funds, non-bank government-sponsored enterprises, securities lenders, and investment banks – is estimated at US$67 trillion worldwide. There is wide international agreement that shadow banking should be better regulated, yet there is little consensus even on basic questions such as how to define 'shadow banking', let alone how to go about regulating it. Without greater effort to keep the regulations over banking and non-banking finance in step, however, financial institutions may simply channel more of their activities 'into the shadows' where their actions remain unscrutinised, even as risks to financial stability remain.

Location of shadow banking



Source: FSB Global Shadow Banking Monitoring Report 2012

The use of capital controls is constrained by international trade and investment agreements. There is growing consensus that capital controls are an important and useful regulatory instrument for limiting asset bubbles, and preserving currency and macroeconomic stability, particularly for developing and emerging economies. Yet many preferential trade agreements and bilateral investment treaties severely restrict the use of capital controls. Trade and investment agreements must be scrutinised, and where necessary revised, to ensure they do not compromise the ability of governments to pursue financial stability.

We lack an effective mechanism for sovereign debt restructuring. In the wake of Greece's massive recent debt restructuring – the largest in history – and ongoing legal battles between Argentina and hedge funds holding sovereign claims, sovereign debt restructuring has emerged as a critical and contentious international issue. As the scale of sovereign obligations that have to be treated in crises has grown immensely, so too have the costs of delays in taking action to restore sovereign solvency when it is under threat. A fair and efficient mechanism to make sovereign debt restructuring more predictable, transparent, and timely is urgently needed.

Key principles to guide global financial regulation in the run-up to September's G20 Summit

As world leaders prepare to once again discuss progress (or lack thereof) in building a stronger, more resilient, and more efficient global financial regulatory regime, here are six principles to guide their thinking and identify priorities:

- **Inclusion:** Global debates over financial reform need to be made more inclusive – giving greater voice to small and poor developing countries, who will be significantly affected by new international standards – without excessively slowing or complicating decision-making processes and procedures.
- **Not one-size-fits-all:** Policymakers are aiming to establish a 'level playing field' with harmonized international standards in several areas. Flexible standards that allow for considerable national discretion will be necessary in others. Crucial will be to ensure that a decentralized system functions harmoniously and cooperatively, rather than as a fragmented and balkanized global regime.
- **Simple rules:** Regulators need to ensure that banking rules are simpler and clearer so that they can be enforced more consistently and with fewer regulatory resources.
- **Transparency:** The persistent lobbying efforts of large international banks have weakened new regulations. Government leaders need to open up processes of global financial regulation so as to reduce the scope for lobbying behind closed doors.
- **Scope:** Increasing concerns about the shadow-banking sector suggest that the scope of regulation needs constantly to be reassessed. Many now argue that shadow-banking should be regulated in a manner which maximizes economic efficiency while minimizing systemic risks. Equally, a more effective and equitable mechanism for managing sovereign debt restructuring needs discussion.
- **Coherence:** As new financial regulation is forged, leaders must consider how to ensure consistency and agreement across the global trade, investment and finance regimes, and how contradictions might be resolved.

World leaders arriving at the G20 summit in St Petersburg on 3 September 2013 need to deliver on the collective promises they made in November 2008. More effective regulation of global finance requires greater adherence to each of these principles.

The Global Economic Governance Programme fosters research and debate into how global markets and institutions can better serve the needs of people in developing countries. It is co-hosted by University College and the Blavatnik School of Government.

The Blavatnik School of Government was founded at the University of Oxford to inspire and support better public policy and government around the world.
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