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Financial Regulation and the G20

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Contents

Overview: Refining the role of the G20 in strengthening financial regulation 4
By Mike Callaghan

A stocktake of global financial reform five years after the collapse of Lehman Brothers 8
By Hugh Jorgensen

The G20 and financial sector reforms..16
By Stephen Pickford

Financial regulation: strengthening the coordination role of the G20 21
By Richard Gray

Financial regulation and the G20: is there a gap in the governance structure? 27
By Mike Callaghan

Are the G20's financial regulatory reforms adequate? 35
By Ross Buckley

Whither the G20 and the FSB? The 2014 agenda...44
By Steven Bardy

The financial sector's role in Asia-Pacific growth 47
By Graham Hodges

We must keep meeting like this: summary of regional 'Think 20' seminar...........................53
By Hugh Jorgensen

Contributors 58

Overview: refining the role of the G20 in strengthening financial regulation

Mike Callaghan[1]

This issue of the Monitor canvases the role of the G20 in strengthening financial regulation.

It contains articles by Hugh Jorgensen (Lowy Institute), Stephen Pickford (Chatham House), Richard Gray (Westpac), myself, Steven Bardy (Australian Securities and Investment Commission), Ross Buckley (University of New South Wales) and Graham Hodges (ANZ). It also includes a summary of the discussion at a regional 'Think 20' seminar recently held at the Lowy Institute.

Financial regulation has been a central agenda item of the G20 since the first leaders' summit in November 2008 and the topic has retained a prominent place in the communiqués from meetings of G20 leaders and finance ministers and central bank governors since then. The G20 transformed the Financial Stability Forum into the Financial Stability Board (FSB) and the FSB has pursued a wide range of financial sector reforms, with the backing of the G20.

The papers in this issue of the Monitor reflect a cross section of views on financial sector reform. The objective in compiling them is to contribute to determining what Australia's approach to this topic should be when it chairs the G20 in 2014.

The extent of the reform agenda

The vast range of work in strengthening financial regulatory arrangements is extensively documented by the FSB, which provides a status report to G20 leaders and finance ministers prior to their meetings.

Stephen Pickford points out that the financial sector reform agenda has grown substantially in complexity, particularly in terms of the range of institutions covered, the breadth of instruments subject to regulation, the level of detail involved, and their cross border implications. As to lessons from the experience of the G20 and financial sector reform, Pickford notes that: pressure from leaders does produce responses; most G20 finance ministers and central bank governors fortunately have policy responsibility for the financial sector; it is important to have a technical body to translate political ambitions into concrete actions; and peer review is an important part of the enforcement mechanism.

Richard Gray notes that the progressive implementation of this extensive regulatory reform agenda, which is designed to increase the resilience of the global financial system, has renewed attention on issues such as the extraterritorial impacts of domestic reforms, regulatory inconsistency, and the fragmentation of financial systems, with efforts now being made to ring fence the capital and liquidity of local entities. Gray suggests that these trends can have a detrimental impact on financial market efficiency by creating uncertainty, uneven playing fields and additional compliance costs.

Hugh Jorgensen reviews the IMF's stocktake of the international community's progress towards a safer financial system that can better serve the real economy. [2] This is no easy

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assessment, as the precise attributes of the financial system being pursued were not clearly defined in advance of the reform agenda. Accordingly, the IMF proposes some normative benchmarks for a 'safer financial system'. Such a system would be less complex, more transparent, less volatile, better capitalised, have fewer systemically risky linkages, have clearer resolution mechanisms, and the same regulatory standards would apply to similar risks.

The IMF's assessment is that while the thrust of the reform agenda is heading in the right direction, market-based financial intermediation remains largely unchanged, financial systems remain overly complex, concentrated, interlinked and dependent on wholesale and non-bank funding. In short, there is a long way to go — it is a highly complex industry and a great many reforms are being advanced at the same time.

In a similar vein, I note in my paper that a range of concerns have been raised regarding efforts to strengthen the regulation of the financial system. In many cases what seemed bold, simple and obvious in the aftermath of the crisis has turned out to be much harder to implement. There has been criticism that the approach taken is too complex, leading to added uncertainty. I also address the question of whether structural changes in the financial system are not only making the system safer through new standards, but in a way that is promoting better economic outcomes.

Steven Bardy highlights the impact of the changes to the financial regulatory architecture on the role of securities regulators, and International Organization of Securities Commission (IOCSCO) in particular. Some of the issues raised from a regulatory perspective include; the importance of the FSB respecting the roles and responsibilities of standard setting bodies; the need for the FSB to avoid mission creep; the fact that the G20 has acted as an uncritical rubber stamp of the FSB's work; the necessity of undertaking a cost-benefit analysis before new regulatory initiatives are launched: and the requirement to understand the cumulative impact of all the reforms.

Ross Buckley's assessment is that the G20 and FSB have done quite well in responding to the financial crisis. But progress has been more problematic in responding to profound changes in the world of finance that commenced in the 1970s, including: the removal of derivatives from the purview of gaming laws; the removal of capital controls that have contributed to the globalisation of financial systems; the rise of algorithmic and high frequency trading; and the change in behaviour of bankers from a world of prudent intermediation to a world of speculating on markets.

Graham Hodges focuses on the challenges facing the Asian financial system, noting that while Asia has been in the economic ascendancy over the past decade, insufficient attention has been paid to the significant underdevelopment of the region's capital markets. This is a timely reminder of the need to take into account the specific challenges facing financial systems in emerging markets, specifically in the case of Asia, and of the need to ensure that new regulations aimed at enhancing financial stability do not impede the deepening of financial markets. Hodges points out that while Asia is an extraordinarily diverse region with different countries at different stages of development, if the necessary reforms can be implemented, it will become home to a growing number of the world's financial centres. The implication is that Asia should play a larger role in setting international financial regulations.

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[2] IMF, *Global Financal Stability Report*, Washington, DC, International Monetary Fund, October 2012.

The view of the B20

The preliminary report of the B20 (business representatives from G20 economies) working group on financial regulation recommends that there be '…an independent assessment of the results of the financial reform — especially the Basel III capital and liquidity requirements and the impact of reforms on other areas such as trade financing, SMEs financing, and infrastructure financing'.[3] It is not specified who should be the 'independent' assessor of the impact of these regulations.

Business also emphasises the importance of providing regulatory certainty, avoiding uncoordinated initiatives that may undermine the harmonisation of global minimum regulatory standards, and progress in implementing the Basel III reform timeline.

What should be on the financial regulation agenda in 2014?

A common view is that the focus of the G20 in 2014 should be one of consolidation and implementation. This was articulated by the Governor of the Reserve Bank of Australia, Glenn Stevens, when he recently said '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]

Bardy suggests the focus in 2014 should be on orderly implementation of work to date. But he also goes on to suggest reviewing the cumulative impact of the regulatory reform agenda, particularly in terms of balancing the quest for stability with the economic impact of the new standards, along with reviewing how the work is conducted.

Gray proposes that the G20 needs to refocus its work on coordinating the regulatory reform agenda and to move from monitoring and reporting to taking a more direct role in the implementation process. Towards that end, he proposes that the FSB be given additional resources and an expanded mandate. Gray also calls for a process that requires regulators to consider extraterritorial impacts when developing and implementing regulations. In order to avoid duplication in complying with similar regulations in different jurisdictions, he recommends that 'substituted compliance' be introduced.

Hodges also highlights the importance of consistent application of Basel III rules across regional jurisdictions, noting that this will encourage cross-border financing while minimising unnecessary complexity. In terms of promoting financial integration in Asia, he advocates a pan-regional approach that would see national capital market development plans providing for future regional market integration with common regulatory and operating standards.

Buckley suggests the priorities for responding to the profound changes in the global financial system should include further progress in regulating credit rating agencies, in particular the ratings of structured products, along with tighter controls over banker remuneration. He also suggests the G20 should advance the concept of imposing a levy on the assets of financial institutions, limit the activities of deposit-taking banks from engaging in proprietary trading,

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[3] B20-G20 Partnership for Growth and Jobs, *Recommendations From Task Force*, Moscow, 2013.

[4] Stevens, Glenn, *Financial Regulation: Australia in the global landscape. An Address to the Australian Securities and Investments Commission (ASIC) annual forum,* 26 March 2012 2012.

and introduce a financial transactions tax in order to curtail short-term, speculative transactions.

In my paper, I suggest that what has been missing from the G20's involvement in financial regulation is consideration of 'higher-order' issues. To broaden, intensify and re-energise political involvement in international financial regulation, I have proposed that a *Finance Ministers and Central Bank Governors Committee on Financial Regulation* be established. It would consist of G20 finance ministers, central bank governors and heads of regulatory agencies along with the non-G20 members of the International Monetary and Financial Committee (MFC)plus Hong Kong. It would meet at the time of the spring and annual IMFC meeting and would replace the G20 finance ministers meeting held at that time. The committee would have a specific charter, which would cover not only oversight of the development and implementation of the new regulatory standards, but also their overall impact on financial stability and economic growth. The secretariat to this committee would be the FSB and IMF.

Conclusion

It is not surprising that financial regulation has featured so prominently on the G20 agenda. The first G20 leaders' meeting was a response to a devastating financial crisis and the public wanted some assurance that steps were being taken to ensure that a similar crisis would be avoided. And it is appropriate that the G20 continues to focus on financial regulation, because the financial sector has been, and is likely to continue to be, a source of economic crises. With this in mind, a theme the G20 should pursue in 2014 is how it can play a stronger role in overseeing the strengthening of financial regulation. Steven Bardy has summarised the shortcomings of current arrangements when he observes '[the G20] has tended to act as an uncritical rubber stamp of the FSB's work. It should aim to challenge the FSB in the work it does'. Making this happen is the challenge confronting the G20 in 2014.

A stocktake of global financial reform five years after the collapse of Lehman Brothers

Hugh Jorgensen[1]

Introduction

It is nearly five years since Lehman Brothers' filing for chapter 11 bankruptcy brought the global financial system to its knees.[2] Yet it was the corresponding free-fall in the real economy[3] that led legislators in the world's major financial centres to acknowledge that prudential officials operating within and between their own economies lacked the adequate 'institutional infrastructure' to properly supervise the product innovation and globalisation of credit that had driven growth in the global financial industry over the previous two decades.[4] In particular, regulation had not successfully adapted to the boom in more 'market-based' activities: fee-based income sources, trading activities, non-deposit liabilities, nonbank financial intermediation and 'exotic' securitisations and derivatives.[5] These innovations represented a marked shift away from 'traditional bank-based intermediation,' where profits were essentially the differential between interest rates charged on loans over those paid out on savers' deposits.[6] Accordingly, regulators, supervisors and central bankers, operating at both the multilateral and domestic level, have since been tasked by G20 leaders to devise a host of financial regulatory reforms that:

> supplement strong microprudential regulation with a macroprudential overlay to more effectively monitor and address the build-up of risks arising from excess liquidity, leverage, risk-taking and systemic concentrations that have the potential to cause financial instability.[7]

While it is still too early to offer a binary assessment of whether this post-crisis reform agenda has been 'successful' or 'unsuccessful,' the sheer breadth and depth of financial regulatory reform that has emerged in the past five years does call attention to an important

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[2] The collapse of Lehman Brothers that occurred on September 15, 2008 is generally regarded as the point at which the 'credit crunch' turned into a full-blown global financial crisis and sparked a multi-trillion dollar fall in the value of global bank assets over the following twelve-month period. See IMF, Global Financial Stability Report, edited by Monetary and Capital Markets Department, Washington, DC: International Monetary Fund, 2010, p. xiii

[3] GDP in crisis affected countries is still running ten to fifteen per cent below a simple extrapolation of long term trends, see Andrew Haldane, Simon Brennan and Vaseleios Madouros, What is the contribution of the financial sector? Miracle or mirage? In *The Future of Finance: the LSE report*, London, London School of Economics and Political Science, 2010.

[4] Such as CDOs based upon subprime securities that were themselves created according to faulty underwriting standards, for a broad summary of the financial developments over the previous two decades, see pp. 78-79 of IMF, *Global Financal Stability Report*.

[5] Ibid. p.77

[6] Colloquially known as the 3-6-3 rule of bank management: pay 3 per cent on deposits, charge 6 per cent on loans and be on the golf course by 3pm.

[7] G20 Working Group 1, *Enhancing sound regulation and strengthening transparency: final report,* 25 March 2009.

and somewhat overlooked interim question: are we at least making progress towards a safer financial system that can better serve the real economy?

This is a complex question, as it requires an integrated understanding of reforms occurring within major financial centers such as Europe, the US and the UK, how well these reforms correspond to commitments made in transnational regulatory coordination processes like Basel III, and the impact these reforms will likely have upon existing forms of financial intermediation. A preliminary 'investigation' in to this infant debate can be found in chapter three of the IMF's October 2012 Global Financial Stability Report (GFSR), titled *The Reform Agenda: An Interim Report on Progress Towards a Safer Financial System.*

The IMF's investigation finds that 'while the intentions of policymakers are clear and positive, the reforms have yet to effect a safer set of financial structures.'[8] This paper provides: (1) a summary of the goals and expectations for post-crisis reform of the financial sector; (2) a review of the assessment on progress towards a 'safer financial system'; and (3) a brief discussion of the 'remaining gaps' and opportunities for improvement in the reform agenda.

Goals of 'the reform agenda': more transparency, less complexity, less leverage

The premise of the GFSR review is that to make an assessment of progress towards a 'safer financial system,' it is first necessary to define what such a system might actually look like. The IMF approaches this task by looking for transformations in three structural features of the pre-crisis financial landscape that exacerbated or facilitated the 2008 banking meltdown: principally, the move to (i) more deregulated market-based intermediation, (ii) highly concentrated financial systems and (iii) financial globalisation. Accordingly, a hypothetically 'safer financial system' - relative to the pre-crisis system — would exhibit the following 'normative benchmarks,' against which progress can be measured:

- **Better information:** a financial system that is less complex and more transparent than that of the pre-crisis period, where investors and regulators better understand the risk profile of investments and can more accurately price 'all risks, including systemic ones;'

- **Less volatility:** a less leveraged system with lower levels of maturity mismatch and pro-cyclical liquidity risks;

- **Better capitalised:** financial institutions that operate with 'higher and better quality capital and liquidity buffers' that can more effectively withstand periods of severe distress and thereby avoid insolvency;

- **Less systemic risk**: a financial sector that involves less systemically risky linkage between the banking sector, non-banking sector and foreign banking sector such that contagion risk is limited;

- **Better resolution of failed banks:** clearer resolution mechanisms for systemically important financial institutions that impose a minimal cost upon taxpayers; and,

[8] IMF, *Global Financal Stability Report*, p.75

- **More coordinated regulation:** better alignment of prudential standards for similar risks, so as to de-incentivise regulatory arbitrage.

Importantly, the proposed normative framework does not simply advocate for the abandonment of all recent innovation in the global financial sector. Rather, the goal is to maintain the 'efficiency benefits' of positive innovations, like financial globalisation, while bringing greater clarity to the risk-profit trade-off that is made when choosing between traditional and non-traditional models of intermediation. For example, 'well-conceived' products that disseminate the concentration of risk to those most able to bear it — like corporate bonds and equities — can promote credit and economic growth, while more opaque products, such as the subprime derivatives behind the recent crisis, can result in extremely costly spillovers. Accordingly, in addition to desiring fewer 'taxpayer-paid bailouts' and 'large disruptions to economic activity,' the GFSR assents to post-crisis reforms that incentivise financial institutions to more effectively:

> …internalise the risks and explicit or implicit costs of their business activities, mainly through the imposition of additional costs on activities that, in the crisis, were shown to be riskier than originally envisaged or had broader systemic effects.[9]

A brief and early look at reform expectations

The implementation of the post-crisis global regulatory reform agenda is still in very 'early days.'[10] Indeed, by January 2013, regulations relating to the enhanced capital and liquidity requirements of Basel III had only commenced 'rollout' in eleven of the twenty-seven Basel committee member jurisdictions,[11] with several other key jurisdictions, including the United States and members of the European Union, yet to move beyond the drafting stage.[12] As discussed below, the targeted activities broadly involve banking, non-banking finance and OTC derivative trades. The delay in implementation relates to differing perspectives and expectations over the key policy objectives that have made up the 'ambitious and global' reform agenda to date, as well as their potential impact on the broader financial landscape.[13]

Banking & non-banking intermediation

Increasing capital charges on higher risk-weighted assets (RWAs) and revising minimum liquidity coverage ratios (LCRs) will likely incentivise banks to optimise the composition of their balance sheets by expanding into business lines that demand lower capital charges and less costly liquidity standards. Tighter definitions of capital, the introduction of leverage ratios, and additional surcharges on globally systemically important banks (G-SIBs), should also encourage banks to 'deemphasise' activities that involve higher RWAs.

Yet if these reforms are effective, they will ultimately lead to lower short-term returns on equity. Depending on the demands of investors in financial institutions, this may unintentionally cause a shift in banking business models towards even more market-based

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[9] Ibid. p. 76

[10] Basel III has an extended deadline for completion until 2019.

[11] Australia, Canada, China, Hong Kong SAR, India, Indonesia, Italy, Japan, Mexico, Saudi Arabia, Singapore, South Africa and Switzerland. See: FSB, *Financial regulatory factors affecting the availability of long-term investment finance: report to G20 finance ministers and central bank governors,* 8 February 2013..

[12] Ibid.

[13] IMF, *Global Financal Stability Report*, p. 82.

intermediation, as activities that demand more capital will become less attractive than net interest margin focused products (NIM — ratio of interest earned minus interest paid over total interest-earning assets).[14] Even where banks do divest their non-traditional business-lines due to increased capital costs, the potential for exacerbating market concentration and the risks posed by 'too-big-too-fail' banks might still increase, as larger competitor banks with scalable business models may simply capture any abandoned market share.[15]

Furthermore, non-banks that are not subject to the same standard of capital or liquidity reserve requirements might become even more attractive instruments for intermediation, as their relative competitive cost position against banks would likely improve, essentially luring even more intermediation into the opaque world of shadow banking. Although shadow banking can broaden access to finance and improve market depth, the limited amount of satisfactory data on nonbanking activities does suggest greater regulatory attention should be devoted to uncovering potential systemic risks within the sector.[16]

OTC derivatives

The most 'far-reaching' component of the plan to reform OTC derivatives is to shift non-cleared OTC transactions onto central counterparties (CCPs). A well-coordinated transition to the use of CCPs should lead to more effective risk dispersion and resiliency within the financial system. However, an insufficiently detailed or supervised transition may result in insufficient competition between CCPs, which could result in even more efficiency losses and market opaqueness than before the crisis. For example, while the objective is to bring greater transparency to the OTC market, the concentration of OTC derivatives on the balance sheets of newly created CCPs may actually engender a whole new class of systemically important financial institutions that become 'too-big-to-fail.'

If the above reforms are fully implemented as intended, it is probable that they will lead to more 'stable, traditional banking'. Yet there are evidently potential pitfalls if the reform agenda is weakened or only partially fulfilled — not least due to the natural incentive for highly innovative and well-resourced financial institutions to circumvent new regulations or exploit unforeseen loopholes.

The next section looks for early evidence that progress is being made overall.

An early assessment of whether post-crisis reforms are resulting in a safer financial system:

Although the GSFR finds that 'the thrust' of the post-crisis reform agenda is 'pushing in the right direction' and that some 'improvements along some dimensions [in] some economies' are discernible, its overall conclusion is that market-based financial intermediation remains largely unchanged and that financial systems are still overly complex, concentrated, interlinked and dependent on wholesale and non-bank funding. Essentially, while the report's authors stress that their findings are tentative, the indicators used in their analysis do suggest that post-crisis reforms are yet to make financial systems 'safer than before the crisis'.[17]

[14] Ibid. p. 101
[15] Ibid. p. 85.
[16] Christine Lagarde, *The global financial sector - transforming the landscape*. Paper presented at the Frankfurt finance summit, Frankfurt, 19 March 2013.
[17] IMF, *Global Financal Stability Report*, p. 103.

'Market-based intermediation: dented but not reversed'[18]

While some market-based intermediation activities have experienced a post-crisis decline, the general level of non-traditional banking activity in advanced economies remains relatively unaffected.[19] This is concerning, as previous IMF studies show that banking systems which exhibited 'excessive' reliance on 'non-traditional' sources of income were among the hardest hit in the financial crisis.[20]

The non-bank sector's role in intermediation has also fallen only slightly in advanced economies, with its share of the total financial sector's loan and bond holdings remaining largely stable — although this figure is likely propped up by the increased issuance of corporate bonds after the fall in demand for securitised products such as mortgage backed securities (MBS), collateralised debt obligations (CDOs) and over the counter (OTC) derivatives.

The level of non-traditional banking in emerging economies remains at a fairly low and static level, where it has not historically been a significant contributor to the revenue of financial institutions.

Concentration: 'financial systems are still concentrated, with strong domestic interbank linkages.'[21]

Concentration in advanced economy banking sectors has actually increased in the wake of the crisis,[22] largely due to mergers of distressed banks with healthier ones, or the amalgamation and nationalisation of ailing banks. Even where less distressed institutions were able to successfully sell off business lines and riskier components of their balance sheet in order to meet minimum capital requirements, these assets were generally acquired by larger and healthier institutions and thereby effectively exacerbated, rather than ameliorated, the risk and moral hazard represented by 'too big to fail' (TBTF). Nevertheless, despite an increase in nominal terms, there has at least been a proportional decline in the size of the global financial sector relative to GDP.[23]

There has also been little change in the general level of 'interconnectedness' among financial institutions within advanced economies - measured by the ratio of interbank assets, liabilities and wholesale funding as a proportion of the total respective figures for each bank. However it is worth noting that this figure also captures wholesale funding from central banks, which have become key post-crisis providers of liquidity, and is therefore probably inflated.[24]

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[18] Ibid. p. 97

[19] It is worth noting that results were not uniform among the selected advanced economies assessed in the GFSR: from 2008-2011, banking systems in France, Spain, Germany and the United States became somewhat less reliant on short-term funding, trading and fee income, whereas Swiss, Japanese, Canadian and British banks in fact expanded their non-traditional business lines.

[20] Jose Vinals, Jonathan Fiechter, Ceyla Pazarbasioglu, Laura Kodres, Aditya Narain and Marina Moretti, *Shaping the new financial system,* IMF Staff Position Note SPN/10/15, IMF, 3 October 2010.

[21] IMF, Global Financial Stability Report. p. 99

[22] According to the three bank concentration ratio, ibid. p. 100

[23] Ibid. p. 82.

[24] Ibid. p. 101.

Relatedly, the ongoing influence of crisis intervention policies from governments and central banks, which initially prevented a total financial collapse, may be slowing efforts to create a safer financial system. Indeed, while the expansion of central bank balance sheets in Japan and the euro area may be a necessary response to sluggish credit markets, crisis induced monetary policies unaccompanied by structural reform of the financial system might in fact be 'inhibiting adjustments in the structure of banking systems.' For example, the IMF estimates that because of implicit government guarantees, bigger banks are able to borrow funds at a discount of 0.8 percentages points over their smaller counterparts - for the five largest banks in the United States, this equates to an annual subsidy from the government of around $64 billion.[25] Ongoing cheap interest rates, courtesy of central bank policy, might even increase the attractiveness of investing in higher RWAs where higher yields are available than in traditional banking.

Financial globalisation: not severely affected as yet

On a slightly more positive note, the IMF finds that long-term trends in financial globalisation have 'not been significantly affected,'[26] 'despite reversals from some crisis-hit economies.' The measure for financial globalisation is gross foreign asset holdings by banks as a percentage of GDP. Generally the levels have remained steady at around eighty per cent in selected advanced economies, and have increased from about sixty to seventy per cent in Asian economies (other regions remain static). However while there is presently no significant evidence of a move towards de-globalisation, it could still occur if the reform agenda fails to deliver a 'level playing field and good cross-border resolution framework.'[27] Furthermore, without significant structural reform, those institutions with higher exposure to foreign assets or streams of financing will remain more susceptible to global contagion than their more 'domesticated' counterparts.

Data analysis

Drawing on available data from forty-five countries,[28] the IMF have also devised several financial indices to test for a relationship between progress toward the normative benchmarks listed earlier and each country's level of implementation of standards approved by the Basel Committee on Banking Supervision (BCBS).[29] The econometric analysis essentially finds that there is a tentative but statistically significant relationship between implementation of previous rounds of BCBS regulatory measures and the likelihood that banking systems have taken steps to alter their liability structures and re-engage in securitisation activity (albeit in a more tightly controlled fashion relative to pre-2008).

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[25] Lagarde, *The global financial sector — transforming the landscape*.
[26] IMF, *Global Financal Stability Report*, p. 104
[27] Ibid. p. 103
[28] The selected countries are advanced economies within the OECD, alongside the largest economies in central and eastern Europe, Asia and Latin America.
[29] While the recently agreed Basel III requirements for enhanced capital and liquidity buffers represent the most significant transnational post-crisis coordination effort at building a safer financial system, they have only just been approved by the BCBS and are not scheduled for full implementation until 2019. Hence, as a proxy measurement for whether post-crisis reforms have had a discernible effect on financial structures, the indices test the econometric relationship between each country's stage of implementation of Basel II/2.5 — seen as a 'stepping stone' to implementation of Basel III — and developments within relevant indices in the matching financial sector.

Of concern, the econometric analysis also finds a negative relationship between the BCBS standards and rates of financial globalisation, particularly in banks providing intermediation services in foreign markets;[30] whether this is only a result of the particular period under assessment or the beginning of a long-term trend deserves more research, as it may suggest that BCBS rules need to be tweaked in order to maximise the benefits of cross-border risk sharing.

Yet the broader point here is that the interpretation and implementation of BCBS standards remains misaligned among systemically important economies, which is in itself a major pitfall for the objective of minimising regulatory arbitrage.[31]

Implications of GFSR findings: policymakers need to speak more about reform 'tweaking'

In answering the question 'are [post-crisis] reforms moving the structures toward a safer financial system,' Laura Kodres, the IMF's head for global financial stability, pithily summarises with the comment 'somewhat, but not enough.'[32] This is evidently an area where sound analysis will require ongoing monitoring, and the GFSR provides a useful blueprint for the complex task of taking a qualitative and quantitative 'stocktake' of post-crisis global financial reform on a regular basis. It also contains lessons for policymakers and officials within G20 economies on which areas of reform are most in need of attention, enhancement or rethinking. Several such areas that warrant deeper consideration from policymakers relate to:

1. 'Too important to ail': Policymakers should commence 'a global level discussion on the pros and cons of direct activity restrictions' because national initiatives that force banks to divest or 'ringfence' certain business lines, like the Liikanen, Vickers and Volcker proposals, will have an impact beyond domestic borders. Left uncoordinated, global standards may become even more uneven; indeed, early studies by the Bank for International Settlements have identified 'considerable variation' in the risk weighting of assets across banks and jurisdictions.[33]

2. More effective 'recovery and resolution planning for large institutions' than is currently taking place, particularly for G-SIBS with significant cross-jurisdictional operations.

3. 'Enhanced monitoring of systemic risks posed by nonbanks' — it is clear that by raising the cost of consuming higher RWAs for banks, that non-banks will become relatively more cost-competitive providers of intermediation. If policymakers wish to prevent even more financial intermediation from leaking to the non-bank sector, then a common (or at least better aligned) set of prudential standards is required for both banks and nonbanks.

[30] Laura Kodres, *Not making the grade: Report card on global financial reform,* 2012: http://www.voxeu.org/article/not-making-grade-report-card-global-financial-reform..

[31] Lagarde, *The global financial sector - transforming the landscape*.. See also Eric Helleiner, and Pagliaro, The end of an era in international financial regulation? A postcrisis research agenda, *International Organization* 65 (1) 2011, pp. 169–200, p. 1.

[32] Kodres, *Not making the grade: Report card on global financial reform.*

[33] Basel Committee on Banking Supervision, *Report to G20 Finance Ministers and Central Bank Governors on monitoring implementation of Basel III regulatory reform,* Bank for International Settlements, 2013, p. 2.

4. ‘Further thought on how to encourage the development of simpler products’: policymakers should do more to encourage better quality information that reveals interconnections, buildups and potential spillovers of the risks inherent in financial products.

5. ‘More consideration of risks in moving OTC derivatives to CCPs’: as discussed earlier, insufficient attention has been paid to the potential risks inherent in creating a new class of essential financial intermediaries like CCPs that, left unchecked, could become TBTF in their own right.

Evidently, moving towards a less volatile global financial system with more effective prudential supervision will require a truly global compact. Yet the ongoing complexity, lack of transparency and highly leveraged nature of global finance means that a great deal more of political and social impetus is required if the normative benchmarks listed at the beginning of this paper are to be credibly pursued. Unfortunately, it is by no means assured that the right incentives are presently in place to meet the benchmarks, or that supervisors have been imbued with sufficient authority to enforce them. Indeed, the GFSR chapter closes with the somber warning that without sufficient political leadership or effective support from the relevant global economic governance institutions, the global financial reform agenda may ‘wither and die’. The challenge for the G20 is to galvanise its own members into ensuring that it does not.

The G20 and financial sector reforms

Stephen Pickford[1]

Introduction

This paper focuses on the following points:

- Financial sector reforms have been an important feature of the G20's agenda since 2008, when G20 Leaders first met in Washington.
- Financial sector issues have been one of the more successful examples of the G20 as a mechanism for international policy coordination. The Financial Stability Forum (FSB) was strengthened to effectively become an instrument of the G20 to formulate detailed actions to put political agreements into practice, and to oversee implementation.
- Over successive summits the agenda of financial sector reform has grown substantially in complexity; the G20 has made major strides forward in these areas over the last five years, and its agenda has evolved to reflect changes in the financial landscape. But while the FSB has helped drive forward the political priorities of greater coordination on financial regulation, detailed implementation of regulations at the national level is still lagging behind.
- The relative success of the G20's efforts in financial sector reform are due to political leadership through the summit process, policy ownership by finance ministers and central bank governors, a permanent technical body to oversee and implement agreements, peer review processes to encourage national implementation, and an overriding rationale for international cooperation. This may have lessons for other areas of the G20's work.

Reform of financial regulation has been a priority issue for the G20 since its rebirth as a leaders' process in 2008.

Financial sector failures, both of private financial institutions and by supervisors and regulators, were at the heart of the global crisis of the late 2000s. As a result, financial sector strengthening formed a key part of G20 discussions at the Washington summit in November 2008. A comprehensive action plan was formulated and a number of international institutions were tasked with taking forward different aspects of the plan.

In particular the Financial Stability Forum (FSF), which had been set up at the same time as the finance ministers and central bank governors G20 in 1999, brought together finance ministries, central banks and regulators of the major financial centres. Following the Washington summit it was given a broad oversight role for financial sector reform, its membership was expanded to include all the G20 countries, it received more resources and responsibilities, and it was renamed the FSB.

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At that time the G20 stressed: 'regulation is first and foremost the responsibility of national regulators.'[2] But the rationale behind coordinated international action was clear — 'our financial markets are global in scope, therefore, intensified international cooperation among regulators and strengthening of international standards, where necessary, and their consistent implementation is necessary to protect against adverse cross-border, regional and global developments affecting international financial stability' — even though achieving that level of coordination was not easy.

The crisis showed that if the state provides guarantees, either implicitly or explicitly, to important institutions, sectors or instruments of the financial system (so that they are too important to fail), some private institutions will be tempted to take too many risks. And unless failing institutions can be ring-fenced, one failure can bring down the entire system, with catastrophic consequences both within and across national borders. So the issue of financial stability became a key public policy issue for G20 countries, individually and collectively.

Financial sector reforms

In successive summits since then, the G20 program of financial sector reform has expanded its scope and drilled down into greater detail, including:

- Strengthening of the **Financial Stability Board**;
- changing the approach to **risk management** in private financial institutions, including through controls on compensation systems;
- Instituting a new bank **capital and liquidity framework** to constrain leverage and maturity mismatches, capital buffers and leverage ratios;
- Addressing the **'too-big-to-fail'** issue through a resolution framework and more intensive supervisory oversight for systemically important financial institutions (SIFIs), as well as building a robust core financial market infrastructure; and
- Instituting mandatory international **recovery and resolution** planning and risk assessment by international supervisory colleges, in particular for global systemically important financial institutions (G-SIFIs).

In addition, at the Seoul summit the G20 mandated a further program of work[3] covering:

- International **peer review** of national supervisors;
- Strengthening regulation and supervision of **hedge funds, over-the-counter derivatives, and credit rating agencies**;
- Creating a single set of global **accounting standards**;
- Further work on **macroprudential policy** frameworks; and
- Strengthening regulation and supervision of the **shadow banking** system and **derivatives** markets.

At Cannes the G20 committed to full implementation of this reform agenda and the creation of a global legal entity identifier (LEI[4]) to identify parties to financial transactions. Los Cabos

[2] G20, Declaration: Summit on Financial Markets and the World Economy, 2008.
[3] The G20 Seoul Summit leaders' declaration, 2010.
[4] FSB, *A global legal entity identifier for financial markets*, 8 June 2012.

repeated these commitments and pledged to make national resolution regimes consistent with the 'Key Attributes'[5] developed by the FSB.

Over successive summits this agenda of reform has grown substantially in complexity, in five dimensions:

- The range of **institutions** covered by the supervisory net has risen dramatically, from banks and insurance companies initially, to bring into the net hedge funds, other forms of 'shadow banking', and the financial infrastructure institutions (clearing and settlement systems, and credit rating agencies);
- The coverage of **instruments** under detailed regulation has increased, notably for asset-backed securities, and OTC derivatives;
- The level of **detail** on capital, liquidity, leverage, accounting standards, and conduct of business issues has also expanded dramatically. For example, Basel I ran to 30 pages, Basel II to 347 pages, and Basel III to 616 pages;
- The **processes** around supervision have also been strengthened, for example the setting up of supervisory colleges, and processes for bank resolution, especially for SIFIs; and
- Measures have been introduced aimed at regulating the **behaviour** of financial institutions, e.g. guidelines on compensation, and corporate governance.

While these measures have primarily been taken forward internationally through the FSB and the standard-setting bodies (including the Basel Committee, the IASB and IOSCO)[6], much of this agenda has to be implemented by the relevant national regulators and supervisors.

The state of progress with the reforms

Given the starting level of international cooperation on regulation and supervision in 2008, the G20 has made major strides forward in these areas over the last five years. The process of international coordination and convergence of standards for financial regulation and supervision has gathered momentum, driven by the institutional structure of the FSB. And over time the agenda has evolved to reflect changes in the financial landscape.

But while the FSB has helped drive forward the political priorities of coordination on financial regulation, detailed implementation of regulations at the national level is still lagging behind. The assessment of the G20 Research Group[7] is that implementation by some countries (especially the United States, Canada and European countries) has been good, but that overall this is one of the weaker areas of G20 implementation (with an average score of 0.23). And in a recent speech[8] the IMF's First Deputy Managing Director, David Lipton, also concluded that the global regulatory reform process had made significant progress, but that

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[5] *Key attributes of effective resolution regimes for financial institutions*. October 2011.

[6] The Basel Committee on Banking Supervision (BCBS) is a committee of banking supervisory authorities whose purpose is to encourage convergence towards common banking regulations and standards. The International Accounting Standards Board (IASB) is an accounting standard-setting body tasked with developing a single set of 'high quality, understandable, enforceable and globally accepted' international financial reporting standards. The International Organisation of Securities Commissions (IOSCO) is an association of organisations that regulates the world's securities and futures markets.

[7] G20 Research Group, *G20 Meetings of Finance Ministers and Central Bank Governors and Deputies,* G20 Information Centre 2012: http://www.g20.utoronto.ca/ministerials.html.

[8] David Lipton, *Speech on Financial Sector Regulatory Reform to the Chartered Financial Analyst (CFA) Society of Washington Annual Dinner,* 12 March 2012: http://www.imf.org/external/np/speeches/2013/031213.htm.

countries needed to speed up implementation of the new rules, including the Basel III capital rules, the liquidity coverage ratio for banks, and recovery and resolution plans for G-SIFIs.

Nevertheless, compared with the speed of progress on regulatory reform before the crisis, G20 pressure has ensured much greater and faster progress than would have been likely with the pre-2008 structures for international cooperation. Of course, given the causes of the crisis, lack of action in this area was not an option. And the strengthening of the financial system cannot guarantee that there will not be failures in the future. But overall the coordinated response to the shortcomings of the global integrated financial system has been much more effective than prior to the crisis.

Conclusion and lessons

There are a number of lessons from this experience:

- **Pressure from leaders does produce official responses**: G20 summits have proved a very effective way of reaching agreement between countries and across different parts of national administrations. Finance ministries, central banks and regulators within a single country can have divergent views or agendas. In those circumstances only leaders can force the institutions to bury their differences. Even in very technical areas such as financial regulation (where leaders and their advisors are unlikely to have complete mastery of the details) they can be effective;
- **Finance ministers' and central bank governors' policy responsibilities in this area allow effective responses** at the national level: in most countries finance ministers have policy responsibility for the framework of financial supervision and regulation, and central banks often have executive responsibility for regulating and supervising major parts of the financial sector. And central banks have typically been the main conduit for international coordination in this area through the Basel Committee. So the G20 meetings of finance ministers and central bank governors are important venues for preparing the leaders' discussions at summits, and for ensuring implementation within their countries of what has been agreed;
- **An effective technical body is needed to translate political ambitions into concrete actions**, and to enforce implementation: in this area the FSB has played a very important role in translating political will into concrete agreements on new regulatory measures. The FSB's role as a coordinating mechanism for standard-setting bodies in the financial area has allowed it provide a degree of consistency across different parts of the financial sector. But in order to increase the capacity and effectiveness of the FSB it was necessary to strengthen its administration and to expand its membership so that it was seen as a legitimate body to coordinate internationally. In particular, the decision in 2009 to expand its membership to include all G20 countries was essential in legitimising its role as a delivery mechanism for the G20; and
- **Peer review is an important part of the enforcement mechanism**: since regulation and supervision remains essentially a national competence, a key challenge in this area is to ensure that agreements at the international level are translated across to national legislation and (as importantly) are put into practice by supervisors equitably across national boundaries. In Europe the Commission and ECB can play this role; but more broadly this is a challenge. The FSB has adopted widely the practice of peer review so that national regulators and supervisors are assessed by their counterparts from other countries to ensure a level playing-field, but despite this, to date the FSB has been more

successful at getting regulators to agree new regulatory measures than at ensuring that they are implemented at the national level.

These lessons could well have wider applicability in other areas of the G20's work. They are already standard practice in macroeconomic coordination, in particular through the MAP (though with less impressive results to date).

Financial regulation: strengthening the coordination role of the G20

Richard Gray[1]

Synopsis

This paper examines the role of the G20 in establishing a comprehensive regulatory reform program for the international financial system and suggests that it may be timely for the G20 to further increase its active coordination of the program in order to maximise the effectiveness and international cohesiveness of the reforms with consequent enhancement of global system stability and efficiency.

Introduction

There has been a profound transformation of the financial regulatory landscape over the past five years. The turmoil and subsequent economic impact of the global financial crisis (GFC) exposed the need for reform of the financial sector. Specifically, the global financial system needed to be made more resilient to shocks, transparency of activities needed to be increased, while risks needed to be more appropriately managed and regulated.

The first G20 leaders' summit in November 2008, soon after the peak of the GFC, set the agenda for reform of the global financial system. At that first meeting, G20 leaders set out common principles for financial market reform, including sound regulation, strengthened transparency and greater integrity. In particular, leaders specified that international cooperation and coordination of regulatory efforts was important so as to ensure consistent formulation and implementation of reforms.

The G20 London summit in April 2009 saw the re-establishment of the Financial Stability Forum as the Financial Stability Board (FSB), with a broadened mandate which specified the coordination of those bodies responsible for international financial stability. The Pittsburgh summit of September 2009 specified 'target reform areas' including enhanced capital requirements, strengthened liquidity requirements, improving over the counter derivatives markets and addressing cross-border resolution and systemically important financial institutions. These determinations laid the broad framework for the financial regulatory reform agenda.

Trends

The comprehensive regulatory reform program has been designed to significantly increase the resilience of the global financial system, enhance the preparedness of institutions and markets in the face of potential shocks and provide protection to consumers and taxpayers. Regulators around the world have worked intensively to implement what represents unprecedented reform of the international financial system. However, as the extensive range of reforms has been progressively implemented, we have seen the emergence of several issues across the international regulatory landscape that are worthy of renewed attention.

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- *Extraterritoriality*: Each member jurisdiction is seeking to develop and implement domestic regulations that satisfy their commitments in the G20 reform agenda. However a number of these regulations have extraterritorial impacts. For example, some of the regulations set out in the Dodd-Frank Act of the United States, such as the Volcker Rule or the OTC derivatives/swaps requirements, potentially have far reaching effects beyond the United States due to certain broad definitions or specifications incorporated in the legislation. In some cases the extraterritorial effects of legislation do not appear to be intended and, if left unchanged, will lead to particularly difficult paths to compliance for those affected.

- *Inconsistency*: Different jurisdictions, in seeking to implement global regulatory reforms, are often adjusting aspects of the international regulations including the content, the timing or the implementation approach. Such inconsistency may cause issues for those subject to the regulations in more than one jurisdiction and may impact the efficient delivery of financial services and the effective functioning of international capital markets.

- *Fragmentation*: Due to inconsistent local implementation of global reforms, several instances of potential regulatory fragmentation have emerged. In a speech in February 2013, the FSB Chairman Mark Carney highlighted the risks to market efficiency and to global system resilience posed by this trend: '*Measures to ring fence the capital and liquidity of local entities are being proposed. Left unchecked, these trends could substantially decrease the efficiency of the global financial system. In addition, a more Balkanised system that concentrates risk within national borders would reduce systemic resilience globally…… A global system that is nationally fragmented will lead to less efficient intermediation of savings and a deep misallocation of capital. It could reverse the process of global economic integration that has supported growth and widespread poverty reduction over the last two decades'*.[2]

These trends have led a number of finance officials in different jurisdictions to raise certain issues directly with their counterparts. For example, in April 2013 finance ministers and officials from nine jurisdictions and the EU sent a letter to US Treasury Secretary Lew to '*express our concern at the lack of progress in developing workable cross-border rules as part of the reforms of the OTC derivatives market*.'[3] The letter talks of evidence of regulatory fragmentation due to a lack of regulatory coordination and, in order to avoid regulatory conflicts and minimise overlaps, the officials propose measures aimed at agreeing to more appropriate outcomes in relation to implementation timetables, registration requirements and 'substituted compliance.'[4]

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[2] Mark Carney, *Rebuilding trust in global banking,* Paper presented at the 7th annual Thomas d'Aquino lecture on leadership, Western University, 25 February 2013.

[3] The finance ministers and officials were from Brazil, the European Commission, France, Germany, Italy, Japan, Russia, South Africa, Switzerland and the United Kingdom, see: Taro Aso, Guido Mantega, Michel Barnier, Pierre Moscovici, Wolfgang Schauble, Vittorio Grilli, Anton Siluanov, Pravin Gordhan, Widmer-Schlumpf Eveline and George Osborne, *Ministerial-level joint letter addressed to US Secretary of the Treasury on cross-border OTC derivatives reform,* Financial Services Agency, 18 April 2013: http://www.fsa.go.jp/en/news/2013/20130419.html.

[4] The process of 'substituted compliance' (or 'equivalence' or 'mutual recognition' as it is also referred to) allows for a bank to satisfy one jurisdiction's requirements by satisfying those requirements in their home jurisdiction, provided that it has been determined that the requirements of the bank's home jurisdiction are 'comparable.'

Also in April 2013, European Commissioner Barnier wrote to US Federal Reserve Chairman Bernanke regarding certain aspects of proposed prudential regulation of the operations of foreign banking organisations in the United States. Barnier talks of the potential fragmentation of global banking markets and regulatory frameworks as a result of the proposed rules and also cites their potential for creating an uneven playing field. Barnier also raises the possibility that the proposed rules *'could spark a protectionist reaction from other jurisdictions, which could ultimately have a substantial negative impact on the global economic recovery.'*[5] Any such response would of course directly conflict with one of the objectives set down by the G20 at their inaugural leaders' summit, which called on leaders to avoid protectionist actions in implementing the post GFC reform program.

It should be acknowledged that some of these developments reflect the fact that an unprecedented program of international financial reform is being undertaken. Further, because many of the reforms represent new territory for regulation, the potential impacts have only emerged as the detailed rules have been developed or new requirements have been proposed and progressed.

In addition, some of the issues that have emerged simply reflect the differing states of development experienced by markets in different jurisdictions, distinctive market characteristics or the varying stages of development or implementation of regulations.

Another aspect which has contributed in some instances to these trends has been a disconnect between the priorities of some lawmakers, particularly in response to a perceived mood among the community for action, and the likely approach to reform proposed by regulators who may seek more consistent and measured regulatory responses and more appropriate and reasonable timetables.

Potential impacts

The emergence of these trends creates the potential for several unintended impacts. The overriding impact is one of uncertainty, and uncertainty can be detrimental to growth because of the effect it has on confidence. It is more difficult for banks to invest in, and grow, business areas confidently if the path to regulatory compliance for those businesses is uncertain or if they face the prospect of multiple compliance requirements across different jurisdictions for essentially the same types of activities. Product development and customer engagement is similarly affected in a less certain and fragmented regulatory environment.

Another potential negative impact is the creation of an uneven playing field — where participants from one jurisdiction may end up having some advantage due to inconsistent implementation of regulations. This may lead to reduced competition as institutions withdraw from certain products, or even completely from certain markets, due to regulatory disadvantage.

The cost of compliance is a further issue. Banks are willing to support compliance frameworks that make the financial system more resilient. However where there is an unclear path to compliance (due to looming deadlines but incomplete regulations) or multiple compliance requirements due to unforeseen extraterritorial effects, the compliance investment

[5] Michel Barnier, *Letter addressed to US Federal Reserve Chairman Ben Bernanke,* 18 April 2013: http://www.federalreserve.gov/SECRS/2013/April/20130422/R-1438/R-1438_041913_111076_515131431183_1.pdf.

can be inefficient and inappropriately directed creating unnecessary cost for all participants in the system.

A significant issue for international markets is the detrimental impact on financial market efficiency caused by the 'Balkanisation' of cross-border banks' operations in different jurisdictions, as mentioned by Mark Carney. This could lead to trapped capital and liquidity in each of these jurisdictions leading to significantly reduced efficiency of flows in the international capital markets.

These potential detrimental impacts are emerging at a critical time in the economic cycle given the fragile state of the global economic recovery.

Some suggestions

The international regulatory reform program is at a crucial stage. There have been some encouraging signs of regulators seeking to address these issues or examples of increased co-operation between regulators — in late 2011 the FSB set up a Coordination Framework for Implementation Monitoring to intensify its monitoring of implementation of the reform program. Also in late 2011 the principals of regulatory authorities charged with regulating OTC derivatives markets in eight countries, as well as the EU and two Canadian provinces, formed the OTC Derivatives Regulators Group to discuss reform of the derivatives markets, including the objectives of increasing regulatory certainty, minimising inconsistent regulation and avoiding duplicative requirements.

However, as discussed, there continue to be examples of uncertainty, regulatory inconsistency and potential fragmentation.

It should be acknowledged that, given the nature and extent of the international regulatory reform agenda, it is inevitable that some unintended consequences will emerge. Further, it is extremely challenging to develop such a broad range of regulatory measures in a way that achieves the desired objectives in a consistent and effective manner given the different characteristics and stages of development of the many jurisdictions for which the regulations are being designed.

However, it is timely that the G20 and its agencies consider the regulatory reform landscape and evaluate measures that could further enhance the extensive progress achieved to date. The following suggestions are proposed to contribute to this debate:

- The G20 should increase its efforts to actively coordinate the international regulatory reform agenda. Over recent years, despite comments at the early leaders' summits regarding coordination, the focus has largely been on monitoring and reporting on the progress of implementation of the regulatory reforms. More direct active involvement is justified given the issues that are emerging in the implementation of the reforms.

- In particular, the G20 could reinforce and strengthen the mandate of the FSB as its official agency in the active co-ordination of the regulatory reform program. The international financial community welcomed the re-establishment of the FSB in 2009 with a broadened mandate. It was also a positive development in early 2013 when the FSB was formally constituted as a legal entity. It would be timely for the FSB to take a more proactive role in seeking to coordinate the development and implementation of the

G20 financial reform agenda. Under an expanded and strengthened co-ordination mandate, it would also be crucial that the FSB is sufficiently resourced so that it can effectively carry out this critical function.

- The G20 could specifically direct the FSB to address the aspect of extraterritoriality in the formulation, development and implementation of regulations. The FSB could provide guidelines that formally require regulators to consider potential extraterritorial impacts when developing and implementing regulations for their jurisdictions. A review process could be implemented which allowed for potential instances of extraterritoriality to be considered in a FSB sponsored forum.

- It is inefficient to require duplicated compliance with similar regulations in different jurisdictions. The reform of OTC derivatives activities is particularly relevant to this issue. Different jurisdictions may be firmly committed to the G20 objectives pertaining to central clearing, trade reporting and exchange trading of derivative transactions. However, due to the different nature and characteristics of markets, the legislative and regulatory frameworks in these jurisdictions will rarely be identical. The process of substituted compliance provides an apposite solution to this issue. However in order for the substituted compliance process to be reasonable and effective, the comparability assessment should be outcomes based, rather than a line-by-line comparison of regulations, and be sufficiently flexible to take into account differences in markets, different stages of development and local conditions. The process should be collaborative to provide for a progressive assessment and determination. It should also provide sufficient information as to identified gaps, how they can be reasonably filled and time to do so. This issue of substituted compliance is becoming an increasingly important feature of the international regulatory landscape and the FSB could develop a process framework that could form a roadmap for regulators to follow in conducting their comparability assessments and substituted compliance determinations.

Timetables

One aspect of the regulatory agenda that is contributing to many of these issues is that in some cases the timetables for development and implementation of regulations are proving to be impractical. Many of the original deadlines for reform of the different areas were set during 2009 in the immediate post GFC turmoil, no doubt influenced by the prevailing mood of a need for significant change and rapid action. An example is the ‘end 2012’ deadline for implementation of the OTC derivative reforms. The FSB’s Fifth Progress Report on implementation of the OTC Derivatives Market reforms published in April 2013 acknowledged that not one member jurisdiction had fully implemented the requirements by the ‘end 2012’ deadline originally set by the G20. However the framework objectives were very high level, and the process of development of legislation and regulations to achieve those high level objectives have no doubt brought into focus the challenges many jurisdictions faced and the ambitious nature of the original deadline.

While continued appropriate reform is accepted as a must by market participants, it is more important in the long run to ensure that the regulatory frameworks which are developed and implemented are the optimal reform measures, not simply those which can be most expediently implemented. Currently the global system appears to have the benefit of some time to achieve such an outcome.

From the perspective of pure loss absorbency capacity, the global banking sector is materially more resilient than in the period leading up to the GFC. Average capital levels have increased significantly over the past five years and, as more countries implement the Basel III capital reforms, along with the increased loss absorbency requirements under the SIFI framework, this trend can be expected to continue.

Further the capital requirements for defined banking activities, along with progressive reforms in the areas of liquidity and OTC derivatives, are influencing the nature and approach of banking activities, leading to improved risk management and further increasing transparency and system stability. In addition, the significantly increased focus on supervision is further strengthening confidence in the resilience of the global financial system.

These positive trends, in concert with a subdued global economic environment, provide a backdrop for the G20 and its agencies to re-evaluate existing proposed timelines and to inform appropriate timetables for proposed new reforms.

Conclusion

The G20 has initiated a program of reform that is dramatically reshaping the global financial landscape. Five years into this reform program it is timely for the G20, and its main regulatory agency the FSB, to re-assert and strengthen their co-ordination role. Although the challenging nature of achieving a consistent but appropriately flexible international regulatory framework is recognised, through active coordination of the reform program, the FSB, and through it the G20, are both well placed to ensure that the worthwhile financial reform objectives of the G20 are most appropriately realised.

Financial regulation and the G20: is there a gap in the governance structure?

Mike Callaghan[1]

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 communiqués of leaders, finance ministers, and central bank governors at subsequent meetings. Progress in strengthening financial regulation 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 wholesale changes from here would risk overload.'[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, five years since the onset of the crisis, to reflect on what lessons can be learned from the intense effort to improve financial regulatory standards. There have inevitably been unintended consequences, and questions have been raised as to whether the right approach was taken. Without questioning the overall thrust of the efforts to strengthen financial regulation, there is at least a valid contention as to whether the approaches that have been

[1] Director G20 Studies Program, Lowy Institute for International Policy. The views expressed in this paper are entirely the author's own and are not those of the Lowy Institute for International Policy nor of the G20 Studies Centre

[2] FSB, *Report of the Financial Stability Board to G20 Leaders*, 29 September 2009.

[3] Stavros Gadinis, The Financial Stability Board: The New Politics of International Financial Regulation, *Texas International Law Journal,* Forthcoming, 2013.

[4] Stevens, *Financial Regulation: Australia in the global landscape. An Address to the Australian Securities and Investments Commission (ASIC) annual forum.*

taken, particularly in regard to accountability, will lead to optimum outcomes. In this regard, a specific issue that needs to be considered is the relationship between the FSB and the G20.

The G20's focus on financial regulation

Prior to the crisis in 2008, placing financial regulation onto the agenda of a leaders' summit would have been unlikely, let alone obtaining an endorsement from leaders for a communiqué that addressed technical issues such as capital and liquidity requirements for banks, the clearing of OTC derivatives or the operations of shadow banks. Such matters traditionally lay in the realm of financial regulators. As Stavros Gadinis has noted, it was thought that regulation of the financial system was best left to highly sophisticated technocrats who were protected from the distorting influence of politics.[5]

Yet although the G20's detailed 'zeroing in' on financial regulation was unexpected, it is not really surprising that the political response to a devastating financial crisis, which in part was the result of poor regulatory supervision, involved 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 that the FSF 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's push to strengthen financial regulations.

It was only three weeks prior to the event that President George W Bush announced his intention to host the inaugural G20 leaders' summit in Washington DC in November 2008. The expectations for the Washington G20 Summit were high, and the US recognised that more needed to come from the summit than good intentions. This was largely achieved. The communiqué from the Washington Summit conveyed a sense of urgency, contained a focused action plan and used precise language. This sense of action and precision was achieved by the G20 communiqué's adoption of the detailed recommendations from the FSF's report to G7 finance ministers.

Accordingly, it served the G20 well to 'adopt' the FSF report at its inaugural summit and make it a feature of its communiqué. However, this meant that G20 leaders were henceforth 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 in which they are obligated to participate.

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[5] Gadinis, The Financial Stability Board: The New Politics of International Financial Regulation.

[6] David Wright, *Remarks by David Wright Secretary General of IOSCO 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'.[7] David Lipton, First Managing Director at the IMF, has observed that there has been progress, with most G20 countries starting to implement the Basel III capital rules, but there is a long way to go.[8] A particular worry is the delay in the implementation of Basel III in the EU and the United States. There are also significant differences in banks' calculations of the Basel III 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.'[9] 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:[10]

- insufficient prioritisation 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 minimisation, rather than risk optimisation;
- 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 [and] political focus drifting' such that there is a need for re-energisation…'

There will inevitably be tension between financial institutions and regulators when it comes to strengthening 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, and whether implementation in the jurisdictions they operate in may be harsher than in other jurisdictions.

How should we assess progress on financial regulation?

A range of concerns have been raised regarding the post-crisis effort to strengthen regulation of the financial system. Yet it is unsurprising that the reform process has not been smooth sailing; as Stevens notes, it is a highly complex industry and the reforms that seemed 'so

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[7] Stevens, *Financial Regulation: Australia in the global landscape. An Address to the Australian Securities and Investments Commission (ASIC) annual forum.*

[8] Lipton, *Speech on Financial Sector Regulatory Reform to the Chartered Financial Analyst (CFA) Society of Washington Annual Dinner.*

[9] Ibid.

[10] Ibid.

simple and obvious, so bold and so sweeping in the immediate aftermath of the crisis in 2008', have turned out to be harder to implement than first expected.[11] Compounding matters is that 'so much' is being progressed 'at the same time.'

Andrew Haldane from the Bank of England caused considerable controversy among the banking regulators, although won 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.[12] 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 rough indicators of progress. 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' communiqués has been pitched at a very high level.

In order to assess progress towards establishing a safe and efficient financial system, more clearly articulated guidelines as to the type or structure of system being sought are required. In setting these revised benchmarks, the focus should not solely be on whether the new regulatory standards are being implemented, rather, there also has to be some basis to determine whether the standards are having their desired effect in restructuring the financial system.

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:

- less complexity and more transparency, where regulatory authorities and investors understand the location of risks and the way institutions are interconnected;
- institutions that are less dependent on leverage and thus less prone to boom and bust cycles;
- institutions with higher and better-quality capital and liquidity buffers that can better absorb shocks and losses;
- institutions that are not exploiting an implicit government guarantee and that are encouraged to properly price all risks;
- similar prudential standards that are applied to similar risks to avoid regulatory arbitrage; and,

[11] Ibid.
[12] Andrew G Haldane, *The dog and the frisbee,* 31 August 2012: http://www.bis.org/review/r120905a.pdf.

- systemically-important financial institutions that could be resolved in an effective and timely way.

The overall assessment by the IMF was that despite improvements 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 products 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 notes 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 needs 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 need to be understood, they need to be transparent and appropriately priced.

The IMF also points out that while some financial structures may be associated with both safety and efficiency, policymakers might also face a trade-off between the safety of financial systems and economic growth. The GFSR poses 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 actually promotes better economic outcomes.

To date, conclusions about the relationships between differing financial structures and economic outcomes are 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 fits 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 that is many multiples the size of the economy gets into trouble. Stephen Cecchetti from the BIS points out that there appears to be a relationship between a growing share of a financial sector within an economy and a slower overall economic growth rate.[13] Similarly, Cecchetti notes that financial globalisation might also only be beneficial up to a point, and the world may have passed that point.

[13] Stephen Cecchetti, *Is globalisation great? Remarks prepared for the 11th BIS Annual Conference,* 21 June 2012: http://www.bis.org/speeches/sp120625.htm.

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

In terms of assessing the impact of financial regulation, as opposed to its implementation, the November 2012 meeting of G20 finance ministers and central bank governors requested international organisations 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.[14] The FSB concluded that there was little tangible evidence to suggest that global financial regulatory reforms have significantly contributed to current long-term financing concerns. However, the report acknowledged that implementation was at an early stage and that the impact of the reforms needed to be monitored on an ongoing basis for further assessment. The report also recommends 'the regulatory community is vigilant to avoid material unintended consequences and to analyse potential impacts prior to finalisation of the reforms'.

While it is important that the regulators undertake such assessments, there is a valid question as to 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. 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, and 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 surrounding 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.[15] And as noted previously, the communiqué from the meetings of leaders and finance ministers and central bank governors cover, in significant detail, the FSB's work program. Moreover the new financial reforms are often attributed as originating from the G20.

One positive outcome 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.

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[14] FSB, *Financial regulatory factors affecting the availability of long-term investment finance: report to G20 finance ministers and central bank governors*.

[15] 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.'

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. Yet non-member countries of the FSB have expressed concern that they are expected to apply the FSB's financial standards, even though they are not members of the standard setting authority. The FSB's response has been to establish six regional consultative groups.[16] 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 as to whether the G20 is the appropriate political forum for overseeing international efforts at strengthening financial regulation and, moreover, if the G20 is even providing the necessary oversight of the FSB's activities. Accountability is a two way processes. The FSB provides 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 communiqués, G20 ministers and governors should have been focusing on '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 overseeing 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. These would include examining 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 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

[16] FSB regional consultative groups cover: the Americas, Asia, Commonwealth of Independent States, Europe, Middle East and North Africa, and Sub-Saharan Africa.

Committee (IMFC).[17] In essence it would be a combined G20 and IMFC meeting, but specifically focused on the issue of financial regulation. The chairs of the FSB and IMFC could jointly chair the committee. The secretariat of 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.

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 G20 finance ministers and central bank governors 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 overseeing international financial regulation, but there is also a question whether the G20 has in fact been providing the necessary oversight of the FSB itself. 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,* that combined members of the G20 and the IMFC, and that 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.

[17] 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.

Are the G20's financial regulatory reforms adequate?

Ross P. Buckley[1]

One of the most important decisions this century was when the G7, realising that it had neither the right nations at the table, nor the moral authority, to craft a credible response to the 2008 Global Financial Crisis (GFC), passed the baton of economic leadership to the G20.

As a regulatory response to the GFC, the G20 has done quite well. As a response to how profoundly the world of finance has changed in the past 40 years, the G20 reforms are more problematic. The avoidance of future major crises is likely to require an adequate response to the profound changes in finance since 1970, not merely a response to the specific factors that gave us the GFC.

The main reforms mandated by the G20 include:

- Strengthening capital adequacy rules: Basel III[2]
- Addressing 'too big to fail' by regulating systemically important financial institutions[3]
- Regulating the shadow banking system[4]
- Reforming over-the-counter derivatives principally by bringing them onto exchanges[5]
- Strengthening and converging accounting standards[6]
- Building a common legal entity identifier[7]
- Reducing reliance on credit ratings and improving oversight of credit rating agencies[8]
- Enhancing compensation practices[9]

All of these reforms are worthwhile. All matter. Many have lengthy implementation timeframes

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[1] CIFR King & Wood Mallesons Professor of International Finance and Regulation, and Scientia Professor, University of New South Wales. Sincere thanks to Nicola Edwards, Jessie Ingle and Rebecca Stanley for their research assistance. All responsibility is mine.

[2] Basel Committee on Banking Supervision, *Report to G20 Finance Ministers and Central Bank Governors on monitoring implementation of Basel III regulatory reform*.

[3] FSB, *Reducing the moral hazard posed by systemically important financial institutions: interim report to G20 leaders*. FSB, 2010. Also see *Chair letter sent to G20 ministers and central bank governors: progress of financial regulatory reforms,* 2013.

[4] *Overview of progress in the implementation of the G20 recommendations for strengthening financial stability,* 2012: http://www.financialstabilityboard.org/publications/r_120619a.pdf..

[5] Li Lin and Jay Surti, *Capital requirements for over-the-counter derivatives central counterparties*, IMF working paper WP/13/3, IMF, 2013.

[6] G20, *Cannes summit final declaration — building our common future: renewed collective action for the benefit of all,* 2011: http://www.g20.utoronto.ca/2011/2011-cannes-communique-111104-en.html. See also *Communique of G20 finance ministers and central bank governors,* 2013: http://en.g20russia.ru/load/781302507.

[7] FSB, *Fifth progress note on the global LEI initiative.* 2013: http://www.financialstabilityboard.org/publications/r_130111a.pdf..

[8] *Overview of progress in the implementation of the G20 recommendations for strengthening financial stability.*

[9] Ibid, p. 26.

and progress has been slow, in part because implementation is done by national authorities. However, few of these changes respond sufficiently to the profound changes in the system of the past 40 years and I believe we won't have a stable system until we adequately address these changes.

The profound changes in global finance since 1970

All of the changes to global finance since 1970 would fill a multi-volume treatise. This paper focuses on (i) the legalisation of financial gambling, (ii) the globalisation of the system, (iii) the rise in algorithmic and high frequency trading, and (iv) the fundamental changes in banks and bankers.

The legalisation of financial gambling

The *Gaming Act 1845* (8 & 9 Vict.c.109) in the United Kingdom made gaming houses illegal and gaming contracts unenforceable. Australia, the United States and Hong Kong had broadly similar legislation. For over a century, courts held that derivatives contracts (as they came later to be known) entered into by at least one party for hedging purposes were valid under these enactments, but derivatives entered to place a bet on the price of something were unenforceable.

From the 1980s onwards, legislatures began to exempt derivatives from the application of these laws.[10] In the United States, the Financial Crisis Inquiry Commission in its final report concluded that the enactment of the *Commodity Futures Modernisation Act* of 2000 'to ban the regulation by both the federal and state governments of over-the-counter derivatives was a key turning point in the march toward the financial crisis'.[11] A wide variety of parties had used derivatives to hedge or speculate, but 'without any oversight, OTC derivatives rapidly spiralled out of control and out of sight'. As Lynn Stout wrote, the enactment of the CFMA was a 'sudden and wholesale removal of centuries-old legal restraints on speculative trading in over-the-counter (OTC) derivatives',[12] that played a large role in the 2008 crisis.

The removal of derivatives from the purview of gaming laws was primarily because sophisticated financial market participants were thought to be able to protect their own interests — an assumption falsified by the GFC.

[10] Phillip Wood, *Set-off and netting, derivatives, clearing systems*, 2nd ed., Vol. 4, The law and practice of international finance series, Suffolk, Sweet & Maxwell Limited, 2007. For example, in the United Kingdom, see s63 of the *Financial Services Act 1986* (UK).
[11] Financial Crisis Inquiry, p. xxiv.
[12] Lynn Stout, Derivatives and the legal origin of the 2008 credit crisis, *Harvard business law review* 1 (1) 2011. P.21.

The globalisation of the international financial system

In 1970, capital controls blocked most capital flows between nations. Over the next two decades these controls were progressively dismantled, such that capital now moves freely between most countries. This liberalisation, coupled with the rise of computers and telecommunications, means that capital today is among our most globalised markets. Without these profound changes, the US sub-prime crisis would have remained domestic. Globalised markets have allowed pension funds in Norway and local governments in Australia to lose hundreds of millions of dollars on repackaged US home loans.

Keynes and White crafted a system in 1944 to promote international trade and keep finance national. If designing a globalised financial system, they would have created a global financial regulator, a lender of last resort, and a sovereign bankruptcy scheme — for no national financial system works without these institutions.[13] The current system of financial regulation involving the Basel Committee, BIS, FSB, and other institutions, is a soft-law response to the absence of a global central bank and financial regulator.[14]

The rise in algorithmic and high frequency trading

Algorithmic[15] or computer-driven trading accounts for about 70 per cent of US equity trading and 30 to 40 per cent of European and Japanese equity trading.[16] Algorithms also drive much of high frequency trading (HFT). Research suggests HFT tends to make exchange rates and stock and commodity prices diverge from those reflecting economic fundamentals, because short-term price runs fuelled by algorithmic trading programs accumulate to baseless trends and price distortions. The resulting over-shooting of prices favours speculators over longer-term investors and thereby feeds into ever-higher levels of trading.[17]

The change in banks and bankers

If a lawyer from 1970 were brought forward in time, much would be familiar. The manner of lawyers, the way they carry themselves, the way they are trained, the way they look backwards to find authority, has all changed very little.

Yet if a banker from 1970 were put in a modern investment bank, or in the investment banking arm of a commercial bank, much would be different. The manner of bankers, the way they carry

[13] Ross P Buckley, How the international financial system, to its detreiment, differs from national systems, and what we can do about it, *University of Hong Kong Law Journal,* 24 2004, pp. 321-338.
[14] Chris Brummer, *Soft law and the global financial system: rule making in the 21st century,* Cambridge, Cambridge University Press, 2011.
[15] Algorithmic trading uses high-speed computer programs to generate, route and execute orders.
[16] Thornton, p. 19.
[17] Stephan Schulmeister, *A general financial transactions tax: motives, effects and implementation,* Paper presented at the The Brussels Tax Forum, Brussels, 2010. See also, *Boom-bust cycles and trading practices in asset markets, the real economy and the effects of a financial transaction tax*, Working paper no. 364, Austrian Institute of Economic Research, 2010, p. 1.

themselves, the way they are trained, and the way they see the world, has all changed profoundly. You needed maths to run a bank in 1970, but it was primary school math. Today bankers are trained in highly mathematical finance and economics, or in maths and physics.

Bankers in 1970 were as prudent, cautious and dull as lawyers.[18] Until the 1980s, the traditional degree for a London banker was classics (Greek and Latin language and history). A background in classics, or having served as an officer in a good regiment, were considered good training for banking, as banking was perceived to be about prudence and judgment, qualities seen to be promoted by the study of history or through officer training.

Today an investment bank, or the investment banking arm of a commercial bank, is typically filled with ultra-numerate people with little knowledge of history or the humanities. In their worldview, markets and corporations exist primarily to produce profits, not to serve their customers and communities. Most of their remuneration is by way of an annual bonus, and they see the world through a quantitative/analytical lens, not a human one.

Furthermore, what a bank actually 'does' has changed profoundly. Banks in 1970 essentially intermediated money. They received deposits and made loans. In contrast, investment banks and investment banking arms of major commercial banks derive relatively little of their current income from financial intermediation, and far more from speculating on markets, underwriting stock and bond issuances, etc.

To reiterate, a banker travelling forty years into the present would not recognise much of what a bank does today. Indeed, as seen above, much of the business of a contemporary bank would have been illegal in 1970.

The G20 reforms as a response to the profound changes in the global financial system

All of the G20 reforms are worthwhile. Some, such as Basel III, were in train anyway, but even those that were not are still beneficial. A more significant question is whether the reforms address the fundamental changes in the system. The only ones on target to do this relate to credit rating agencies (CRAs) and remuneration, but the G20's proposals in these areas don't go far enough. The reforms actually needed are analysed below.

Reforms to credit rating agencies

The G20's proposed CRA reforms are inadequate. The fact that the issuer pays for the rating gives rise to a powerful and distorting conflict of interest. US Senator Al Franken has proposed to remove this conflict by authorising the Securities and Exchange Commission (SEC) to establish an independent panel that assigns the ratings of structured products (not of companies or sovereigns) to the CRA, the panel believed was best equipped to provide the rating. The financial incentive to provide a favourable rating to continue to get an issuer's business would thus be removed.[19] Moreover, if the G20 were serious about reforming CRAs, it would mandate

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[18] Susan Strange, *Casino Capitalism*, Manchester, Cromwell Press, 1997, pp. 1–2.

[19] Sarah N Lynch, *Bipartisan senators ask SEC for action on Credit Rating Agency pay,* Insurance Journal Online 14 May 2013: http://www.insurancejournal.com/news/national/2013/05/14/291912.htm.

a global requirement along these lines and then extend it to all ratings, not just structured products.

Banker remuneration

The G20's commitments to reforming banker remuneration were advanced by the Europeans, and have achieved most saliency in the EU in terms of scope, scale and implementation. The European Union has agreed to limit bankers' bonuses to a year's salary, or two years' salary with the approval of at least 66 per cent of shareholders holding at least 50 per cent of the shares. To encourage bankers to take a long-term view, a minimum of 25 per cent of any bonus exceeding one year's salary must be deferred for at least five years. EU countries need to implement the rules nationally by 1 January 2014. The agreement is designed to curb the culture of excessive bonus payments that encouraged risk-taking for short-term gains that contributed to the financial crisis.[20]

These changes come on top of the rules European regulators announced in December 2010 that require banks to defer at least 40 to 60 per cent of bonuses for three to five years and pay at least 50 per cent of bonuses in shares (rather than cash) and publish pay details for senior management and risk takers.[21]

Bonuses often represent 80 per cent or more of total remuneration. If shareholders approve bonuses of up to two years' salary, that will water down the effect of these changes, and if they hold the line, this will be a major change. Bankers will derive more of their income in fixed salary form, and less in bonus, which should encourage less risk taking.

The proposed remuneration caps are a step down from earlier restrictions that required at least one-half of bonuses to be paid in shares, deferral of the payment of much of the bonus for three to five years, and making bonuses subject to 'claw back' provisions. Nevertheless, the revised caps do represent a change if the regulators are sufficiently vigilant and insistent to bring them about, which would do much to change risk-taking behaviour. Given the culture of banks, refusing to pay a banker part or all of a deferred bonus - because assets they created or acquired prove to be of far less value than was anticipated - would be a major cultural change. With the two sets of bonus reforms that have been agreed upon, we may well see different banker behaviour in the EU in five years' time.

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[20] European Parliament News, *Parliament votes reform package to strengthen EU banks,* European Parliament 16 April 2013: http://www.europarl.europa.eu/news/en/pressroom/content/20130416IPR07333/html/Parliament-votes-reform-package-to-strengthen-EU-banks; Council of the European Union Press, *Bank capital rules: council endorses agreement with EP,* 5 March 2013: http://register.consilium.europa.eu/pdf/en/13/st07/st07088.en13.pdf.

[21] Committee of European Banking Supervisors, *Guidelines on remuneration policies and practicies,* 10 December 2010, p.60, 65.

Other potential G20 reforms to respond to the profound systemic changes

There are three other reforms the G20 could have mandated, had it wished to address the fundamental changes in the global financial system.

(i) Bank levies

The IMF recommends that governments impose a levy on the assets of their financial institutions. In its words, 'expecting taxpayers to support the [financial] sector during bad times while allowing owners, managers and/or creditors of financial institutions to enjoy the gains of good times, misallocates resources and undermines long-term growth.'[1]

France, Germany, and the United Kingdom imposed levies in 2011 to: (i) recoup some of the costs of bailing out their financial sectors in the wake of the GFC; (ii) accumulate funds so that future bailouts are funded by the financial services industry rather than taxpayers; (iii) shrink the size of financial sectors that are seen to have grown too large, in part due to being under-taxed; and (iv) discourage risky behaviour within those sectors. There is a strong argument that financial sectors in some countries are too large and profitable and consume a disproportionate amount of the financial and human capital in those countries.

Bank levies are an attempt to redress these issues, and will help. A financial transactions tax is another means of achieving the same end.

(ii) Global Volcker rule

Section 619 of The Dodd-Frank *Wall Street Reform and Consumer Protection Act* prohibits depository institutions and their affiliates from engaging in proprietary trading, acquiring or retaining an interest in a hedge fund or a private equity fund, or sponsoring a hedge fund or a private equity fund. These provisions (commonly referred to as the Volcker Rule, after former Chairman of the Federal Reserve, Paul Volcker) apply to proprietary trading and fund activities by US banks in any location. Some trading activity is still permitted, such as trading in government securities, in connection with underwriting or market making, on behalf of customers, or for the purposes of risk-mitigating hedging.

In response to the lobbying of the US financial services industry, the Volcker Rule has been needlessly watered down and made extraordinarily complex. Globally, the G20 could have required a simple rule that 'banks that accept deposits from the public cannot engage in proprietary trading,' coupled to a simple definition of proprietary trading. In law-making there is much to be said for simple fuzzy laws that leave the details to the courts. Fuzzy law deters much behaviour. Hyper-detailed laws of the type being written pursuant to the Dodd Frank Act allow clever lawyers to navigate their way around or through them. Such detailed laws in themselves are an indicator of potential regulatory capture.

This simple law would do much to stabilise the global financial system. Of course, this would require the United States to agree to implement a simple, clear-cut rule domestically in furtherance of the G20 directive, which is unlikely given the way that special interest groups

[1] IMF, *A fair and substantial contribution by the financial sector, final report for the G20,* 2010: http://www.imf.org/external/np/g20/pdf/062710b.pdf.

in the financial services industry have worked so hard to water down the effectiveness of the rule in the US.

(iii) Financial transaction tax (FTT)

A FTT is a tiny impost of perhaps between 0.01 per cent and 0.1 per cent on all wholesale capital market secondary transactions. It was first proposed almost 80 years ago by Keynes,[2] and resurrected 40 years ago for foreign currency transactions by Tobin.[3] Their thinking was that the essential function of capital markets is to intermediate capital effectively — to allocate it to the parties best placed to use it. In their view, such a tax would dissuade purely speculative, short-term transactions, while doing little to nothing to dissuade longer-term investments. Markets would thus be encouraged to trade more on economic fundamentals and less on what speculators believe the price for an asset will be in the next few minutes or hours. On this reasoning, the argument for a FTT is more powerful today than ever before.

In 2011 the European Commission voted to implement a FTT in 2018.[4] In January 2013, the EU voted to allow 11 countries to implement a FTT much sooner, possibly by early 2014. These countries are Austria, Belgium, Estonia, France, Germany, Greece, Italy, Portugal, Slovakia, Slovenia and Spain.[5] This tax will apply to trades of shares and bonds, and derivatives on shares and bonds, at rates of 0.1 and 0.01 per cent respectively. The tax base for derivatives is the nominal value of the underlying assets. The proposed tax will be levied according to the fiscal residence of the seller of an asset.

A FTT today is eminently feasible. When James Tobin suggested his tax on foreign currency transactions forty years ago, its implementation was highly problematic because most trading was conducted on proprietary systems. However trading has migrated to centralised exchanges and clearing houses that undertake the function exceptionally efficiently, and moving trades away from these exchanges and clearing houses would cost far more than the amount of the tax.

Indeed, when the IMF considered the administrative feasibility of levying a FTT in 2011, it concluded that a FTT 'is no more difficult and, in some respects easier, to administer than other taxes.'[6]

A FTT will have the effect of encouraging the simplification of transactions and thereby enabling securities regulations to be more effective. The complexity of many CDOs in the lead-up to 2008 defeated disclosure as an organising market principle. The cascading effect of a FTT — applying to multiple transfers that together comprise one transaction — offends some economists' sense of propriety, however if the G20 really wants to encourage accuracy

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[2] John Maynard Keynes, *The General Theory of Employment, Interest and Money*, Cambridge, Cambridge University Press, 1936.

[3] James Tobin, A proposal for international monetary reform, *Eastern Economic Journal* 4 (3), 1978, pp. 153-159.

[4] European Commission, *Proposal for a council decision on the system of own resources of the European Union*, 29 June 2011.

[5] Phillip Inman, EU approves financial transaction tax for 11 eurozone countries, *Guardian*, 22 January 2013: http://www.guardian.co.uk/business/2013/jan/22/eu-approves-financial-transaction-tax-eurozone?INTCMP=SRCH.; John Dizard, Trouble brews over EU transactions tax, *Financial Times*, 12 April 2013: http://www.ft.com/intl/cms/s/0/817af53a-9b7c-11e2-8485-00144feabdc0.html#axzz2QslZc1oN.

[6] John Brondolo, *Taxing financial transactions: an assessment of administrative feasibility*, IMF Working Paper 11/185, IMF, 2011.

in pricing and thus promote the most important form of market efficiency - *allocative* efficiency, a FTT is the way to go.[7]

The debate on an FTT in Asia has been far less extensive and vigorous than in Europe.[8] Nonetheless, in the past few years the idea has gained some traction. In early 2013 the South Korean government discussed imposing a modified Tobin tax on foreign currency transactions to limit speculative inflows of foreign capital.[9] The proposed model was a Spahn tax — a tax at very low rates in normal times, but rises dramatically with extreme fluctuations in the value of the currency. At the time of writing, it seems that there is general consensus in Korea that such a tax should be implemented if speculation in the won intensifies, and that the threat of such a tax is itself having a salutary effect in dampening speculation in, and appreciation of, the won.[10]

Xia Bin, of the Monetary Policy Committee of the People's Bank of China, has been reported as having written, 'China should continue to strengthen its regulations on capital inflows to fend off the risks produced by hot money.'[11] He suggested 'the government impose a 'Tobin tax' type levy on all spot conversions of one currency to another, to penalise short-term financial 'round-trip' excursions into other currencies.'[12]

In 2010, Foreign Minister Katsuya Okada of Japan proposed politicians internationally should consider a tax on international finance in order to help support developing nations, and Deputy Finance Minister Naoki Minezaki said Japan should consider implementing a FTT to dampen speculative capital flows and market volatility.[13]

So the idea of a FTT, in its various guises, is now part of the debate in the region, although it will take decisive leadership in more than one nation to see its implementation.

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[7] Ross P. Buckley, and Gill North, A financial transaction tax: inefficient or needed systemic reform? *Georgetown International Law Journal,* 43 (3), 2012.

[8] Young-Chul Kim, Understanding the silence amid turmoil: the Tobin tax and East Asia, In *New rules for global finance coalition*, edited by Jim Weaver, Randall Dodd and Jamie Baker, 2003, p. 135.

[9] Editorial, Curbing currency volatility, *Korea Times,* 2013: http://www.koreatimes.co.kr/www/news/opinon/2013/02/202_129932.html;
The Korea Times, *S Korea's new finance minister cautious on adopting Tobin tax,* 24 March 2013: http://www.koreatimes.co.kr/www/news/nation/2013/03/116_132622.html. Vidya Ranganathan, *Korea becomes the red flag for Asia's currency war,* 1 February 2013: http://www.reuters.com/article/2013/02/01/markets-currency-war-idINDEE91003520130201. Yoo Seugnki, *S. Korean president-elect Park stresses currency stabilization,* Xinhua News Agency, 3 April 2013: http://news.xinhuanet.com/english/world/2013-02/20/c_132181100.htm.

[10] Carla Bain, Won bets ease as South Korean calls for transaction tax escalate*, Bloomberg,* 3 April 2013: http://www.bloomberg.com/news/2013-04-03/swaps-exemption-libor-delay-brazil-swaps-compliance.html.

[11] Xiaotian Wang, Safe promises crackdown on 'hot money', *China Daily,* 5 August 2011: http://www.chinadaily.com.cn/cndy/2011-08/05/content_13054240.htm. Joy C. Shaw and Rose Yu, Adviser mulls Tobin tax, *Wall Street Journal*, 25 November 2010: http://blogs.wsj.com/marketbeat/2010/11/25/pboc-adviser-mulls-tobin-tax/.

[12] Wang, *Safe promises crackdown on 'hot money'.*

[13] Edmund Conway, 'Robin hood' bank tax wins backing of Japanese foreign minister, *The Telegraph,* 2 March 2010: http://www.telegraph.co.uk/finance/newsbysector/banksandfinance/7352791/Robin-hood-bank-tax-wins-backing-of-Japanese-foreign-minister.html.; Toru Fujioka, Japan should impose taxes on financial trading Minezaki says, *Bloomberg*, 17 February 2010: http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aOYvwYcuJD5I.

Conclusion

In Joe Stiglitz's words,

> Financial markets are not an end in themselves, but a means: they are supposed to perform certain vital functions which enable the *real economy* to be more productive: (a) mobilising savings, (b) allocating capital, and (c) managing risk, transferring it from those less able to bear it to those more able.[14]

The GFC was a direct result of treating the creation of financial products as an end in itself — as a valuable driver of economic growth independent of the products' effects.

The G20's reforms are worthwhile, necessary and helpful. Most are a long way from full implementation, and after five years that is disappointing. However, it is likely the reforms are insufficient to avert another global crisis in their present form. Levies on banks, real reforms of banker compensation, removal of the conflict of interest that compromises all credit ratings today, and a financial transactions tax, taken together, would do the job. Collectively, these policies would facilitate a model of banking that is less profitable and far less crisis-prone than it is today, and the individual incentives of bankers would be far better aligned to those of the real economies in which the banks do business.

[14] Joseph Stiglitz, *Principles for a new financial architecture,* The Commission of Experts of the President of the UN General Assembly on reforms of the international monetary and financial system, 2009.

Whither the G20 and the FSB? The 2014 agenda

Steven Bardy[1]

Introduction

The post-crisis regulatory architecture has seen a significant change in the role and standing of securities regulators globally, particularly the International Organisation of Securities Commissions (IOSCO).

Before the Crisis, IOSCO was seen as providing guidance and standards, bringing together and summarising regulatory approaches at both national and regional levels. It had a limited profile outside of the securities regulatory community.

The crisis — and the architecture established around the FSB and the G20 — has changed this. IOSCO played a key role in responding to the crisis by providing policy guidance and standards in new areas of regulation. Examples include OTC derivatives regulation, the regulation of financial markets infrastructure, the regulation of commodity futures markets, oil price reporting agencies and the regulation of shadow banking (for instance, securitisation and money market funds). Each of these initiatives was either taken at the request of, or in conjunction with, the FSB or the G20. IOSCO is, as a result, now seen by policy makers as — and indeed sees itself as — a standard setter for financial services and market regulation.

The benefits of the new architecture

The new regulatory architecture has also led to important changes in how standards and guidance are developed. Specifically:

- There has been a marked improvement in the speed with which IOSCO has developed standards and guidance. The creation of the FSB has increased the amount of pressure to develop guidance and standards in significantly tighter timeframes than had been IOSCO's practice.

- There has also been greater pressure to develop more granular and useable guidance and standards than had been IOSCO's practice. An example is the 'Principles for Financial Markets Infrastructure' and related methodology;

- It has provided a platform for IOSCO to engage on a regular basis and cooperate with standard setters from other sectors in developing cross-sectoral responses. Examples have included the financial regulatory community's work on securitisation, OTC derivatives, Financial Market Infrastructure, identification of systemically important institutions and (more generally) shadow banking;

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Opportunities for improvement

The basic parameters of the current architecture and how it operates are sound — although some concerns remain which key financial regulators believe should be addressed.

Concerns to be addressed include the following -

- Respecting the roles and responsibilities of Standard Setting Bodies (SSBs): concerns remain about the FSB extending its coordinating and oversight role into standard setting in areas that are the traditional remit of the SSBs. The work on global systemically important banks (GSIBs) and shadow banking are examples. The FSB should respect — and not seek to replicate — the expertise of the SSBs.

- Scope creep: concerns also remain that the FSB is moving beyond its financial stability mandate. Initiatives in the audit and consumer protection have been recent examples;

- Effective G20 oversight: although the G20 has provided both the FSB and SSB's with useful and appropriate guidance, it has tended to act as an uncritical rubber stamp of the FSB's work. It should aim to challenge the FSB in the work it does;

- Ensuring the case for action is carefully made out — before initiatives are taken: the FSB has an important role to play in challenging the need for regulatory action and undertaking a high level cost-benefit analysis before work is started. This should also apply to initiatives proposed by the G20. This will assist in managing unintended consequences.

- Understanding the cumulative impact of SSB initiatives. The FSB's work to date has played little heed to the need to understand the impact of the SSB initiatives it oversees — as those initiatives are being undertaken. The FSB is well positioned to monitor and assess cross-sectoral impacts and should do so. It is one thing to explore the impact of initiatives after they have been taken. It is quite another to monitor those impacts as initiatives are designed. The FSB should work with SSBs to ensure engagement through the development and guidance of standards.

- Improved engagement with industry. One of IOSCO's great strengths is the way it engages with the regulated population. Industry's views are an important input into every IOSCO project, with views being expressed through formal consultation processes and through industry round tables. IOSCO has also recently developed and refined processes for dialogue at a strategic level, including periodic stakeholder consultation meetings and participation by industry leaders in roundtables preceding our Board meetings. FSB would benefit from similar ongoing dialogue processes with industry representatives. Industry has expressed concern that it has only been able to engage with the FSB at the late stages of developing guidance and standards. It has had little say into whether and how particular projects are undertaken. Industry argues that the absence of consultation contributes to a lack of pragmatism in FSB proposals.

The 2014 agenda

The Agenda for next year should be about consolidation and refocus. Rather than pursuing new initiatives we should take a deep breath and reflect on the work done to date. Specifically:

- We should focus on supporting **orderly implementation** of work to date. The FSB should act as a forum and provide guidance about how the implementation of global standards, at national and regional levels, is knitted together. This will involve building on the monitoring work already in train, but also developing guidance and approaches to how national laws, that won't always be the same, can work together.

- We should **review the work we have done** to date. We need to assess the cumulative impact of our work and adjust and tweak it to address any unnecessary burdens.

- We should **review how we do our work**. We need to ensure early impact assessments are a key part of international standards and policy development.

- We need to think about **balancing our focus on stability with the economic impact of our recommendations**. G20 and FSB processes also need to recognise the role capital markets can and should play in building recovery as an adjunct or alternative to finance sourced through conventional banking channels.

The financial sector's role in Asia-Pacific growth

Graham Hodges

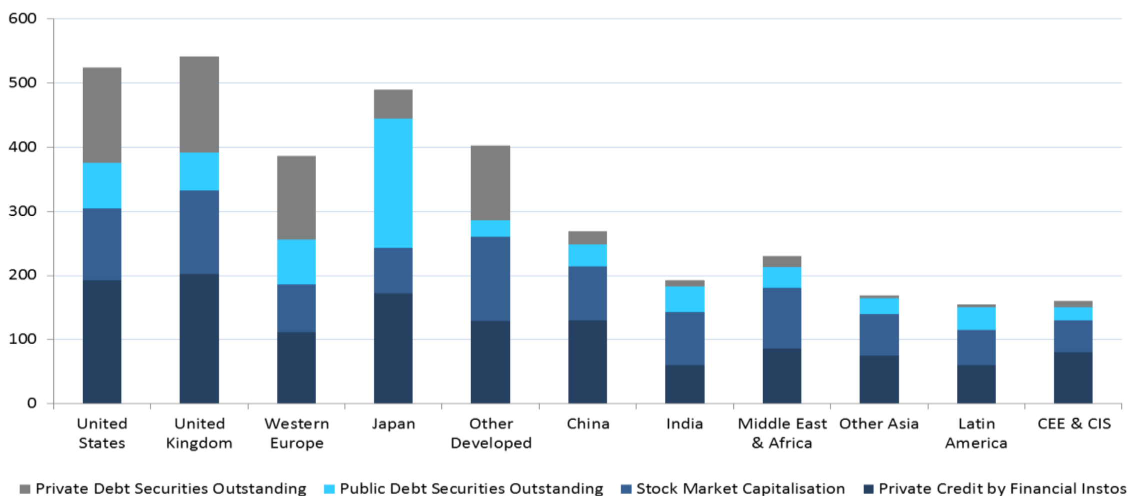
Background

A major focus of the G20 since the 2008 crisis has been the strengthening of financial regulation through the work of the Financial Stability Board (FSB) and the International Standard Setting Bodies. A driving influence behind this regulation has been the experience of the United States and Europe. While consistency in the implementation of strengthened standards is important and regulatory arbitrage should be avoided, it is important that the challenges and pressures confronting other financial systems are appropriately recognised. The Asian financial system proved resilient through the 2008 global financial crisis. Yet it faces many on-going challenges and it will be important when Australia chairs the G20 in 2014 to ensure that the challenges facing financial systems outside of the US and Europe are taken into account.

Asia is set to become the world's largest economic region, accounting for nearly 40 per cent of global GDP, by 2030. The economic ascension of Asia has been clearly evident over the past decade, especially in the period following the global financial crisis. Less attention has been paid to the significant underdevelopment of the region's capital markets, which have lagged the growing real economic weight of the region. In capital markets, Asia is punching well below its economic weight.

The structural gap between the real and financial sectors in Asia became particularly pronounced after the 1997 Asian financial crisis. In particular, it largely brought to an end the process of financial deepening which generally accompanies real income growth. As governments implemented restrictive monetary and fiscal policy regimes and clamped down on capital outflows, investment ratios collapsed across the region. Increasing foreign reserves saw authorities invest surplus savings outside of the region, contributing to a period of financial over-deepening in the world's major developed markets. Despite the region's economic growth, governments have been slow to unwind the Asian financial crisis policy responses and adopt a more liberal stance to capital and investment flows.

Assessing financial depth ratios globally, there are clear discrepancies. With the exception of China and India, Asia's financial markets are shallower than those of the Middle East and North Africa. If not addressed, this relatively shallow financial depth will increasingly become a barrier to sustaining the current pace of regional economic development. It is important that the implementation of new regulatory financial standards do not stand in the way of the deepening of Asian financial markets.



The banks of the United States and Europe have been deleveraging in the aftermath of the global financial crisis. Asian financial sectors will need to replace these sources of funds, reducing their dependence on the developed capital markets as they accelerate the process of 'catch-up' financial deepening that is now underway.

One of the key structural dynamics that has held back financial deepening in the region has been the incomplete liberalisation of regional capital accounts. These restrictions on both inward and outward capital flows have effectively ‘locked up’ rich pools of savings accumulated over recent decades in each economy. In turn this has hindered the development of both deeper domestic and more integrated regional capital markets.

Successfully developing capital markets will require significant policy reform in the region and there will be many challenges to overcome. At the same time, Asia will be in the process of implementing the new regulatory standards agreed by the FSB. Over time Asia will need to move away from strong central government controls and bank-dominated financial systems if capital markets (especially debt and equity) are to flourish. The opening up of the Chinese capital account will be a crucial step in the process of financial deepening. Just as China’s economic ascension to the World Trade Organisation was a real-sector supply side shift, the opening up of the Asian capital account will be a profound financial-sector supply-side shift that significantly deeper financial markets regionally will be required to absorb. Within that deepening, we can expect a dramatic pick up in intra-regional capital flows.

The opportunities are enormous. If Asia can implement the necessary reforms, it will become home to a growing number of the world’s financial centres and a number of its financial institutions will be global champions by 2030. An implication of this is that Asia should play a larger role in the setting of international financial regulation.

Opportunities and challenges

The promise of the Asian Century is only likely to be fully realised if Asia deploys its own savings at home and that it does this more efficiently and for higher return than the current ‘outsourcing’ of intermediation allows. Based on some simple observations and extrapolations, ANZ’s projections for Asia’s capital markets include the following:

- If Asia's trend growth continues then some three billion additional Asians will become affluent by 2050. The intermediation of future income (credit) and past income (savings) that will be required by the region's retail banking sector is very significant.
- China's equity market capitalisation could outstrip that of the US by 2030.
- For emerging Asia, equity market capitalisation under a high growth and financial deepening scenario could also eclipse the US by 2030.

The revenue opportunities for financial intermediaries are enormous, including through primary equity issuance and similar opportunities in corporate debt underwriting and regional government bond markets.

Before any of these spectacular projections can be realised, there are many actions that will need to be taken to enable financial market development and build depth and resilience. While this process will take time, some of the more immediate issues that should be addressed include:

- **Debate and agreement across the region at a political and policy level about how it will coordinate medium term policy convergence to achieve a pan-Asian path to development and liberalisation:** there are several bodies within the region successfully advocating change but harmonisation would benefit from greater cooperation among countries that have traditionally been regional competitors. The region should increase its collective voice in such international forums as the G20 and FSB.
- **Improved prudential oversight, corporate governance and the rule of law:** as many commentators have already noted, standardisation of regional policies and markets starts with establishing basic property rights (such as a fair and efficient judiciary, enforcement, rights of ownership and insolvency), improved market knowledge and information including development of credit bureaux, clear and transparent standards, rules and laws for accounting, reporting, disclosure, etc. For a number of Asian economies, strengthening these components will be their top priority.
- **Liberalisation of managed exchange rate regimes and capital controls across the region:** while the management of exchange rates and capital flows has helped insulate domestic economies in times of stress, they will impede regional cooperation and investment flows. Recent steps to liberalise the RMB are therefore welcome and further policy loosening in key currencies and markets needs to be supported.
- **Consistent application of Basel rules across regional jurisdictions:** this will encourage cross-border financing while minimising unnecessary complexity, which increases costs and operating and credit risks.
- **Deregulation of interest rate markets:** this will support investor confidence and economic activity. This reform process has to be accompanied by greater policy transparency and central bank independence to aid decision-making and guard against the creation of economic 'bubbles' in asset or financial markets.

Typically, the sequence of financial deepening starts with the banking sector, then moves to equity, and finally debt. It is the government and private bond markets that are particularly under-developed in Asia and this must be addressed as a matter of urgency.

At the same time, regulatory changes such as Basel III have increased the need for better functioning bond markets. Banks in compliant jurisdictions must now hold more capital (carry greater capital costs) for longer tenor lending. Banks will therefore be less able to fund

long-dated projects such as infrastructure development, or will increase the cost of that funding. With equity funding already a significant component of total financing (and even more costly) the big opportunity for competitively priced funding is through the development of diverse, liquid and flexible capital markets. And these funds will increasingly come from within Asia - from individuals, corporates and from the growing pools of pension and social security funds.

Likewise, pragmatic application of Basel capital rules to trade and IOSCO requirements for derivatives will be important to facilitate growth and prudent risk management by the regions' banks and corporates.

Another challenge is the speed with which reform must take place. Asia is currently in a demographic 'sweet spot' and will not stay there much beyond 2025. It is home to the largest, oldest and youngest economies in the world. There is plenty of opportunity for intra-Asian capital flows, given that the countries are so diverse demographically. Open capital accounts will speed up the relocation of production from fast aging (surplus investment/infrastructure) to slower aging (sparse investment/infrastructure) economies with the regional reallocation of surplus savings boosting regional welfare.

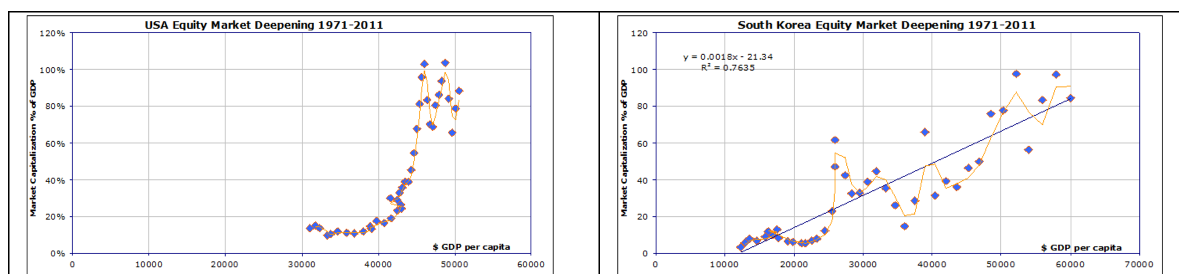
As real incomes converge across the region and it becomes generally richer, it is also worth noting that higher income economies tend to hold each other's financial assets whereas developing economies do not. This demographic and savings diversity gives Asia the greatest potential for regional financial integration among regions across the world, but the demographic projections suggest that this potential diminishes after 2025.

Without continued progress on these reforms, the savers and investors in the region will remain detached, leading to too great a reliance on the banks of the developed world and insufficient risk capital in the region. In short, the needs of the region could be better met from within the region itself, provided its capital markets are sufficiently open and safe.

Policy & markets' responses

Asia is an extraordinarily diverse region with different countries at very different stages of development. This must be taken into account when it comes to implementing strengthened regulatory standards. While it is difficult to expect each country to enact the necessary reforms at the same pace, it is reasonable to assume that the early adopters of more open financial systems will benefit enormously and provide role models to encourage others along a similar path.

The process of financial deepening is underway in many parts of Asia and we believe that further progress will occur sooner than popularly thought as financial globalisation has lowered the per-capita income tipping point. The deepening of the US financial markets appears to have taken off at income levels of around $40,000 per capita. A decade later, Japan's financial markets deepened with income levels around $35,000 per capita. A decade later still, South Korean financial deepening occurred with income levels of $30,000 per capita. Over the course of the 2000's, China's markets deepened when income levels reached $15,000 per capita and most recently Indian and Indonesian financial market deepening appears to be occurring with income levels below $10,000 per capita.



Another cause for optimism is the fact that a number of coordinated regional initiatives have been enacted, such as the APEC infrastructure fund, the Asian Bond Market Development and the Chiang Mai Initiatives. More of these initiatives will be needed to meet the challenges. One stark way to demonstrate the importance of a regional approach is to pose the question: If China opened its capital account tomorrow, would Asian financial markets be able to absorb this enormous pool of savings without causing significant dislocations in regional and global capital markets? The answer is no. There has to be a fundamental financial deepening process right across Asia that quickly builds world-leading financial centres and capital markets.

Regional integration will be crucial. First and foremost, it will cement the region's hard-won economic gains in the face of vulnerabilities to global shocks. Over the longer run, it will allow the varying capital requirements of each economy (given highly variable savings rates based on different demographic profiles) to be met by Asia itself, rather than exclusively by the rest of the world. Finally, the growth of a deep pan-regional financial services industry will be a vast conduit for the services' share of GDP to rise and assist the fast-growing converging economies in avoiding the Middle Income Trap.

Implementation

The savings of Asia have largely been channelled to the United States, financing its huge current account deficit, via the purchase of dollar denominated assets such as US Treasuries. The funds have returned to Asia through US direct and portfolio investment.

The challenge for Asia is to foster domestic financial markets and regional financial integration to intermediate Asia's savings within the region attracting foreign investment in instruments denominated in Asian currencies. This is the best outcome, reducing Asia's reliance on foreign currency borrowing and the region's exposure to maturity and currency mismatches.

The path to this optimal outcome is very likely to be marked by stops and starts, given the extreme aversion of policy-makers to destabilising capital flows. Just as the economic literature notes the positive contribution deep financial markets make to growth, the literature is equally adamant that financial development, in particular 'financial openness', may increase a country's vulnerability to crises. This has perhaps seen policy makers and regulators tread too cautiously on financial deepening when we would suggest that it is the creation of deep and liquid regional markets which will add to and enhance macro-economic and financial market stability by the simple process of reducing the reliance on foreign capital which recent and historical experience has shown can be flighty and volatile.

A pan-regional, co-ordinated approach needs to be adopted in the spirit of the Chiang-Mai Initiatives. National capital market development plans should provide for future regional

market integration, with common regulatory and operating standards and a particular focus upon the following:

- Formal ‘coordinating and implementing’ structures;
- Strategies for regional financial market integration;
- Market consultation;
- Transparent policy-making processes;
- Harmonisation of securities market regulation in line with international standards and best practice; and
- An agreed set of core principles.

The process to achieve these reforms is complex and must involve both private sector and governments. Gaining wider access to national markets should be negotiated at the political and official level, and steadily phased in over time. Even at the national level, the level of coordination required is substantial.

Beyond the policy reforms to be enacted by the relevant regulator, central bank and finance ministry, the development, infrastructure and justice ministries will, in nearly all cases, also need to be heavily involved in legislative programs. For instance, issues such as the rule of law, identified above, can only be addressed by justice departments.

As noted, the official sectors will not bear the reform burden alone; there is a key role for the private sector in the process of financial deepening, in building capacity and in shouldering the responsibilities of good governance and disclosure that must accompany market reforms. Best practice behaviour post the global financial crisis should guide policy reform. We have already highlighted debt markets in Asia as the most immature sector, and banks, among others, must play a role in encouraging the development of these markets through their client networks and product offerings.

With these things in mind, Asia can seize the tremendous opportunities that lie before it.

We must keep meeting like this: summary of regional 'Think 20' seminar

Hugh Jorgensen

Introduction

Over 22–24 May 2013, the G20 Studies Centre at the Lowy Institute, in conjunction with the Asia Development Bank Institute (ADBI) and the Korea Development Institute (KDI), hosted a regional Think 20 seminar in Sydney titled 'The G20 leaders' process five years on: an assessment from an Asian perspective.'

The seminar, held under the Chatham House rule, brought together representatives from think tanks and universities from around the Asian region. Australian G20 officials and representatives from the Russian G20 Sherpa's office — responsible for coordinating this year's G20 — also attended the seminar.

How or whether the G20 can transition from 'crisis management-forum' to an effective 'global governance steering forum' underpinned much of the discussion. In this regard, participants reflected on the G20's evolution as a 'premier forum for global economic cooperation' since the first leaders' summit in 2008, on progress towards commitments made at G20 leaders' summits, and on whether the G20's priorities should be more inclusive of perspectives from the Asian region.

On the G20's role as a 'premier forum for global economic cooperation'

Although the G20 proved to be a successful venue for coordinating macroeconomic stimulus measures in the immediate period after Lehman brothers' collapse, the urgency and resolve of G20 members to also pursue long-term policy coordination appears to have waned. Seminar participants considered the reasons why the G20's momentum had slipped (or whether this was merely a matter of perception), as well as various ways in which the G20 could be 'reinvigorated' as a 'premier forum for global economic cooperation.'

For example, on the G20's commitment to redressing global economic imbalances, it was suggested that the G20 might gain traction by spending less time on what constitutes an acceptable metric of fiscal surplus or deficit, and more time on tackling the actual structural impediments to debt and deficit consolidation within and between G20 countries. However, there was some debate as to whether a granular approach to rebalancing would require a formal G20 backed mechanism capable of pressuring non-compliant countries, and if so, whether a more realistic and discretionary form of coordination built around indicative guidelines is actually better suited to an informal forum like the G20.

The issue of perception versus reality with regards to the internal dynamics of the G20 was a contentious one, particularly on whether G20 members are divided within the forum according to their status as an advanced (G7) or an emerging economy (BRICS), or whether G20 members in fact engage on a more issue-specific basis — for instance, such as whether they are a surplus or deficit economy when it comes to discussing global imbalances.

Regardless, given the G20's exclusive membership, participants agreed that the G20's credibility depended on the forum being — and being perceived to be — a more consistently

effective forum of global economic governance. In this regard, several participants suggested the G20 would benefit by better incorporating the historical experience of *non-G7* countries (from both within and outside the G20), in dealing with post-crisis structural reform, so as to enhance the willingness of non-G7 G20 members to invest more time and energy into the forum, and thereby enhance its legitimacy. Being more inclusive of the knowledge and experiences of small countries - the 'canaries in the coal mine' of the global economy - was raised as one potential avenue for further exploration, as small states like Singapore depend heavily on stable global economic governance, and arguably have an incentive to work more closely with the G20.

The response of countries and institutions within Asia during and after the Asian Financial Crisis (AFC) was highlighted as a 'case-study' from which the G20 could learn. Several participants noted the increasingly high level of economic integration between Asian countries post the AFC that has been facilitated by regional free trade agreements (FTAs), the Association of South East Asian Nations (ASEAN), the ASEAN+3 and Chiang Mai initiatives. Although such institutions and initiatives are often criticised for replicating the work of broader-based multilateral bodies such as the WTO or World Bank, it was felt by many that this 'duplication' might actually be positive in that it increases the 'institutional space' in which key-decision makers are able to hammer out consensus on contentious but important issues. The role of the ADB in promoting infrastructure investment in Asia, in conjunction with the World Bank, was put forward as one such example. Accordingly, it was suggested that there might be similarly mutually beneficial gains to be made by linking the G20 agenda more effectively with the work of these regional bodies - possibly bolstering the political legitimacy of both processes.

In light of the above, consideration was also given to how Australia's G20 presidency in 2014 might be able to build upon the Seoul G20 Summit of 2010. Seoul was notable in that it represented the first G20 leaders' summit to have been hosted in an emerging economy, as well as in Asia. The Korean hosts sought to build upon this symbolism by actively working to promote the influence of emerging market and developing economies (EMDE) in forming the G20 agenda, and also through pursuing greater representation for EMDEs within key international financial institutions — most publically through IMF quota reform. It was noted that while a number of objectives from the Seoul summit remain a work in progress, Australia's presidency represents a potentially significant opportunity to 're-energise' objectives of the 2010 Korean hosts, namely: boosting Asian and EMDE participation in the G20, utilising 'knowledge networks' like the 'Think 20' to bolster the work of the Troika, and delivering more focused and shorter communiqués.

Progress towards commitments made at previous G20 summits

The seminar also saw participants engage in a progress assessment of key commitments within the G20 agenda, particularly those relating to the 'framework for strong sustainable and balanced growth' that leaders approved at the 2009 Pittsburgh Summit. Specifically, analyses were offered on the G20's Mutual Assessment Process (MAP), its efforts at reforming the international financial architecture and international monetary system, financial regulatory reform within G20 members' markets, as well as the G20's role in promoting international trade, investment and sustainable development.

Views on the success of the MAP were mixed. A handful of participants regarded the MAP as an essential component in the G20's efforts at staving off a second great depression — by

galvanising financial reform within certain G20 member states, as well as greater cooperation between G20 economies, the MAP was identified as a useful tool for comprehending structural issues at the basis of macroeconomic imbalances. However, most participants agreed that the MAP left much to be desired. The slow recovery from the global financial crisis, record levels of unemployment, and persistent currency misalignments all suggest the incentives for major economies to speedily and diligently comply with their MAP commitments remain unsatisfactory.

Other attendees viewed the MAP's implementation more harshly, noting that where evidence of global rebalancing between 2008-2011 was discernible (in data provided by the IMF's world economic outlook), it was mostly the result of cyclical factors, such as the decline in global demand and varying rates of currency appreciation, rather than the outcome of any serious structural reform instigated by the MAP. Moreover, even where the MAP does address imbalances, its methodology is not as well aligned to contemporary trade practice as it could be, as it still uses balance of trade figures based on total 'end product' value — rather than the actual value-added contributions of each country to products that, realistically, are now 'made in the world.' However, it is difficult to get G20 countries to agree on any process that relies upon 'naming and shaming' intransigent countries. Hence, absent of any independent global arbiter on matters relating to current account and currency misalignments, the G20 and initiatives like the MAP remain a substantially useful venue for at least debating what is and what is not possible in terms of potential cooperation on these issues.

Echoing earlier discussions, several participants pointed to the opportunity that the G20 had to revitalise the international financial architecture (IFA) by backing an increased role for Asia within core institutions like the IMF. Yet it was also noted that this would require a concerted reciprocal effort from the Asian countries to 'speak up.' While there is an apparent desire among Asian states to retain their privileged position within the G20, many discussants conceded there was, to date, a hesitancy and tentativeness in the way Asian representatives had engaged with the forum.

This is perhaps not surprising - much of the post 2008 agenda for the G20 has reflected the experience of governments and financial institutions in North America and Western Europe, in a way that is not as well matched to their Asian counterparts, who face a different set of circumstances and challenges. Yet a continuation of this trend may lead to a dwindling interest in the G20 from Asia, and exacerbate the drift in global economic governance away from multilateral economic institutions towards a more fragmented system of regionally focused cooperation. However, as the world's foremost region of economic growth, the future legitimacy of the IFA is arguably dependent on securing Asia's resolute backing, and this is an area where the G20 can make a real contribution.

Further food for thought for the G20

Trade and development are two areas where the G20's credibility hangs in the balance. With regards to trade, the declining resolve of the G20 to realise the Doha development agenda (DDA) is evident in an analysis of G20 leaders' communiqués: at the 2009 summits in London and Pittsburgh, leaders committed to an 'ambitious and balanced conclusion' of the DDA and set a deadline for 2010; by 2012, with the self-imposed deadline clearly unmet, leaders merely consented to 'continue to work towards concluding the DDA.'

Hence, although the standstill on protectionism agreed to by G20 leaders at the 2008 Washington summit appears to have forestalled a repeat of depression-era protectionism, making an actual *positive* contribution to the multilateral trading system will likely require a concerted restoration of trade to the 'heart' of the G20 agenda. Whether this 'renewal' of the trade agenda is sought through resurrecting the DDA (or at least Doha-lite), an updated trade round that is better matched to the 21st century economy, or accepting and accommodating the devolution of the multilateral system to regional agreements like the TPP and TTIP, is a matter for debate.

Regardless, as many participants noted, growing awareness of the role of global value chains, the turn towards regional and preferential trade agreements, and the incorporation of China into the global trading system, have significantly altered the practice of international trade and the channels through which it is conducted since the DDA was launched. The key point for the G20 is that its own reputation, and that of the WTO and the multilateral trading system in general, depends on the forum being able to produce a clear and well-articulated position on these issues sooner rather than later.

Participants also sought to assess whether the underlying principles of development within the G20's 'framework for strong sustainable and balanced growth' were adequate. For example, whether the G20 was sufficiently inclusive of the demographics and countries that are subject to its commitments on development was a matter of contention. Many felt the G20 could do a better job of incorporating the views of major developing countries like China and India in the G20's development working group, as well as the domestic-level experiences of countries like Indonesia in the area of infrastructure investment. Precisely how the G20 could value-add to issues like the post-2015 development agenda, labour mobility and enhancing opportunities for women in a non-superficial way was also cause for debate. The main suggestion put forward was that the G20 should start with a principle of 'do no harm' on these objectives, and then proceed to more effectively integrate them into the broader G20 agenda in a strategic and comprehensive fashion, rather than simply create new working or study groups on development issues and thereby exacerbate G20 'mission creep' or 'bloat.'

Conclusion

To date, the incorporation of the experiences and voice of Asia within the G20 has not been commensurate with the economic weight of the region, and this has been to the detriment of the G20 agenda's relevance and inclusiveness. In this regard, the regional think 20 Seminar highlighted the need for the G20 to develop a more focused agenda and a more clearly articulated understanding of its own role with respect to the multilateral institutions of global economic governance — not least those in Asia. More broadly, seminar discussions about the various policy 'streams' of the G20 process also emphasised the importance of maintaining an integrated and holistic understanding of the G20 agenda and how (or whether) it relates to the domestic experience of *all* its members in a meaningful way.

Ultimately, from trade to financial regulation and from current account imbalances to fighting unemployment, all G20 members have an incentive to regularly step back from the 'institutional minutiae' of the G20 process and assess whether the forum itself, and global economic governance more generally, is headed in the right direction, or in need of recalibration. This was the objective of the regional Think 20 seminar, and it is hoped that the discussion started in Sydney will be an ongoing one throughout Australia's presidency of the G20 and beyond.

Contributors

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