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POLICY BRIEF

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Ensuring Equitable Reform in Global Financial Governance: Lessons from Recent History

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In the five years since the outbreak of the global economic crisis, policymakers have made extensive efforts to strengthen the regulation and supervision of the international financial system. Despite the strong political will behind these efforts, however, global financial rules continue to favour the very same large private-sector institutions whose reckless behaviour was at the heart of the crisis. This policy brief asks: How can policymakers ensure that reform of the international financial architecture is *equitable* – that is, it reflects the interests of a wide range of public and private stakeholders? In addition to large financial institutions, key stakeholders include consumer groups, national regulatory bodies, international organizations, and – often overlooked – competing private-sector actors such as community lenders and emerging market banks. Equitable reform is not only desirable from a normative perspective. As the crisis has powerfully illustrated, regulation that solely reflects the interests of a narrow range of private-sector interests is unlikely to provide the basis for a robust and resilient global financial system. Drawing on lessons from recent regulatory history, both before and after the crisis, I propose four key principles for designing governance structures in global finance that produce equitable distributional outcomes:

1. Governance structures should ensure a clear distance between regulators and financial institutions to prevent the formation of strong informal social links between them.
2. Governance structures should minimize information asymmetries between stakeholders regarding the international regulatory agenda.
3. Governance structures should prohibit the delegation of key regulatory functions, such as the drafting of provisions, to stakeholders.
4. Governance structures should include robust oversight mechanisms that enable stakeholders to hold regulators to account for producing inequitable rules.

REFORMS IN THE WAKE OF THE CRISIS: BUSINESS AS USUAL

At the Pittsburgh Summit in September 2009, the leaders of the G20 proposed a series of far-reaching regulatory reforms to "tackle the root causes of the crisis and transform the system for global financial regulation."[1] The centrepiece of the reform effort was Basel III, a new set of international capital adequacy standards to be drawn up by the Basel Committee on Banking Supervision (BCBS), a group of central bankers and financial supervisors. The BCBS's preliminary proposals for Basel III, issued in December 2009, shook the finance industry and heralded, in the words of BCBS Chairman Nout Wellink, a new era of "higher capital and liquidity requirements and less leverage in the banking system."[2]

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1 Leader's Statement, The Pittsburgh Summit, September 24-25 2009. Available at: <http://www.treasury.gov/resource-center/international/g7-g20/Documents/pittsburgh_summit_leaders_statement_250909.pdf > (accessed 08 April 2014).

2 Westlake, M. (2009) 'Basel Supervisors Endorse Tough New Regs Package', *Global Risk Regulator, 7, 11: 7.*

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WHAT ARE CAPITAL ADEQUACY STANDARDS?

Over the past 25 years, capital adequacy standards have emerged as the principal form of prudential regulation for financial institutions. These rules stipulate the minimum level of regulatory capital – a mixture of shareholders' equity, disclosed and undisclosed reserves, loan-loss provisions, and other financial instruments – that banks are required to maintain as a proportion of their total risk-weighted assets. The rationale for regulatory capital is to provide a "buffer" against unexpected losses incurred by banks. By reducing the risk that such institutions will become insolvent during periods of low or negative earnings, they play a key role in maintaining a stable supply of credit and payment services to the real economy.

At the same time, capital requirements have a significant impact on the distribution of wealth both *among* banks and *between* the financial sector and the real economy. Because capital is a more expensive source of financing than debt – largely because of tax advantages and implicit government guarantees for the latter – banks view capital adequacy standards as a form of "regulatory taxation." A reduction in capital requirements enables banks to reduce funding costs, increase leverage, and boost their return on equity, giving them a major competitive advantage over rivals. At the same time, it increases the likelihood that they will require a public bailout in the future and thus represents a transfer of wealth to them from taxpayers.

It is now clear that such claims were premature. During subsequent rounds of regulatory negotiations between 2009 and 2011, the BCBS's proposals for Basel III were progressively watered down – with large international banks the principal beneficiaries. In response to pressure from lobby groups such as the Institute of International Finance (IIF) – a powerful Washington-based organization representing the world's largest banks – the BCBS backed away from proposals for significantly higher capital requirements, setting the overall minimum capital ratio at just 4.5 percent. This is less than half of the equivalent ratio maintained by major banks before the crisis. Indeed, economists at the Bank of England later admitted that a "huge mistake was made in letting banks come to have much less equity funding . . . than was normal in earlier times."[3]

Large international banks also succeeded in diluting a proposed capital surcharge on them addressing the systemic risks they pose due to their highly interconnected nature. Despite initially suggesting that the surcharge would be binding – a proposal strongly supported by consumer groups, community banks, and emerging market financial institutions – the BCBS ultimately adopted a "guided discretion" approach to implementation. The calibration of the surcharge proved equally favourable to major banks. Ignoring recommendations by Federal Reserve economists that the surcharge should constitute up to 7 percent of risk-weighted assets, the BCBS ended up setting it within a range of just 1.5 to 3 percent.

Why have regulators been unable to resist pressure from large international banks? An important part of the explanation lies in the strong *informal social links* that exist between senior employees of these banks and members of the BCBS. These links are a product of the highly technical and complex nature of global finance: only a handful of actors – namely, individuals with extensive first-hand knowledge of global markets garnered from years of professional experience at the helm of the world's largest financial institutions – possess the technical know-how to contribute to the development of international financial rules. Consequently, regulatory bodies frequently recruit from the ranks of the largest banks and rely on the assistance of their most senior experts to write rules that are operationally viable.

The BCBS is no exception. A prominent member of the BCBS during the drafting of Basel III, the New York Federal Reserve's Marc Saidenberg, was head of regulatory policy at Merrill Lynch and a member of the IIF Committee on Market Best Practices until 2008. Several former members of the BCBS, meanwhile, have moved in the opposite direction in recent years, further strengthening informal social links with major banks. During negotiations for Basel III, Roger Ferguson, a former vice chairman of the Federal Reserve's Board of Governors, sat on the IIF's board of directors; Darryll Hendricks, formerly of New York Federal Reserve, chaired the IIF Working Group on Valuation; and Patricia Jackson, formerly of the Bank of England, chaired the IIF Working Group on Ratings. In perhaps its greatest coup, the IIF managed to recruit Jacques de Larosière, a former governor of the French central bank and author of a widely read European Commission report on the lessons of the crisis for European financial regulation, to head its Market Monitoring Group.

3 Miles, D., Yang, J. and Marcheggiano, G. (2011) 'Optimal Bank Capital', External MPC Unit Discussion Paper No. 31, January, p.37.

REGULATORY PREFERENCES AND DISTRIBUTIONAL OUTCOMES IN THE BCBS

PROVISION	ACCORD	PREFERENCE OF LARGE INTERNATIONAL BANKS	PREFERENCE OF SMALLER BANKS AND PUBLIC INTEREST GROUPS	FINAL RULE
Total minimum capital ratio	Basel III (2009-2011)	Keep new minimum capital ratio low to avoid undermining economic recovery	Significantly raise total capital requirements	Minimum capital ratio set at just 4.5 percent
Capital surcharge for systemic institutions	Basel III	Keep surcharge low; ensure that it is nonbinding	Impose binding surcharge on large financial institutions	Surcharge made nonbinding; set between 1.5 percent and three percent
Internal ratings	Basel II (1999-2004)	Recognize internal credit risk models used by large banks	Maintain fixed asset risk weights for all financial institutions	Recognition of internal ratings for large banks
Market risk	Basel II	Recognize internal VaR models for calibrating market risk	Prohibit the use of VaR models since they underestimate "extreme" market events	Recognition of VaR models in 1996 (and retention in Basel II)

WE'VE BEEN HERE BEFORE: THE DISTRIBUTIONAL CONSEQUENCES OF BASEL II

In many respects, Basel III represents a case of history repeating itself. 15 years ago, partly in response to the Asian financial crisis, the BCBS set out to replace the existing capital adequacy regime, Basel I, with a more stringent set of rules. The most important innovation in the new regime, Basel II, was the inclusion of an "advanced internal ratings-based" (A-IRB) approach under which large banks would be able to use their own models to estimate credit risk. Banks lacking the resources to develop internal models would adopt the "standardized" approach, which linked credit risk to external ratings issued by credit rating agencies. Crucially, internal ratings would give large banks a major competitive advantage over smaller financial institutions. One impact study conducted by the BCBS, for example, showed that A-IRB banks would experience a capital reduction of up to 26.7 percent, while banks adopting the standardized approach would see a 1.7 percent *increase*.[4]

Large banks were also permitted to use internal models to assess market risk – that is, the risk of losses on assets arising from movements in market prices – extending their competitive advantage to trading activities as well as traditional lending. Since 1993, the IIF had lobbied the BCBS to allow banks to calculate market risk using complex mathematical models that produced estimates of "value-at-risk" (VaR). Although reluctant at first to consider the use of VaR models, the BCBS began to consider the proposal following the establishment of an informal dialogue with the IIF in early 1995 (see below). Just months later, after intensive technical work with IIF staff, the BCBS published a new market risk framework allowing the use of VaR models. Within a few years, however, the limitations of VaR models were becoming increasingly clear. Indeed, at the very time the BCBS was formulating the first draft of Basel II in early 1999, banks were reporting major losses on Russian government bonds that were entirely unanticipated by their VaR models. Despite such events, however, the BCBS refused to abandon the original market risk charge during negotiations for Basel II.

What explains Basel II's inequitable distributional effects? Once again, informal social links between members of the BCBS and large international banks are an important part of the story. These links can be traced back to the close relationship between the BCBS chairman in the mid-1990s, the Bank of Italy's Tommaso Padoa-Schioppa, and IIF managing director Charles Dallara. After meeting at a social occasion in 1995, the two agreed to establish an "informal discussion" on regulatory issues under "ground rules" of strict confidentiality.[5] This dialogue continued under the chairmanship of William McDonough, a head of the New York Federal Reserve who presided over most of the BCBS's work on Basel II. Another close friend of Dallara's from his 22-year career in the banking industry, McDonough gave the IIF unprecedented access to the BCBS from the earliest stages of negotiations for Basel II. Before negotiations had even begun, the IIF had established a new body – the Steering Committee on Regulatory Capital – specifically to advise the BCBS on the new accord. This body played a crucial role in drafting the key provisions of Basel II, ensuring that large international banks exercised disproportionate influence in the reform process.

4 BCBS (2006) *Results of the Fifth Quantitative Impact Study (QIS-5). Bank for International Settlements, Basel, p.2.*

5 Author's interview with former BCBS member representing the Financial Services Authority (FSA), London, December 2008.

POLICY IMPLICATIONS: FOUR KEY PRINCIPLES FOR GLOBAL INSTITUTIONAL DESIGN

Given the importance of equitable financial rules for the health of the global economy, it is instructive to reflect on the implications of this analysis for the design of global governance structures in the financial sphere. The analysis suggests four key principles for designing governance structures that serve the interests of a wide range of financial stakeholders:

1. Governance structures should ensure a clear distance between regulatory officials and the finance industry to prevent the formation of strong informal social links between them. Such a separation could be achieved by placing restrictions on the "revolving door" between rulemaking bodies and financial institutions; expanding the range of backgrounds from which officials are recruited; and limiting the number of secondees, interns, and temporary staff standard-setters hire from the private sector. Curbs on the revolving door have been implemented with some success at the domestic level (in countries such as Japan and the US) but have yet to be adopted internationally. Some international bodies have, however, made a conscious effort to broaden staff recruitment. In response to concerns about its lack of intellectual diversity, for instance, the IMF has in recent years relaxed restrictions on the types of institutional, geographical, and educational backgrounds from which staff are hired.[6]
2. To foster broad participation in the standard-setting process, governance structures should minimize information asymmetries regarding the regulatory agenda. To this end, officials should be required to conduct regular consultations with a diverse range of stakeholders and guarantee that new initiatives are widely publicized. Such consultations could be modelled on processes of "negotiated rulemaking" that have proven effective at the domestic level, in which competing interests are formally invited to participate in negotiations. Such processes have the added benefit of making relationships between stakeholders and officials more explicit and thus less informal. While asymmetries in technical expertise would remain, most stakeholders are sufficiently knowledgeable to grasp at least the basic distributional implications of financial standards; thus, regulatory proposals that disproportionately benefit narrow interests (such as large banks) would likely be met with robust opposition.
3. Governance structures should prohibit the delegation of key regulatory functions, such as the drafting of provisions, to stakeholders. To safeguard officials' operational independence, rulemaking bodies must be given the financial resources and administrative support necessary to attract high-quality technical expertise and to conduct in-depth research into complex regulatory issues. Where delegation cannot be avoided, regulatory functions should be divided among several stakeholders to prevent narrow interests from monopolizing them.
4. Governance structures should be open to public scrutiny and include robust oversight mechanisms. Rulemaking bodies must be held to account both by the international organizations that have delegated authority to them and by national governments through domestic ratification. They should also introduce procedures to improve compliance with internal directives and to allow stakeholders to question their success in terms of their own goals. Here, a notable example is the World Bank's Inspection Panel, an independent complaints mechanism established in 1993 that provides an outlet for stakeholders who are adversely affected by the organization's projects to express their grievances and seek redress.

To be sure, translating these principles into concrete governance reforms is not a simple task. Each principle can be realized through several different design features, and it is only via a time-consuming process of institutional trial and error that we can assess which combination of features is most effective. In addition, reform efforts are likely to meet strong opposition from the large financial institutions profiting from the regulatory status quo. Yet such obstacles are not insurmountable, particularly if policymakers manage to forge alliances with the many stakeholders who do have an interest in more equitable global financial rules. Successful reform is likely to be a long and hard-fought battle. Yet the analysis presented in this policy brief suggests that the benefits of enhancing the accountability, inclusiveness, and legitimacy of the international financial architecture would more than justify the costs.

6 See Chwieroth, J.M. (2009) *Capital ideas: The IMF and the rise of financial liberalization. Princeton, N.J.: Princeton University Press.*

FURTHER READING

Lall, Ranjit (Forthcoming) *Timing as a source of regulatory influence: A technical elite network analysis of global finance.* Regulation & Governance.

Lall, Ranjit (2014) *The distributional consequences of international finance: An analysis of regulatory influence.* Global Economic Governance Programme Working Paper 2014/90.

Lall, Ranjit (2012) *From failure to failure: The politics of international banking regulation.* Review of International Political Economy 19, no. 4 (2012): 609-638.