Civil Society Proposals to the Russian G20 Presidency on Global Financial Reforms

Make Finance Work for People and the Planet!

G20 must better regulate financial markets, stabilize the system of global finances and find sustainable solutions for the sovereign debt crisis

Civil Society actors from many countries have written this document[1]. It is a brief to serve as a platform for dialogue with the G20 Working Group on Financial Architecture and Market Regulation during the 2013 Russian Presidency. The paper first lists 9 propositions of Civil Society on financial reform each with a background. It then details its own principles for the reform and ends with a plea for re-launching the earlier spirit of the reform process.

1. *Civil Society's policy propositions on financial reform*

a. *Civil Society propositions on Basle III:*

- *Final implementation should be realized by the end of 2015*
- *Increase the total minimum capital requirements (tier 1 + 2) from 8% to 12%*
- *For Systemically Important Financial Institutions (SIFIs) the rate should be 15%*
- *Increase and give central role to the leverage ratio, compared to the acceptance of risk-weighting capital in the capital buffers*
- *Regulators and supervisors must have all necessary resources and expertise to deal with the the complexity of their tasks*

Background: The implementation of the Basel III recommendations on capital ratios would improve the resilience of banks. This will to some extent reduce the likelihood of taxpayer support being required in the event of bankruptcy. The increase of leverage should be seen as progress. Civil Society expects Basel III be implemented without relenting to claims that financing becomes more expensive. Higher financial stability will not come without cost. Yet, there are many flaws in the existing proposal:

- The time frame for final implementation 2019 is much too long
- The new capital requirements are too low and are mostly based on "risk weighted assets" which are subject to manipulation
- It should require a clear separation of proprietary or retail banking from speculative trading
- It should address in a more effective way the problem of systemic importance of global banks and financial institutions whose possible insolvency can cause the collapse of the entire financial system

b. *Civil Society propositions on the derivatives' market and food price speculation:*

- *Civil Society expects full legal dis-aggregation of derivative trades from commercial banking*
- *A derivatives trade register must be established to document each transaction and each trader, providing complete transparency*
- *Clearing Houses need to have a secure level of capital buffers to provide collateral for trades*
- *OTC trades must be banned*

[1] The paper was coordinated and edited by the C20 Working Group on Global Financial Architecture, Market Regulation and Sovereign Debt Management, one of seven international networks cooperating on the G20 Civil Society Platform of the Russian G20 Presidency 2013

- *Appropriate intervention powers for market regulators and authorities are required to address disorderly commodity and food markets and prevent market abuses. They need to be required the ability to set ex-ante position limits, particularly for the delivery month.*

In the long run the global community requires the stabilizing effects and the revenues of a financial transaction tax simultaneously introduced by all IMF member states.

Background: The derivative markets must not be permitted to pose risks to the overall financial system. Since their 2009 Pittsburgh summit the G20 have aimed at bringing Over-The-Counter derivatives (OTC's) to exchanges, installing Central Counterparty Clearing financial institutions to collateralize trades and make risks transparent. While this might mitigate some of the risks that led to the financial crisis, it will not end speculative business models nor halt the growth of derivatives markets. Because of the need for collateral, the Clearing Houses are the new too-big-to-fail entities that could trigger much bigger bailouts than experienced in the financial crisis. But given the dilemma that the risks of derivatives will never disappear neither on-exchange nor off-exchange it is paramount to massively reduce the overall use of derivatives. **On food prices:** The 2011 Cannes Leaders Summit of the G20 had aimed at preventing commodity price volatility affecting food prices and commodity market abuse. This has not been achieved. A lasting solution lies only in a prohibition against food price speculation by banks and financial institutions beyond commodity specific fundamental fluctuations

c. ***Civil Society propositions on Shadow Banking:***

- All actors in the shadow banking system must be subject to supervision.
- Shadow banks with an annual turnover of over 100 million USD must be treated like commercial banks.
- Innovative products must go through a clearance procedure before being authorised. Innovators must prove the product is consumer friendly and not harmful to the stability of the system.
- Banks should make sufficient information available to all stakeholders to enable them to assess the nature and size of the risks to which they are exposed. This includes the full range of off-balance sheet items, structured financial products and exposure to the so-called "shadow", or unregulated, banking sector. Detailed information on the asset side of balance sheets should be routinely provided to prudential regulators by those banks in receipt of an explicit or implicit public subsidy. Financial institutions should also report annually on the measures they are adopting to strengthen risk management, especially in relation to bribery and corruption at the board and senior management levels.

Background: According to the Financial Stability Board (FSB) the shadow banking sector trades USD 67 trillion annually. Unlike traditional commercial banks, the shadow banking system is not required to ensure public coverage of its investor deposits. During the financial crisis liabilities of this sector hit the balance sheets of commercial banks. The interconnections between banks and shadow banks constitute a severe contagion problem. Civil Society is concerned that the efforts to regulate the sector by the Financial Stability Board will address only some risks, do nothing to inhibit "innovation." In the lead up to the 2007/8 crisis many of these "innovations" created only illusory liquidity, even as they enormously increased risk.

d. *Civil Society propositions on recovery and resolution mechanisms for banks (Too Big to Fail):*

- *Civil Society expects all SIFIs to submit their plans for an orderly winding down shortly*
- *Global rules for simplifying and reducing the size of the SIFIs must be adopted, particularly by dividing up their investment and their commercial components*
- *No more bail outs of the investment business of private sector financial institutions and banks with public money*
- *A resolution mechanism must protect employees and focus on the responsibility of the firms' leadership and largest shareholders*
- *Establishment of a resolution fund in each country mobilized by the financial industry to cover the losses that cannot be absorbed by the shareholders, but subsidiary to creditors being bailed-in.*

Background: The G20 has agreed on measures to prevent the future need for the bailing out SIFIs. However, the proposals overstate the capacity of regulators to act in situations of systemic failure given their complexities that even their own executives do not understand. Moreover, as a result of mergers and acquisitions post 2008, the financial sector is even more concentrated today, with firms becoming bigger and more interconnected. The FSB under estimates the number of global SIFIs. The "key attributes" of their recovery and resolution in the event of bankruptcy as laid out in what in their "living wills" are too slow to take effect in an emergency. There are serious doubts that the speedy and orderly resolution of a large and interconnected firm can be achieved on that basis.

e. **Civil Society propositions on credit rating agencies:**

- *Civil Society expects from the G20 to work to establish rating agencies that are independent of states, industries and markets, and serve the regional level.*
- *Multilateral agreements must reduce regulatory requirements for the reliance of investors/pension funds on the rating opinions and remove the exemption of rating agencies from legal liability for negligence.*
- *In the long run rating agencies must qualify their algorithms to include social and environmental criteria, rating the usefulness of a client's activity.*

Background: The rating agencies work on an "issuer-pays model", a central reason they were unwilling to foresee the impending 2007 financial crisis despite clear indicators.

f. ***Civil Society propositions on debt management:***

The G20 process needs to acknowledge the need for sovereign debt work out as a global public good.

- *It should establish milestones for a global dialogue and a common debt work out framework.*
- *To guide the process, a G20 working group should be instituted, which would take stock of existing reform proposals (from the UN system, the International Financial Institutions, academia and civil society), propose a global dialogue, define the milestones to be reached and agree on a time frame for introduction.*

Background: Un-payable levels of sovereign debt have strong negative macro-economic effects such as stifling growth, currency depreciation, increased refinancing cost, pressure on reserves, and restructuring. Debt services are looting the national budgets on whose support the sick, the old and the un-educated depend. In order to address systemic roots of over-indebtedness an important policy is to increase state revenue through progressive taxation of income, resource extraction and sales, private assets as well as of socially and environmentally harmful practices.

Economists recommend a global governance-instrument for sovereign insolvency since Adam Smith (1723-1790). Yet, such an instrument needs to be established before a crisis hits. Once it is in place, all stakeholders can calculate risks better. The moral hazard between financial institutions and public finance will decrease. Meanwhile, Codes of Conduct and instruments such as Collective Action Clauses (CACs) can guide financial policy, ring alarm bells or help debtors regarding specific loans as well as certain classes of creditors, but they are no substitute for a coherent framework. The more a country's debt work out is based on rules valid for all sovereigns and all creditors the more predictable it is and the more likely it is to be speedy, efficient and fair.

g. ***Civil Society propositions on fiscal paradises (tax havens), regulatory arbitrage, anti-corruption, transparency, bank secrecy:***

- *The G20 Summit must enhance corporate transparency by obliging companies in all sectors to publish payments to governments on a project-by-project and country-by-country basis as well as revenues and key organisational data on a country-by-country basis.*
- *In addition, disclosure of all subsidiaries should be required.*
- *Mandatory national level registers should require disclosing all types of ownership and the information be shared with relevant investigative and judicial authorities, domestically and internationally and with financial institutions to assist with their customer due diligence processes.*
- *All countries, including developing countries and offshore financial centres, must join the "Global Forum on Transparency and Exchange of Information" and the "Multilateral Convention on Tax Information Exchange", leading to general agreement to automatic exchange of tax-related information.*
- *To facilitate recovery of misappropriated assets, which are held in financial institutions in G20 countries, all countries must implement the recommendations in the Stolen Asset Recovery Initiative's (StAR) and publish guides on their respective legal processes*
- *The G20 should address tax evasion by multinational corporations and rethink the current regime for international taxation.*

Background*:* The scams that led to the financial crisis, the corruption in the financial markets (e.g., the LIBOR scandal), money laundering, tax evasion, etc. are criminal and create unaffordable high levels of damage.

h. ***Civil Society propositions on Institutional concerns of the global financial system:***

- *Leadership selection must be transparent, merits based and democratically reflect the membership composition in both the World Bank and the IMF.*
- *In the short run, the changes for the quota formula must give adequate voice to borrowers especially, the poorer ones as well as donors, reflect population size, and purchasing power parity (PPP) at least as much as market and financial criteria.*
- *In the long run, Civil Society foresees the quota formula incorporating positive indicators such as human development criteria, employment, climate, and equality. Related work for the global community would be the recalibration of the measurement of "GDP".*

- *Regarding lending policies and advice, in the short run, the IMF needs to support employment oriented growth policies to overcome deficits rather than focus on austerity.*
- *In the long run IMF Surveillance should: a) use natural resource accounting to provide an alternative to targets relative to GDP, fiscal and monetary targets, and b) uphold full employment goals in setting and enforcing such targets.*
- *Efforts to calculate extraterritorial impact of national decisions (spill over) are welcomed.*

Background: Leadership selection: From 2002 the boards of World Bank and the IMF agreed to reform the existing leadership selection practices. But even a decade later nothing is achieved. **Governance:** A shift towards a quota and vote situation of 47% lower and middle income countries to 53% advanced countries to be implemented in October 2012 is a step forward but does not touch the over-representation of Europe in the IMF board, does not support a stronger voice for the poorest developing countries, does not touch the de-facto veto privileges of the USA, and does too little to appropriately represent the aspirations of the emerging economies. **IMF resources:** Even though the IMF has failed to reform its leadership selection process and quota formula and made only marginal changes to its lending and surveillance policies, the G20 has affected a monumental increase in IMF resources. **IMF Advice**: The 2011 independent evaluation report underscored how a thorough, open and self-critical debate on the macro-economic paradigm on which the IMF is based is long overdue. The recent admission by the IMF research department of the miscalculation of the "fiscal multiplier" in practice means the IMF remains blind to austerity measures impacting faster and more negatively on growth than stipulated. This endorses Civil Society's view that the intellectual and theoretical fundamentals of the Fund's policies are seriously flawed.

i. ***Civil Society propositions on global imbalances and the reform of the international monetary system:***

Reforms towards a system that supports stability, trade, and adjusting global imbalances without recessionary consequences would involve looking at a revamped system of IMF Special Drawing Rights as the cornerstone of the international monetary system (which could also generate extra development and climate finance), a credible framework for exchange rate management and coordination while supporting greater regional and sub-regional mechanisms for monetary cooperation. Further ***c****ore elements to curb imbalances are* ***capital controls****. Moreover, the surplus countries have a particular obligation to contribute to a better balance.*

Background: Imbalances touch the heart of the global coordination capacity of the G20. These imbalances are recognized to breed new dangers for all economies. The country specific differences in the balances of trade and payments and the related credit needs provide ample opportunities for the financial markets to pro-cyclically further un-balance the system. Therefore, imbalances necessarily need to be addressed by the G20.

In the absence of reform, the existing *de facto* mechanisms for adjusting imbalances force deficit countries to adjust having to endure all the related problems and disadvantages while surplus countries can continue their national development plans. **Capital controls:** The G20 stipulated IMF "framework for managing capital flows" stops short of curbing the right of countries to implement capital controls. It refers to capital account liberalization as a desirable long-term goal. Regional monetary coordination, rather than being supported, is being shoehorned under the IMF with a one-size-fits-all mentality. It has been shown that the reliance on the US- Dollar as global reserve currency agenda is intricately linked to the generation of imbalances (Triffin dilemma). The above G20/IMF framework fails to agree on a credible and symmetric mechanism for coordination of adjustments among surplus and deficit countries.

2. Civil Society principles for a new financial architecture

Stability is necessary, but not enough: Financial stability is a public good and civil society supports all sound efforts to strengthen the stability of the global financial system. But stability is not enough. Important dimensions of the present system are not addressed through a pure stability approach, in particular the negative effects of financial markets on distribution and equality, the negative feed-back between trade imbalances and finance and the over-dependence of public finance on financial markets. These factors take effect already before and independently of a financial crash. If finance should serve the real economy and the entire society (see below), these issues have to be addressed in the further reform process.

Making financial markets serve the real economy: The financial sector must be placed at the service of a the real economy that is geared to the achievement of human rights, human well-being, the common good, the prevention of climate change and sustainable development. Finance should not be a primary force driving the economy, but a pillar to support it. Financial regulation should reorient markets into promoting support for an alternative paradigm that improves the quality of life and reduces the unsustainable drain on natural resources, as well as creating decent jobs and guaranteeing a livelihood. Reforms should embrace a commitment to providing comprehensive protection and implementation of all human rights - civil and political rights and also economic, social and cultural rights.

Containing speculation, especially food prices: Food, the most basic of all Human Rights must be kept outside the realm of speculation that does not support its ready availability and price stability. Food prices are in any case subject to fundamental volatility due to fluctuations in production conditions. Food index funds and other financial market investors must be prevented from driving up the volatility of food prices. Betting on the barest necessities of poor families across the world is deeply unethical, should be illegal and has no place in the speculative financial markets.

Shrinking the financial sector, breaking its power over politics: The financial sector's inflated size has given it also a strong sway on the institutional structures and political avenues to discuss regulation. The approach that has come to prevail in financial regulatory processes is one where only those familiar with the complexity and technicalities of financial markets are able to influence regulation. Not surprisingly, alternatives that threaten financial firms' profits or business models, or place other interests above them, tend to be systematically pruned out of the debate. But all sectors of society have a stake in financial regulation; so all sectors of society should be involved in designing and debating regulation of the financial sector.

"Too Big to Fail": Systemically Important Financial Institutions (SIFIs)s assume that the state will intervene in the case of insolvency. The state guarantee may be implicit (the possibility of future bail-outs) or explicit (deposit guarantee schemes), but the effect is to provide a public subsidy to those institutions deemed too important to fail with a consequent distortion of markets and competition. There is a corresponding failure of market discipline. For example, creditors, credit rating agencies and analysts all mis-price lending risks with the result that managers and shareholders lack an important incentive to curb excessive leverage or risk-taking. Financial institutions should be made to pay for the true cost of their funding by issuing “bail-in” bonds i.e. debt instruments that can be converted to equity at the injunction of a supervisor in advance of insolvency.

Intensifying multilateral cooperation: Capital flows are mobile and, therefore, only concerted action by all governments will be able to tame them. At the same time, the difficulties of increased multilateral cooperation should not be taken as an excuse by any individual jurisdiction to not implement regulatory proposals on a unilateral basis or, worse, as an excuse for a “race to the bottom” on regulatory standards. Neither should it be used as an excuse by regulators to override stricter policy interventions that may be demanded by the populations in their jurisdiction to whom they are primarily accountable.

Give up the failed economic theory Myth of efficient and self-regulating financial markets: The paradigm of self-regulation, heavenly shaped “efficient markets” hypothesis, has proved conclusively out of sync with the reality of financial markets and actors. Not only have instances of irrational behaviour of market participants been exposed in this post-crisis period, but also the many instances of outright corruption and manoeuvring to profiteer from the system at the expense of any notion of efficiency that the lack of control may have been meant to foster. So a new financial architecture would have to be one that has no blind faith in markets or their self-regulatory power and one that recovers trust in the role of democracy and the State as guardians of the public interest.

3. The importance of re-launching the reform process:

The second and third leaders’ summits in London and Pittsburgh (2009) had raised hopes that substantial reforms would be undertaken particularly, to better regulate the financial markets. However, momentum is more and more being lost. Only few reforms have been implemented. The regulation put in place so far would today, not suffice to prevent another speculation-induced collapse of the financial system. In the light of this disappointing balance civil society is demanding for a re-launch of the initial reform spirit. **A decisive element of such a re-launch would be a strong participation of civil society at all levels.**

A real historic turn, a new economic paradigm is required. It is not enough to make the casino safer. As UNCTAD has put it: “Nothing short of closing down the big casino will provide a lasting solution.“ [2]

The Civil Society platform for the G20 Presidency in Russia 2013 has taken up the increasing inequality of people and countries on the globe as its overarching theme. The out-of-balance global financial system scarcely regulated financial institutions and unregulated markets deliberately leaving space for regulatory arbitrage, moral hazard, tax evasion and huge illicit financial flows have already led to severe levels of inequality. Like economic imbalances these levels of inequality will strive towards adjustments and when they do may cause enormous human, social, environmental and economic cost. Civil Society demands to re-launch the reform process of the global financial system now.

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[2] UNCTAD Secretariat Task Force on Systemic Issues and Economic Cooperation: The Global Economic Crisis: Systemic Failures and Multilateral Remedies, Geneva, 2009, (http://unctad.org/en/Docs/gds20091_en.pdf)