Preventing the next financial and debt crisis

G20 must address systemic risks in financial markets, continue the financial reform process, and find solutions for the sovereign debt crisis

12 June 2015 – Civil society actors from around the world[1] have contributed to this paper, which is addressed to the G20 finance ministers, central bank governors and sherpas, and which will serve as a platform for discussion with policy makers from the G20 during the Turkish G20 Presidency in 2015.

1. The necessity of completing the reform process

The 2009 G20 Summit raised hopes that substantial reforms would be undertaken to improve the regulation of financial markets, entities and instruments and establish regulations and oversight of Over the Counter trades. However, the political momentum that is required to agree on certain reforms and to implement other reforms that have already been agreed by G20 finance ministers and central bank governors is rapidly diminishing. Regulations put in place so far would not suffice to prevent another collapse of the financial system. Many critical reforms remain unfinished business, including: resolution and restructuring of too big-to-fail banks to prevent any public bailouts; addressing the risks of securities financing transactions; measures to prevent market disruption by high frequency trading; cross-border standardization of financial data reporting to enable regulatory surveillance; reducing reliance on credit rating agencies; and greening the financial markets.[2]

There is pressure on G20 Leaders to put the brake on financial regulation and, instead, focus on short term growth. However, this stance is short-sighted and dangerous: most of the post-crisis regulatory reform is focused on making *individual* banks more robust, but inadequate action has been taken to make the financial system *as a whole* more resilient. Even less has been done to make finance serve the whole economy and society. Adequate action should include:

- A macro-prudential approach to financial sector regulation, including further steps to identify and address some sources of systemic risk, including contagion, the simultaneous failure of a number of even medium-sized banks due to collective exposure to asset risks and new vulnerabilities, such as overpriced securities, rapid sell-offs of funds[3] or illusionary liquidity.[4]
- Comprehensively address the systemic risks of shadow banking, which is likely to increase moral hazard as there are no effective private backstops. In contrast, the crisis showed that non-bank lending has an implicit and indirect access to public safety nets.
- Address misconduct in the financial industry.[5] As Financial Stability Board (FSB) Chairman Mark Carney wrote to the G20 finance ministers on April 9, "The scale of misconduct in some

[1] See list of signatories at the end.

[2] For an attempt, see UNEP's work: http://www.unep.org/newscentre/default.aspx?DocumentID=26802&ArticleID=34981.

[3] See Mark Carneys Statement from April 18th 2015, Washington D.C.

[4] See Mark Carney: Future of Financial Reform. Speech at the Monetary Authority of Singapore Lecture, Singapore 17 November 2014.

[5] A recent survey of financial industry professionals demonstrates a significant tendency toward misconduct. See "The Street, The Bull and The Crisis" May 2015. http://www.secwhistlebloweradvocate.com/LiteratureRetrieve.aspx?ID=224757.

financial institutions has risen to a level that has the potential to create systemic risks." The FSB has agreed on a work plan to examine these risks. It is essential that this work include input from civil society and other non-industry actors to broaden the perspective. The lack of diversity of opinion and research was one reason for the failure of the financial regulatory system to prevent the crisis.

The financial reform process is far from complete. If these matters are not addressed, the risk and severity of future crises will not be mitigated – undermining global efforts to promote inclusive and sustainable economic growth. Also, by not providing sufficient financial services that meet the needs in the economy and society, the financial sector still lacks the trust it needs to operate. In other words, the status quo undermines the G20's central goal of "strong, sustainable and balanced growth". Indeed, with continued inaction, another crash is only a question of time.

Civil society groups are keen to support the implementation of responsible financial reforms through engagement with policy makers and legislators, public education, and, ultimately, by ensuring regulators have sufficient resources and enforcement capacity.

2. Civil Society principles for a new financial architecture

Going beyond stability: In addition to ensuring financial market stability, other dimensions of financial markets must be addressed, especially their negative effects on equality. Also, the basic principle of transparency of the financial sector still needs to be fully incorporated.

Making financial markets work: The financial sector must be placed at the service of the economy and society as a whole and be oriented towards inclusive, sustainable development as well as the protection of human rights and the environment.

Curbing speculation on food prices: Commodity markets must be well regulated to prevent excessive speculation and distortions in the prices of commodities. At the very least, food, which is the most basic of all human rights, must be protected against excessive speculation.

Shrinking the financial sector: The financial sector's inflated size relative to the non-financial economy is harmful. Furthermore, the financial lobby and its huge financial resources have given it disproportionate influence on legislation and regulation.

Ending "Too Big To Fail" (TBTF): Systemically Important Financial Institutions (SIFIs) are dangerous because they and others can reasonably assume that the state will intervene to prevent their insolvency. For this reason and to prevent future tax-payer bailouts, ending TBTF is essential.

Intensifying multilateral cooperation: Only concerted action by all governments will be able to tame global capital flows and institutions. Difficulties in cooperation should not prevent regulation on a unilateral basis. Nor should multilateral agreements override stricter national policy interventions.

Abandoning failed economic theory: The paradigm that always assumes self-regulation and "efficient markets" has been proven wrong. A modern financial system must rebuild trust in the role of democracy and the State as guardians of the public interest.

3. Civil Society's policy proposals on financial reform

A. Banking capital requirements and structure

- *Final implementation of Basel III by 2019 is much too late; at least there must be no further extensions.*
- *Total minimum capital requirements must be increased, particularly for Systemically Important Financial Institutions (SIFIs.) A binding leverage ratio should be introduced and its role increased compared to the acceptance of risk-weighting capital in the capital buffers.*
- *Apply accounting requirements that limit "gaming" or manipulation of balance sheets used to calculate a leverage ratio.*[6]
- *The ambitious standards for loss absorbency capacity must be finalized and implemented.*
- *All risky trades on own account and all risky entities such as hedge funds completely should be legally separated from deposit taking banks.*

Background: The international bank capital standard, Basel III, improves the resilience of banks and, to some extent, reduces the likelihood that taxpayer support would be required in the event of bankruptcy. As pointed out by the FSB, the Bank for International settlements (BIS) and various academics, higher capital ratios will not necessarily harm credit provision, particularly for long-term financing.[7] Yet, there are many flaws in the existing reforms, including a lack of action to address the systemic causes of bank failure. Furthermore, there is a need to review the risk-weighting system used in capital regulation, which can create incentives for banks to invest in securities in the market rather than the real economy, such as business loans.[8] In terms of structural reforms, the G20 and FSB have not made progress in promoting international cooperation, particularly on the matter of separating retail and investment banking. Moreover, proposals for restructuring of banks in the EU are being watered down. There are concerns, often brought forward by the financial lobby, about the consequences of structural reforms. However, these concerns seem exaggerated. The FSB should address them through its assessment of unintended consequences of reforms for all stakeholders, which includes a focus on long-term financing.

[6] E.g., the Global Capital Index, published by US FDIC Chairman Hoenig, shows the differences between leverage ratios which are calculated using different accounting standards. https://www.fdic.gov/about/learn/board/hoenig/statement4-2-2015.html.

[7] See FSB report the G20 "Update on financial regulatory factors affecting the supply of long-term investment finance." September 16, 2014.

[8] Anat Admati and Martin Hellwig. "The Parade of the Bankers' New Clothes Continues: 28 Flawed Claims Debunked", July 2014. http://bankersnewclothes.com/wp-content/uploads/2014/07/Parade-continues-July-2014.pdf.

B. Recovery and resolution mechanisms for banks

- *There should be no more bail-outs of the investment business of private sector financial institutions and banks with public money.*
- *Global rules for simplifying and reducing the size and permitted activities of the Systemically Important Financial Institutions (SIFIs) must be adopted.*
- *All SIFIs need to submit their plans for an orderly winding down to the relevant regulators.*
- *During cross-border resolutions, it needs to be ensured that Domestic Systemically Important Banks (D-SIBs) in developing countries, often not considered "material" to the resolution, are protected.*

Background: The G20 has agreed but not implemented measures to prevent the bail out of SIFIs in any future crisis. However, the agreed measures overstate the capacity of regulators to act in situations of systemic failure given the complexity of SIFIs that even their own executives do not understand. Moreover, as result of post 2008 mergers and acquisitions, the financial sector is even more concentrated today, with firms becoming bigger and more interconnected. The "key attributes" of the recovery and resolution of SIFIs in the event of bankruptcy (as set forth in their "living wills") would be too slow to take effect in an emergency. There are serious doubts that the efficient and orderly resolution of a large and interconnected firm can be achieved on the basis of current measures.

C. Derivatives' market and food price speculation

- *The new derivatives trade registries must work properly and document each transaction and each trader, providing complete transparency.*
- *Clearing Houses need to have a secure level of capital buffers and margins collected from traders to provide collateral for trades.*
- *Appropriate intervention powers for market regulators are required to address disorderly commodity derivatives markets and prevent market abuses. Regulators must be able to set and enforce meaningful ex-ante position limits, particularly for the delivery month.*

Background: The derivative markets must not be permitted to destabilize the overall financial system. Since its 2009 Pittsburgh summit, the G20 has aimed at bringing Over-The-Counter derivatives (OTC's) to exchanges, installing central counterparty clearing houses to collateralize trades and make risks transparent. Because of the need for collateral for transactions in the $700 trillion (notional value of contracts) OTC market, the clearing houses could become the new too-big-to-fail entities, if there are no agreed terms for the resolution of clearing houses, clearing members and their customers. But given the dilemma that the risks of derivatives will never disappear, neither on-exchange nor off-exchange, it is of paramount importance to massively reduce the overall use of derivatives. The 2011 Cannes Summit aimed at preventing excessive commodity price volatility affecting food prices that is induced by financial "innovations" and financial actors with no commercial interest in hedging price risks. This goal has not been achieved because reforms in the United States are delayed and in the EU are insufficient.

D. Shadow banking

- *All actors and activities in the shadow banking system must be adequately regulated, which will require prevention of activities in offshore financial centers.[9] Where shadow banks provide similar functions to the ones of commercial banks, they need to be treated equally.*
- *The promotion of "good" securitization must only include the most basic structures to ensure simplicity and sustainability.*
- *As the financial system becomes increasingly collateral-intensive, the G20 must address the systemic risks of financing securities transactions by introducing minimum haircuts for all such transactions and by stopping the re-use of collateral.*
- *Banks[10] 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 shadow banking sector.*

Background: According to the Financial Stability Board (FSB) the shadow banking sector trades USD 75 trillion annually and is still growing. Compared to traditional commercial banks, the shadow banking system is largely unregulated. During the financial crisis, some shadow banking activities, for example the bank hedge funds or the interbank market, caused severe problems. Some money market funds in the United States would have gone bankrupt without public support. Civil Society is concerned that the efforts to regulate the sector will only address some risks, and do nothing to inhibit harmful "innovation," that may invite regulatory evasion. In the lead up to the last crisis, many of these "innovations" created only illusory liquidity. The increasing use of non-bank lending is likely to create a more pro-cyclical and interconnected system by reinforcing the central role of collateral. This might lead to domino effects in crisis situations. Non-bank lending also has no access to public safety nets and private backstops proved ineffective. In order for it to be stable, there is only the choice between shrinking the size of shadow banking or extending public safety nets at the risk of increasing moral hazard. This is all the more important as in the EU the Capital Markets Union is promoting the growth of shadow banking.

E. Sovereign debt management

- *The G20 needs to acknowledge the need for a sovereign debt restructuring framework and should fully support the programme of work by the UN General Assembly.*
- *Better collective action clauses can improve coordination among bondholders, but additional instruments are needed to facilitate comprehensive debt workouts that include all debt categories, including official loans, and link debt workouts to development needs and rights.*
- *It was right that the FSB added sovereign debt restructuring to its agenda. The FSB should establish a working group, which includes non-FSB member countries, to focus on the regulatory treatment of sovereign debt instruments and the role of credit rating agencies.*
- *The burden sharing of credit risks must be re-thought. Creditors and debtors should share the responsibility for failing loans.*

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[9] The FSB Regional Consultative Group for the Americas also proposed this in their 2014 Shadow Banking Report. http://www.financialstabilityboard.org/wp-content/uploads/r_140822b.pdf.

[10] The term bank also includes bank-holdings and bank groups. Both of these include banking and shadow banking activities.

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, restructuring costs, etc. Debt service can loot national budgets. Since the days of Adam Smith, economists have recommended a global governance framework for sovereign insolvency. Accordingly, the General Assemble of the UN has taken a decision on 9 September 2014 to develop such a framework. Yet, it needs to be established before a crisis hits. Once the framework is in place, debt crises can either be fully prevented, or at least managed faster, mitigating the negative economic and humanitarian consequences. The moral hazard among financial institutions and public finance will also decrease. The more a country's debt workout is based on rules valid for all sovereigns and all creditors, the more likely that it will be predictable, speedy, efficient and fair. There are many areas where financial regulation and sovereign debt intersect, such as the risk-weights assigned to sovereign debt, complex sovereign debt instruments and credit ratings, which ultimately impact the price of sovereign debt.

F. Institutional concerns of the global financial system

- *Leadership selection at the IMF and the World Bank must be transparent, merit based and democratic – that is, reflecting the composition of each institution's membership.*
- *In the short run, the changes for the World Bank and the IMF quota formula must give adequate voice to borrowers especially, the poorer ones, as well as donors, by reflecting population size, and purchasing power parity (PPP) at least as much as market and financial criteria. In the long run, the World Bank and the IMF quota formula must incorporate positive indicators such as human development criteria, employment, climate, and equality. To this end, the global community should recalibrate the measurement of "GDP" (gross domestic product).*
- *Other institutions such as the Financial Stability Board, the International Organization of Securities Commissions (IOSCO) and the Bank of International Settlements (BIS) need to include all stakeholders and become more transparent. In the long run, financial reform must be coordinated by a globally-inclusive body, such as the UN, not by the G20.*

Background: From 2002 onwards, the boards of World Bank and the IMF have agreed to reform the existing leadership selection practices. But more than a decade later, no progress has been made. The over-representation of Europe on the IMF board, the need for a stronger voice for the poorest developing countries, and the de-facto veto privileges of the USA are still not addressed. In addition, the 2011 report by the IMF's independent evaluation office 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 which impact growth in a more rapid and negative way than previously anticipated. This endorses Civil Society's view that the intellectual and theoretical fundamentals of the Fund's policies are seriously flawed.

G. Global imbalances and the reform of the international monetary system

- *A revamped system of IMF Special Drawing Rights (SDRs) should be the cornerstone of the international monetary system while supporting greater regional and sub-regional mechanisms for monetary cooperation. Deficit and surplus countries have a particular obligation to contribute to a better balance.*
- *There is a need for a credible framework for exchange rate management and coordination.*
- *Capital controls need to be enabled and supported.*

Background: The country specific differences in the balances of trade and payments and the related credit needs provide ample opportunities for procyclical destabilization of the financial markets. Therefore, imbalances necessarily need to be addressed. In the absence of reform, the existing *de facto* mechanisms for adjusting imbalances force deficit countries to adjust and endure all the related problems and disadvantages while surplus countries can continue their national development plans. On capital controls, the G20 critiqued the IMF "framework for managing capital flows", which 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 by the IMF with its "one-size-fits-all" mentality. Over-reliance on the US dollar as global reserve currency agenda is intricately linked to the generation of imbalances. To date, the above G20/IMF framework fails to identify a credible and symmetric mechanism for coordination of adjustments among surplus and deficit countries.

H. Free trade and investment treaties

- *It needs to be acknowledged that the financial services and capital flow liberalization undertaken in the WTO framework and in bilateral/plurilateral trade and investment treaties was one reason for many of the financial crises in the last decades and is detrimental to measures needed in financial crises.*
- *The current policies should be reviewed accordingly, by excluding financial services from trade and investment agreements or, at least, replacing the "prudential carve-out" by a clear and unrestricted right to regulate with no requirements for regulatory standstills.*
- *The current Investor-to-State Dispute Settlement (ISDS) system has to be abandoned.*

Background: Many governments of developing and emerging countries as well as many academics acknowledge the role that financial services and market liberalization plays in creating and intensifying financial crises. With liberalization, crises have multiplied and become more severe. Indeed, the global financial crisis originating in the subprime U.S. mortgage market after 2007 was the worst crisis since the Great Depression. At the same time, the strengthening of investor rights in investment treaties has led to many investor complaints against financial market measures, particularly those taken in financial crises, such as debt cuts, currency devaluations or bank nationalization. Argentina alone faced – many successful – complaints worth more than one billion dollars. Belgium faced one complaint for a bank nationalization which amounted to over 3.7 billion US dollars; it was rejected, but only for formal reasons. These kinds of actions lead to unacceptable levels of financial risk and legal uncertainty for states that are forced to solve a financial crisis. It is also unacceptable that their agreements are negotiated secretly.

Signatories

Americans for Financial Reform, United States

Berne Declaration, Switzerland

Bread for the World – Protestant Development Service, Germany

Center of Concern, United States

Eurodad – European Network on Debt and Development, European Union

Heinrich Böll Foundation

Institute for Agriculture and Trade Policy, United States

Jubilee Debt Campaign, United Kingdom

New Rules for Global Finance, United States

Social Justice in Global Development, United States

SOMO – Centre for Research on Multinational Corporations, Netherlands

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