Report from International Workshop:

Integrating Financial Reform & Public Policy Goals

Ankara, Turkey

September 2015
INTRODUCTION: BEYOND STABILITY

For civil society, it is very clear that an ill-regulated financial system has potential for economic, social and environmental destruction. The current financial reform agenda – carried forward at the international level by the G20 and Financial Stability Board (FSB) – has aimed at reducing financial instability and, ultimately, the incidence of financial crises and its huge costs for economies and societies. The outcomes from this agenda (at both domestic and international levels) have broad and cross-cutting implications beyond the financial sector itself – impacting communities in Indonesia, small business owners in Uganda and retirement accounts in the United States. It is important, therefore, that reforms to the global financial system do more than just mitigate future crises; regulations also promote financial inclusion, protect jobs, reduce inequality and catalyze the transition to a strong, sustainable global economy.

Unfortunately, the inter-linkages between financial regulatory frameworks and sustainable development, particularly in developing countries, have been largely overlooked. The FSB deserves credit for broadening its scope of work (e.g. financial inclusion) and evaluating the “unintended consequences” for Emerging Markets and Development Economies (EMDEs) but this exercise does not address all the gaps. More importantly, it does not empower developing countries to influence reforms and rules in other jurisdictions, or to the tradeoffs between stability and development.

For this reason, this Workshop was organized to deliberate the need to move beyond the traditional objectives of financial regulation and examines the tradeoffs between the objectives behind the global framework for financial regulation and the strategic objectives of development. Whatever these tradeoffs might be (e.g. level of capital requirements for domestic banks financing sustainable development goals), those whom are impacted should have a voice.

Some Emerging Market and Developing Economies (EMDEs) have begun to balance these tradeoffs and integrate financial reforms with public policy objectives. Indonesia, for example, plans to put in place strong sustainability assessment and disclosure requirements for financial institutions. The problem is that the palm oil industry (which is responsible for a great deal of social and environmental damage in Indonesia), is financed by more than 20 banks from 11 different jurisdictions¹, which each face different disclosure requirements and report to different regulators. Without stronger cooperation on disclosure rules and sustainability requirements demanded by regulators (and investors alike) in the US, UK, Singapore and other countries. Indonesia – which is a member of both the G20 and FSB – will struggle to protect both its people and environment while the voice from its citizens is insufficiently heard at the other jurisdictions.

Stronger standards for disclosure is only one “pressure-point” where academics, civil society and other stakeholders can press international organizations and governments to develop a global financial system that drives inclusive and sustainable economies and societies.

This Workshop convened participants to discuss various pressure-points and other key issues for two and a half days. Below is an overview of the workshop, followed by a summary of key takeaways and recommendations for work going forward.

¹ Tycoon-controlled Palm Oil Groups in Indonesia. TUK Indonesia. 2015
WORKSHOP OVERVIEW

In September 2015, a diverse group of stakeholders from advanced and developing economies convened to discuss how to integrate these public policy goals with the financial reform agenda. The meeting was held on the sides of the G20 Finance Ministers and Central Bank Governors meeting in Ankara, Turkey.

More than 20 organizations from 14 countries participated in this two and a half day workshop – bringing diverse perspectives from academia, civil society, labor unions, government and inter-governmental organizations. The workshop had three key components: 1) Presentations and discussions focused on identifying the major gaps in the financial reform agenda, particularly in the context of sustainable development, and alternative proposals to fill those gaps; 2) Capacity building or training on several technical issues (e.g. shadow banking system); and 3) Strategic planning session to coordinate actions, opportunities and how to strengthen the global coalition.

The global coalition of stakeholders behind this initiative prepared a position statement on financial reform, which was delivered to Mark Carney, Chairman of the Financial Stability Board (FSB), Mario Draghi, President of the European Central Bank (and former FSB Chairman) and other high-level representatives from central banks and finance ministries during the G20 meetings in Ankara.

KEY TAKEAWAYS & RECOMMENDATIONS

Capital Flows and Foreign Exchange Missing from Agenda

Throughout Workshop discussions, participants repeatedly emphasized how various financial sector activities, regulatory policies and central bank actions influence capital flows (inflows and outflows) and foreign exchange rates for emerging markets and developing economies (EMDEs). Below are some of the main points raised during these discussions:

- From the perspective of developing economies, volatile and short term capital flows as well as the volatility and uncertainty of the value of the exchange rate are two of the most relevant issues in terms of impact by global financial markets. Unfortunately, both of these issues have been missing from the agenda of international financial fora, despite their significance for macro-prudential policy, financial stability, currency values and impact for citizens. For example, regulatory failures for foreign exchange markets can have significant consequences for developing country currencies, and consequently their economy (e.g. import and export prices) and their foreign debt financing.

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2 This workshop builds on the success of FSB workshops in 2013-2014, the work of previous Civil Society Working Groups on G20 Finance and the current global coalition of public interest groups tracking the G20 financial reform agenda. The workshop could not have happened without the financial support from SOMO and Brot fur die Welt, and the intellectual contributions from all the organizations part of the NGO working group on G20 finance.

3 Foreign exchange markets remain largely unregulated: transactions remain over-the-counter off of formal and transparent exchange platforms, short-selling is virtually unrestricted and codes of conduct to prevent abuse or manipulation remain entirely voluntary.
The foreign exchange (FX) market is the largest, most liquid market in the world – with around US$ 5.3 billion traded daily (according to the BIS triennial survey). FX trading is driven by speculative transactions (more than 80 percent) where high-frequency trading has contributed to greater volatility. Despite all of this, the market it is essentially unregulated. It is critical that regulatory frameworks be designed to safeguard volatility in currencies.

Turkey is an example where foreign direct investment has been declining, and capital flows have become more short-term and speculative in nature. The lack of capital controls prevents protecting the Turkish economy from international financial markets and advanced countries’ monetary policies to increase capital on the markets.

Bank reforms, such as Basel III, do not address one of the most important sources of systemic risk for developing economies: volatile and short-term external capital flows intermediated through the domestic financial system. This may require controls on banks’ short term external liabilities or minimum stay requirements on external capital inflows. Basel III’s countercyclical capital buffer of 2.5 percent of risk weighted assets is inadequate to act as a constraint to a credit boom because many banks in developing economies already hold capital in excess of the regulatory minimum. To properly mitigate these risks it may be necessary for regulators to impose more direct controls on bank lending during a credit boom, or on loan to value ratios, as has been done in some south East Asian countries.

More work needs to be done to emphasize the “systemic risks” of poorly regulated capital flows and lack of capital controls. There are already some financial private sector models to manage financial flows more prudently during times of crisis.4 Although the IMF position has been somewhat more accommodating to allow the ‘management’ of capital flows, it remains a politically sensitive issue at the international level, which hampers regulation and the political will to act. Market based capital mechanisms cannot prevent the negative effects of current capital flow trends and it is important to note that some countries which introduced capital controls have had positive experiences (e.g. Malaysia).

Safeguarding EMDEs: Participants discussed several regulatory areas that need greater attention, including greater transparency and oversight of currency trading, FX markets and instruments linked to corporate bonds from developing countries (such as Exchange Traded Funds) and strengthening capital flow management (i.e. capital controls) tools to mitigate inflows in good times which become destabilizing outflows in bad times.

Challenges with Promoting Long-term Horizons for Finance

According to the FSB’s most recent report on long-term investment finance to the G20 (September 2014), financial reforms have not been “designed to encourage or discourage” long-term finance. If financial reforms at the international and domestic level do encourage long-term financing, EMDEs will continue to rely on tax incentives and foreign currency bond issuances – both of which harm long-term debt sustainability. One potential solution stressed by EMDEs during consultation with the FSB5 is to develop stronger local currency bond markets.

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4 One such model is the ISDA Resolution “Stay Protocol” which is an industry led initiative to manage financial flows more prudently during times of crisis. In this case, it refers to the temporary hold on the right of counterparty in cross-border derivatives swap to terminate transaction and trigger payment.

5 Financial Stability Board. “Update on financial regulatory factors affecting the supply of long-term investment finance”, September 2014 (pg 6)
Workshop participants encouraged further evaluation of other reforms which could be designed to promote long-term finance.

- Concentration of wealth and large “cash pools” searching for short-term returns with high yields has led to growth of hedge funds and private equity funds with short-term and/or very high profitability expectations, which feeds the increasing inequality and has broad societal consequences. High-risk investments could support economic growth but strategies have been mostly unrelated to real sector activity.

**Commodity Derivatives Markets**

Developing countries have experienced and continue to experience the impact of regulatory and market failures of commodity derivatives in multiple ways. Commodity markets have very direct links to the real economy; commodities still account for more than 25% of global trade and in many developing countries a large portion of small farmers are involved in agricultural commodity production. Price volatility and price hikes affect food and energy import dependent developing countries as well as countries that rely on commodity exports. The original purpose of commodity derivatives markets is to discover prices and give price guarantees to commodity producers and buyers (‘hedging’). However, excessive speculation and trading of commodity derivatives, especially by financial players, has been problematic within and across borders, and has impacted the poorest households and producers the most. Reforms of important commodity derivatives markets in the US and the EU has been too weak to prevent speculation.

- Commodity derivatives markets in developing countries such as India do not result in price stability for farmers and producers when there are regulatory and supervisory failures that result in price speculation and manipulation, lack of storing and other capacity adapted to small and local farmers, lack of price stabilization mechanisms.
- Privatized production and financing of commodity production in developing countries such as Ghana have resulted in farmers/producers taking on most of the risks. Therefore, resorting to derivatives markets for price hedging, as the World Bank promotes, might not have the desired stabilizing results.
- Solutions to avoid excessive price volatility due to speculation can be: a commodity transaction tax (CTT). India and Taiwan have such taxes (Taiwan’s tax is 0.001 percent). India also has securities transaction tax (under implementation since 2005); Proposals that reconsider price stabilizing mechanisms other than derivatives markets.
- The international standard setting body IOSCO (International Organisation of Securities Commissions) has introduced principles of commodity derivatives regulation: each country could be checked whether they have followed those principles.

**Breaking Down the Shadow Banking System**

Following a presentation on the shadow banking system, participants discussed its various elements and how the risks within these unregulated financial intermediaries may ultimately affect real economies in developing and advanced countries. Here are some of the key takeaways from this dialogue:

- A shared definition from the workshop: System of unregulated actors performing the same or similar activities that a large bank might have under one roof. Now shadow banking is being
referred to as a more industry-friendly term “market-based financing” and is still hardly regulated, with little political will to do so.

- Banks remain strongly integrated into the shadow banking system: they often guarantee/sponsor shadow banking entities or use to get their wholesale finance (60% of the SIFIs funding comes from shadow banking). The challenge is how to explicitly put these assets on bank balance sheets and prevent banks from behaving like hedge funds. Actors in the shadow banking system are not just hedge funds, but also money market funds, pension funds and even large cash pools of large corporations who make money through a series of shadow banking entities and instruments, mostly in secrecy jurisdictions.

- Concerns are that emerging market (EMDE) bonds (public and private) have become an important part of collateral framework in the shadow banking system. If the value of the EMDE bonds that are used as collateral decreases, then shadow banking contracts increase “margin calls” (requesting more collateral or seizure of the collateral), which leads to further decreasing value of EMDE bonds – not only impacting asset managers in advanced economies, but also pension funds and bond issuers in EMDEs.

- There are broad concerns about banking activities being shifted to non-banking institutions and shadow banking sector, where a growing percentage of finance becomes short-term with expectations for high-profitability.

- Among participants, there was concern about the disconnect between the real economy and financial activity in the shadow banking and offshore system. Also in developing countries like Uganda the use of offshore shadow banking instruments are growing, which requires a cross-border approach of regulators.

- In the developing country context, the shadow banking system can be viewed through the lens of financial inclusion, since many unregulated financial services in these countries often serve poor, rural communities and the “unbanked”. However, this does not mean that such financial services are detached from the greater shadow banking system. Even hedge funds based in tax havens become shareholders of micro-financial institutions. In China, there is a large shadow banking sector (potential case study how regulators deal with it).

The Role of Central Banks

Central banks are a critical component of the international financial infrastructure. Workshop participants discussed central banks mandates, and their unique role in proposing and executing reforms as well as in achieving sustainable development goals.

- EMDE central banks have no control over monetary policy in EU or US, given that there are no to little capital controls. This has major influence on the (short term) capital and investment flows, the value of the currencies, interest rate policies and inflation of EMDE countries. Therefore, EMDE central banks are maintaining high foreign exchange reserves as buffers. This leads central banks to tradeoff between regulatory/stability concerns and development objectives: Should central banks save foreign exchange reserves to act as a buffer to external vulnerabilities or finance domestic development as a long-term strategy to weathering external crises and address development needs of the country?

- Participants recognized that central banks have limitations, and can only act where they have effective tools. However, participants discussed the need to broaden central bank mandates, such as including sustainable development or inequality as a central bank policy objective, which
is being implemented in several EMDE countries. How would this change oversight and regulation of the financial sector?

- In many cases, it is important that large foreign banks are obliged by the host central bank with a supervisory role to establish subsidiaries (not “branches”) for activities in host developing countries. A branch structure gives authority to the home supervisor abroad to facilitate the resolution of foreign branches if an international bank is failing. From the perspective of developing economies, this can be problematic – especially if the home supervisor decides that closing local branches abroad will help resolve the bank’s problems at home (i.e. reduce the need for taxpayer bailout). This can happen even if this bank is critical for the local economy, small businesses or depositors of the host country. When subsidiaries need to be set up, the host supervisor can require a deposit insurance scheme and the loss absorption capacity.

- Cross-border resolution of large international and TBTF banks: It is crucial that there legally binding agreements (MoU) between home and host country supervisors in case a foreign bank fails. However, developing country supervisors are often underrepresented in bank crisis management groups.
  - The Financial Stability Board developed a set of “Key Attributes” for the resolution of cross border banks. The Key Attributes include the setting up of Crisis Management Groups (CMGs) for each cross border bank, comprising the home regulator and host regulators of “materially significant subsidiaries”. In addition, there should be an Institution Specific Cross Border Cooperation Agreement (COAG) which specifies the processes of cooperation and information sharing among the home and host regulators.
  - It is imperative to have close cooperation between the home and host regulators if a distressed cross border bank is to be resolved in an optimal manner, which minimizes the losses to creditors or taxpayers. However, developing economy host regulators of cross border banks should not be excluded from the CMGs simply because the relevant subsidiary has a small share of the global bank’s assets. Many of these subsidiaries are of systemic importance in the host economy. It is crucial that developing country interests are properly taken into account when resolution plans are prepared, which will only happen if developing country host regulators are properly represented on the relevant CMGs.

- The new international standards for capital reserves by banks (‘Basel III’) are based on the problems of the banking sector in the advanced economies and are decided with no to little input from small developing countries where central bankers have to address other needs and avoid that the new standards lead to less credit.

- The central banks in developing countries have to deal with the unintended consequences of the anti-money laundering measures decided in forums where the rich countries dominate.

**Reforms of Bank Structures and Systemic Risk Issues Need to be Back on the Agenda**

During a roundtable dialogue with a representative from the trade unions and Labor 20 (L20), key issues from a labor perspective were discussed.

- Safeguarding pensions and worker retirement funds was – and continues to be – exposed to systemic risks in the financial sector. Also, pension funds are encouraged to be involved in
infrastructure projects, long term investments and even public private partnerships, but are pensioners sufficiently protected against the risks?

- The L20 has also expressed strong support for structural reforms (e.g. downsizing the financial sector and the profits it makes compared to the rest of the economy, reforming private equity funds and shadow banking), but the L20 has emphasized that more work is needed to understand the implications for employment, inequality and the economy. Financial instability and crises have huge costs for workers, citizens, the economy and society.
- Reforms of bank structures – meant to separate core banking activities from market-based and risky activities – were part of the original G20 and FSB reform agenda but have since been removed. It is critical that structural reforms remain on the agenda as a policy option for addressing too-big-to-fail banks (TBTF).
- Various bank structure reforms have progressed at the national level: Volcker Rule in the US, Vickers in the UK and Barnier proposal in the EU. However, the recent initiatives from the European Commission, especially the “Call for evidence: EU regulatory framework for financial services” represent a reversal from the post-crisis goal of creating a stable and more resilient financial system and that deregulation is back on the political agenda.
- There is a need strong legal frameworks that EMDE central banks can build upon in order to separate basic and more speculative banking activities (initial reference points could be India which has rules, and the US which has rules albeit loopholes).

**Links between national and international financial systems**

- Arguments that EMDEs are not interconnected to the global financial system is wrong. There is a need to broaden the discussion on cross-border finance, and focus on the whole financial system, e.g. not just making individual banks or other financial actors more resilient.
- The international financial system penetrates EMDEs through, among others, foreign bank presence, loans by foreign banks to large projects or (extractive) companies that can cause huge local social and environmental harm (e.g. palm oil), local EMDE pension funds being attracted for infrastructure projects, financialisation of commodities (see above) which are produced in developing countries visions. Regulating at national level banks and investors to respect and report on sustainable development principles during their risk weighing for loans , e.g. in Indonesia and other countries, will solve part of the problems that are caused by financial players who are often not identified as part of the problem. However, the international financial players also need to be disciplined in the same way in their home country jurisdictions.
- An interconnection that has become growing financial instability concern for both advanced and developing economies is corporate debt and bond markets. For EMDEs, this concern is particularly acute for a couple reasons: a large amount of corporate debt has been issued in US dollars. When EMDEs weaken and capital flows out, local currencies weaken (which is already happening due to large decrease in commodity prices) it becomes very difficult to service those debts.
- Tax avoidance schemes play an important role whereby a corporation borrows from its “offshore” subsidiary in a low-tax jurisdiction. This is done because interest paid on this loan is far less than the tax that would be paid if that money was repatriated (i.e brought home). In addition, the interest paid on this loan is tax-deductible in some countries.
- Offshore financial activity and its relationship with real sector activity: Participants shared the experience of Kenya and Tanzania, which tried to slow offshore flows in order to assess how
these financial flows were impacting real economy, but this exercise was difficult to execute and ultimately could not be achieved.

- International standards such as capital requirements for banks are influencing the financial services to the poorest part of the population and the economy. There is a tradeoff between financial stability and co-called financial inclusion. Too high capital requirements reduce the banks’ willingness to serve the poor and undermine the possibilities to set up alternative financial services. For developing countries, proportionality in the implementation of the international standards and more information disclosure (on lending practices, fees, etc.) would allow more regulation and policies adapted to their priorities and access to finance.

- Credit rating agencies are based and weakly regulated in advanced economies but have a huge impact on the interest rate that developing countries and their companies have to pay on their debt.

- The international financial fora are promoting increasing in all countries market based finance: who will bear the risks and who will reap the benefits?

**Other Important Issues**

- Unintended consequences of anti-money laundering and anti-terrorism financing legislation and related de-risking: Around the world, banks have to comply with increasingly strict anti-money laundering and combating the financing of terrorism laws. Banks which fail to comply face very large fines. Unfortunately the huge size of the penalties involved and indiscriminate manner in which they have been applied has made banks very risk averse in conducting any transactions with countries afflicted with terrorism.

- Market misconduct: The effects of regulation on correspondent banking and the trends in “de-risking.” Some de-risking is related to anti-money laundering risks, but it’s unclear what is actually driving banks out in other areas, and this has consequences for remittances flows as well as other financial services. The G24 is doing a complimentary study on de-risking, and the FSB is looking into this issue as well.

- The Global Legal Entity Identifier System (GLEIS) is critical for greater transparency in finance and governments should make it a priority. The GLEIS will not only improve risk management but it also supports other important efforts to strengthen AML regulations, beneficial ownership reporting and anticorruption measures.

- “Inclusive finance” issues: are being discussed at G20 level but there needs to be discussion about the national experiences (e.g. in India, Indonesia) and the national needs to ensure that appropriate policies are set up that benefit the poor and very small companies.

- Reform proposals from the UN related to the Sustainable Development Goals and systemic issues in the financial sector (from the Finance for Development agreement in Addis Ababa (2015) might have little impact on the financial sector reforms. The advanced economies refuse interference by the UN, where all countries are represented, in financial system reforms.

- Reform alternatives and progressive proposals: We need to discuss what alternatives financial reforms civil society should propose and what the goals of these proposals should be. For instance, do we propose a do-no-harm financial system, a financial system that is cut down to size and brought back to being subservient to non-financial businesses, or should finance be a positive factor in the necessary transition to a socially just, ecologically sensible and more democratic economy and society? Developing and advocating positive proposals has the
potential to better mobilize civil society organizations and citizens. Instruments are being
developed to measure in how far financial reforms are in the public interest (e.g. Dashboard by
Finance Watch).
- Regulatory capture: The financial regulatory process is being unduly influenced by the financial
industry, which weakens the financial reforms, including at international level. Such regulatory
capture has been identified as one of the causes of the financial crisis. This results in the critical
voice of civil society to be hardly heard and listened to. There is a need to diminish the financial
business lobby e.g. by and exposure, naming and shaming, calling on regulators and policy
makers to balance external inputs.

NEXT STEPS

Strategic Goals for an international civil society network

- Strengthen and deepen the international network covering international financial (regulatory)
issues: more participants from different regions, include social responsible banks/community
banks, risk analysts; mobilising at, and engaging in the other forums, such as the Financing for
Development process and around the IMF/WB meetings, have a core group among whom the
tasks and responsibilities of the network are distributed, with a focus organization per region.
- Important to continue to link to international financial regulatory issues and financial structures
with financial processes at national and grassroots level and with sustainable development, such
as regulatory changes to finance of infrastructure (e.g. through African pension reforms),
- Develop, at both international and national level, educational material and framework of the
various international and national “pressure-points”, through case studies and events. Include
grassroots organizations in network meetings and activities, such as capacity building and
translating or simplification of regulatory issues.
- Redefine the “goals” of financial regulation and influence policy discourse on balancing financial
stability and growth (i.e. macro prudential policy); cannot rely on private banks to address needs
of society.
- Advocacy targets (who to influence): regulators, supervisors, legislators and policy-makers,
financial sector as a whole, behavior of individual banks or investors (demand for long-term,
sustainable products/investments), changing investor services industry (e.g. disclosure reporting)
and influencing consumers and public opinion.
### Participating Organizations

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<td>AFRODAD</td>
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