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International Financial Architecture Reform: The Case for Focusing on Implementation

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At this week's G20 summit in St. Petersburg, the leaders of the world's largest economies will discuss the progress made on one of the group's key priorities: reform of the international financial architecture. Since it first met in 2008 in response to the global financial crisis, the G20 has strived to create a more stable international financial system. Despite the urgency of establishing a stable global financial framework, the implementation of many reforms has been slow. Rather than develop further recommendations, these leaders should now focus on promoting the implementation of the reforms that have been agreed so far.

The global financial crisis of 2007-2008 revealed that the international financial architecture (IFA)—the collective global governance arrangements for ensuring the effective functioning of the global financial system—is structurally flawed. Many of its features, such as increasingly deregulated markets and reliance on credit rating agencies, are widely considered to be the main contributors to the crisis. As a result, a slew of financial regulatory reforms have been undertaken at the global and national levels to restructure the IFA.

This reorganisation of the IFA has broadly been led by the G20, which brings together "systematically important industrialized and developing economies". The G20's national leaders met in Washington in November 2008 in response to the crisis. Financial system reform has been at the core of the group's activities since then. At its summit in St. Petersburg this week, the G20 will consider what progress has been made so far in the implementation of IFA reforms.

How the G20 Drives IFA Reform. The global nature of the crisis, as well as its gravity, shaking the global economy in a way that had not been seen since the Great Depression, required radical action and an inclusive approach. Thus, the G20 took responsibility for guiding IFA reform, which has two major elements: regulatory and institutional.

In the regulatory aspect of IFA reform, the G20 tasked the FSB (Financial Stability Board, created in April 2009 as a replacement for the Financial Stability Forum) with determining target areas for reform. On the basis of FSB recommendations, the G20 sets the agenda for specific reforms of rules that govern the functioning of the IFA. These are then taken up by states and other institutions. The main recommendations put forward by the FSB concern capital adequacy rules, systemically important financial institutions ("too big to fail"), shadow banking systems, international accounting standards, credit rating agencies, financial institution compensation practices, over-the-counter (OTC) derivatives, and others.

The institutional aspect of IFA reform consists of rebalancing global financial institutions to counter their domination by industrialised countries. The G20 summits have led to reform of the FSB, which has 13 new members, 10 of which are from emerging markets. The Basel Committee for Financial Supervision has grown by 14 members. The G20 has also set timetables for its members to pass legislation pertaining to the International Monetary Fund's (IMF) 2010 voting quota realignment, which, once approved by members holding 85% of the total voting share, will increase developing countries' share of the quotas by 6% and replace two of the 24 Executive Board members from developed European countries with representatives from developing countries.

Delays in Implementation. The G20 recommendations for some reform areas, such as oversight of credit rating agencies or the development of global legal entity identifiers (unique identity numbers that would apply to legal entities anywhere), are being properly instigated. However, the implementation of many recommendations has been slow. This can be put down to the technical complexity and delicate politics of many of the reforms, extending the already lengthy legislative procedures that implementation requires.

Capital adequacy rules for banks—the so called Basel III agreement—have been implemented by only half of the FSB's member jurisdictions. A similar number have implemented reforms of rules pertaining to OTC derivative trading. New rules for financial institutions that are "too big to fail" are being unevenly implemented, and progress is especially slow for reform of resolution regimes in case of failure. Recommendations for reform of oversight of shadow banking systems (non-bank financial intermediaries that carry out credit transactions) have been implemented in strikingly different ways in various FSB member jurisdictions. Progress in developing regulations aimed at improving the quality of international accounting standards has been slow. More work is also needed in order for recommendations regarding sound compensation practices to be properly implemented.

The Case for Focusing on Implementation. The delays in the implementation of the IFA reforms cause problems not only because they put off the creation of a new, transparent global financial system but also for several other reasons. First, until the reforms proposed so far are implemented, their consequences and side-effects (such as additional costs of operation) cannot be known, and further progress on stabilising the IFA could be compromised. This is because in making its recommendations, the FSB relies mostly on *ex post* analyses. For example, it was only during the implementation of recommendations regarding institutions that were "too big to fail" that it became clear that changes had to be made to the FSB's cross-border crisis-management groups, a reform measure created for the world's 24 most important banks.

Second, consistency in implementing reforms is vital for achieving clarity in the IFA. As jurisdictions implement the FSB's recommendations, they do so at different speeds, which causes inconsistency and undermines the overarching aim of creating a transparent and reliable IFA. This is particularly salient in the case of EU and U.S. OTC derivative reforms: the timelines and specificities of their respective reforms (the EU Markets in Financial Instruments Directive, aka MiFID II, and the U.S. Dodd-Frank Act) are constantly evolving, and as such create an uncertain and challenging environment for firms. The situation is further complicated by the fact that different jurisdictions can implement the FSB's recommendations in various ways. For example, in response to the FSB's risk retention requirements for shadow banking systems, the EU and the U.S. have chosen to focus on different financial actors: in Europe on investors, while the American rules apply to the institutions that provide the investor with liquidity (so called sponsors).

Third, the growing complexity of the reforms proposed by the FSB to the G20 has added to the overwhelming uncertainty of international financial regulation. Over successive G20 summits, the IFA reform agenda has grown increasingly complex, as the range of institutions and instruments covered has grown, the level of detail and number of processes around supervision have increased, and new measures aimed at regulating the behaviour of financial institutions have been introduced. For example, 2,000 amendments have been submitted to MiFID II since the publication of the first draft in October 2011.

The consequences of delays in the implementation of IFA reforms are serious and could even undo the hard work that has gone towards stabilising the global financial system so far. Moreover, as regulations become more complex and implementation is ever-more drawn out, interest in IFA reform amongst the G20 leaders continues to wane.

Conclusions. It is hoped that the St. Petersburg summit will accord the implementation of IFA reforms the attention it deserves. Temporarily refraining from developing new recommendations and focusing on promoting the implementation of proposals that have already been developed will allow the G20 to rekindle some of the lost enthusiasm among their members and rebuild the collective political will necessary to reform the IFA. This is vital at a time when other topics are vying for the group's attention, with issues such as international trade, sustainable development and corruption on the summit agenda.

An emphasis on implementation will permit the G20 to focus on motivating outliers to conform. For example, without American ratification there can be no further progress in rebalancing—and thus legitimising and strengthening—the IMF. Rather than proposing a new formula for calculating quotas, as proposed by Russian President Vladimir Putin in February,[1] the St. Petersburg Summit should focus efforts on getting the U.S. to implement the reform.

Taking a break from making recommendations in order to focus on implementation may also allow the G20 to step back and reassess the system that has evolved so far. Indeed, what is needed is not only an IFA that creates a stable international financial system but also one that promotes growth. Implementing the current batch of IFA recommendations will allow leaders and regulators to soberly consider the positive and negative effects of the steps they have taken to stabilise the IFA since the peak of the global financial crisis. Even for Poland, which survived the global financial crisis relatively unscathed, though its economic growth is still very dependent on the situation in the eurozone, any measures that could stabilise the international financial system are welcome. But for the potential to become reality, implementation is key.

[1] V.Putin, "Speech at the Meeting with G20 Finance Ministers and Central Bank Governors", 15 February 2013, www.eng.kremlin.ru.