Governance & Development: Views from G20 Countries

Session 1
Presentation

Revisiting Global Governance

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Why global governance is important

- With growing integration of economies, crisis in one country is relevant to one region or world as a whole

- Increasing integration results in more cross-border activity, international trade, cross-border banking and financial flows that may be source of financial instability, threat to national security etc
Main players in today's global financial system

- Main players include: Governments and Central banks of countries and multilateral institutions like World Bank (WB) and International Monetary Fund (IMF)

- Among the multilateral institutions IMF works for international monetary and financial stability

- IMF executive board works with International Monetary and Financial Committee (IMFC) and Development Committee (DC) on various issues relation to global financial system

- Till 1990 G-7 set the IMFC and DC agenda

- After 1999, deliberations in IMFC and DC have been influenced by G-20

Issues in global governance – our focus

- **Quota system of IMF may not reflect ground reality**
  - If GDP PPP is used in quota calculation formula many EME will gain enormously
  - If GDP PPP is used the top 10 countries will include – US, China, Japan, India, Germany, Russia, UK, France, Brazil and Italy
  - International financial reforms and governance must address this aspect lopsided tilt towards industrialized countries

- **Risk Governance**

- **Only aspect on which there is some agreement/understanding is on Basel regulations**
Relative strength within the G-20 nations

<table>
<thead>
<tr>
<th>Economy</th>
<th>Total IMF Quota (%)</th>
<th>Voting Share (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Industrialized</td>
<td>60.52</td>
<td>57.88</td>
</tr>
<tr>
<td>Emerging market</td>
<td>19.78</td>
<td>19.01</td>
</tr>
</tbody>
</table>

Source: Vasudevan (2012)

- Voting power in IMF Executive Board is exercised by Executive Directors
- Executive directors representing the industrialized economies represent 58.42% of the total voting rights
- After the formation of EU there are more than one executive directors to represent EU countries

Reforms in global governance

- Reforms in global financial system have centered around the IMF in post crisis period
- Reform in IMF was discussed in London Summit in April 2009 and in Pittsburg in September 2009
- 14th General Review of Quota did not meet the expectations of EME in November 2010
- Industrialized economies lost 2.8% of combined quota from 60.5% in Apr 2008 to 57.7% in 2010
  - Gainers: US, Japan, Spain and Italy
  - India gain 0.31%
Reforms in global governance

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  - IF GDP PPP is used the top 10 countries will include – US, China, Japan, India, Germany, Russia, UK, France, Brazil and Italy
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- Other issues which need attention but no deliberations
  - Monetary regulation
  - Regulation of trade and investment in financial services
  - Cross border activity
  - Co-ordination of national financial regulation
  - Coordinate taxation of financial transaction
  - Arrangement for sovereign debt problem
  - Cross border bankruptcy
  - Regulations on international money laundering

- Only aspect on which there is some agreement/understanding is on Basel regulations

An illustration of Effective Risk Governance

An effective ERM framework can provide reasonable assurance that the organization’s strategic objectives can be achieved. Building an effective framework requires a number of interrelated components including:

- A strong risk governance structure
- A clearly articulated risk appetite
- A clear risk strategy aligned with strategic objectives and key value drivers
- A strong risk management culture and capability
- Ongoing review of the risk framework, tolerances, and settings
- A common risk language and criteria

- Clear risk prioritisation and coordination
- Clear line of responsibility and accountability
- A strong compliance focus
- Continuous risk monitoring and review
- Efficient and effective processes, with appropriate tools and technology
- A commitment to continuous improvement, training and learning
### Chronology of financial crises date back to 19291/2

<table>
<thead>
<tr>
<th>Risk category</th>
<th>Year</th>
<th>Crisis</th>
<th>Country of origin</th>
<th>Industry</th>
<th>Impact¹</th>
</tr>
</thead>
<tbody>
<tr>
<td>Credit Risk</td>
<td>1929</td>
<td>Banking Crisis</td>
<td>USA</td>
<td>Financial Services, Banks</td>
<td>$50 bn</td>
</tr>
<tr>
<td>Credit Risk</td>
<td>1974</td>
<td>Bank Herstatt failure</td>
<td>Germany</td>
<td>Financial Services, Banks</td>
<td>$1.5 bn</td>
</tr>
<tr>
<td>Credit Risk</td>
<td>1978</td>
<td>Banking Crisis</td>
<td>Spain</td>
<td>Financial Services, Banks</td>
<td>50 banks impacted</td>
</tr>
<tr>
<td>Market Risk</td>
<td>1984</td>
<td>Savings &amp; Loan Crisis</td>
<td>USA</td>
<td>Financial Services, Banks</td>
<td>$160 bn</td>
</tr>
<tr>
<td>Credit Risk</td>
<td>1988</td>
<td>Banking Crisis</td>
<td>Norway</td>
<td>Financial Services, Banks</td>
<td>$2 bn</td>
</tr>
<tr>
<td>Credit Risk</td>
<td>1991</td>
<td>Banking Crisis</td>
<td>Sweden</td>
<td>Financial Services, Banks</td>
<td>$9.4 bn</td>
</tr>
<tr>
<td>Credit Risk</td>
<td>1991</td>
<td>Banking Crisis</td>
<td>Japan</td>
<td>Financial Services, Banks</td>
<td>$0.5 bn</td>
</tr>
<tr>
<td>Market Risk</td>
<td>1994</td>
<td>Orange County Interest Rate</td>
<td>USA</td>
<td>Municipal Institution</td>
<td>$1.6 bn</td>
</tr>
<tr>
<td>Market Risk</td>
<td>1998</td>
<td>Long Term Capital Management</td>
<td>USA</td>
<td>Financial Services-Hedge Funds</td>
<td>$3.5 bn</td>
</tr>
<tr>
<td>Operational Risk</td>
<td>1999</td>
<td>Prudential – Class Action Suit</td>
<td>USA</td>
<td>Financial Services, Insurance</td>
<td>$2 bn</td>
</tr>
<tr>
<td>Market Risk</td>
<td>2000</td>
<td>Equitable Life</td>
<td>UK</td>
<td>Financial Services, Insurance</td>
<td>$3.5 bn</td>
</tr>
<tr>
<td>Operational Risk</td>
<td>2001</td>
<td>Linon &amp; WorldCom-Accounting</td>
<td>USA</td>
<td>Manufacturing</td>
<td>$60 bn</td>
</tr>
<tr>
<td>Operational Risk</td>
<td>2001</td>
<td>Swiss RE-External events</td>
<td>USA</td>
<td>Financial Services, Insurance</td>
<td>$3.5 bn</td>
</tr>
<tr>
<td>Operational Risk</td>
<td>2004</td>
<td>Choice Point-Data Theft</td>
<td>USA</td>
<td>Data Brokerage</td>
<td>1.1 lakh people affected</td>
</tr>
<tr>
<td>Operational Risk</td>
<td>2005</td>
<td>AIG-Accounting</td>
<td>USA</td>
<td>Financial Services, Insurance</td>
<td>$1.0bn</td>
</tr>
<tr>
<td>Operational Risk</td>
<td>2005</td>
<td>Citigroup-AML violations</td>
<td>USA</td>
<td>Financial Services-Banks</td>
<td>NA</td>
</tr>
<tr>
<td>Credit Risk</td>
<td>2008</td>
<td>Credit Crisis</td>
<td>USA</td>
<td>Financial Services-Banks, Insurance, Hedge Funds, Investment Bank</td>
<td>$15000 bn</td>
</tr>
</tbody>
</table>

Source: Collated from several other sources: www.about.com

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### Financial Crisis (Sep’2008 onwards): Key Learnings  1/2

#### Key Findings
- Risk management systems were informal
- Boards did not understand their risk profile
- Strategies delinked from risks
- Large variance between chief executive and non-executive compensation policies
- Misalignment with long-term shareholder value and CEO/Chairman’s personal wealth

#### Key Learnings
- Board must establish & oversee the risk management structure
- Defined risk appetite
- Internal control framework should be structured, formal, risk-based, and working effectively
- Risk management functions have adequate stature
- Alignment of corporate strategy with risk appetite and the internal risk management structure
- Alignment of corporate strategy with risk appetite and the internal risk management structure
- Risk management framework / structure should effectively with ample “Risk Dialogue”
- Remuneration must be established through an explicit/ transparent governance process, where roles and responsibilities of those involved are clearly defined and separated. Significant role should be given to NED members in the process
- It should be considered good practice that remuneration policies are submitted to the annual meeting and as appropriate subject to shareholder approval
## Key Findings and Key Learnings

<table>
<thead>
<tr>
<th>Board Professionalism</th>
<th></th>
<th>Key Learnings</th>
</tr>
</thead>
<tbody>
<tr>
<td>Erosion in independent / objective oversight role of boards</td>
<td>Clearly establish the objectivity of the Board</td>
<td></td>
</tr>
<tr>
<td>Combined chairman / CEO (US) Boards were less independent than they appeared</td>
<td>Solid leadership by the Board chairman and the CEO</td>
<td></td>
</tr>
<tr>
<td>There may have been too few executives on the board</td>
<td>Functions of Chief Executive Officer and Chair of the Board of Directors in unitary boards should be separated (in UK, nearly 95% of FTSE 350 companies has adopted this practice. However, in US, the corresponding %age is 20%)</td>
<td></td>
</tr>
<tr>
<td>Technical expertise may have been inadequate</td>
<td>Appoint experienced NEDs</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Disclosure and Transparency</th>
<th></th>
<th>Key Learnings</th>
</tr>
</thead>
<tbody>
<tr>
<td>Significant financial and non-financial non disclosure</td>
<td>Internal audit has broad mandate (not just financials) and reports independently to the Board</td>
<td></td>
</tr>
<tr>
<td>Variety of problems and debates over accounting standards (e.g. mark-to-market / fair value)</td>
<td>Independent external auditor is independent, reputable, and conducts no other advisory services</td>
<td></td>
</tr>
<tr>
<td>Concerns over disclosure of risks</td>
<td>Information and communication within the organization flows adequately to support transparency &amp; subsequent disclosure</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Shareholder Roles and Rights</th>
<th></th>
<th>Key Learnings</th>
</tr>
</thead>
<tbody>
<tr>
<td>Debates over shareholder engagement and passivity during run-up to crisis</td>
<td>Shareholders should have defined rights and obligations</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Right to appoint directors</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Right to obtain information about the company</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Institutional investors should play an active role</td>
<td></td>
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</tbody>
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### Learning from Financial Crises from the past

#### Great Depression of 1929
- Independent external audits made mandatory in 1932

#### US corporate crisis of 1970
- Audit committees

#### Asian financial crisis (1998)
- Dotcom bust (2000)
- Enron, Worldcom & Tyco scandals in US
- Parmalat earnings mis-statement Italy (2002)
- Enlarging the scope of audit committees
- “Independent” directors
- Codes of best practice in corporate governance
- New stock market listing rules governing disclosure and financial reporting (eg, quarterly reporting, quicker reporting of annual results, disclosure of price-sensitive information)
- Major changes to company and securities laws

#### Global financial crisis (2008)
- Risk Governance
- Remuneration and Alignment of Incentive Structures
- Board Professionalism
- Disclosure and Transparency
- Shareholder Roles and Rights
- Redefined regulatory framework with more emphasis on enterprise

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Corporate Governance and Financial Crisis, IFC (2009)
Summing up from crisis

- Global financial crisis should facilitate strengthening
  - Inadequate risk governance processes
    - Board should ensure an existence of a governance structure adequately structured, formal, risk-based, and working effectively
    - Risk management framework / structure should effectively with ample ‘Risk Dialogue”
  - Misaligned corporate incentive structures
    - Compensation structure be established through an explicit/ transparent governance process
    - Compensation policies to be aligned with longer-term corporate interests
  - Lack of Board professionalism & oversight
    - Clearly establish the objectivity of the Board
    - Functions of Chief Executive Officer and Chair of the Board of Directors should be separated
  - Significant financial and non-financial non disclosure
    - Independent external auditor is independent, reputable, and conducts no other advisory services
    - Information within the organization flows adequately to support transparency & disclosure
  - Lack of shareholder engagement and shareholder passivity
    - Shareholders should have defined rights and obligations
  - Redefining regulatory framework with more emphasis on enterprise

Beyond box ticking: A new era for risk governance*

- In May 2009, the Economist Intelligence Unit (sponsored by KPMG and ACE) surveyed 364 executives around the world across a range of regions and industries on their approach to risk management and corporate governance

- The key findings were:
  1. Companies recognise the need for greater risk expertise but there is a reluctance to recruit it in some areas
  2. Financial constraints are hampering necessary investments in risk management
  3. Compliance, controls and monitoring are consuming a disproportionate amount of time but risk managers’ real priorities lie elsewhere
  4. More needs to be done to ensure that the right risk information is reaching the right people
  5. There is a window of opportunity for chief risk officers to take on a more strategic role

*Source: Economist Intelligence Unit, May 2009 survey results
Summing up..

- Evidence suggests existence of a regulatory / risk management framework prior to the crisis
  - COSO, Basel norms

- Regulatory / Risk management framework however has more often been reactive

- 2008 financial crisis has been contrary to popular perceptions
  - Failure of Governance & Oversight

- There are increasing examples of operational risk failures and it difficult to disentangle operational risk from credit risk and even market risk

- Need to revisit regulatory framework (for example, like Basel III, Dodd Frank)

- Going forward, it is advisable to have a 3 layered structure with
  - Governance
  - Appetite
  - Infrastructure
    - Identification
    - Measurement
    - Monitoring
    - Reporting / Disclosure

Financial regulations – Basel accord

- Basel accord – a regulation to secure financial stability

- However, Financial Stability Board (FSB) which is at the forefront for creation of Basel Accord does not include all the members of IMF/WB

- FSB will address the following topics:
  - Monitoring of Basel III implementation among its members
  - Adoption of the methodology for the selection of, and apply a supervisory regime to, domestic systemically important financial institutions
  - Promotion of shadow banking regulation;
  - Development of the global legal entity identifier (LEI) system;
  - Reduction of mechanistic reliance on Credit Rating Agency (CRA) ratings;
  - Completion of the over-the-counter derivatives reform
Basel regulation and financial governance in India

- Highlights of latest assessment report by IMF for India (Aug 29, 2013)
  - India made considerable progress towards developing a stable financial system through improvements in the legal, regulatory and supervisory framework, which led India to be less affected by the global financial crisis
  - RBI has made significant progress regarding supervisory information sharing and cooperation with jurisdictions where Indian banks are operating
  - Reserve Bank has entered into Memorandums of Understanding (MoUs) on “Supervisory Co-operation and Exchange of Information” with 16 overseas jurisdictions where Indian banks have significant presence
  - Significant progress made regarding supervision of financial conglomerates and monitoring of corporate indebtedness with the amendment of Section 29A of Banking Regulation Act in December 2012

- To streamline and further strengthen the statutory framework and address regulatory overlaps, the Financial Sector Legislative Reforms Commission (FSLRC) has been made recommendations that are under the consideration of the Government of India

- Assessment identifies several gaps and constraints in the implementation of regulatory and supervisory framework

- These include international and, domestic supervisory information sharing and cooperation, consolidated supervision of financial conglomerates, higher large exposure limits for group borrowers and some limits on the independence of the RBI
Other issues in financial regulation

- Nationalization of AIG demonstrated the risk of how crisis in banking can spillover into insurance sector and heighten systemic risk

- There is need to relook at the present position on regulation of banking and insurance sector jointly

- Some issues include:
  - Definition of capital in banks and insurance companies
  - Assess the impact of two different regulatory framework Basel II and Basel III in banking and Solvency II in insurance companies