Governance & Development: Views from G20 Countries

Session 1 **Presentation**

Revisiting Global Governance

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Revisiting Global Governance

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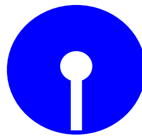

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Why global governance is important

- 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 todays 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

Quota and voting share within IMF

Economy	Total IMF Quota (%)	Voting Share (%)
Industrialized	60.52	57.88
Emerging market	19.78	19.01
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

- **Quota system of IMF may not reflect ground reality**
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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
  - International financial reforms and governance must address this aspect lopsided tilt towards industrialized countries
- **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 1929 1/2

Risk category	Year	Crisis	Country of origin	Industry	Impact[1]
Credit Risk	1929	Banking Crisis	USA	Financial Services-Banks	$50 bn
Credit Risk	1974	Bank Herstatt failure	Germany	Financial Services-Banks	$1.5 bn
Credit Risk	1978	Banking Crisis	Spain	Financial Services-Banks	50 banks impacted
Market Risk	1984	Savings & Loan Crisis	USA	Financial Services-Banks	$160 bn
Credit Risk	1988	Banking Crisis	Norway	Financial Services-Banks	193 banks impacted
Credit Risk	1991	Banking Crisis	Sweden	Financial Services-Banks	$9.4 bn
Credit Risk	1991	Banking Crisis	Japan	Financial Services-Banks	$0.5 bn
Market Risk	1994	Orange County- Interest Rate	USA	Municipal Institution	$1.6 bn
Market Risk	1998	Long Term Capital Management	USA	Financial Services-Hedge Funds	$3.5 bn
Operational Risk	1999	Prudential – Class Action Suit	USA	Financial Services-Insurance	$2 bn
Market Risk	2000	Equitable Life	UK	Financial Services-Insurance	$3.5 bn
Operational Risk	2001	Enron & WorldCom-Accounting	USA	Manufacturing	$60 bn
Operational Risk	2001	Swiss RE-External events	USA	Financial Services-Insurance	$3.5 bn
Operational Risk	2004	Choice Point-Data Theft	USA	Data Brokerage	1.1 lakh people affected
Operational Risk	2005	AIG-Accounting	USA	Financial Services-Insurance	$1.6bn
Operational Risk	2005	Citigroup –AML violations	USA	Financial Services-Banks	NA
Credit Risk	2008	Credit Crisis	USA	Financial Services-Banks, Insurance, Hedge Funds, Investment Bank	$15000 bn

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

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

	Key Findings	Key Learnings
Risk Governance	• Risk management systems were informal	• Board must establish & oversee the risk management structure • Internal control framework should be structured, formal, risk-based, and working effectively
	• Boards did not understand their risk profile	• Defined risk appetite • Regular meetings of risk committees • Risk management functions have adequate stature • Regular actions & follow-up
	• Strategies delinked from risks	• Alignment of corporate strategy with risk appetite and the internal risk management structure • Risk management framework / structure should effectively with ample 'Risk Dialogue"
Remuneration and Alignment of Incentive Structures	• Large variance between chief executive and non-executive compensation policies • Misalignment with long-term shareholder value and CEO/Chairman's personal wealth	• 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

Corporate Governance and Financial Crisis, IFC (2009)

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

	Key Findings	Key Learnings
Board Professionalism	• Erosion in independent / objective oversight role of boards	• Clearly establish the objectivity of the Board • Solid leadership by the Board chairman and the CEO
	• Combined chairman / CEO (US) Boards were less independent than they appeared	• 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%)
	• There may have been too few executives on the board	• Appoint experienced NEDs
	• Technical expertise may have been inadequate	• Assigning key tasks to board committees composed of a majority of NEDs • Board should develop specific policy for identification of NED
Disclosure and Transparency	• Significant financial and non-financial non disclosure	• Internal audit has broad mandate (not just financials) and reports independently to the Board
	• Variety of problems and debates over accounting standards (e.g. mark-to-market / fair value)	• Independent external auditor is independent, reputable, and conducts no other advisory services
	• Concerns over disclosure of risks	• Information and communication within the organization flows adequately to support transparency & subsequent disclosure
Shareholder Roles and Rights	• Debates over shareholder engagement and passivity during run-up to crisis	• Shareholders should have defined rights and obligations • Right to appoint directors • Right to obtain information about the company • Institutional investors should play an active role

Corporate Governance and Financial Crisis, IFC (2009)

Learning from Financial Crises from the past

Great Depression of 1929

- Independent external audits made mandatory in 1932
- Securities Act of 1933 and Securities Exchange Act of 1934 enacted in US for "discloser based"regulatory system.

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)

(In process)

- 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

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

Thank You