G-20 Background Note

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Introduction

The third meeting of the G-20 heads of government will take place in Pittsburgh, PA on September 24-25, 2009. The outgoing Bush Administration convened the first meeting of G-20 heads of state in Washington, DC in November 2008. Since then, the G-20 is rapidly establishing itself as the leading international forum for coordinating national policies to limit the damage from the global economic crisis, and for recommending changes to the global financial architecture that will help to prevent a future crisis, or mitigate its effects.

This background note will provide an overview of the origins of the G-20 as a heads-of-state meeting, review the outcome of the two previous G-20 meetings in Washington, DC and London in April, 2009, and discuss the agenda for the Pittsburgh meeting and expectations for what policy outcomes may be achieved there.

Background

The group was started in 1999 as a meeting of finance ministers and central bank governors in response to the Asian Financial Crisis. The G-20 group includes the membership of the G-8 group - US, UK, France, Russia, Germany, Japan, Italy and Canada - as well as a more geographically diverse group of major emerging economies including China, India, Australia, South Korea, Brazil, Mexico, Saudi Arabia, South Africa, Argentina, Indonesia, Turkey, and the European Union.[2] The Bush Administration, led by the Treasury Department, decided to convene the G-20 forum as a head-of-state meeting for the first time, rather than a smaller G-8 meeting, in November 2008 in Washington, DC in response to the global economic crisis.

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[2] Information on the composition of the G-20 and its working groups at: http://www.g20.org.

Because the November 2008 G-20 meeting followed the U.S. presidential election, initial expectations were low. The need for a global response to the economic crisis was clear, but it was not certain that a meeting format adopted by the outgoing administration would be continued.

The Washington meeting was considered successful in that it established a broader group of nations than the G-8 to address the global economic crisis: the G-20 nations collectively represent almost 90 percent of the global economy and two-thirds of the global population.[3] It also established continuity for the G-20 format as an ongoing head-of-state meeting by mandating a second meeting, and solved the sensitive political problem of which emerging economies to include in the expanded group by elevating the existing G-20 meeting of finance ministers and central bank governors to the head-of-state level.[4]

While the G-8 was criticized for being Euro-centric and unrepresentative of the global economy, the G-20 now includes China, India, and major emerging economies in Asia, Africa and South America in discussions on the future direction of the global economy. Countries are also included in the G20 meetings by special invitation: Abhisit Vejjajiva, Prime Minister of Thailand, will participate in the Pittsburgh meeting as the chair of the Association of Southeast Asian Nations (ASEAN); Spain and the Netherlands – both EU member countries – will also participate directly in the Pittsburgh Summit at the invitation of the Obama Administration.[5]

The Washington, DC and London G-20 meetings

Washington, DC – November 2008

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[3] Colin I Bradford, Johannes Linn, and Paul Martin, "Global Governance Breakthrough: The G-20 Summit and the Future Agenda," Brookings Policy Brief Series #168, December 2008.
[4] Ibid.
[5] Jenilee Guebert, "Plans for the Third G20 Summit: Pittsburgh 2009", G20 Research Group, September 1, 2009, p. 53.

Issued on November 15, 2008, the Washington G-20 summit declaration set out a series of common principles to govern financial market reforms globally:

- **Strengthening Transparency and Accountability**: requiring clearer disclosure of the terms of complex financial products, accurate disclosure of the financial positions of firms, and creating incentives to avoid excessive risk-taking;
- **Enhancing Sound Regulation:** strengthening prudential oversight and risk management throughout financial markets, including enhanced oversight of credit rating agencies;
- **Promoting Integrity in Financial Markets**: improving investor and consumer protection, mitigating conflicts of interest throughout the economy, avoiding market manipulation, and promoting information sharing;
- **Reinforcing International Cooperation**: national and regional regulators should formulate consistent regulations, and enhance cross-border coordination on capital flows, crisis prevention, management and resolution;
- **Reforming International Financial Institutions**: reform of the World Bank, IMF and other international financial institutions (see discussion of the reconstituted Financial Stability Board (FSB) below).

As noted above, the fact that the Washington Summit Declaration mandated a follow-up meeting by April 30, 2009 served the dual purpose of focusing the G-20 governments on achieving short-term progress on key financial reforms, and of ensuring that the G-20 head-of-state meeting format would have a chance to take hold, with the Obama Administration participating.

London – April 2009

UK Prime Minister Gordon Brown was among the chief advocates for the global response to the economic crisis to create a new global financial order – a "Bretton Woods II." While first two G-20 meetings did not result in this level of reform, the pair of declarations following the London meeting marked some significant changes.

The G-20 agreed to make an additional $850 billion in financing available to emerging market and developing countries,[6] as well as the introduction of new IMF lending procedures (a "Flexible Credit Line") aimed at reducing the market stigma attached to IMF lending and ensuring that the IMF is better able to make funds available to member countries in a crisis. The second London Summit Declaration provided a progress report on the action items agreed to at the Washington meeting, and specified that the G20 members had agreed on reforms in several areas, including:

- **International Cooperation**: reforming the structure of the FSB (discussed below) to enlarge its role in cross-border crisis management and begin its collaboration with the IMF on "early warning exercises" to identify vulnerabilities in the global economy; and to encourage both organizations to develop international frameworks covering bank resolution authority and coordinated exit strategies from national economic stimulus programs;
- **Prudential Regulation**: maintaining minimal capital standards until economic recovery is assured, but then strengthening regulations governing minimum capital requirements, increasing the quality of capital, and creating guidelines to harmonize the definition of capital internationally; implementing G20 recommendations to mitigate pro-cyclicality by requiring banks to maintain buffers of resources to counter market downturns; supplementing risk-based capital requirements with measures that account for off-balance sheet exposures; improving the incentives for risk management of securitization; progressive adoption of the Basel II capital framework by all G20 countries;
- **Scope of Regulation**: ensuring that national regulators have the necessary information to assess potential sources of systemic risk; producing IMF/FSB guidelines for national regulators on the definition of systemic significance; registration of hedge fund managers and their portfolios to assess their systemic significance; promoting the standardization of credit derivatives markets and the use and regulation of central clearinghouses for derivatives;

[6] "Declaration on Delivering Resources through the International Financial Institutions", London, 2 April 2009. Available on-line at: http://www.g20.org/Documents/Fin_Deps_IFI_Annex_Draft_02_04_09_-_1615_Clean.pdf

- **Compensation**: establishing compensation practices in line with a firm's long-term goals and prudent risk-taking; involving firm boards of directors in designing and assessing appropriate compensation schemes; bringing the timing of bonus payments in line with the time horizons of risks; requiring firm disclosure of pay structures;
- **Accounting Standards:** reducing the complexity of accounting standards for financial instruments; improving accounting standards for provisioning, off-balance sheet exposures and valuation uncertainty; developing a single set of high quality global accounting standards;
- **Credit Rating Agencies:** registering all credit rating agencies whose ratings are used for regulatory purposes; differentiating ratings for structured products; disclosing the ratings track records of ratings firms; Basel Committee review of the role of external ratings in prudential regulation. [7]

At the London meeting, the G-20 also agreed to expand the membership of the existing Financial Stability Forum to include all G-20 members, re-named the organization the FSB, and outlined its mandate to develop regulatory best practices and to promote coordination between national regulators. The G-20 mandate includes a role for the FSB as an international monitor of systemic risk in the global economy. In addition to instructing the FSB to "assess vulnerabilities affecting the financial system" and to "monitor and advise on market developments and their implications for regulatory policy," the G-20 mandated that the FSB work with the IMF to conduct "Early Warning Exercises" designed "to identify and report to the International Monetary and Financial Committee (IMFC) and the G20 Finance Ministers and Central Bank Governors on the build-up of macroeconomic and financial risks and the actions needed to address them."[8] In addition to the expanded FSB, the G-20 is developing strategies for the coordinated supervision of systemic risk at the international and national levels through the establishment of a European Systemic Risk Board run by the European Central Bank.[9]

While there was general agreement on expanding the FSB's membership to bring it in line with the broader membership of the G-20 and support for the need to monitor the international economy for

[7] "Declaration on Strengthening the Financial System," London, 2 April 2009. Available on-line at: http://www.g20.org/Documents/Fin_Deps_Fin_Reg_Annex_020409_-_1615_final.pdf
[8] Ibid, p.1.
[9] Guebert, p. 56.

new sources of instability, there is some skepticism over the FSB's ability to enforce actions by its member nations in response to any emerging risks it perceives.[10] This reticence to follow the policy lead of international institutions may be particularly strong in America in comparison to Europe and Asia, but other countries are likely to be subject to it as well.

Agenda and expectations for Pittsburgh meeting

Each G-20 head-of-state meeting is preceded by a meeting of finance ministers and central bank governors; the preparatory meeting for the Pittsburgh Summit was held on September 4-5 in London. Where the preparatory meetings for the previous two G-20 summits were marked by fears of a deepening downturn, this month's meeting was marked by cautious optimism that the worst of the crisis may have passed.

Compensation and capital requirements issues (discussed below) feature prominently in the G-20 finance ministers' "Declaration on Further Steps to Strengthen the Financial System" issued following the meeting.[11] The minister groups raised other key issues in its separate communiqué in anticipation of the Pittsburgh meeting. In that document, the G-20 ministers agreed to work with the reconstituted FSB and the IMF in their capacity as monitors of risk to the financial system and coordinators of best practices in national regulation.[12]

Executive Compensation

Debate about executive compensation practices has been prominent in member country governments prior to the Pittsburgh meeting. At the September 4-5 London meeting, several G-20 finance ministers, led by Christine Lagarde of France, publicly backed a "strict" G-20 policy on executive compensation that

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[10] In an article following the London meeting, *The Economist* warned that domestic political pressures would trump any effort by the FSB to get member nations to act on its warnings regarding new risk: "But if it warns, who will listen? Imagine the scene in Congress in 2015. The economy is booming, but Americans cannot get mortgages because some pen-pusher in Basel says the banks are taking too much risk. The banks would be freed faster than you can say 'swing voter'." Spin and Substance: What the G-20 Did and Did Not Achieve," *The Economist*, April 8, 2009.

[11] "Declaration of Further Steps to Strengthen the Financial System," Meeting of Finance Ministers and Central Bank Governors, London, September 4-5, 2009.

[12] Communiqué, Meeting of Finance Ministers and Central Bank Governors, London, 4-5 September 2009.

would ban bonuses that are guaranteed for more than one year, spread bonus payments out over multiple years, and compel banks to make the details of their compensation policies publicly available.[13] France's position on compensation is representative of EU efforts to apply more specific financial penalties for excessive pay practices by sanctioning firms that engage in them, and there is a push within the EU to have the G-20 set the standards which govern such penalties.[14]

Following the September 4-5 meeting, Secretary Geithner expressed strong support for calls for compensation reform from the G-20 member states and discussed the similarities between those proposals and the Obama Administration's reform plans on executive pay released in February 2009.[15] The Obama proposals included the shareholder voting provisions and the disclosure standard for executive pay practices.[16] The Obama Administration also stressed the need to align compensation practices with a firm's long-term risk profile, and suggested placing requirements on executives to hold firm stock for a number of years before being eligible to sell it.

The U.S., U.K., France, Germany and other countries are interested in maintaining competitive financial services sectors; one key concern among member countries is adopting pay standards that couldput them at any competitive disadvantage with others in attracting top talent in the sector. Moreover, with the economy beginning to stabilize and financial firms implementing their own changes to pay practices in response to the crisis, some analysts already perceive G-20 discussions on compensation practices as a "sideshow" that will fade as the economy recovers, and inhibiting discussion of other important structural financial sector reforms.[17]

Capital Requirements

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[13] Christine Lagarde et al, "G20 Must Bring Banks' Bonus Culture to an End", *Financial Times*, September 4, 2009
[14] "EU to Call for Sanctions on Excessive Bank Pay," Associated Press, September 16, 2009.
[15] White House press release: http://www.whitehouse.gov/the_press_office/TreasuryAnnouncesNewRestrictionsOnExecutiveCompensation/
[16] Disclosure of incentive-based compensation practices for financial institutions valued at over $1 billion was also a requirement of legislation on executive pay passed by the U.S. House in July (HR 3269 – the Corporate and Financial Institution Compensation Fairness Act.) That bill also gives a firm's shareholders the right to hold a "non-binding advisory vote" on its compensation practices, and it includes risk associated with compensation practices in solvency regulations for financial firms.
[17] Interview with Steven Dunaway, Adjunct Senior Fellow in International Economics, Council on Foreign Relations, September 10, 2009. Available on-line at: http://www.cfr.org/

Another anticipated agenda item for the Pittsburgh meeting is capital standards. The Treasury Department released a series of core principles for reforming international bank capital standards at the meeting of G-20 finance ministers and central bank governors earlier this month. In its paper outlining the principles, the Treasury acknowledged that capital requirements are only one among many regulatory tools, but concluded that "stronger, higher capital requirements for banking firms are absolutely essential," and that these requirements should be designed to limit any impact on credit availability.[18] The Treasury also sets out a deadline of December 31, 2010 for an agreement on the design of a new global framework on capital standards, based around these principles:

- Capital Requirements Should be Designed to Protect the Stability of the Financial System as well as individual firms;
- Capital Requirements For All Banking Firms Should be Higher, and Capital Requirements for Tier 1 FHCs Should be Higher than Capital Requirements for Other Banking Firms;
- The Regulatory Capital Framework Should Put Greater Emphasis on Higher Quality Forms of Capital;
- Risk-Based Capital Requirements Should be a Function of the Relative Risk of a Banking Firm's Exposures, and Risk-Based Capital Ratios Should Better Reflect a Banking Firm's Current Financial Condition;
- The Procyclicality of the Regulatory Capital and Accounting Regimes Should be Reduced and Consideration Should be Given to Introducing Countercyclical Elements into the Regulatory Capital Regime;
- Banking Firms Should be Subject to Simple, Non-Risk-Based Leverage Constraint;
- Banking Firms Should be Subject to a Conservative, Explicit Liquidity Standards;
- Stricter Capital Requirements for the Banking System Should Not Result in the Re-emergence of an Under-Regulated Non-Bank Financial Sector that Poses a Threat to Financial Stability.[19]

[18] "Principles for Reforming the U.S. and International Regulatory Capital Framework for Banking Firms", September 3, 2009. Available on the Treasury web site: http://www.treas.gov/press/releases/docs/capital-statement_090309.pdf
[19] Ibid.

The Treasury plan identifies these as "high-level principles" and leaves the agreement of specific recommendations, such as the level minimum capital ratios, for deliberation elsewhere. Upcoming finance minister and head-of-state G-20 meetings are a potential venue for negotiating the specifics of new capital requirements.

Future of the G-20

The G-20 head-of-state meeting has started its life as a crisis-management organization and a conduit for coordinating reforms to the global economy. The economy has begun to stabilize, but the process of achieving financial reform will likely take time. Semiannual G-20 meetings are expected, in the short term, to be the major venue where changes to the regulatory architecture are debated and, in the longer term, the venue where these new regulations may even be implemented and updated so that they function practically. The leaders of South Korea and Australia have discussed the importance of the G-20's future role in coordinating national exit strategies from government intervention, guiding international financial reforms by "facilitating international agreements on shared principles and implementing a global monitoring and 'peer review' process."[20]

In a further sign that the G-20's importance may already entrenched, some prominent leaders are already trying to define its mandate. Earlier this year, former Soviet leader Mikhail Gorbachev wrote that "crisis prevention should not be the G-20's main task," and suggested that it hold future meetings jointly with the UN.[21] However, others have suggested that the G-8 is likely to continue as a heads-of-state summit, with its agenda re-focused on foreign policy and security issues, while the G-20 maintains a singular focus on the international economy. Some thought leaders already anticipate that the G-20 could play a role in maintaining the stability of the world economy over the coming years. Having established a new working relationship with the FSB and IMF to monitor the state of the global

[20] Lee Myung-Bak and Kevin Rudd, "The G-20 Can Lead the Way to Balanced Growth," Financial Times, September 2, 2009.
[21] Mikhail Gorbachev, "What Role for the G-20?", *New York Times*, April 28, 2009.

economy, the G-20 could position itself as the main venue for addressing economic problems, such as the issue of global imbalances, which will take years to resolve.[22]

Conclusion

Preparation for the Pittsburgh G-20 meeting has driven substantive discussion of several key financial reform issues – systemic risk, executive compensation and capital requirements. The G-20 process led to the expansion of the FSB and created its new mandate to monitor the global economy for sources of systemic risk, as well as its role as a potential coordinator of efforts to counteract systemic risk in national economies. Proposals on executive compensation from France, the US, the EU and others have been released around G-20 planning meetings, as have proposals on capital requirements. At a minimum, the G-20 process can now be seen as a driver of policy development and a venue for the details of reform policies to be negotiated, agreed to, and monitored. The effectiveness of the G-20 going forward will rely on the level of consistent engagement from its member countries, the resources they devote to it, and their willingness to comply with its outcomes.

[22] C. Fred Bergsten and Arvind Subramanian, "America Cannot Resolve Global Imbalances On Its Own," *Financial Times*, August 19, 2009.