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Observation

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THE G-20 IN PITTSBURGH – SHERPAS BEARING GIFTS

HIGHLIGHTS

- **The G-20 provided a useful roadmap for the twin goals of regulatory reform and addressing regulation without representation for emerging markets.**
- **Capital requirements and leverage ratios look like a done deal, with the definition of capital a crucial remaining sticking point.**
- **The language on compensation policy strongly sets out the global best practice, though implementation is left to national authorities with no globally enforced deadline.**
- **There is some language regarding financial transaction taxes or systemic insurance, which at present is a research agenda but is worth keeping an eye on.**
- **The relegation of the G-7/G-8 to second fiddle behind the G-20 may shine a light on some areas such as protectionism where emerging markets tend to claim there is an air of hypocrisy.**
- **But overall, emerging markets still do not have as strong of a voice as they should in the global system.**

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The leaders of the 20 largest economies wrapped up their meetings in Pittsburgh with the Leaders' Statement providing a roadmap for resolving the two major issues of reforming the global regulatory environment and addressing the regulation without representation problem for emerging markets. Rather than just a timetable, this roadmap was helpful in putting flesh on the skeleton of the new global regulatory architecture for capital requirements first and foremost, leverage and derivatives second, and compensation policy last. There are still some areas for concern and possible surprise, but the overall direction seems promising.

Reforming the Capital Shell Game

While there was some concern the focus may have shifted away from regulatory reform, we were surprised by the breadth of specific deadlines set by the G-20 in this area. We have detailed these (as well as reforms in other areas) in the enclosed "G-20 Pittsburgh Roadmap." As we argued after the April London meetings, there is a need and the time to get this right (see http://www.td.com/economics/special/rk0409_g20.pdf). If all the deadlines are met, this roadmap would clear up the details of regulatory changes by the end of 2010 and see their full implementation by the end of 2012.

The Statement clearly stipulates that stronger capital standards will form the core of regulatory reform and that these will include not just a countercyclical increase in the quality and quantity of capital financial institutions must set aside to ensure an adequate buffer to cover possible losses, but will include a limit on the amount of leverage that can be taken, as well. Final standards for trading books and some areas of the asset-backed and securitization markets are already finalized and slated to take effect by the end of 2010 but these G-20 proposals would extend to the broader market. We specifically addressed some of the issues to overcome in these reforms previously (see page 7 of *Policy Prescriptions in the Age of Global Synchronicity* at http://www.td.com/economics/special/rk0609_synchronicity.pdf).

The most important remaining sticking point in our opinion is the reported debate between the U.S. and continental European countries over the definition of capital. In many ways, it resembles national debates over a flat tax for income. Should capital be defined as simply as possible – tangible common equity and retained earnings – to avoid complications and room for manipulation? Or, should the definition be cast more broadly but with various weights and deductions to account for what is more or less desired (in this case liquidity)? The unlikelihood of finding a "one-size-fits-all" definition would argue for the latter, but ultimately, we are playing a dangerous global shell game if we continue to assume something as esoteric as a deferred tax could ever plug a hole in difficult times, or that no capital is needed because a CDS contract or off-balance sheet vehicle limits our liability. And the argument purportedly put forward by some European sources that some banks would struggle to increase their capital ratios because they are so sensitive to the minutia of the definition of capital is not an argument for standing pat. It is a red flag for action.

THE G-20 PITTSBURGH ROADMAP	
Policy Measures and Reforms	*Implemention Date*
Regulatory Issues	
Capital Requirements and Leverage Ratio	
New, internationally-agreed requirements developed	End-2010
Major G-20 financial centers adopt the current Basel II Capital Framework	2011
New, internationally-agreed requirements implemented	End-2012
Compensation Policy	
FSB deadline to propose additions to best practices	March 2010
Formal implementation of best practices	None*
Derivatives Market	
Standardized OTC derivatives exchange-traded and centrally-cleared	End-2012
Non-standard/non-centrally cleared contracts subject to higher capital requirements	None*
Resolution Plans for Systemically Important Financial Institutions	
FSB deadline to propose needed measures	October 2010
Deadline for firms/authorities to (vaguely) develop contingency plans/infrastructure	End-2010
Accounting Policy	
Intl accounting bodies complete convergence of global accounting standards	June 2011
Non-Cooperative Jurisdictions (NCJs) - Tax Havens, Money Laundering, etc.	
FSB publishes progress report on addressing NCJs	November 2009
Peer review process of NCJs implemented	February 2010
Name and shame of money laundering and terrorist financing centers	February 2010
Unspecified "countermeasures" can be taken against tax havens	March 2010
IMF Report on Options for "Fair and Substantial Contribution" of Financial Sector to Defray Costs of Public Funding of Banking System Repair	June 2010
Representation and Voice Issues	
Framework for Strong, Sustainable and Balanced Growth	
Peer reviews begin	November 2009
Size and Representation in the IMF and World Bank	
Recommit to agreement on 3% increase in voting rights of developing countries	April 2010
Next IMF quota review, to include 5% increase in EM voting share	January 2011
Implement changes to IMF quotas already decided in April 2008	Urgently
Other	
Remain Committed to Concluding Doha Development Round	2010
Energy data and Fossil fuel subsidies	
Publish complete/accurate/timely data on oil production/consumption/stock	January 2010
Energy/Finance Ministers will report on national timelines for phasing them out	June 2010
Intl Orgs report on current scope of subsides and suggestions for phasing out	June 2010
Actually phasing out subsidies that can not be rationalized	Medium-term
*These are set as best practices and the Financial Stability Board is tasked with monitoring and/or reporting on implementation progress by firms and markets, but there is no formal implementation required.	

Remaining Regulatory Reform is Modest to Vague

Outside of capital requirements, the G-20 noted the progress made already in opening up tax havens – which includes stories in recent months on C$7 million in undeclared Canadian income in Switzerland and an unspecified amount of undeclared American income but more than a US$700 million corporate fine paid to U.S. authorities. The Statement cites further unspecified "countermeasures" could be taken against remaining tax havens starting in March 2010. Moreover, announced reforms to derivatives markets and accounting standards will help further transparency in international capital markets. However, there is no deadline provided for subjecting non-standard or non-centrally cleared derivative contracts to higher capital requirements, which would be a weak link in this area if left unchanged.

Moreover, the G-20 laid out a very specific and strongly-worded list of global best practices in compensation policy. There is no firm deadline, however, provided to its implementation and it is left to the discretion of national authorities ensure firms are urged to adopt these best practices. So far, there seems to be plenty of momentum in achieving these changes, with the U.K. even suggesting they will tie bonus structure to capital requirements, but a lack of a firm timetable does leave open some wiggle room. These regulatory changes, once implemented, would dramatically improve the stability of the global banking system. It's interesting to note, however, that they likely mean very little for Canadian banks, whose capital and leverage requirements may already be slightly more onerous than what will emerge and where the best practice in global compensation, such as three-year delays in bonuses, are already the normal practice.

One vague yet titillating addition to the regulatory section is a call for the IMF to prepare a report by June 2010 on options for a "fair and substantial contribution" by the financial sector to defray the cost of public funding of banking system repair. This language, reportedly wanted by some European countries, will have the IMF study the possibilities for a financial transaction tax. This could include something like the Tobin tax, a very tiny tax imposed on cross-border capital flows to discourage short-term speculative flows without impacting longer-term investments. This was last proposed following the Asian financial crisis, but outside of a modified version in Chile which uses reserve requirements to limit short-term flows, has never really been used.

This could also include more recent proposals for "systemic insurance," which would formalize and price moral hazard – the idea that financial institutions take undue risks knowing the government will ultimately deem them "too big to fail" and bail them out later. Rather than pretending this is not the case, these proposals would again institute a tiny tax on financial transactions which could total tens or hundreds of billions of dollars in annual revenue globally in precautionary savings. One risk here, though, is that insurance can have perverse incentives and actually increase risky behavior if you think the potential reward is greater than the up-front cost. Moreover, to the extent you think global imbalances are the primary culprit in the financial excesses we have seen, a miniscule tax would be overwhelmed by the gravity of financial flows driven by these imbalances. As such, it is far from clear anything beyond just an IMF report will emerge on this front, but it is worth watching.

Regulation without Representation

The decision to replace the G-7/G-8 with the broader G-20 was a welcome step, but the former was almost exclusively a venue for world leaders to wax poetic on world affairs over the years. We must still be convinced that the concrete outcomes announced in the London and Pittsburgh summits set precedents for future meetings. Moreover, including emerging markets in this venue was the easy task – harder will be increasing their actual voting shares and representation in the IMF and World Bank. Noting that the Statement calls for concluding a 5% increase in emerging markets' voting rights in the IMF by 2011, while simultaneously calling to "urgently" implement similar such reforms already approved a year and a half ago highlight the slow pace of progress here. There is too much political discretion to change the rules-based calculations of quotas and voting rights and too much history to overcome in terms of the overrepresentation of many European nations. Progress in reforms in those institutions will be one sign of whether the air of inclusiveness is rhetorical or real.

History is Written by the Victors

History is written by the victors, but at least moving to the G-20 puts emerging market grievances higher on the global agenda. For example, while the G-7 has typically beaten the drum of the benefits of free trade, the inclusion of major emerging markets raises the likelihood that advanced economies will be called out in areas such as agriculture, where the G-7 typically follow very protectionist policies that are costly for advanced and emerging markets alike. This does not argue that emerging market protectionist measures are any healthier, but they do tend to be blunter and more obvious tariff-based measures because of the poorly developed financial systems and tax codes. Advanced economies can often hide their protectionism in more elegant and less overt subsidies and tax loopholes. This makes them no less distortionary to global markets, nor does it diminish the fact that they reduce the overall potential growth rate of the global economy by limiting the development of emerging markets and their subsequent demand for exports from advanced economies.

The Framework for Fancy Finger Wagging

Along a similar vein, we also saw a U.S.-inspired suggestion of a grand resolution mechanism for global imbalances come to life. At its heart, this would provide for a peer review of G-20 policies with the IMF playing a support role. The vague details provided for the so-called Framework for Strong, Sustainable and Balanced Growth suggest to us that this is just reinventing the wheel – and a square wheel at that. This forum already exists in the form of the IMF, World Bank, WTO, OECD, or simply picking up the telephone. Too often, the response in the international community is to beware sherpas bearing gifts and ignore sherpas bearing criticism. Nothing in the details of the proposed framework suggests there are teeth to overcome this nationalistic reflex, and with so much history of an inability to tackle the truly important issues in a timely fashion, we would remain skeptical on this initiative until proven wrong.

The Macroprudential Risks of Footballers

Overall, there seems to have been a fair bit of progress in moving the vague suggestions of the G-20 meeting in April closer to becoming a reality. We would once again highlight that the regulatory reforms will help address the vulnerabilities exploited by the last crisis but not necessarily forestall the next one. For example, government liabilities had to be run up to move us through this crisis, but we wish for something like a Framework for Strong, Sustainable and Balanced Growth, but with the teeth to act against vulnerabilities, to prevent the next one. In the U.S., for instance, the federal deficit will fall from its current post-World War II high. However, within a decade, as borrowing costs rise off the floor, the cost of simply paying the interest costs on the national debt will exceed 5% of GDP per year. This will require a sizeable primary surplus by the U.S. just to keep debt levels constant. This is a risk which requires further action.

But news from footballers in the U.K. Premier League highlights why getting the details right will be important, while warning that every action has an equal and opposite reaction. In trying to address their own deteriorating fiscal position, U.K. authorities announced a new top income tax rate of 50% on income above £150,000, which is to take effect in April 2010. Shortly thereafter, it was suggested that some footballers were looking into getting paid by teams in the form of interest-free loans, instead of salaries. Under British tax codes, players could then get away with paying as little as a 2.5% tax rate on these loans, and if the tax code ever reverted, the club could write off the loan, and the money would be taxed as income for the player at the reverted income tax rate. In trying to address long-run fiscal concerns, footballers became an unintended macro-prudential risk.