From Monterrey to Basel: who rules the banks?

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The Monterrey Consensus that emerged from the International Conference on Financing for Development held in Monterrey, Mexico, in March 2002 forged a partnership between developed and developing countries based on mutual recognition of the benefits to be gained from the implementation of policies leading to successful development outcomes. Developing countries committed to introduce sound economic and social policies, to improve governance, eliminate corruption and to create a domestic regulatory environment to support the development of the private business sector. While the Consensus was based on developing countries accepting the responsibility for their own development, developed countries pledged to take measures to provide the financial resources that might be required in addition to the mobilization of developing countries domestic resources to meet development goals. These measures included a pledge to strive to provide official development assistance equal to at least 0.7% of each developed country's gross national income, improved market access for developing country exports and completion of the development dimension of the Doha round of the World Trade Organization, the provision of debt relief to ensure that developing country debt service did not impede development efforts, the facilitation of the development impact of foreign direct investment through greater technology transfer, and improvements in the international financial architecture to predict and prevent financial crises.

The Consensus also noted that if developing countries were to have effective responsibility for the development of their own national resources, they should also have full responsibility in framing the international regulations and institutions that determine the international environment in which they participate and which have a major impact on the success of their national development strategies. This additional responsibility could only be meaningful if developing countries were given equitable representation in those institutions and processes that have been created to govern the rules, regulations and institutions that make up the international trading and financial system.

Unequal governance structure

The most obvious example of the current lack of representation of developing countries is in the governance structure of the Bretton Woods Institutions, the World Bank and the International Monetary Fund (IMF) that were created to manage the post-war international financial and trading system. Although both institutions are "specialized agencies" of the United Nations, their governance structure does not follow the traditional United Nations principle of one country, one vote. Rather, decisions are taken by a governing Board with voting power determined on the basis of a rather complicated formula representing an equal amount of basic votes, plus additional votes determined by the country's financial contribution to the institution, the size of the economy and its participation in world trade. Thus, the more powerful developed countries naturally have a large voting power than developing countries. Since the variable items have been adjusted several times to reflect changes in size of different economies, while the basic votes have remained fixed, countries that have grown most rapidly have increased their influence relatively to some of the slower growing developing countries, particularly those who came into existence and joined the IMF after its creation.

The day to day operation of the IMF and the World Bank is governed by a Board of 24 Executive Directors. There are seven countries that sit on the Board who represent only themselves: the United States, Japan, Germany, France, the United Kingdom, China, and Saudi Arabia. Thus the other 17 Executive Directors must represent the interests of the remaining 160 countries. Each of these 17 Directors is assigned a group of countries. In the current allocation, over forty countries comprising sub-Saharan Africa are represented by only two executive directors. Thus, their interests cannot be given the same hearing in the Boards decisions as the members holding single country seats.

Further, the five developed countries holding single seats account by themselves for nearly a third of the total votes. Other developed countries hold seats with another third of the votes. This ensures that any decision requiring a two-thirds majority requires the approval of the developed countries. In addition, the US holds votes that exceed 17% of the total. This is an important number since most major decisions on the structure of the IMF, such as changes in voting power, require an 85% majority. The World Bank has a similar representation and voting structure.

Thus, while developing countries are urged to take responsibility for their own development, improve their governance structures and ensure that their policies are "nationally owned", the major institutions that determine the architecture of the international financial system, and who are responsible for the majority of institutional funding for development, continue with an anomalous, and far from democratic form of governance in which developed countries have a structural majority.

Lack of representation in other rule-making bodies

It is for this reason that the Monterrey Consensus stressed the need to broaden and strengthen the participation of developing countries and countries with economies in transition in international economic decision-making and norm-setting. It sought to enhance participation of all developing countries and countries with economies in transition in the decision-making of the international financial institutions, and thereby to strengthen the international dialogue and the work of those institutions as they address the development needs and concerns of developing countries. While most of the attention to improve voice and representation has been centered on the IMF and the World Bank, there are other international rules and standards making bodies at the global level in which developing country representation is even less equitable and in some cases non-existent. It is for this reason that the Monterrey Consensus went further and urged the Bank for International Settlement's Basel Committees such as the Basel Committee on Banking Supervision, and Financial Stability Forum to continue enhancing their outreach and consultation efforts with developing countries and countries with economies in transition at the regional level, and to review their membership, as appropriate, to allow for adequate participation. It also included in this call all ad hoc groupings that make policy recommendations with global implications to continue to improve their outreach to non-member countries, and to enhance collaboration with financial standard-setting bodies such as the International Association of Insurance Supervisors, the International Accounting Standards Board, the International Organization of Securities Commissions, the International Organization for Standardization, and the International Federation of Stock Exchanges.

Attention to developing countries' representation on these other bodies is particularly important because most of them have no formal governance structure or are voluntary bodies that provide no representation to developing countries. It is also important because given the lack of any formal governance

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institutions at the global level, these bodies have taken on the responsibility for formulating rules, regulations, standards and codes for the global economy and the international financial system without even minimal formal representation of developing countries. As a result a de facto global governance system is being built up on the basis of

decisions made by developed countries, without any participation from developing countries. It is the unrepresentative nature of this growing global governance structure that has given rise to what has come to be known as a "democratic deficit" because of the absence of equitable representation of the interests of all countries.

The extent and proliferation of these global regulations, standards and codes is often underestimated. They include the core principles for affected banking supervision issued by the Basel Committee on Banking Supervision, Objectives and Principles of Securities Regulation issued by the International Organization of Securities Commissions, Insurance Core Principles issued by the International Association of Insurance Supervisors, Principles and Guidelines On Effective Insolvency and Credit Rights Systems issued by the World Bank, Principles of Corporate Governance issued by the Organization for Economic Cooperation and Development, International Accounting Standards Issued by the International Accounting Standards Board, International Standards On Auditing issued by the International Federation of Accountants, Core Principles for Systematically Important Payment Systems issued by the Committee on Payment and Settlement Systems, Recommendations for Security Settlement Systems issued by the Committee on Payment Settlement Systems and the International Organization of Securities Commissions, the 40 Recommendations and nine Special Recommendations on Terrorist Financing issued by the Financial Action Task Force on Money Laundering, the Code of Good Practices on transparency of Monetary and Financial Policies issued by the IMF, the Code of Good Practices in Fiscal Transparency issued by the IMF and a Special Data Dissemination Standard, and the General Data Dissemination System issued by the IMF.

A de facto regulatory power

The globalization of finance and the growing internationalization of financial crises in recent years have resulted in increased efforts to force countries to adopt similar regulatory arrangements. However, in difference from national financial regulation there is no formal power at the international level to set and enforce regulations worldwide. Representatives of developed country financial market regulatory and supervisory agencies have been drawing up a set of best practice standards and codes whose adoption is encouraged through peer pressure. However, in practice these global regulations are enforced by the international financial institutions such as the IMF and the World Bank, either by introducing them in the conditions that developing countries are required to meet in order to qualify for financing from these institutions, or as part of the standards used in IMF Article IV surveillance, or as standards by which their commitment to sound governance and institutions specified in the Monterrey Consensus are judged.

Mechanisms have also been put in place to encourage their introduction, govern their use and monitor compliance. The key instrument is the Report on the Observance of Standards and Codes, prepared by the IMF as a part of Article IV consultations or through Financial Sector Assessment Programmes conducted jointly by the IMF and the World Bank. They have been carried out for more than 100 countries. It is thus clear that there is in operation today a de facto international regulatory power monitoring implementation of a set of best practice standards for financial institutions operating in international markets.

Since the credit worthiness of individual countries' liabilities assigned by credit rating agencies is also increasingly judged by the quality of individual countries' regulatory and supervisory systems as measured by their adherence to these international standards, it has become crucially important for developing countries to be seen to be adhering to these standards as minimum conditions for attracting and retaining international capital flows. Thus, the ability of developing countries to attract official or private finance increasingly depends on a governance structure in which they do not participate.

"Democratic deficit"

However, the representatives that meet to propose and implement these standards are far from democratically selected. They overwhelmingly represent the Group of Seven (G-7) developed countries and hardly any provide a formal representation for developing countries. There is thus a large "democratic deficit" in the operation of this de facto global governance system in financial markets. A formal study of the operation of this de facto system is necessary to determine if its democratically inefficient mechanism of operation can be justified by delivering the promised results of increased global financial stability.

Most of the attention has been placed on the question of voice and representation in the World Bank and the IMF, and it is because developing countries have some, even if minor, representation in these institutions that they have been most actively engaged in discussion of the means to provide more equitable voice and representation of developing countries in their governance structures since Monterrey. However, nearly five years after the Conference there are still no formal proposals on how this should be done. The issue will be on the Agenda of the next Annual Meetings in Singapore, but given that there is still no formal proposal for action, prospects are not good for more rapid action on the issue.

Much less attention has been given to the other bodies that set global standards. The first of these de facto international governance institutions was the formation of the Basel Committee on Banking Regulation and Supervision, hosted by the Bank for International Settlements to deal with the risks in making international payments between large global banks from developed countries. It produced regulations known as the Basel Concordats in 1975 and 1978 that attempted to allocate the responsibility for the regulation of global banks operating across borders to each bank's home regulatory agency and to require banks to provide financial reports on a consolidated basis covering all their global operation. In essence the Concordat was a global supervisory agreement that was supposed to provide a substitute for an international lender of last resort, or an allocation of international lender of last resort responsibility, for banks operating internationally. The failure of the Concordat to provide lender of last resort support for the failure of an Italian bank owned by a Swiss-Luxembourg holding company led to a search for an alternative arrangement. This took the form of the creation of global capital adequacy standards set out in the first Basel Accord on Capital Adequacy.

The East Asian crisis of 1997 was instrumental in highlighting the importance given to globally coordinated financial regulation and to ensuring that the multiplicity of such regulations were considered by some central body. The answer was the creation of the Financial Stability Forum, established by the Finance Ministers and Central Bank Governors of the G-7 in February 1999. It was given responsibility for defining a set of standards and codes to be observed by all international banks. This was the first attempt to develop a single set of international rules and principles for domestic policy in the financial and monetary spheres that all countries would adhere to. In addition, The Financial Stability Forum has identified 70 financial standards from which the G7 countries and the multilateral financial institutions have identified a subset of standards deemed necessary to ensure financial stability.

While there is clear inequitable representation in the multilateral financial institutions, they do nonetheless have a clear governance structure. On the other hand, the ad hoc voluntary bodies such as the Basel Committees do not have either democratic mandates or transparent governance structures and lack any formal of representation of developing countries. It is here that the most important democratic deficits are to be found. And it is here that there is the least information on how these institutions functions.[2]

The Basel Committee on Banking Supervision has formulated a Revised International Capital Framework, usually known as "Basel II". Informal mechanisms were used to provide developing country participation, but its rules of operation are not transparent. For example, the methods used to select countries to participate in the Basel committees are not made public. Nor is there any information on how these countries participate in the deliberation of these bodies. While the implementation of standards and codes is supposed to be voluntary, and implementation is supposed to be adjusted to meet diverse circumstances of different countries and firms, it is unclear whether these differences across countries are taken into consideration at the stage of formulation of the standards, or whether the differential application is considered as only an unavoidable exception to their full application at some later date.

Further, it is unclear how the developing country representatives are themselves chosen, and to whom they are responsible. Neither is there information on how these primarily developing country representatives prepare for their participation in these bodies and whether they consult with other countries that are not invited or try to represent positions other than their own.

Finally, there is the question of how these voluntary standards are implemented in countries that do not participate in their formulation. Are national governments responsible as part of their domestic policies, and thus subject to parliamentary approval and oversight? Are the decisions taken democratically by national representative governing bodies, or by technical agencies? How important is the suasion by the multilateral financial institutions? Is there influence from private market participants?

The Revised Basel II Framework should provide increased global financial stability. This financial stability goal may not be compatible with the essential function of international capital markets of providing financing for the investment process that allows countries to fully use their domestic resources and to undertake decisions in a way that provides for national ownership of these policies.

For example, it has been argued that the introduction of the Revised Framework will make international capital flows to developing countries more pro-cyclical. This would clearly make the international financial system less stable, and more asymmetric. Others have noted that although its application is supposed to respond to national conditions it has only been developed countries, rather than developing countries, that have introduced changes to meet national conditions and objectives. The majority of developing countries have announced their intention to make full implementation on schedule.

The Revised Framework is intended for private financial institutions operating internationally, but in its initial Basel I version it was applied much more generally to all banks, including government owned banks and national development banks in a number of countries. It is unclear whether the capital of such banks, and in particular national development banks, can be considered on the same level as international private banks and whether such a framework is consistent with their national objectives. This is a particularly important issue as a number of countries are again seeking to give a greater role to their development banking system, or to recreate one if they have previously abandoned it. ■

2 IBASE, with the support of the Ford Foundation, has launched a major research project headed by Jan Kregel and Fernando J. Cardim de Carvalho, to investigate the issue of the role of these institutions in the governance of the global financial system. For more information write to: lcerqueira@ibase.br