FCA Think Piece: The Future of Global Financial Regulation

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Feedback greatly appreciated.

Abstract:

The current architecture of financial regulation is out of step with the evolving global landscape of financial services. Global financial standards tend to respond to the prerogatives of advanced economies, but large developing countries play an increasingly important role as stakeholder and innovator in the global financial system. Moreover, even the world's poorest developing countries are deeply integrated into global finance, so decisions made in international standard-setting bodies have substantial implications for their economic development. We analyze regulatory developments in the areas of prudential banking, anti-money laundering, and shadow banking to show how global financial standards are essential and well-intended, but entail negative repercussions for inclusive growth in developing countries. In our outlook for the future of global financial regulation, we advocate for sustained global coordination and propose three specific reforms: First, standard setters move away from an exclusive focus on financial stability to the pursuit of the twin goals of financial stability and inclusive economic development - the equivalent of a Taylor rule for financial regulation. Second, reforms should be geared towards greater formal representation for developing countries. And third, we propose the transformation of an existing regulatory institution into a standard-setting body for fintech.

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1. Introduction: Where Now for Global Financial Regulation?

With economic nationalism on the rise in the United States and in Western Europe, the future of international cooperation is uncertain in many areas, from financial regulation to international trade. The election of Donald Trump in the United States is the strongest and most overt challenge to international cooperation. The new administration has pledged to find ways around the World Trade Organization, denounced the Trans-Pacific Partnership agreement, and some prominent Republicans are requesting that the US withdraw from international standard-setting bodies (SSB), including the Financial Stability Board (FSB). President Trump has stated his intention to repeal the Dodd-Frank Act and water-down prudential regulation, and the Republican-sponsored Financial Choice Act, which may replace it, would exempt large US banks from Basel III regulations. Meanwhile, in the wake of Brexit there are concerns that the UK will reduce regulatory requirements for its financial sector, and in the rest of the EU there are calls to reduce burdens on banks. Regulatory fragmentation looks likely, and there is the risk of a 'race-to-the bottom' among the world's leading financial centers, with the result that regulation serves large banks rather than the public interest (Dombret, 2017).

In this think piece we take a few steps back from the current debate and pose the question – what should global financial regulation look like? Where do we want to be ten years from now? We argue strongly for robust international financial cooperation, but we also call for substantial reforms. Our focus is on sustainable development and the kind of global financial governance that is needed to support the twin aspirations of financial stability and economic development, particularly in developing countries. Historically the US, EU and Japan have been the key players in international financial standard-setting bodies (SSB) but the world is changing fast. Large developing countries, with China at the forefront, are becoming increasingly important players and this trend is set to increase. Developing countries are the source of many financial innovations that provide new opportunities but pose new challenges for regulators. Moreover, even the world's poorest developing countries are integrated into global finance in a myriad of ways, so decisions made in international SSB have very substantial implications for their economic development and the attainment of the Sustainable Development Goals.

As international regulators look to galvanize international financial cooperation in the face of growing economic nationalism in the world's industrialized countries, they should look to where the energy and appetite is for international cooperation. We propose three specific reforms: First, SSBs move away from an exclusive focus on financial stability in global standards-setting to the pursuit of the twin goals of financial stability and inclusive economic development - the equivalent of a Taylor rule for financial regulation. Second, reforms geared towards greater formal representation for developing countries. And third, the transformation of an existing regulatory body into an SSB with a mandate to foster cross-border regulatory cooperation and oversight of fintech. To make our case we highlight the ways in which current international financial cooperation is valuable but falls short of serving sustainable development and financial inclusion goals. We focus on three areas: prudential banking standards, efforts to curb anti-money laundering, and the regulation of non-traditional financial services.

2. How the International Financial Architecture is Out of Step

We live in a world of globalized finance. Financial globalization has proceeded apace since the 1980s, with cross-border capital flows rising from US$0.5 trillion in 1980 to a peak of US$11.8 trillion in 2007, before decreasing markedly in the wake of the financial crisis (Lund et al., 2013). Cross-border banks were a major vehicle of financial globalization, especially in developing countries (Claessens, 2016).

Thirty banks have now been identified as systemically important on a global level (G-SIBs), these banks are important nodes of global finance and the collapse of any of them would have significant repercussions for financial markets, governments and citizens in many countries.

Forty years ago, when the Basel Committee of Banking Supervisors was created, it was possible to divide the world of global finance into two distinct groups of countries: a relatively small core group of countries housing major financial centers such as New York, London, Hong Kong, Tokyo and Frankfurt; and many more peripheral countries with much smaller financial sectors. The financial systems of the core countries were closely interconnected. Although there were links between the financial systems of core countries and the rest of the world, these links were nowhere near as they are today.

Fast-forward to the present, and we see a very different picture. While a relatively small number of countries still accounts for the bulk of the global finance (BIS, 2017; IMF, 2017), we are seeing three important shifts. First, the financial sectors of the world's largest and fastest-growing developing countries are sufficiently important that they are now part of the core. While foreign banks were overwhelmingly headquartered in OECD countries in the 1990s in the past decade we have seen the cross-border expansion of banks headquartered in developing countries. China for instance is the home jurisdiction for 4 of the 10 largest banks on earth, with operations in over 40 countries (P. Alexander, 2014). Emerging market economies account for a 12% share of the global shadow banking sector, for example (FSB, 2015a).

The second, and less recognized shift is that developing countries are far more interconnected to the financial core and to each other than 40 years ago. Following a wave of privatization and liberalization in the 1980s and 1990s, foreign bank presence increased and by 2007 accounted for more than half of the market share in 63 developing countries. Developing countries now have a higher level of foreign bank presence than industrialized countries, making them particularly vulnerable to financial crises and regulatory changes in other jurisdictions. This heightened interconnectedness was powerfully illustrated during the 2007-8 global financial crisis which, unlike previous crises, it affected all types of countries around the world (Claessens, 2016). Although the majority of foreign banks remain headquartered in North America and Western Europe, banks from emerging markets and developing countries are playing an increasingly important role, accounting for 26% of foreign banks in 2007. There are strong regional patterns at play. In sub-Saharan Africa for instance, pan-African banks are now systemically important in 36 countries and play a more important role on the continent than long-established European and US banks (Marchettini, Mecagni, & Maino, 2015).

Third, OECD countries are no longer the only hub of financial innovation. Especially in the retail financial sector, disruptive technologies are being invented in developing countries. While consumers in OECD countries still rely on credit and debit cards as their primary payment platform, consumers in China use their cell phones for a wide range of quotidian payments and even investment services. China's AliPay digital payment service currently has 450 million users, several times the amount of PayPal worldwide. In 2015, AliPay reached a peak processing volume of 85.900 transactions/second, compared to 14.000 for Visa. The largest American peer-to-peer lending company, Lending Club, issued around $16bn in loans over the last five years, a pale sum when compared with over $100bn in loans issued by its Chinese equivalent Ant Financial in the same period (Chen, 2016). In Kenya, the invention of mobile money has had a transformative impact on financial inclusion. Mobile payments platforms are being used as a vehicle for micro-savings and micro-investments and, increasingly, cross-border money transfers. M-PESA and related products are being emulated in many other developing countries (Ndung'u, 2017).

Challenge 1: Developing Country Influence in Standard-Setting

The institutions and international standards that characterize global financial governance have struggled to keep abreast of these shifts. The Financial Stability Forum (the forerunner to the Financial Stability Board) and the Basel Committee on Banking Supervisors were created during an era of a distinct interconnected core and a much less connected periphery. Only the largest financial centers were represented and international standards were intended for the exclusive use of members. The reasonable assumption was that common standards among the core would be sufficient to safeguard global financial stability, and adverse implications for countries outside of the SSBs were not anticipated.

In the wake of the Global Financial Crisis, the membership of the Financial Stability Board, Basel Committee and other key standard-setting bodies was reviewed and expanded to include all G20 countries, with developing countries represented for the first time. However, a lack of deliberative equality persists. Even though all G20 member countries have a seat at the table, regulators from emerging and developing countries are less engaged than their peers from industrialized countries. This can be attributed to a lack of cross-border experience and regulatory capacity among the former group of members. It may also be a function of the agenda-setting process within SSB that places special importance on regulatory issues and conditions in advanced economies. Elements of Basel III and the current discussion on shadow banking (see below) exemplify a bias towards the largest firms and largest markets that fails to consider the often very different economic and regulatory environment in emerging market economies. The inequality in regulatory input is compounded on the private sector side where firms and business associations from developing countries barely react to request for comments on draft regulations (Chey, 2016; Walter, 2016).

While welcome, recent reforms have not gone far enough to reflect the underlying realities of today's globalized financial markets. Crucially, the expansion of cross-border banks has created very powerful incentives for regulators in developing countries to converge on international standards even if they are not members of the Basel Committee. As a result, many developing countries are implementing standards that are poorly calibrated for their jurisdictions (FSI, 2015; Jones, 2014; Jones & Zeitz, 2017) . Moreover, because of their close integration into the global financial system, countries outside of the standard-setting bodies are often deeply affected by regulatory decisions made at the core of the financial system, as the discussion below on anti-money laundering standards powerfully illustrates. This paper argues that there is a strong case for ensuring that standards-setting bodies are more representative.

Challenge 2: Moving Beyond Financial Stability

Reflecting their origins, global financial standard-setting bodies have focused almost exclusively on the goal of financial stability. This stability is of vital importance, including for developing countries. Lax financial regulatory standards increase the likelihood of a financial crisis both in core and periphery countries, the repercussions of which can wipe out years of development gains. In the wake of the global financial crisis, policymakers around the world called for greater regulatory stringency, including experts that take into account developing country preferences (Stiglitz, 2010; Sundaram, 2011)

Yet developing countries also need to use financial regulation to pursue economic growth and poverty reduction. Research has provided evidence for the positive effect of financial inclusion on the income and well-being of low-income households in developing countries, although widening the perimeter of financial services is no panacea in itself (Banerjee, Chandrasekhar, Duflo, & Jackson, 2013; Cull, Demirgüç-Kunt, & Morduch, 2013). Yet the stringent and inflexible implementation of global standards can jeopardize well-designed financial inclusion policies (GPFI, 2011).

The challenge for global standards-setting is that regulatory goals other than financial stability are rarely considered. The financial stability mandate is enshrined in the Charters of the major global SSB (BCBS, 2013, para. 1; FSB, 2012a, para. 2(3)) and domestic regulatory agencies (UK, 2012, sec. 2A; Tucker, Hall, & Pattani, 2013). As developing countries are increasingly adopting Basel and other international standards, there is a concern that this exclusive focus on stability entails negative consequences for many developing countries, infringing upon their policy space for equitable and inclusive growth (Akyüz, 2011; Gottschalk, 2010; The Warwick Commission, 2009). Upon the insistence of developing country representatives, some global standard-setters have made efforts to identify unintended negative consequences of financial regulatory reform (FSB, 2012b, 2016a; FATF, Asia/Pacific Group on Money Laundering, & World Bank, 2013), but such concerns remain an afterthought.

We thus argue for regulatory bodies to expand their mandate and consistently incorporate development prerogatives. Much like monetary policy at central banks is balanced between price stability and full employment, standard-setting bodies should espouse the twin goals of financial stability and financial inclusion (Taylor, 1993; Koenig, 2013). Such a Taylor rule for SSBs would ensure that financial regulation is not an impediment to inclusive growth in developing countries.

Challenge 3: Regulating New Financial Products

The financial services sector has witnessed significant technological innovation in recent years. New financial products have the potential to support economic growth and poverty reduction, including by dramatically increasing financial inclusion. From relatively simple technologies such as cell phones to sophisticated big data-driven credit assessment models, fintech innovations promise to break through some of the bottlenecks that have constrained financial services markets in history. Yet new financial products can carry old risks in new guises, including leverage, maturity and liquidity mismatches. Their dependency on digital platforms also exposes them to new challenges such as privacy issues and cyber risk. Moreover, as their importance grows, fintech services may contribute to systemic risk (Carney, 2017). In Kenya, M-PESA holds a relatively low proportion of capital and liquidity in the financial sector, so does not pose a systemic credit or liquidity risk, but it is systemically important as a payments system.

There is growing demand for knowledge sharing on how best to regulate fintech at the national level and, given the interconnectedness of contemporary financial markets, we expect to see increasing demand for global standards for fintech in the years ahead. In addition, the fact that fintech services transcend traditional boundaries between telecommunications, credit intermediation, payments and settlements requires concerted action by regulatory agencies that have little history of cooperation. The challenge ahead is to decide which international body should be the focal point for these decisions, which countries should sit at the table, and whether the standards should focus on financial stability or also on economic development and poverty reduction. In this paper we propose the transformation of an existing regulatory body with developing country representation and expertise into a novel global fintech standard setter.

3. Three Case Studies

In this section we substantiate our arguments by presenting case studies that illustrate how the challenges we identify above manifest in the areas of prudential banking, anti-money laundering, and shadow banking.

Case Study 1: Basel Banking Standards

All countries need stable banks. In the context of financial interdependence, there is a strong public interest case for international regulatory coordination as the collapse of a bank in one country can quickly have contagion effects in other countries. Indeed the Basel Committee was created in the wake of the 1974 failure of a cross-border bank. Common standards operate as a mechanism for regulators to reassure each other that the banks they oversee are soundly regulated.

Yet Basel banking standards proved inadequate to prevent the global financial crisis of 2008. Developing countries suffered either directly through reductions in credit flows or indirectly as through a fall in demand for exports, and a reduction in FDI, remittances and aid flows (CIGI, 2009). While the move towards more stringent regulation under Basel III has been widely welcomed, there have been concerns that implementation may have adverse spill-over effects for developing countries. For instance, according to Basel III rules, banks must set aside capital according to a conversion factor depending on the credit rating of the company that receives the loan. International agencies however tend to regard the country rating as an upper bound, disadvantaging financially sound companies in developing countries (Martins Bandeira, 2016).

As the financial sectors of China, India, Brazil, South Africa, Nigeria and other large developing countries grow and their banks expand overseas, there is a strong public interest argument for ensuring that these countries also implement sufficiently stringent regulatory standards, and refrain from engaging in a regulatory race to the bottom. Yet this poses a new challenge for international regulatory cooperation, as the rise of developing countries dramatically increases the heterogeneity of financial sectors to which international regulations should apply. As countries have diverse regulatory interests and capabilities, it becomes even harder to agree on a common set of standards (J. Barth, Caprio, & Levine, 2013; J. R. Barth, Lin, Ma, Seade, & Song, 2013; Brummer, 2010; Tarullo, 2008; The Warwick Commission, 2009).

Basel II and III were designed primarily for financial sectors in advanced economies and remain poorly calibrated for the characteristics of developing countries in several respects. A first challenge for many developing countries is the sheer complexity of the standards. Even national authorities in long-standing Basel member countries have found implementation of Basel II and III challenging (Bailey, 2014). In a survey conducted by the Financial Stability Board, national supervisors from emerging and developing countries cited a shortage of high-quality human resources as the most important constraint to the implementation of Basel II and III (FSB, 2013a). While many regulators welcome the move in Basel III towards macroprudential regulation, the additional resource demands of adopting a macro-prudential approach are considerable, particularly in skills, training, modelling, technology, and data (Murinde, 2012). Gaps in financial market infrastructure can impede Basel implementation. The most striking example is of credit rating agencies, which continue to play a central role in the Basel framework. Many developing countries do not have national ratings agencies and the penetration of global ratings agencies is limited to the largest corporations. In Africa, except for South Africa and Nigeria, the lack of local credit rating agencies is a major problem (Murinde, 2012).

These challenges are compounded by the fact that Basel standards may not reflect the regulatory priorities of developing countries. Macroprudential standards in Basel III, for instance, do not adequately reflect the main sources of systemic risk in many developing countries, which often stem from external macroeconomic shocks rather than the use of complex financial instruments or a high level of interconnectedness among banks. The countercyclical buffer as well as liquidity standards have been criticised for being poorly designed for developing countries (Gottschalk, 2016; Jones & Zeitz, 2017).

An obvious solution to these challenges is for the Basel Committee to design common but differentiated standards, providing regulators with a range of regulatory options that are sufficiently stringent yet also tailored for use in financial sectors at different levels of development. Although the Basel Committee has taken some steps in this direction, the full range of options proposed in Basel III is not properly thought through, resulting in the adoption of overly complex regulations for the level of economic development and complexity of the financial system in many developing countries (World Bank, 2012).

The importance of recalibrating Basel standards extends beyond those countries that pose a source of systemic risk to the global economy. Many regulators in small developing countries outside of the Basel Committee perceive the implementation of international banking standards as necessary for facilitating the expansion of domestic banks overseas, overseeing the operation of foreign banks in their jurisdictions, and attracting investors into the financial services sector (Jones and Zeitz, forthcoming). These strong incentives help explain the diffusion of Basel standards across the globe, even in light of the problems outlined above. As of 2015, 70 countries outside of the Basel Committee were implementing at least one element of Basel II and 41 were implementing at least one component of Basel III (FSI, 2015). Simply put, regulators in small developing countries cannot afford to ignore Basel standards, even if they are ill-suited to their particular regulatory needs.

Over the next ten years the systemic importance of developing countries in global banking will continue to expand, and so too will the need for common and differentiated international standards. The fact that the vast majority of countries outside of the Basel Committee are converging on Basel standards makes reform even more pressing. The need for reform of the Basel Committee will remain even if the US, UK and EU pursue divergent regulatory agendas. Under such a scenario, market pressures for harmonisation will still exist. Ten years from now, developing countries will still be under pressure to harmonise their regulations with the standards set by the largest players, be that the US or China. Reform of the Basel Committee to ensure that it is more representative of developing country interests would ensure that continues to be the primary platform for meaningful dialogue between banking regulators from industrialised and developing countries and, increasingly, between developing country regulators.

Case Study 2: Anti-Money Laundering and Financial Inclusion

The agreement and implementation of international standards to combat money laundering and the financing of terrorism has, like prudential banking regulation, important public interest benefits for industrialized and developing countries alike. According to the United Nations Office on Drugs and Crime in 2009 criminal proceeds amounted to 3.6% of global GDP, with 2.7% (or USD 1.6 trillion) being laundered (UNODC, 2011). The implications for developing countries are substantial. While it is hard to gauge the magnitude of laundered money, recent estimates put illicit financial flows from Africa at over $50bn per year, more than the amount of money that the continent receives in the form of aid, and a substantial portion of these illicit flows result from money laundering (UNECA, 2015).

Yet, as with international banking standards, while the aims have been laudable, the standards and their implementation have not always reflected the interests of developing countries. The Financial Action Task Force (FATF) was created in 1989 by the G7 countries to set standards and promote effective implementation of legal, regulatory and operational measures for combating money laundering, terrorist financing and other related threats to the integrity of the international financial system. FATF members agreed on Forty Recommendations on anti-money laundering (AML) in 1990 and devised additional rules to combat terrorist financing (CFT) in 2001.

The original requirements of the AML/CFT regime, as set out by FATF, espoused a compliance-based approach that aimed at raising international standards to the highest feasible level and apply naming-and-shaming procedures to punish non-compliant jurisdictions. Even though strict compliance with AML/CFT rules imposed barriers to financial inclusion, countries nonetheless implemented the standards because failure to meet FATF standards could have serious consequences. Countries included on the FATF’s grey or black lists suffer reputational costs that affect both capital markets and the banking system (Sharman, 2008).

Steps to address the unintended consequences of AML/CFT standards were first taken at the G20 in 2010, when Korea chaired the G20 Leaders’ Summit. The Seoul Summit saw the establishment of the Global Partnership for Financial Inclusion (GPFI), a network of government officials, non-state organizations, the World Bank, and the major global financial standard-setting bodies (G20, 2010). The GPFI Report issued the following year highlights the negative impact stringent standards are having on financial inclusion. It notes the implementation costs they place on budget-constrained developing countries, and the self-defeating features of strict implementation of AML/CFT rules, which are likely to drive criminals away from the formal financial system and towards cash transactions, making financial crime harder to detect. Crucially, the GPFI report advocates a proportionate application of financial standards, taking into account the nature of risk, regulatory capacity, and the current level of financial inclusion to minimize the unintended negative consequences of standards implementation (GPFI, 2011).

Global standard-setting bodies followed suit, commissioning their own studies and exploring policy options to ameliorate the adverse impacts (CPMI, 2016; FSB, 2015b). But the degree to which these organizations are responsive to this issue varies considerably. On one end of the spectrum, FATF has been open to developing country concerns in the AML/CFT regime. A group of FATF members, co-led by Mexico and the United Kingdom, took the lead in incorporating financial inclusion and development goals in an updated set of global AML/CFT standards. The 2012 revision of FATF Recommendations are now widely acknowledged as a cornerstone in the fight to reduce financial exclusion. In a sense, they embody the idea of a Taylor rule for financial regulation, espousing the twin goals of financial integrity and inclusive growth. FATF promotes a risk-based approach that applies the proportionality principle to regulatory stringency. Know-your-customer identification requirements for example can be more relaxed for small-scale transactions and in low-risk locations, facilitating access for millions of low-income households to remittances and banking services (FATF, 2012).

Despite these positive moves, problems persist. The risk-based approach was designed to allow countries to "adopt a more flexible set of measures, in order to target their resources more effectively" (FATF, 2012, p. 10). Yet, even though regulators permit simplified approaches, banks may be wary of using them. Banks have good reason for concern as, in the wake of the financial crisis, supervisory authorities in the United States and Europe are subjecting global banks to heightened scrutiny, imposing substantial fines for misconduct. For example, in 2012 US prosecutors found that Mexico's Sinaloa drug cartel and Colombia's Norte del Valle cartel laundered $881m through HSBC and a Mexican unit. British politicians and regulators engaged in an ethically questionable but successful intervention to save HSBC from criminal prosecution, but the bank still had to pay a record $1.92bn fine to the US Department of Justice (Neate, 2016). Since then, revelations of misconduct and multi-billion dollar fines have accumulated, shaking the banking sector.

In this context, FATF's transition away from a previously more rules-based system to a risk-based approach has exacerbated uncertainty among global banks regarding regulatory expectations. As the IMF notes, "it may lead to the overcautious use of enhanced due diligence measures resulting in an unnecessary increase in compliance costs" (IMF, 2016, p. 21). Many developing countries have experienced the withdrawal of financial services by international banks in the past five years and while this may reflect strategic business decisions in the wake of the financial crisis, concerns about the costs of complying with AML/CFT requirements are a contributing factor.

Two types of financial services have been hit particularly hard: remittance transfer and correspondent banking services. Remittance service providers need bank accounts to function, but many have seen these services withdrawn. In the UK for instance, in 2013, Barclays bank announced to more than 140 remittance companies that it would be withdrawing its services from them. The impact on remittances has been severe in some countries. Banks in Australia withdrew their services from remittance providers servicing Samoa, citing pressure from their US correspondent banks. Somalia, which depends heavily on remittances, found its remittances providers almost entirely cut off from the international banking system following the withdrawal of banking services to its remittance providers (Trindle, 2015).

A series of studies have documented the withdrawal of correspondent banking relationships, mainly from developing countries, and the stringent application of AML/CFT standards appears to be a key driver (Adisa, 2014; Artingstall, Dove, Howell, & Levi, Michael, 2016; BAFT et al., 2014; Durner & Shetret, 2015; G-24 & AFI, 2015; IMF, 2016; Klapper, El-Zoghbi, & Hess, 2016; PWC, 2015; The Commonwealth, 2016; World Bank, 2015). In Belize for instance, only two of the country's nine banks have managed to retain correspondent banking services with full banking services (IMF, 2016).

In order to address these challenges, FATF took further steps and published specific guidance on AML/CFT and financial inclusion, correspondent banks, and non-profit organizations (FATF, 2014, 2015; FATF et al., 2013). Such regulatory clarifications however may be less effective than desired. The overwhelming majority of enforcement actions against banks related to customer due diligence originate in the United States, and until recently US authorities have refrained from clarifying their expectations regarding AML/CFT compliance (Federal Reserve Board, FDIC, NCUA, OCC, & US Department of the Treasury, 2016).

Unlike the FATF, other standards-setting bodies have been more reluctant to take developing country concerns into account. AML/CFT measures are covered by one of the Basel Core Principles (BCP 29). The Basel Committee incorporated the risk-based approach and the proportionality principle in its 2012 revision of the Principles, but did not mention negative repercussions of overly stringent AML/CFT regulations. The concept of financial inclusion does not appear in the document, not even in an Annex that deals specifically with correspondent banking. High-level advocacy organizations engaged with the Basel Committee in October 2014, pointing out the discrepancy between its call for "strict customer due diligence rules to promote high ethical and professional standards in the banking sector" (BCP 29), and the FATF risk-based approach which is based on the proportionality principle. Yet a 2016 revision of the Guidance document does not contain any changes in this issue area (BCBS, 2012, 2014, 2016b).

The Basel Consultative Group, the main outreach body of the Basel Committee, has started to acknowledge financial inclusion concerns. For instance, regarding customer due diligence (BCP 29), the Consultative Group notes that "Regulation that requires documentation to verify identity creates potential barriers to access to financial services and products" (BCBS, 2015, 2016a). Yet the recommendations of the Basel Committee carry much more weight than those of the Basel Consultative Group.

Membership structure and mandate may help explain the difference in attitude. The Basel Committee was comprised only of industrialized countries until recently, and it has a mandate with an exclusive focus on "enhancing financial stability" (BCBS, 2013, p. 1). In contrast, the majority of Basel Consultative Group members are non-OECD countries. Similarly, developing countries are represented in the FATF either as members or through regional organizations. The latter two SSB have engaged fully with the GPFI-initiated work on financial inclusion, the former has not. So long as the Basel Committee retains its exclusive focus on stability-maximization, the outlook for tackling de-risking remains bleak.

Case Study 3: Shadow banking and fintech

Financial innovation is a double-edged sword. On the one hand, new financial products and services may be designed for the sole purpose of avoiding prudential supervision (i.e. regulatory arbitrage). On the other hand, they may be able to overcome existing bottlenecks and market failures to reach previously underserved sectors of the population, especially in developing countries. The evolving regulatory embrace of shadow banking and fintech shows how, again, a financial stability-maximizing approach may be at odds with developing country needs and preferences.

The global financial crisis highlighted the interconnectedness of the financial system and the destabilizing role money market funds, monoline insurers, and derivatives brokers can play. Regulators recognized that concentrating on the banking sector alone is insufficient to safeguard the financial system. In the wake of the crisis, regulatory scrutiny has expanded to cover shadow banking - non-bank financial institutions that are involved in credit intermediation. Widening the regulatory perimeter is prudent because of what Goodhart (2008) calls the boundary problem: the tightening of prudential requirements for entities within the regulatory perimeter creates incentives to shift activities to areas where regulation and supervision are weaker or non-existent.

The issue of regulating shadow banking entities entered the G20 agenda at the Seoul Summit of 2010. It coincided with the beginning of G20 work on financial inclusion, but the overlap between the two issue areas was not apparent to policymakers for several years. The first round of official reports identifies shadow banking as a pro-cyclical force in the financial sector and a result of regulatory arbitrage that threatens to accumulate systemic risk beyond the reach of policy tools available to financial supervisors. Consequently, G20 members pronounced their commitment to strengthen regulation and increase the resilience of the shadow banking sector (FSB, 2011; G20, 2011). The FSB concentrated its initial work on the kinds of shadow banking entities and activities that are prevalent in advanced economies, such as money market funds, securitization, and securities financing transactions. Applying a stability-maximizing approach to these entities and activities seems warranted, especially given the role they played in the global financial crisis. While such kinds of shadow banking activity are currently concentrated in the world's most advanced markets, they deserve equivalent regulatory scrutiny in developing countries.

Tensions between developed and developing countries arose in the one FSB workstream (WS3) that focuses on "other shadow banking entities" (FSB, 2013b). This ample category covers non-bank institutions that are important vehicles of financial inclusion in developing countries. For example, non-bank financial corporations in India extend services to the rural households that do not have access to the formal bank branch network (Acharya, Khandwala, & Öncü, 2013). Peer to peer lending and mobile banking-based services perform similar financial inclusion functions, but they also fall under the FSB's definition of shadow banks. Many developing country regulators are understandably concerned that adopting stringent regulations to address financial stability concerns could lead to disproportionately stringent regulation that has negative implications for financial inclusion and economic development, as indeed was the case with AML/CFT standards.

No FSB report to date recognizes that a stability-maximizing approach to shadow banking might have negative repercussions for financial inclusion. Regulators from East Asian developing countries took the lead in voicing their dissatisfaction with this neglect of financial inclusion in the discussion of how shadow banking should be regulated. In a 2014 meeting of the FSB's Asian Regional Consultative Group (RCG), one of six groups established in 2010 to elicit the perspectives of non-FSB members, representatives made clear that shadow banks "fill a credit void" in making financial services available to individuals and enterprises that may not otherwise benefit from access to funding. The RCG members also pointed out that in the region, shadow banks already exist within the perimeter of prudential supervision, and that cross-border financial risks generated by the sector are minimal (FSB RCG Asia, 2014).

To date, the FSB's approach to shadow banking has been confined to data-gathering, but the organization may move towards greater regulatory control and the creation of specific standards for the regulation of shadow banking, combined with rigorous peer review among FSB members. So far developing countries have adopted mainly subliminal defensive strategies such as minimal compliance with data-sharing exercises or footnotes expressing disagreement with the FSB definition of shadow banking (as in the case of India and China) (FSB, 2016b, p. 93ff). To avoid the kind of unintended consequences for developing countries we have seen in other areas of global standard-setting, it is important that the FSB explicitly acknowledge potential negative repercussions stringent standards might have for financial inclusion, particularly in the regulation of 'other shadow bank entities'. The organization should take steps to include developing countries in the relevant policymaking groups, and adopts a more transparent approach. Otherwise, global consensus in this important area of financial regulatory reform is likely to remain an illusion.

4. Conclusion: Reform Options

Even though the global financial crisis has not engendered a revolutionary rethinking of global financial regulation, we have witnessed significant change in the regulatory approach to global finance and its institutions. The most notable among them are an extension of the regulatory perimeter to include hedge funds and derivatives markets among other financial sectors, the development of a macroprudential approach to financial regulation, and, as noted above, the opening up of SSBs to a select number of emerging market economies. A few scholars argue that the current setup can deliver both high compliance with global standards and sufficient inclusion of developing country prerogatives Chey (2016). Many critics doubt however that global financial regulation in its current form will achieve a high degree of effectiveness, deliberative equality, and representation of involved stakeholders in the future. We conclude this think piece by presenting three options for institutional improvement that are of relevance for the next decade and beyond.

Option 1: Common global principles with national rules

The first approach to global financial regulation considered here is rooted in the understanding that financial markets exhibit such a high degree of cross-border heterogeneity that common rules and global harmonization are both unfeasible and undesirable. Countries are at different stages in the credit cycle at any given point in time, and the risk profile of each financial market poses unique challenges to supervisors. As the Warwick Commission on International Financial Reform states: "Consequently, while there must be greater information exchange at the international level, the locus of much banking regulation needs to be national." (The Warwick Commission, 2009, p. 6)

In its "Praise of Unlevel Playing Fields", the Warwick Commission acknowledges that a higher degree of national regulatory sovereignty may lead to financial protectionism, whereby supervisors erect regulatory barriers to prevent foreign competitors from entering the domestic financial market. In the eyes of the report's authors however, any such undesired repercussions are outweighed by the benefits of greater autonomy. In particular in developing countries, regulators would have greater policy space to deal with challenges such as volatile and pro-cyclical cross-border capital flows, currency mismatches, and a banking sector that provides insufficient funding to the real economy (Kasekende, Bagyenda, & Brownbridge, 2011). Ironically, the Warwick Commission endorses the FSB as a forum for information exchange and agent of dissuasion against regulatory protectionism exactly because it is perceived as weak and inconsequential, with insufficient power to infringe upon national regulatory sovereignty.

In a similar vein, Dani Rodrik (2009) highlights the undesirability of a global approach to financial regulation. He argues that the opposition of domestic parliaments such as the US Congress makes such an approach unfeasible, and that global standards, even if they were implemented, cannot credibly eliminate cross-border arbitrage opportunities. As a solution, Rodrik proposes a combination of national financial rule-making and their extraterritorial application in order to stave off regulatory competition with more lenient jurisdictions. In the realm of derivatives regulation, both US and European agencies have indeed required all market participants active in their jurisdiction to follow their rules, no matter where they are headquartered. The consequence was a long period of transatlantic acrimony and the failure to deliver on the G20 commitment to implement derivatives regulation among all member countries (Knaack, 2015).

Greater national autonomy in a fragmented global financial system may sound good in principle and it would in theory allow each country to achieve an optimal balance between financial stability and inclusive growth. But in practice it may generate the worst possible scenario for developing countries. Given the power distribution in global financial markets, a few leading jurisdictions can be expected to dictate the rules of finance. Fears of cross-border arbitrage would drive regulators in these jurisdictions to maximize extraterritorial authority, reducing the de facto policy space available to financial supervisors elsewhere. Regulatory protectionism is likely to undermine the growth and outward expansion of financial firms from developing countries. Furthermore, while the largest emerging market economies at least have a seat at the negotiating table of global SSBs, they would have no voice whatsoever in the domestic standard-setting process of dominant jurisdictions.

Option 2: A more representative and formalized system

An alternative option is to reform international SSBs to ensure they are more representative and promulgate international standards that reflect the interests of countries with diverse financial systems. Many observers have noted that the current global financial regulatory governance system is not inclusive and representative enough (K. Alexander, 2015; King, 2010; Ocampo, 2014; The Commonwealth, 2016). Although the rules of global SSBs are designed to apply only to member jurisdictions, the wide adoption of global financial standards by non-members and its repercussions even for non-adopters, as outlined in this paper, raise legitimacy concerns. In essence, the current arrangement violates the equivalence principle of global governance: all jurisdictions affected by a global good (or bad) should have a say in its provision and regulation (Held & Young, 2009; Kaul, Conceicao, Le Goulven, & Mendoza, 2003)

In order to address this issue, experts have made several institutional reform proposals. The most basic among them suggest an expansion of SSB membership, granting developing and especially low-income countries a seat at the negotiation table (Bhinda & Martin, 2011). Such proposals have not fallen on deaf ears. The FSB has rearranged the composition of its Plenary in 2014, giving more seats to officials from emerging market member jurisdictions while reducing those of international organizations (FSB, 2014). The Basel Committee now includes 11 members and 3 observers from developing countries. Its Chairman, Stefan Ingves, recently signaled openness for additional adjustments: "Could we further increase the global representation of the Committee while consolidating the number of seats around the table? Is the regional balance of members adequate, or is there scope for further enhancements? These are just some questions which will no doubt have to be considered at some point in the future." (Ingves, 2016).

Proposals of greater institutional sophistication suggest the merger of existing financial governance bodies. King (2010) argues that the G20 should metamorphose into a "Governing Council for the IMF", while Knight (2014) suggests to merge it with the International Monetary and Financial Committee (IMFC). Avgouleas (2012) envisions the IMF as the organization in charge of global macroprudential supervision. It would work alongside the FSB as a microprudential supervisor, SSBs, the OECD and a newly created global resolution authority on the basis of an umbrella treaty that is signed and ratified by member states in accordance with international public law. Ocampo (2014) adds that the IMF and a global regulator should be complemented by regional monetary funds and regional regulatory authorities in a dense multi-layered web of financial governance.

More radical reform proposals envision the creation of an entirely new international organization. In 2009, at a time when G20 members decided to sideline the United Nations as a global economic governance body (Knaack & Katada, 2013), Joseph Stiglitz spoke out against "elite multilateralism" and proposed to replace the G20 with a new Global Economic Coordination Council under UN purview (Stiglitz, 2010). The global financial crisis also triggered calls for a single regulatory authority to address systemic risk (Crockett, 2009), an international bank charter (Claessens, 2008), and a World Financial Organization in charge of global financial standard-setting and prudential supervision (Eichengreen, 2009). What these proposals have in common is an endorsement of wide or even universal membership in a constituency system akin to that of the IMF or the World Bank, where members of the governing board represent several member countries.

Reform proposals also seek to insulate global financial regulations from capture by special interest groups. Lall (2014) emphasizes the need for an institutional design that establishes a clear distance between regulators and financial institutions, minimizing current practices such as the drafting of key regulatory provisions by the industry, and revolving doors. Barth, Caprio, and Levine (2012) point out that almost every New York Federal Reserve President in history has worked for a financial firm after leaving public office. In order to address the practice of revolving doors and a more general conformity bias of finance experts in public office, Barth et al. (2012) propose the establishment of a "Sentinel": a multidisciplinary team of economists, lawyers, and regulators that is tasked with a regular external assessment of the quality of financial rule-making. In a similar vein, Lall (2014) suggests an independent complaint mechanism for affected stakeholders modeled after the World Bank's Inspection Panel.

As these examples show, there is a rich assortment of proposals for a more formalized and representative system of global financial regulatory governance, rooted in a thorough assessment of the flaws and shortcomings of the current system and which propose sophisticated institutional designs to address them. Yet, in the almost-decade since the global financial crisis none of them has come to fruition. FSB members have considered and dismissed the proposal of conversion into a classic inter-governmental organization as undesirable. They also rejected the proposal of adopting a constituency-based membership system because it would be inconsistent with its institutional model (individual financial agencies are members of the FSB, not states) and because it “would make FSB discussions more rigid” (FSB, 2014, p. 1). The FSB and the SSBs it coordinates operate as government networks (Slaughter, 2004), built on a combination of soft law standards, unilateral domestic implementation and peer review that deliberately eschews the strictures of international public law. At a time where existing inter-governmental organizations struggle to make decisions (WTO) or reform their governance structure (IMF) due to parliamentary opposition in member countries, it is hard to imagine that the creation of a new formal organization is a feasible option anytime soon (Brummer, 2014).

While a radical overhaul of SSBs may not be feasible, more moderate reforms could be pursued. The Basel Committee and other SSBs could change their mandates to adopt a Taylor-style mandate that balances the twin goals of financial stability and inclusion. They could increase the representation of developing countries by giving a seat to the co-chairs of the six FSB Regional Consultative Groups. They could also and introduce a mechanism to periodically review membership to ensure that all countries meeting a specific threshold of financial sector importance are directly represented (for instance the number of internationally active banks headquartered in their jurisdiction).

Option 3: A standard-setting body for digital financial services

Digital financial services provide an opportunity to establish a new SSB that is tasked with developing global standards for the prudential regulation of digital financial services, which takes the challenges laid out in this paper seriously. Such a body would be forward-looking in addressing the challenges of next-generation financial services regulation with an approach that balances the twin objectives of financial stability and inclusive growth. Moreover, it would respond to legitimacy concerns by involving all affected stakeholders while safeguarding effectiveness.

When the G20 set up a so-called “Financial Inclusion Experts Group” at the 2009 Pittsburgh Summit, few observers would have imagined how much political momentum the topic of financial inclusion would gain in the following years. Since 2010 we have seen the Seoul Summit and the G20 launch the Global Partnership for Financial Inclusion (GPFI) while the UN Secretary-General’s Special Advocate for Inclusive Finance for Development has explicitly connected financial inclusion to the UN Sustainable Development Goals (Alliance for Financial Inclusion, 2014; Cull et al., 2013; Klapper et al., 2016). Recently, the technical team of the GPFI, chaired by officials from the Chinese central bank and the World Bank, worked to transform the 2010 framework for *Innovative* Financial Inclusion into the 2016 High-Level Principles for *Digital* Financial Inclusion. The Principles were endorsed by G20 leaders at the Hangzhou Summit in September 2016, along with a plethora of other initiatives and action plans that promote fintech and digital financial inclusion (GPFI, 2011, 2016a; G20, 2016)..

In spite of such considerable global political momentum, global SSBs have shown a certain degree of recalcitrance to change. The 2016 GPFI report commends the ground-breaking work of the Financial

Action Task Force (discussed in section 2), but notes that "in contrast with FATF's assessment methodology for mutual evaluations, financial inclusion considerations have not yet figured significantly in the other SSBs' methodologies for standards-related self-assessments and peer reviews" (GPFI, 2016b, p. 82). The unwillingness of the Basel Committee to consider financial inclusion has been discussed above. The reluctance of established SSBs to reconsider regulatory objectives is not surprising given the mandate of the organization and their members. There is insufficient evidence that financial inclusion contributes to financial stability, in fact it may be a source of financial risk. Regulators from rich countries face clearly asymmetric incentives: financial inclusion is not a domestic priority for them, financial stability is. Moreover, they are not rewarded if new financial services for example in Malaysia contribute to inclusive growth in that country, but they are likely to be punished if a financial crisis triggered by lax regulation of those services spills over into their home jurisdiction. Providing developing countries with more formal representation in SSBs is not going to change that situation. As Walter (2016) points out, officials from developed countries in SSBs "form a relatively well-resourced elite network that has developed shared trust, knowledge and experience over decades" (p. 180). As long as SSBs are dominated by this elite network, and as long as they follow a stability-maximizing mandate, considerations of financial inclusion will remain at the margins of the global financial standard-setting process.

Rather than seeking to address digital financial services within old organizations that resist reform, a new SSB could be created that espouses a balanced approach between two goals: financial stability and financial inclusion. An SSB with a mandate to achieve these twin goals is in a position to develop the kind of "development-enabling regulation" many scholars have called for (K. Alexander, 2015; Avgouleas, 2012; Murinde & Mlambo, 2010).

An exclusive focus on *digital* financial services would entail two advantages for the new SSB. First, it would allow regulators to concentrate on the financial sector that is of greatest concern for developing countries (FSI, 2016). Digital financial inclusion to date is driven by non-bank financial institutions and technology firms, not big banks. Over the last two decades, "financial innovation" by large, internationally active banks has contributed more to the global financial crisis than to the financial inclusion of underprivileged parts of the global population. Leaving these firms under the conservative, watchful eye of the Basel Committee is unlikely to harm digital financial inclusion in the years to come.

Second, digital financial services require a new regulatory skill set. Digital financial operations involve new actors, risks, and cross-sector services that the current silo system of sector-specific regulation is ill-equipped to deal with (BCBS, 2015; GPFI, 2016b; Magaldi de Sousa, 2016). Moreover, it reduces inequalities in regulatory experience and capacity between developed and developing-country regulators. For example, the Central Bank of Kenya has accumulated nine years of experience in regulating mobile-based payment and banking services (M-Pesa), while China's regulators oversee the many of the world's largest providers of digital financial services. In their daily struggle to improve prudential supervision over a fast-growing sector and reigning in fraudulent behavior and other risks, financial regulators in developing countries are gaining valuable experience that they can share with their colleagues from high- and low-income countries. Fortunately, regulatory initiatives such as Project Innovate by the UK FCA indicate that supervisory authorities focusing on digital financial services in advanced economies have a more open attitude towards experimentation and peer learning than their colleagues in the traditional banking supervision departments do (Arner, Barberis, & Buckley, 2015).

The composition of a new digital financial services SSB should reflect the importance of both representation and regulatory capacity. Building it around the Basel Consultative Group (BCG) has several advantages. The BCG is engaged in regulatory work on financial inclusion since 2008 and published a guidance document on the Basel Core Principles relevant for financial inclusion in 2015. It includes officials from ten jurisdictions that are Basel Committee members (directly, such as Germany and Mexico, and indirectly through the EU). It further hosts officials from twelve non-member jurisdictions, nine regional groups (including the Islamic Financial Services Board and the Caribbean Group of Banking Supervisors), the World Bank, the IMF, and the BIS Financial Stability Institute. Input from developing country regulators would be enhanced by further including the Alliance for Financial Inclusion that represents financial supervisors from 94 countries. Retaining the institutional identity of the BCG as a transnational regulatory network would provide this new SSB with the benefits of a quasi-constituency-based system without the cumbersome process of a traditional inter-governmental organization.

Under a twin mandate of financial stability and inclusion, this SSB could then develop a new regulatory paradigm that can take inspiration from the 12 principles for internet finance regulation formulated by Zhang Xiaopu (2016). The Deputy Director of the Policy Research Bureau of the China Banking Regulatory Commission and Basel Committee official suggests a system of “dynamic proportionate supervision”: regulators should regularly assess the risk profile of a given digital financial service and adjust supervision in increasing order of stringency, from self-regulation, to licensing, regular monitoring and finally the imposition of capital, liquidity, and other requirements. Such an approach would also envision comprehensive and real-time data monitoring and analysis, an exercise that is technically feasible for the supervision of digital financial services. Given the marginal contribution to systemic risk of digital financial services at the current stage, the operations of this new SSB would initially be limited to peer learning and the development of best practices. However it can be expected to slowly rise in global importance along with the scope of the financial services under its purview in the coming decade. Hopefully this will be enough time for mutual trust, capacity, and experience to grow among a new network of regulators that embody a better balance of developing and advanced economy interests than any of the current bodies of global financial regulatory governance.

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