G20 Eminent Persons Group (EPG) on Global Financial Governance: Update for the G20 Meeting of Finance Ministers and Central Bank Governors

Buenos Aires, March 2018

I. Introduction: Global Financial Governance for a New Era

1. This note summarizes some of the key ideas being developed by the EPG on reforms to improve the functioning of the global financial architecture and governance, in keeping with its mandate. They have benefitted from very constructive discussions with the International Financial Institutions (IFIs) and a wide range of other stakeholders, and will be further developed in the coming months.[1]

2. We note at the outset that while some of the reforms represent **low-hanging fruit**, others involve more **complex trade-offs** or require significant operational hurdles to be crossed. Some of the more fundamental issues in global governance fall in the latter category. We have included them in this note in the spirit of transparency at this stage of our work, while we deliberate further on them.

3. The IFIs play unique and **indispensable roles** in the global community: in providing trusted advice and technical assistance, mobilizing finance for development, helping to pre-empt and resolve economic and financial crises, in tackling challenges in the global commons, and in upholding internationally agreed norms and standards.

4. However, the **IFIs' continued effectiveness will rest on significant evolution in their policies and governance**, to respond to the structural changes that have been reshaping the global economic and financial order:

a. **Growing multipolarity and diversity.** There is now a multiplicity of international players, across global, regional and bilaterally-oriented institutions and programs. While there are clear benefits in this diversity, it is critical that we achieve better **coherence and complementarity** between different parts of the system, aimed at maximizing their collective impact on inclusive and sustainable growth, and on financial stability.

b. **The increased salience of private capital and cross border capital flows.** There is both immense need and untapped potential for developing countries to access private capital markets. The IFIs' principle orientation should be to **provide policy advice and assist in capacity-building, and mitigate risks**, so as to catalyze private investors wherever possible[2], enable a sustainable cost of funding for borrowers, and achieve the much greater scale of development financing required in the next two decades.

IFIs also play an important role in preserving global financial stability and helping countries to **secure the benefits of capital flows for growth.** They aid countries in implementing

[1] The EPG's final recommendations will be submitted to G20 FMCBG by October 2018.
[2] The mix of public and private funding that can be achieved will vary significantly across countries. However, with appropriate policy development and risk-mitigation instruments, there is scope for greater private investment in most countries.

sound domestic policies, as well as in mitigating excessive volatility of capital flows and exchange rates when needed to sustain sound domestic policies.

c. **Technological advances and growing interconnectivity.** Technology can enable the development of low-cost, scalable solutions - to deliver healthcare and education; reduce poverty; broaden access to global markets and 'democratize' innovation; and to harness data to serve both development and financial stability more effectively. The IFIs have to develop close partnerships with other players such as philanthropies and the private sector, to pilot and grow these solutions.

d. **Growing threats to the global commons.** These include especially climate change, the growing risk of pandemics, and challenges to the integrity of the global financial system posed by money-laundering, terrorism financing, tax evasion and cyber-related financial risks. The IFIs have a key role in shaping the response to these threats, but tighter partnerships with other international, regional and national agencies are needed.

5. Changes in global financial governance to meet these challenges and opportunities are essential to **an open and more stable international system suited to a new era**, and supportive of national policies aimed at securing more inclusive and sustainable growth.

6. Good progress is being made within the IFIs, to shift priorities and operations. However, the scale and urgency of needs requires a decisive, system-wide approach. **Shareholder, policy and operational coherence** has to be a key priority, so that we get a system that is much stronger than the sum of its parts. The issues set out in this note are focused mainly on these **system-wide** issues.

II. Securing inclusive and sustainable growth

7. Global leaders have coalesced around the Sustainable Development Goals (SDGs) and the 2030 Agenda. By any measure, the scale of what needs to be achieved is larger than previously seen - given in particular the large waves of demography and urbanization in the developing world, and the consequent challenges of human capital development, infrastructure and jobs. Failure to lift these youthful populations will have more than economic consequence.

8. There is, however, considerable potential to strengthen development impact through the IFIs working together as a system. The **six approaches** discussed below reflect this potential, and will be subject to further validation in the coming months. Each of these system-wide collaborations can be achieved without creating new governing bodies or institutions.

9. **First, the Multilateral Development Banks (MDBs) should agree on a set of core development principles, upon which they would align their operations.** The principles should aim at achieving coherence amongst the multiplicity of today's actors, while recognizing their different institutional backgrounds and identities.

a. Aligning around principles, policies, and key procedures would open space for productive competition in speed, efficiency and innovation in approaches and products, while avoiding competition that lowers standards or uses subsidies on official loans in areas with no clear market failure.

b. Common principles would also aid in aligning ex-ante and ex-post metrics, which are key for assessing best practices, as well as graduation policies, which recognize the need for different mixes of MDB engagement in different income categories.[3]

10. Efforts in recent years to advance principles for various purposes[4] provide a good basis for developing these core development principles at a further level of specificity to enable operational coherence. The MDBs should also work towards a consensus on principles with bilateral lenders, who already occupy an important part of the financing landscape.[5] Agreeing on system-wide principles would also simplify the environment for clients and investors.

11. **Second, the IFIs should collaborate through country platforms – in capacity-building, strengthening the investment environment, developing the supply of bankable projects, and sharing knowledge and data**[6]. These platforms should be owned by the countries' governments, with appropriate support and coordination from the IFIs.

12. Country platforms should also enable MDBs and the IMF to leverage the capabilities of the private sector, NGOs and philanthropies – for example to accelerate adoption of technology-driven solutions - drawing on the IFIs' unique role as honest brokers for country authorities. Contributions from different institutions should be flexibly combined along the value chain according to their comparative strengths and coordinated transparently.[7] To facilitate this, country platforms should involve the early sharing of the MDBs' project pipelines.[8]

13. **Third, the MDBs should collaborate on system-wide risk insurance.** Risk is a key deterrent to private sector investment in EMDCs today. In particular, **perceived political risk results in investors shunning projects that could otherwise be bankable, or requiring large risk premia** and hence high costs for project sponsors and sovereigns.

14. A system-wide political risk insurance platform can lower risk premia meaningfully. This can be achieved by adopting a **programmatic approach to risk guarantees as distinct from the current project-by-project approach** and servicing all MDBs across geographical areas and income levels. There is also opportunity to lay off risks on a standardized and pooled basis to private reinsurers.[9] This has the further advantage of creating the basis for securitization of cash flows, which expands the pool of potential investors (see below also).

[3] MDB engagements need to ensure access to official resources during crisis times, as well as to provision of global public goods in MICs. However, the mix of MDB engagements with a country should shift, and pricing policies should reflect declining subsidy components, as per capita income grows.
[4] These include: the G20 Principles on Crowding-in Private Sector Finance, the G20 Principles on Effective Coordination between the IMF and MDBs, the G20 Operational Guidelines on Sustainable Financing, and the G7 Principles for Promoting Quality Infrastructure Investment (2016).
[5] Members of the International Development Finance Club – 23 DFIs with assets of $ 3.5 trillion and loans of over $0.8 trillion – have recently embarked on a process to align policies across their institutions.
[6] In some instances, regional platforms will also be value-adding.
[7] For instance, joined-up efforts by the MDBs and the IMF can help develop local capital and currency markets.
[8] MDBs could also establish joint project preparation funds.
[9] The cost of reinsurance can be kept low if it is provided on an indemnity basis, i.e. reinsurers pay once losses exceed a threshold. Sovereign counter guarantees (for a portion of risk) should also be explored, as they would lead to a lowering of risk and perceived risk.

15. **No new institution is needed. MIGA[10] is uniquely placed to take on this expanded function,** with MDB financial contributions from net income being adequate to fund this expanded MIGA facility. Net income contributions would also enable managerial input from the respective institutions in the expanded facility.

16. **Fourth, the MDBs should collaborate to enable system-wide securitization so as to mobilize institutional investors.** Securitizing on a large scale, across the MDB system, will in effect create new asset classes and attract a wider range of investors. Equally important, planning for securitization downstream confers significant benefits upstream in the project cycle, by driving **standardized documentation and commercial discipline**.

17. The MDBs' value added is highest during the design and implementation of development projects (on average about 7 years), but loans tend to remain on their balance sheets for well beyond this phase. There is opportunity to substantially increase private participation system-wide, either through outright sales of loans or the creation of tranched financing structures where the MDBs retain a junior stake.[11] Securitization could start with private sector loans (B-loans) which do not carry a subsidy element. However, in principle, both sovereign[12] and B-loans can be pooled on a wider basis to avoid concentration risk – across geographies, sectors, country income levels – so as to produce diversified portfolios with lower risk premia.[13]

18. System-wide securitization should not require the creation of a new institution. Either an existing MDB or a private sector agent could be charged with this function. The MDBs would also have to collaborate in constructing infrastructure data platforms and asset class benchmarks.[14]

19. **Fifth, MDBs' governance structures and internal incentives should be reoriented towards achieving development impact, rather than deployment of their own financing.** Rigorous internal procedures and incentives are required to ensure additionality in MDB operations, and to make crowding in private investment a priority over the direct provision of loans, wherever possible.

20. Private sector input can also be brought into MDB decision-making more systematically. One approach is for individuals with specific professional and commercial expertise to be involved as observers or "adjunct" non-voting members on the Board and/or Board committees, or as members of advisory panels on investments. Precedents for this have been found useful.[15]

21. **Sixth, clear visibility of responsibilities and complementarities between the different agencies involved in tackling the challenges of the global commons is needed.** Arresting threats like climate change, developments in the world's biological eco-system, pandemics and natural

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[10] MIGA currently provides political risk insurance against currency inconvertibility and transfer restrictions; expropriation; war and civil disturbances; non-honoring of financial obligations; and breech of contractual obligations.
[11] Rather than leave subsidized loans on the MDB balance sheets, its conversion to a first loss insurance will crowd in the private sector and lower expected borrowing costs. This feature has been used in IFC and EIB operations.
[12] The treatment of the preferred creditor status will need to be examined carefully.
[13] Cash and synthetic securitization, which bring different benefits, can both be explored, to appeal to the widest range of private investors.
[14] The IFC-EIB 'GEM' initiative is an important start.
[15] There is precedent for this in institutions like the EIB, and in national investment banks and debt management offices.

catastrophes, which have large spillover effects across regions and globally, is critical to achieving broad-based, sustainable growth. A diverse set of organizations – with the IFIs and UN agencies at the center – are involved in surveillance; prevention and intervention to contain threats; and in the provision of commons. They include coalitions of countries as well as public-private coalitions that are focused on tackling specific commons.[16] Major philanthropies have been active in testing innovative solutions on a small scale, often cooperating with academic institutions undertaking basic R&D; MDBs could aid in the scaling up phase.

22. Again, the diversity of actors responding to these global challenges is a positive feature. However, clarity on the division of labor, coordinating roles, and modalities of cooperation is needed for operational coherence and impact.

III. Securing the Benefits of Open and Stable Financial Markets

23. Governance of the international financial and monetary system (IMFS) should aim at **securing the benefits of open financial markets and preempting and mitigating financial crises.**

24. Sound domestic macroeconomic policies and financial supervision are fundamental to securing the benefits of open markets for growth and development. However, it is the nature of today's highly interconnected global financial markets that even well-run economies live with the reality of spillovers or experience volatility in capital flows and exchange rates. Excessive volatility reduces the room for maneuver in policy-making, and can lead to responses that are sub-optimal both nationally and internationally.

25. **Three pillars are hence necessary in the IMFS to support sound domestic policies and keep financial markets on a path towards openness:**

- *a.* a framework to assess and enable mitigation of excessive volatility of capital flows and exchange rates;
- *b.* a more resilient and predictable global financial safety net (GFSN);
- *c.* strengthened surveillance and risk identification in a more complex and decentralized global financial system.

26. There are currently significant gaps in these pillars. **There is no internationally agreed framework for assessing and mitigating excessive volatility of capital flows and exchange rates.** While important steps have been taken in the last decade, existing frameworks either lack broad support or are incomplete. With regard to financial safety nets, **a decentralized, multi-layered structure of global, regional and bilateral arrangements has evolved over the last decade, but lacks the necessary coordination and joining-up** – it is not clear who will do what in a major crisis. In the absence of an effective and predictable GFSN, there remains incentive for inefficient policy choices such as self-insurance through reserve accumulation. In the area of **surveillance**, the IMF,

[16] For instance: Delta Coalition, an international coalition of countries that are working together to increase the resilience of urban deltas; Coalition for Epidemic Preparedness Innovations (CEPI), a public-private coalition speeding up the development of vaccines.

FSB and BIS have significantly expanded their capacities for bilateral and multilateral risk identification. What is still needed is **effective integration of their different institutional perspectives into a coherent risk map and with follow-up policy guidance**.

27. The EPG is considering **approaches to address these three gaps**, as set out broadly below. We will be engaging in further deliberation on these approaches.

28. **First, a framework for assessing mitigating excess volatility of capital flows and exchange rates** is needed to guide policies at the national level. This would not add new obligations for the membership. There could be three elements of such a framework:

a. The development of a **clear evidence base** of the domestic and cross-border drivers (both push and pull) of capital flows; the role of exchange rates as both shock absorbers and shock transmitters; the interactions between domestic macro-economic, macro-prudential, exchange rate and capital flow management policies; funding at risk; and the attendant impact on financial stability is a necessary first step. In the last few years, a rich mass of data, experiences and research findings has become available on these issues. This knowledge needs to be brought together to support a coherent and complete view of policy options.

b. Building on the evidence base, a **framework for constructive policy advice** should be established. Such a framework needs to **integrate** considerations of macroeconomic and financial stability, exchange rate assessments, and the origins and impact of spillovers, to provide a basis for policy advice to countries on the appropriate use of a range of instruments.

c. As these discussions would involve assessments of the macroeconomic backdrop, domestic policy settings and exchange rates, the **IMF is best positioned to manage such an evolving framework, with regular input from BIS and relevant central banks, and to integrate the framework into its surveillance activities**. The framework would take into account a country's level of financial market development, with the OECD Code of Liberalization of Capital Movements as the aspiration.

29. **Second, we need a resilient and predictable GFSN** to support good domestic policies and reduce the need for continued build-up of self-insurance. While the current decentralized, multi-layered structure has its merits, especially in providing for strong regional ownership and bringing additional resources to the table, what is needed is stronger coordination – specifically, **a clearer identification of modalities and protocols for cooperation across the layers of the GFSN in the context of different stress scenarios** (liquidity, solvency; systemic and tail risk). The actual provision of support can take various forms and be applied flexibly under the defined modalities.[17] However, there is no one set of modalities to coordinate all regional (or bilateral) arrangements with the IMF, given the very different legal and legislative frameworks within which they operate.

[17] Generally, one could expect that liquidity stress could be met with a larger contribution from bilateral swap arrangements (BSAs) and regional financial arrangements (RFAs), whereas solvency cases may require a stronger element of IMF financing with appropriate conditionality.

a. One important scenario requiring coordination and contribution of resources across the layers is the provision of **adequate financing to systemic countries**. While the surveillance framework for systemic countries is well-developed, a structure of adequate provision of liquidity to these countries is missing, including the definition of need[18] and resources.

b. A further element of a well-coordinated GFSN is the **maintenance of sound and credible standards** on appropriate ex-ante or ex-post conditionality, to avoid costly adjustment later. The IMF having developed the strongest capability in this area, across a long span of experience and country conditions, should be involved in the **design of all programs, with or without its participation in financing**.

30. **IMF resources, as part of a resilient GFSN, should to be responsive to different stress situations.** Its permanent resources should be kept updated to meet the needs of balance of payments crises and contagion in most circumstances[19], but not necessarily for an extreme or tail risk event involving a liquidity shock of systemic dimensions.

31. In addition, we need a **mechanism for substantially larger resources to be mobilized and deployed within a short period in the event of such tail risks**.[20] We recognize that such options have significant global governance implications, and some past proposals had not received broad support among shareholders. However, it remains important that gaps in the IMFS be addressed for the long term, and a consensus be built on the most effective ways to fill the gaps. The status quo leaves too much at risk. The EPG is studying these issues.

32. **Third, we should institute a more integrated financial surveillance and institutionalized early warning exercise**. This is especially salient in the context of the continued rise of debt ratios globally and stretched valuations of many assets. The IMF, FSB and the BIS are the three main organizations with responsibilities for surveillance of the international financial system. Each has unique strengths, spanning the macro-financial, regulatory and macroprudential, and banking and central banking, respectively. Whilst there have been loose cooperation and exchanges since the last crisis, each organization has tended to operate quite independently. Their individual strengths and collective wisdom could be joined to enable deeper and more comprehensive analysis and insight.[21]

a. To achieve this, **a high-level forum for agenda setting based on the risks identified in a joint submission from the IMF, FSB and BIS[22] should be institutionalized**. Without

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[18] Building upon the approach developed for identifying the Systemic 29, metrics on external vulnerability and funding risks relating to the capital account of these countries need to be developed and leveraged.

[19] While respecting existing lending policies including the Exceptional Access Framework.

[20] Some of the major central banks which extended swap lines during the last crisis may not have the latitude to do so in future, or on the scale required.

[21] Examples of possibilities include thematic and jointly staffed FSAPs that examine system-wide issues – for instance, the stability implications of spillovers from monetary and regulatory actions – integrating FSB horizontal reviews with IMF surveillance of spillovers, and leveraging BIS perspectives on global flows and infrastructures and IMF macro-financial perspectives. Other examples are studies of the impact of technology on the integrity of the payments and settlement systems.

[22] The unique perspective of BIS including the work on payments and settlement infrastructures as well as of the CGFS on currency and banking flows – especially of the major money centers – is currently missing from the consideration of systemic risks.

creating a new structure, the forum could build on the Early Warning Exercise (EWE) whereby the three organizations integrate their perspectives on financial risk into a single assessment and propose a set of follow-ups which could include further monitoring and study or policy development and regulatory action. This joint submission would be discussed at the EWE bi-annually and follow-up actions would be endorsed and assigned to specific IFIs for follow-up. Progress can be reported at subsequent meetings of the same forum.

b. They should also intensify cooperation with other relevant bodies, such as the OECD and the Financial Action Task Force on Money Laundering (FATF), to tackle the challenges to the integrity of the global financial system, including those posed by tax evasion, money-laundering, terrorism financing, and cyber-related risks to financial stability.

IV. The G20 and its relationship with the IFIs

33. The relationship between the G20 and the IFIs is key to the effective functioning of global financial governance for a new era as described in the first section of this note – one that provides sustained strategic direction and oversight for the IFIs to function as a joined-up and coordinated system whilst retaining their individual strengths.

34. G20 members form the majority of shareholders in almost all the IFIs and can be a powerful impetus for change in the IMFS. Further, members have an equal standing within its consensus based organization, which gives the G20 added credibility in a multipolar world. The G20 has used these leadership advantages to promote change in several important areas since the global crisis, for example in strengthening financial regulation via the FSB and tax transparency via the OECD.

35. However, the G20 does not have universal membership and unlike treaty-based organizations is not legally-constituted to deliver on decisions. It has to work in coordination with the IFIs and their own governance bodies to advance many of its aims. Some initial ideas follow.

36. The G20 FMCBG is well-placed to forge consensus on **key strategic directions** for the IFIs collectively to operate better as a system in such areas as common operational principles among the MDBs, protocols setting out roles and relationships among the layers of the GFSN and better integrated financial system risk surveillance.

a. A joint report could be prepared by the IFIs periodically, setting out progress towards the directions and targets set for the system as a whole. This would be provided simultaneously to both the G20 FMCBGs and each IFI's own board. (This report could also be done by the collective of independent evaluation offices.)

37. At the same time, the G20 could refocus on setting and achieving **a multi-year strategic agenda**. This will enable the G20 to sustain progress towards important global goals whilst rationalizing work streams that are outside of this agenda. The G20 should also leverage more actively on the capabilities of the IFIs, individually or jointly, to work on areas within their broad mandates.