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International financial regulation, access to finance, systemic stability, and development

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Abstract

Global financial markets are subject to a complex web of soft law rules and standards called International Financial Regulation. The main rationales/objectives of International Financial Regulation revolve around the protection of investors and depositors and the safeguarding of financial system stability. In recent months International Financial Regulation has come under attack for its lack of proper structures and flawed rules, which have been held to be among the main causes of the global credit crisis. As a result, a major reform exercise is under way. This paper argues that, as part of this reform, policy makers and regulators must attempt to widen the objectives of International Financial Regulation so that they become cognizant of the impact of financial sector development and access to finance on economic growth and poverty eradication. In this context, the paper proposes a global licensing scheme for international investment funds and the reform of the Basle Capital Adequacy Standards. Implementation of the proposals would enable International Financial Regulation to both strengthen the global financial stability framework and facilitate access to finance in poor and very poor countries.

JEL: G 150, G180, G 280, G 290, K 220, L 380, O160

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1. Introduction

It could be safe to say that the pursuit of economic development and poverty reduction in the poorest of the developing countries has largely failed. Explanations about the causes of such failure range from lack of natural endowments, cultural barriers and path dependence to severe governance failures (including corruption and lack of properly functioning institutions). It has been well documented that these situations sometimes prove to be severe obstacles to the operation of well functioning markets, the development of the domestic financial system, and the attraction of foreign direct investment. On the other hand, the development agenda in the post-Washington consensus era is struggling to address the issues of development and poverty eradication by devising innovative approaches that can withstand the scrutiny of empirical testing without repeating the mistakes of Washington Consensus policies.

Widening access to finance, one of the main ingredients of Financial Sector Development (FSD) - the most recent acquisition in the armoury of development policies - has come to be considered as key tool in the struggle for growth and eradication of poverty. It is in this context that the use of microfinance schemes, which mainly comprise the provision of financial services to the poor,[1] is seen as a potent weapon in the fight against poverty.

It is also widely acknowledged that policies that facilitate access to finance are of great importance in the achievement of the United Nations Millennium Development Goals

[1] *See* Jonathan Morduch, 'The Microfinance Promise' (1999) 37 *Journal of Economic Literature* 1569. [Hereinafter Morduch, *The Microfinance Promise*]. E.g., the achievement of MDGs in health and education is also conditional on poor households' ability to afford these services.

(MDG).[2] In the *International Conference on Financing for Development* in Monterrey, Mexico in 2002 high-income and developing countries reached a consensus on mutual responsibilities for achieving the MDGs.[3] The lesson from the Monterey conference is that new and innovative approaches must be devised to facilitate access to finance fostering financial sector development and supporting microcredit and microenterprise schemes, at least, when they are commercially viable. It follows that global financial markets should be one of the main tools used by policy initiatives that seek to foster development and eradicate poverty.

Global financial markets have grown exponentially in the past two decades, due to a combination of factors such as technological advancements, abolition of national restrictions on capital flows, and trade liberalization. To a large extent the markets for banking and investment capital are borderless, whereas the regulators supervising parts of them and their rulebooks are subject to jurisdictional constraints.[4] This paradox seems to have been resolved through the so called 'soft law' approach.[5] Since the 1990s we have witnessed the gradual emergence of a global regulatory system for international financial markets. This comprises recognized international law actors such as the IMF and the World Bank and, more importantly, quasi-formal regulatory networks with a global focus. The principal centres in this complex web of quasi-formal global regulators

[2] *See* Elizabeth Littlefield, Jonathan Morduch, and Shyed Hashemi, 'Is Microfinance an Effective Strategy to Reach the Millenium Development Goals?', GCAP, Focus Note 24, January 2003.

[3] *See* 'Monterrey Consensus of the International Conference on Financing for Development', 18-22 March 2002 [hereinafter *The Monterrey Consensus*]. The full text is available at http://www.un.org/esa/ffd/Monterrey%20Consensus.pdf

[4] For analysis see Emilios Avgouleas, *The Mechanics and Regulation of Market Abuse, A Legal and Economic Analysis* (Oxford: Oxford University Press, 2005), ch 2.

[5] See JJ. Norton, *Devising International Bank Supervisory Standards* (The Hague: Martinus-Nijhoff, 1995), *esp*. p. 216 *et seq*.

are the International Organization of Securities Commissions (IOSCO)[6] and the Basel Committee on Banking Supervision,[7] which has designed regulatory standards for the cross-border supervision of international banks. Regulatory initiatives emanating from those centres attempt to address the challenges of an increasingly integrated global marketplace and are focused on fostering the convergence of national regulatory systems, especially in terms of governing principles and rule content.

Although the official membership of the Basle Committee is restricted to representatives from a small number of countries and the standards it promulgates do not, *prima facie*, have binding legal force, the process through which they are drafted and the institutional might of participant organizations mean that most of them end up incorporated into national legal systems. For this reason, they are considered part of the emerging body of global administrative law[8] and are treated and examined with the deference reserved for formal legal rules by both national regulators and the global financial services industry.[9]

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[6] As a federation of national securities Commissions whose members regulate more than 90% of the world's securities markets, IOSCO is the most influential international standard setter for securities markets. IOSCO adopted in 1998 a comprehensive set of Objectives and Principles of Securities Regulation (IOSCO Principles), which are today recognized as the international regulatory benchmarks for all securities markets. In 2002 IOSCO adopted a multilateral memorandum of understanding designed to facilitate cross-border enforcement and exchange of information among the international community of securities regulators. The main objectives of IOSCO principles and of their enforcement are (a) The protection of investors, (b) Ensuring that markets are fair, efficient and transparent, (c) the reduction of systemic risk. The Executive Committee of IOSCO has established two specialized working Committees: the Technical Committee and the Emerging Markets Committee. The more influential Technical Committee comprises fifteen agencies that regulate some of the world's larger, more developed, and internationalized markets. See www.Iosco.org.

[7] A concise analysis of the workings of the Basle Committee is offered in section 3. For a comprehensive and critical analysis of the work of the Basle Committee and of IOSCO see Kern Alexander, Rahul Dhumale, and John Eatwell, *Global Governance of Financial Systems, The International Regulation of Systemic Risk* (2006), ch 2.

[8] *See* for an overview Nico Krisch and Benedict Kingsbury, 'Introduction: Global Governance and Global Administrative Law in the International Legal Order' (2006) 17 *European Journal of International Law* 1.

[9] See Michael S. Barr and Geoffrey P. Miller, 'Global Administrative Law: The View from Basel' (2006) 17 *European Journal of International Law* 15.

In recent months International Financial Regulation has come for fierce criticism, as its lack of proper structures and the operation flawed rules have been held to be among the main causes of the global credit crisis.[10] As a result, a major reform exercise is under way. This paper argues that, as part of this reform, national and international policy makers and regulators must take into account, apart from the regulatory objectives of systemic stability and investor/depositor protection, the wider objectives of economic development and poverty eradication, especially in very poor countries. In this context, the paper proposes a set of concrete policy reforms that would enable International Financial Regulation to achieve a wider set of policy objectives.

This paper is divided in six sections. The first section is the present introduction. The second section discusses the impact of financial sector development and access to finance on economic growth and rates of poverty. The third section discusses some of the different tenets of international financial regulation giving special emphasis on the function of the Basle Committee's capital adequacy standards for banks. The fourth section sets out the main parameters of the paper's reform proposals. The fifth section explains how a reform of the Basle capital adequacy standards and the establishment of a global licensing scheme for international investment funds could both enhance global financial stability and access to finance in poor and very poor countries. The sixth section brings the different straddles of the present analysis to a comprehensive conclusion.

2. Financial Sector Development, Access To Finance, Growth, And Poverty

2.1 Defining Access to finance

[10] For extensive analysis see Emilios Avgouleas, 'Financial Regulation, Behavioural Finance, and the Global Credit Crisis: In Search of a New Regulatory Model', May 2008, available at SSRN: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1132665.

Access to finance, one of the main criteria to assess FSD, is a very difficult term to define and, perhaps, in the case of the poor, not even the most appropriate one. Normally, access to finance is taken to mean access to certain institutions, such as banks, insurance companies, or microfinance institutions; or access to the functions (services) that they provide, such as payment services, savings or loans and credits, or use of certain financial products, such as credit cards, mortgage and insurance products.[11] A more conceptual approach would take access to mean[12]: (a) the availability of financial services and reliability of financial services (namely, whether finance is available when needed/desired), (b) convenience, which is the criterion that, apart of geographic access, measures the degree of ease of access and its continuity; can finance be accessed repeatedly? (c) geographic access, namely, how far or near a consumer is from the point of service and proximity or accessibility of financial advisers to community-based infrastructure, (d) the cost/price at which financial services are available; this criterion is also called affordability of financial services, which is measured by the cost of basic access relative to income, (e) the quantity, type and quality of financial services offered, and (f) flexibility: is the product tailored to the needs of the users?

[11] Anne-Marie Chidzero, Karen Ellis, and Anjali Kumar, 'Indicators of Access to Finance, Through Household Level Surveys, Comparisons of Data from Six Countries', paper presented in the World Bank conference: *Access to Finance: Building Inclusive Financial Systems*, 30 May 2006, p.1, [hereinafter *Indicators of Access to Finance*].

[12] See, in general, Stijn Claessens, 'Access to Financial Services: A Review of the Issues and Public Policy Objectives', World Bank Policy Research Working Paper 3589, May 2005, pp 6-12 [hereinafter Claessens, *Access to Financial Services*]; David Porteous, 'Making Financial Markets Work for the Poor', 31 October 2004, a paper commissioned by the SA FinMark Trust, www.finmarktrust.org.za [Porteous, *Making Financial Markets Work for the Poor*]; Augusto de la Torre, Juan Carlos Gozzi, and Sergio L. Schmukler, 'Innovative Experiences in Access to Finance: Market Friendly Roles for the Visible Hand?', World Bank mimeo, 30.03.2006, pp. 10-18 [hereinafter de la Torre *et al*., *Innovative Experiences in Access to Finance*].
In describing the criteria of access this chapter draws on the above papers.

Most of the above criteria allow for an objective measurement of access.[13] Yet, even if access can be measured it may not be the right criterion.[14] First, there are many dimensions to access, making it more difficult to establish the degree of (lack) of access. Second, even if there exists a market where some financial services are accessible, poor people may still choose not to use it. Accordingly, an alternative approach, which measures not so much access, but usage of financial services, may be more appropriate in the case of the poor.[15] Usage can be measured quite easily using historical data. It can also be compared across sectors, since the usage patterns of particular markets can be tracked over time. Therefore, a market which works for the poor is one in which usage of the service by poor people is increasing over time. Increasing usage clearly implies both accessibility and appropriateness, without the need to define either too closely.[16] As a result, if the proportion of poor customers to total customers in a particular market segment increases over time, then relatively more poor people are using the products provided by that market.[17]

2.2. Access/Usage barriers

2.2.1 Constraints relating to financial institutions

Explanations of the lack of access to/usage of finance fall into two broad categories: (a) financial institutions' specific constraints and (b) barriers arising from the overall

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[13] *See* Chidzero, Ellis and Kumar, *Indicators of Access to Finance*, n 11 above, p. 4.

[14] Porteous, *Making Financial Markets Work for the Poor*, n 12 above, p. 10. According to Porteous, the access frontier 'is the maximum proportion of usage possible under existing structural conditions (of technology, infrastructure and regulation)'. *Id*. p. 3.

[15] For the complex relationship between access and usage see Chidzero, Ellis and Kumar, *Indicators of Access to Finance*, n 11 above, p. 3.

[16] Porteous*, Making Financial Markets Work for the Poor*, n 12 above, pp. 10-11.

[17] *Ibid*.

institutional environment prevailing in each country.[18] The following access/usage barriers may be regarded as constraints relating to financial institutions[19]: (a) access exclusion, (b) condition/product exclusion, (c) marketing exclusion: with some people effectively excluded by marketing and sales targets, (d) cultural exclusion due to ethnic and class biases, (e) self-exclusion: some persons do not seek to obtain financial services in the belief that their application would be refused.

Access exclusion may be the result of many factors. For instance, through risk screening banks may consider some households and firms as less attractive customers and are, therefore, not willing to extend financial services to them. This is an especially strong barrier as poor customers are not usually able to provide collateral, which could be used for risk mitigation.

Condition/product exclusion means that there is a lack of products that suit the needs of the poor or of small firms. Households and firms in developing countries may seek financing or insurance for specific purposes (major life events such as marriage, health or specific crop insurance), for which contracts are difficult to design. Firms may be underserved for the same reasons. Small firms seek different products than large enterprises, as are, for instance, payment services for small amounts. Thus, banks may not consider small firms as sufficiently attractive clients. Moreover, if the size of the

[18] *Ibid*. p. 12.

[19] The systematic categorization offered here draws on, but does not fully endorse, relevant classifications, in a number of works including E. Kempson *et al.*, 'In or out? Financial exclusion: A Literature and Research Review' Report prepared for the UK's Financial Services Authority (London: Financial Services Authority, 2000), pp 21-29; Porteous, *Making Financial Markets Work for the Poor*, n 12 above, and Claessens, *Access to Financial Services*, n 12 above.

market is such as to be difficult to develop/reap economies of scale, it becomes unprofitable for financial institutions to offer new products specifically for that market.[20]

Cost/price exclusion may also be due to a variety of reasons. High transaction costs for small volumes are often mentioned as constraining financial services providers from broadening access. Small borrowers need to borrow frequently and repay in small installments. They consequently do not want financial products with high per unit costs, yet for banking institutions the costs per transaction are often similar regardless of the size of each transaction. The fixed costs of financial intermediation make the provision of financial services to small clients and in small markets very hard, even if specialization and increasing volume absorb some of this cost.[21]

Finally, formal financial services provision may entail other, non-pecuniary barriers, such as requiring (greater) literacy. In such cases, households and firms will not seek financial services from formal financial institutions and will instead opt for informal sources of finance, such as family and friends. For instance, people wanting to transmit payments to their relatives, whether domestic or international may rely on informal networks, although at higher costs. This is most obvious in the transmission of international remittances, where unit costs can be very high when informal mechanisms are used.[22] Yet, these informal mechanisms are often preferred due to non-pecuniary barriers. This lack of demand is also a powerful explanation of why usage is not universal: many

[20] Glaessens, *Access to Financial Services*, n 12 above, p. 13.

[21] *Ibid.* pp. 13-14.

[22] Maria Solo Tova, John Caskey, Clemente Durán, 'The Unbanked in Mexico and the USA: Five Questions Addressed', World Bank, Swarthmore College, Universidad Nacional Autónoma de México (2004) mimeo.

households and firms may not use financial services, although they do have access to some financial services.

2.2.2 *Institutional Constraints: Institutions Matter*

Institutional barriers of access to/usage of finance usually refer to the low quality of legal systems, uncertainty regarding the enforceability of commercial contracts and of property rights, low level of protection for minority shareholders,[23] and the absence of institutional mechanisms for the gathering of reliable information. Levine, Loayza and Beck in their article on financial intermediation and growth show that legal and regulatory changes that strengthen creditor rights, contract enforcement, and accounting practices boost financial intermediary development with positive repercussions on economic growth.[24]

Furthermore, there is ample empirical evidence on the importance of institutional barriers in the financing of small firms.[25] Evidently, small firms and firms in countries with poor institutions use less external finance, especially less bank finance.

2.3. Access to Finance, Growth, and Poverty Alleviation

[23] Rafael La Porta, Florencio López-de-Silanes, Andrei Shleifer, and Robert W. Vishny, 'Legal Determinants of External Finance' (1997) 52 *Journal of Finance* 1131; La Porta *et al.* 'Law and Finance' (1998) 106 *Journal of Political Economy* 1113. And for more recent studies strengthening the argument regarding the fundamental role that institutions play in economic development, *see* Thorsten Beck, Asli Demirgüç-Kunt, and Ross Levine, 'Law and Finance: Why Does Legal Origin Matter?' (2003) 31 *Journal of Comparative Economics* 653, and Daron Acemoglu, Simon Johnson, James Robinson, 'Institutions as the Fundamental Cause of Long-Run Growth', in P. Aghion and S. Durlauf (eds), *Handbook of Economic Growth* (Elsevier, 2005).

[24] Ross Levine, Norman Loayza, and Thorsten Beck, 'Financial Intermediation and Growth: Causality and Causes' (2000) 46 *Journal of Monetary Economics* 31. *See* also Asli Demirgüç-Kunt and Vojislav Maksimovic, 'Law, Finance and Firm Growth' (1998) 53 *Journal of Finance* 2107.

[25] Thorsten Beck, Asli Demirgüç-Kunt, and Vojislav Maksimovic, 'Financial and Legal Constraints to Firm Growth: Does Size Matter?' (2005) 60 *Journal of Finance* 137; Anjali Kumar and Francisco Manuela, 'Enterprise Size, Financing Patterns and Credit Constraints in Brazil Analysis of Data from the Investment Climate Assessment Survey', World Bank, 24 September 2004. This survey found that size affected Brazilian firms' access to finance stronger than performance.

2.3.1 The Link between FSD and Growth

Over the recent years a large number of studies have been undertaken examining the link between FSD and growth.[26] Thus, a large body of evidence now supports the theory that the deeper a country's financial system the higher its growth potential.[27] This is due to a number of factors. Finance allocates resources to their most productive use and allows for the renewal of a country's economy by pulling funding from underperforming or ageing sectors and pouring them to newer, more innovative and promising ones, much in accord with Schumpeter's theory of 'creative destruction'.[28] In addition, finance helps growth through facilitation of raising and pooling of funds to undertake risky investments and through the creation of innovative instruments, which can be used for risk mitigation.

One of the first studies to find empirical evidence of the close correlation between financial sector development (FSD) and the overall rate of a country's economic growth was undertaken by the late Professor Goldsmith in 1969.[29] Using data from 35 countries covering the period between 1860–1963 Goldsmith found evidence of a relationship between economic and financial development over long periods, and that periods of rapid economic growth have often been accompanied by an above average rate of

[26] For an overview of relevant studies see Ross Levine, 'Finance and Growth: Theory and Evidence' in P. Aghion and S. Durlauf (eds), *Handbook of Economic Growth* (Amsterdam: Elsevier, 2005) and Department for International Development, Policy Division Working Paper, 'The Importance of Financial Sector Development for Growth and Poverty Reduction', August 2004, UK, pp. 7-15.

[27] Raghuram Rajan and Luigi Zingales, 'Financial Development and Growth' (1998) 88 *American Economic Review* 559; Cesar Calderon and Lin Liu, 'The Direction of Causality between Financial Development and Economic Growth' (2003) 72 *Journal of Development Economics* 321. For an overview of relevant studies see Patrick Honohan, 'Financial Development, Growth and Poverty: How Close are the Links?' World Bank Policy Research Working Paper 3203, February 2004.

[28] *See* Joseph A Schumpeter, *Theorie der Wirtschaftlichen Entwicklung* [The Theory of Economic Development] (Leipzig: Dunker & Humblot 1912); translated by Rredvers Opie for the English edition (Cambridge Ma: Harvard U. Press, 1934).

[29] Raymond W. Goldsmith, *Financial Structure and Development* (New Haven: Yale University Press, 1969).

financial development. More recent studies have also provided strong evidence of the positive relationship between financial sector development and growth. For example, King and Levine in three studies (1993a,[30] 1993b,[31] 1993c[32]) examined 80 countries over the period 1960–1989. After controlling for other factors affecting long-run growth, they examined the capital accumulation and productivity growth channels separately and used different measures of the level of financial development. They found evidence of a strong, positive relationship between the various financial development indicators and growth.[33] By themselves, however, these results do not necessarily imply that FSD leads to higher growth. It may be that growth leads to FSD, as it generates greater demand for financial services that induces an expansion in the financial sector. As a result, many researchers have examined this issue explicitly. King and Levine have found that, even after controlling for other factors that may affect growth, the relationship between the initial level of financial development and growth is large. Subsequent studies, such as Levine, Loayza, and Beck (2000),[34] have confirmed that FSD exerts a large positive impact on economic growth. Calderon and Liu also adopted an innovative econometric technique to analyse this issue,[35] using data from 109 countries over the 1960-1994 period. Their results showed that there was bi-directional causality: FSD has a causal impact on growth and growth has a causal impact on FSD. However, the impact of FSD on growth is more important than the impact of growth on FSD. In fact, Calderon and

[30] Robert G. King and Ross Levine, 'Finance and Growth: Schumpeter Might Be Right' (1993) 108 *Quarterly Journal of Economics* 717.

[31] Robert G. King and Ross Levine, 'Finance, Entrepreneurship, and Growth: Theory and Evidence' (1993) 32 *Journal of Monetary Economics* 513.

[32] Robert G. King and Ross Levine, 'Financial Intermediation and Economic Development', in C. Mayer and X. Vives (eds), *Financial Intermediation in the Construction of Europe* (London: Centre for Economic Policy Research, 1993), 156.

[33] King and Levine, *Finance, Entrepreneurship, and Growth*, n 31 above.

[34] Levine, Loayza, and Beck, *Financial Intermediation and Growth*, n. 24 above.

[35] Calderon and Liu, n 27 above.

Liu's study suggested that financial sector under-development is more likely to hold growth back in developing countries.

Furthermore, Berthelemy and Varoudakis (1996)[36] suggest that financial sector underdevelopment could be a serious obstacle to growth even when a country has established other conditions necessary for sustained economic development. For instance, they found evidence that countries with a high level of educational achievement, but a low level of FSD, were trapped in relatively low standards of living compared to those countries with a similar level of educational attainment, but a more developed financial sector. Moreover, they found that educational attainment had no significant impact on growth in countries where FSD was weak. This result implies that the lack of a sufficiently developed financial system may compromise the positive contribution of education to growth.

2.3.2 Availability of Finance and Poverty Alleviation

It is certain that the availability of financial services has a direct impact on poverty at the micro level, primarily by affecting the ability of poor people to accumulate usefully large lump sums—whether for life cycle, emergency or opportunity investment purposes.[37] Thus, access to credit, insurance, and savings facilities can reduce the vulnerability of the poor to a number of external shocks, including bad harvests or health difficulties. The mobilisation of savings also creates an opportunity for re-lending the collected funds into the community strengthening community ties.

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[36] J. C. Berthelemy and A. Varoudakis, 'Economic Growth, Convergence Clubs, and the Role of Financial Development' (1996) 48 *Oxford Economic Papers* 300.

[37] Daniel C Hardy, Paul Holden, and Vassili Prokopenko, 'Microfinance Institutions and Public Policy', IMF Working Paper 02/159, 2002; Karla Hoff and Joseph Stiglitz, 'Modern Economic Theory and Development' in Gerald Meier and Stiglitz, (eds), *The Future of Development Economics in Perspective* (Oxford: Oxford University Press, 2001).

Availability of finance has special importance for poor households and smaller firms in a number of other ways. For instance, availability of credit can strengthen the productive assets of the poor by enabling them to invest in productivity-enhancing new 'technologies' such as new and better seeds, work equipment, or fertilizers etc., or to invest in education and health, all of which may be difficult to finance out of regular household income, but which could provide for a higher income in future. The availability of credit can also be an important factor in the creation or expansion of small businesses, thus generating self- and wage-employment and increasing incomes. Eswaran and Kotwal have argued that just the knowledge that credit will be available to cushion consumption against income shocks, should a potentially profitable but risky investment turn out badly, it can make the household more willing to adopt more risky technologies.[38] Such behaviour will lead to increased use of modern technologies boosting productivity, and hence enhance income. For the same reason, access to credit and other financial services is likely to decrease the proportion of low-risk, low-return assets held by poor households for precautionary purposes (such as jewels), and enable them to invest in potentially higher risk and higher return assets, (such as education, or a rickshaw), with serious long-term income enhancing results.[39] Similar are the results of the availability of insurance for the poor,[40] as it protects them from financial vulnerability due to external shocks such as an illness or a bad harvest.

At the macro level, finance may have an impact on poverty both directly, by raising the income of the poor and making more equal income distribution, and indirectly by

[38] Mukesh Eswaran and Ashok Yeshwant Kotwal, 'Implications of Credit Constraints for Risk Behaviour in Less Developed Economies' (1990) *Oxford Economic Papers* 473.

[39] Angus Deaton, 'Saving and Liquidity Constraints' (1991) 59 *Econometrica* 1221.

[40] *See* or the importance of micro- insurance for poverty alleviation Jonathan Morduch, 'Microinsurance: The Next Revolution?' New York University, mimeo, 2003.

stimulating overall economic growth. Cross-country studies on the link between finance and poverty studies have examined the reverse causality between availability of finance and poverty and found that financial development caused smaller income inequality.[41] Clarke, Xu, and Zou (2003) found that inequality decreases as finance develops and, the more concentrated income is the higher the country's level of poverty. The fact that finance helps to distribute income opportunities more evenly becomes a significant factor in poverty reduction.[42] In the same mode, Beck, Demirgüç- Kunt and Levine, using a broad cross-country sample, have shown that financial development not only raises disproportionately the income of the poor reducing income inequality, but also that countries with better-developed financial intermediaries experience faster declines in poverty and income inequality.[43]

Beyond (the largely unmeasured) direct impact of access to/usage of financial services on poverty, the indirect impact of FSD on poverty is certain through its impact on growth. For instance, as economic production is changing and countries are liberalizing their economies, it has become clearer that the degree of financial development greatly influences the ability of countries, firms and individuals to make use of (new) growth opportunities.

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[41] Thorsten Beck, Asli Demirguc-Kunt, and Ross Levine, 'Finance, Inequality and Poverty: Cross-Country Evidence', World Bank Policy Research Working Paper 3338, June 2004. See also Stijn Claessens and Enrico Perotti, 'The Links between Finance and Inequality: Channels and Evidence', May 2005, background paper for the 2005 World Development Report, World Bank, University of Amsterdam.

[42] George Clarke, Lixin Colin Xu, and Heng-fu Zou, 'Finance and Income Inequality, Test of Alternative Theories', World Bank Policy Research Working Paper 2984, 2003.

[43] See updated version of the paper of Thorsten Beck, Asli Demirguc-Kunt, and Ross Levine 'Finance, Inequality and Poverty: Cross-Country Evidence' submitted to the World Bank conference, 'Access to Finance: Building Inclusive Financial Systems', 30 May 2006.

However, the poor in developing countries often do not have access to a continuous and formal stream of financial services. Thus, they are forced to rely instead on a narrow range of often expensive and more risky informal services. In addition, the availability of finance has, as mentioned above, a disproportionate effect on the growth opportunities of SMEs. Beck, Demirgüç-Kunt and Levine have shown that, while large SME sectors are characteristic of successful economies, SMEs do not 'cause' growth, nor do SMEs alleviate poverty or decrease income inequality.[44] Yet, finance accelerates growth by removing constraints on small firms, more so than on large firms. Finance allows SMEs to operate on a larger scale and helps leveling the playing field among firms in terms of financing opportunities.[45]

Finally, access to finance may become a good agent of economic and social change that improves governance structures decreasing some of the causes of poverty. Two well known economists: Raghuram Rajan and Luigi Zingales, who have endorsed the Schumpeterian view of creative destruction, have suggested that access to finance through, *inter alia*, free and open capital markets, is the only means to erode the power or incumbent elites.[46] Normally, such elites have a vested interest to push back economic growth, which would entail the empowerment of the disenfranchised parts of society (normally its biggest part), and thus the erosion of their privileges. An even more realistic path for the facilitation of access to finance for the disenfranchised is the provision of credit and of other financial services to poor households and micro-entrepreneurs.

[44] Thorsten Beck, Asli Demirgüç-Kunt, and Ross Levine, 'SMEs, Growth, and Poverty: Cross-Country Evidence' (2005) 10 *Journal of Economic Growth* 197.

[45] Claessens, *Access to Financial Services*, n 12 above, p. 4.

[46] Raghuram Rajan and Luigi Zingales, *Saving Capitalism from the Capitalists* (New York: Princeton University Press, 2004, 1st ed. Random House, 2003).

3. Aspects of International Financial Regulation

3.1 Introduction

It is widely accepted that financial stability regulation can also affect growth and thus poverty.[47] In fact, relevant evidence suggests that financial crises severely affect the poorest and most vulnerable groups as they cause major reduction in growth levels and increase poverty.[48] Therefore, financial regulation has an economic (development/poverty reduction) and a social aspect – an increase in poverty levels leads to social strife – much bigger than it was suspected a decade ago.

Regulation can also have important implications for access to finance of poorer clients through its impact on the incentives financial institutions have to innovate, compete, and increase their low income customer base.[49] In addition, as it is argued in this paper, financial regulation may be used as tool to widen access to finance and thus foster growth and facilitate poverty eradication. Given the integrated nature of global financial markets and the increasing importance of international financial regulation, this paper focuses on international financial regulation reform and does not touch on national regulatory regimes. Accordingly, the next two paragraphs provide a concise analysis of the remit and work of the Basle Committee on Banking Supervision and of its Capital Adequacy Standards.

3.2 The Basle Framework

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[47] Douglas W. Arner, *Financial Stability, Economic Growth, and the Role of Law* (2007).

[48] 'Finance for Growth: Policy Choices in a Volatile World', World Bank Policy Research Report, Oxford University Press, New York (2001/2).

[49] Department for International Development, Policy Division, 'The Importance of Financial Sector Development for Growth and Poverty Reduction', Working Paper, August 2004, 16.

The Basle Committee on Banking Supervision (initially called 'Basle Committee on Banking Regulation and Supervisory Practices') was founded in 1974 under the auspices of the Bank of International Settlements (BIS), which furnished a conveniently neutral meeting place for the Committee's membership. The establishment of the Committee, an initiative of the G10 central bank governors to whom the Committee still reports, came in the aftermath of the twin collapse of the Franklin National Bank and the Bankhaus Herstatt in 1974. Both events sent shockwaves to the spine of the then emerging global financial system and made apparent the pressing need to set up a forum that would facilitate international cooperation among banking regulators.[50] The Committee's membership - currently 13 countries are represented[51]- comprises representatives from the central banks of the member countries. Where central banks do not discharge the duties of banking regulators, an additional representative of the competent national authority participates in the proceedings, without increasing the number of votes held by each member country.

The first challenge that national regulators had to answer concerned the allocation of supervisory responsibility for internationally active banks, namely which (home or host country) supervisory authority was responsible for supervising bank branches and subsidiaries across borders. The result of those discussions was the Basle Concordat of 1975, which has since undergone numerous refinements and amendments. The Concordat was further refined in 1983, following the collapse of Banco Ambrosiano in 1982, to tighten the framework for international banking supervision, and was effectively

[50] For the history of the Basle Committee see Duncan Wood, *The Basle Committee and the Governance of the Global Financial System* (Aldershot: Ashgate Publishing, 2004) and Michael Malloy, 'Emerging International Regime of Financial Services Regulation' (2005) 18 *Transnational Lawyer* 329.

[51] Belgium, Canada, France, Germany, Italy, Japan, Luxemburg, Netherlands, Spain, Sweden, Switzerland, the UK, and the US.

replaced in 1992 in the aftermath of the BCCI debacle in 1991 with a set of minimum standards on the supervision of international banking groups.[52] These were followed by the publication in 1997 of the Core Principles on Banking Supervision developed by the Committee in cooperation with the IMF and the International Bank for Reconstruction and Development.[53]

Further to this work, the Committee devised in the 1980s a common framework of guidelines governing the measurement and enforcement of bank capital adequacy. This referred to the prescribed capital resources that internationally active banks were required to set aside so that to be deemed as operating on a prudent and sound basis. In this respect, the Committee developed a framework of standards that would foster effective capital adequacy regulation of banks and facilitate convergence of national regulatory standards in this field. The main focus of the first framework (widely known as Basle I), published in 1988, was on credit (counterparty) risk and much less on other important risks such as currency risk, interest rate risk, and market risk. In this respect, the framework required a minimum 'ratio of certain specified constituents of capital to risk-weighted assets.' The prescribed regulatory capital constituents comprised: Tier 1 (core) capital, which mainly consists of shareholders equity, disclosed reserves, and retained post tax profit and Tier 2 (supplementary) capital, which mainly consists of subordinated debt. The Basle I framework endorsed a risk-weighted approach to the assets denominator of the capital assets ratio.[54] The Basle I framework established a relatively simple methodology for risk-weighting with only five risk weights: 0, 10, 20, 50

[52] Basle Committee on Banking Regulation and Supervisory Practices, 'Report on Minimum Standards for the Supervision of International Banking Groups and Their Cross-Border Establishment', July 1992.

[53] Basle Committee on Banking Supervision, 'Core Principles for Effective Banking Supervision', Basle, September 1997, revised in October 2006. The revised document is available at http://www.bis.org/publ/bcbs129.pdf

[54] Malloy, n 50 above, pp. 332-333.

and 100 percent of asset value, assigned to all types of assets and all types of counterparties, judged by the origin of the counterparty (OECD non-OECD countries) and its organizational/legal/economic nature (sovereigns, credit institutions, corporates), without any separate assessment of its creditworthiness. For instance, the risk-weighted ratio for all corporates was one hundred percent (100%). In addition, following further consultation, the Basle Committee adopted a target standard capital to assets ratio of eight percent (8%) of which core capital constituted at least four percent (4%).

Due to the institutional weight of participating public organizations, the importance of the countries they represented, and the need to level the playing field in the fast growing global market for financial services, the Basle I Accord has been adopted by most countries, regardless of whether they participated in the workings of the Committee. In fact, most developed countries, including the US and the EU member states, extended the application of the Basle I framework to domestic banks that did not maintain a significant international presence.

However, it soon became apparent that the Basle I framework suffered from a number of technical weaknesses relating to its narrow band of credit risk classifications[55] and its inability to adapt to changes in the global financial services industry. It was especially inept at accommodating the emergent new techniques and instruments used to mitigate risk, such as credit derivatives and securitisations. In addition, the narrow band of borrower classification did not allow lenders to distinguish between major, stable and

[55] *e.g.* one obvious distortion was the zero weight given to loans to OECD sovereigns irrespective of the riskiness of the country, which allowed countries such as Korea and Mexico to be treated for capital adequacy requirements the same as more developed countries with lower ratios of public debt.

recognized companies versus risky upstarts.[56] Moreover, little attention was given to correlations and the mitigating effect of uncorrelated credits to well diversified loan portfolios.[57] Finally, Basle I did not properly account for operational risk in banks' loan and securities market portfolios.

3.3 The Basle II Framework

The weaknesses of Basle I led to an extensive round of negotiations for the drafting of a new accord. Given the many changes in the financial services industry and the growing difficulties experienced by supervisors with the complexity and changing nature of risk in global financial markets, the starting point was to emphasize the role of market discipline in risk management. In June 1999, the BIS issued a proposal that would significantly change the capital adequacy Accord through extensive revision and refinement of Basle I and by providing an alternative approach to measuring risk that would bring the capital framework closer to global market risk management practices.[58] Following several rounds of consultation, the revised Accord was finally published in June 2004[59] and further additions were released in 2005.[60]

The Basle II framework for the assessment of the capital adequacy of international credit institutions and monitoring of their compliance is based on three pillars: Pillar 1 provides

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[56] Stijn Claessens, Geoffrey R. D. Underhill and Xiaoke Zhang, 'Basle II Capital Requirements and Developing Countries: A Political Economy Perspective', October 2003.

[57] *Ibid*. pp. 19-23.

[58] A New Capital Adequacy Framework, Basle, Bank for International Settlements, 1999, available at http://www.bis.org/publ/bcbs50.pdf.

[59] BIS, Press Release, 'G10 Central bank governors and heads of supervision endorse the publication of the revised capital framework', 26 June 2004, available at www.bis.org/press/p040626.htm.

[60] Basle Committee on Banking Supervision, 'International Convergence of Capital Measurement and Capital Standards, A Revised Framework', Updated November 2005. [Hereinafter Basle II Accord].

minimum capital requirements; Pillar 2 describes the process for the *supervisory review* of capital adequacy; and Pillar 3 provides the mechanisms to facilitate and enforce *market discipline* through public disclosure.

Of the three pillars, by far the most extensively discussed in the successive consultation rounds was Pillar 1, which involves significant changes in capital adequacy regulation. More specifically, although Pillar 1 reproduces the basic provisions of Basle I, it also introduces important changes in the way aspects of credit risk are to be calculated and expands the range of risks to include operational risk. Three different options are available to banks to measure the regulatory capital that they have to assign for each asset. The first option is the *standardized approach*, which is intended to be used by less sophisticated institutions. Although it is based on Basle I, it uses enhanced risk sensitivity measures, as it differentiates among exposures to different classes of bank clients. 'Risk weightings' for sovereign and corporate exposures may be calculated according to external credit assessments provided by rating agencies or public organizations such as the OECD. The second and third options are based on the new *Internal Ratings Based Approach* (IRB). Under the IRB, international banks are required to establish their own internal methods for assessing the relative risks of their assets in determining the capital requirement for given exposures. In this mode, the *foundation* version of the 'Internal Ratings Based' (IRB) approach for risk management, makes limited use of internal Value at Risk (VaR) models. The *advanced* IRB approach makes much wider use of VaR and is meant for the largest and most sophisticated financial institutions.

The IRB approach is based on measures of unexpected losses (UL) and expected losses (EL). The risk components include measures of the probability of default (PD), loss given default (LGD), the exposure at default (EAD), and effective maturity (M). In some cases, banks may be required to use a supervisory value as opposed to an internal estimate for one or more of the risk components.[61] In the *foundation* version of IRB, only PD is calculated by the bank and all other risk components are specified by the supervisor. In the advanced version, all credit risk components are calculated by the bank itself. This means that the advanced approach relies entirely on 'self- supervision', except that the bank has to qualify the models it uses with the supervisor and obtain its approval. Collateral and loan guarantees are to be taken into account.

In relation to the application of IRB approaches to risk assessment, a specific framework has been created for the treatment of corporate exposures that present the characteristics of specialized loans (SLs). As SLs qualify corporate credits that rely, for repayment of the loans, upon a stream of income generated by an asset rather than the creditworthiness of the borrower, such as project finance, income-producing real estate, lease financing (or 'object financing'), commodity financing, and high-volatility commercial real estate. These forms of credit financing are subject to a tailor made framework of capital standards.[62]

For a number of reasons the Basle II framework has given rise to several serious concerns. First, it provides no framework for the creation of liquidity cushions within highly geared financial institutions. The liquidity crunch that followed the trigger of the global credit crisis in July 2007 has shown that the existence of liquidity cushions is necessary to stabilize banking institutions and avert a credit crisis. Second, the framework is very pro-cyclical providing an inadequate capital cushion during economic

[61] Basle II Accord, paras 210-212.

[62] *Ibid.* paras 220-228 and 275-284.

downturns.[63] Third, there are problems with the implementation of Basle II by the less sophisticated financial institutions in emerging market economies. These, due to lack of resources and sophistication, are expected to adhere to the *standardized approach* of Pillar 1, which is by definition more costly and will therefore affect the competitive playing field.[64] Finally, developing country corporates and other entities naturally have lower ratings, which attract under Basle II higher capital charges under all approaches.[65] Thus, the implementation of Basle II is forecasted to have significant implications for the cost of capital for developing countries and could reduce credit capital flows to them.

As said earlier, this chapter sets out a proposal (in section 4) for the creation of a further separate class of corporate exposures comprising loans made to specialized central country funds or similar wholesale finance providers that would on-lend funds to mainstream financial institutions and Microfinance Institutions (MFIs) to be used as private development finance loans.

4. A New Regulatory Framework For International Finance: Safeguarding Systemic Stability And Fostering Development

4.1 Utilizing the Basle Capital Adequacy Standards to Foster Development

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[63] On the role of Basle II capital adequacy requirements in increasing pro-cyclicality see C. Goodhart, B. Hofman, and M. Segoviano, 'Bank Regulation and Macroeconomic Fluctuations' (2004) 20 *Oxford Review of Economic Policy* 591-615 and Goodhart and A. Taylor, 'Procyclicality and Volatility in the Financial System: The Implementation of Basel II and IAS 39' in Stefan Gerlach and Paul Gruenwald (eds), *Procyclicality of Financial Systems in Asia* (Palgrave, 2006).

[64] Robert Bailey, 'Basel and Development Countries: Understanding the Implications', LSE, Development Studies Institute, Working Paper 05-71, December 2005, pp. 34-35 and 38-39.

[65] Stephany Griffith-Jones and Stephen Spratt, 'The New Basle Capital Accord and Developing Countries, Issues, Implications and Policy Proposals', Discussion Paper No. 2002/36, World Institute for Development Economics Research, March 2002.

The pro-cyclicality nature of the Basle II standards has been widely discussed and a consultation for reform is already under way. In the context of the reform of the Basle II framework it is proposed that a class of corporate credits, called here private development finance loans, should be designed as a separate asset class within the Basle II framework and be assigned favourable risk weightings, in order to reflect their very low default rate. Low regulatory capital requirements for such loans would provide incentives to international banking institutions, which are also the largest, to participate in schemes that provide private development finance to the poor. [66]

The term private development finance is understood to extend to all microfinance and mainstream finance schemes utilized by low-income individuals or SMEs in poor countries with the obvious objective of acquiring a productive asset and may not be confused with development finance loans or aid provided by multilateral development banks, donor organizations, or foreign governments. Moreover, it does not include transfer of funds in the context of Direct Foreign Investment schemes. This definition enables the present proposal to avoid unnecessary distinctions between mainstream finance and microfinance schemes, allowing it to focus on the purposes sought to be served by every collective or individual financing project used by the poor.

Essentially, it is suggested that microfinance loans will have to be divided to two broad classes of loans. Those intended for a productive/development use and those moving into consumption. The first class should merge with loans, and other forms of credit, provided by mainstream financial institutions to the poor with the purpose of acquiring a

[66] This paragraph draws on my earlier article: 'Access to Finance, Microfinance, and International Capital Adequacy Standards for Banks: A New Approach to Development', (2007) 4 *Manchester Journal of International Economic Law* 3.

productive asset. Together such schemes should comprise a new asset class: private development finance loans.[67] This would include all forms of financing to low income people and small enterprises, as defined by local standards and the standards of the World Bank, that have an evident development goal regardless of whether the provider is an MFI or a mainstream financial institution. Naturally, group-loans would be considered development finance and financing schemes for individuals and SMEs in low income countries that are intended for investment in some form of a capital asset, or acquisition of a means of production (*e.g.*, plant seeds) would also be included. Loans for health and education purposes, although they have a clear impact on the income of the poor and a development bias, should (provisionally) be excluded from this asset class, until their repayment rate is reliably calculated. All other loans provided by MFIs shall comprise a second asset class. In the case of the latter class of microfinance schemes subsidization may continue, as the default rate of such loans could render commercial funding unsustainable.

Given their similarities and very low default rates,[68] private development finance loans merit to be treated as a separate class of corporate exposures for capital adequacy purposes receiving preferential treatment within the Basle II framework. Yet, some MFIs have either a dismal loan repayment record or under-report default rates.[69] Thus, a two

[67] This term is used here autonomously from any previous uses and is not directly linked with Development Finance Institutions despite several similarities as to what goals should be pursued through finance provided by these Institutions. See 'The Challenge of Development in Development Finance Institutions, A Practitioner Perspective', Development Finance Forum, CAPITAL PLUS, January 2004.

[68] Despite the lack of systematic data on a global scale, there is a convincing body of evidence that microfinance loans with a development objective, such as group loans and loans to microenterprises, included under the present proposal to the suggested class of private development finance loans, have zero or very low default rates. *See* Stanley Fischer, 'Wall Street Meets Microfinance', WWB/FWA Lenore Albom Lecture Series, 3 November 2003, p. 2. Fischer, a former deputy managing director of the IMF, was at that time Vice President of Citigroup. *See* also Microrate, 'The Finance of Microfinance', Washington, November 2002, at http://www.microrate.com/PDF/Finance%20of%20Microfinance.pdf and MicroCredit Enterprises at http://www.mcenterprises.org/index.aspx

fold strategy must be devised so that the risk of lender institutions is measured by reference to repayment rates (cash flows) and the creditworthiness of a counterparty that is remote from any risk of bankruptcy associated with the MFIs and the credit ratings assigned to MFIs. Therefore, it is suggested that private development finance lending is moved up a level (reflecting to a large extent current market practice) and relevant funds are borrowed by central country schemes,[70] or other specialized corporate vehicles operating as wholesale finance providers.[71] The business objectives of such functionaries would not extend beyond on-lending to MFIs or mainstream financial institutions - for exclusive use in the provision of development finance loans – the gathering of information regarding such loans, including borrower credit scoring, and the facilitation of access of such institutions to payment systems and other infrastructure services. The same national schemes may be used to facilitate the securitisation of such loans and the sale of resulting bonds to investors in the global capital markets.[72]

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[69] Bhagwan Chowdhry *et al.*, 'Pricing Microfinance Loans and Loan Guarantees using Biased Loan Write-off Data' mimeo, UCLA Anderson School, April 2005, pp. 1-2.

[70] While private development finance schemes must be provided and administered at the local level for reasons of furthering access to finance, of increasing microfinance penetration, and of lowering transaction costs and information asymmetries all of which lead to higher efficiencies, the funding of MFIs is more efficiently managed if it is centralized or conducted on a wholesale basis. A good example of a centralized national scheme used for the funding of private institutions operating in unbanked areas (administration of government subsidy funding distributed to MFIs) and the provision of infrastructure services to them is the Mexican development bank BANSEFI (Banco de Ahorro Nacional y Servicios Financieros, *National Savings and Financial Services Bank*). See for an analytical description of the operation of BANSEFI, de la Torre *et al*., *Innovative Experiences in Access to Finance*, n 12 above, pp. 48-51.

[71] Granting private development finance loans to a centralized country scheme that operates as an independent entity or other specialized corporate vehicle operating as wholesale finance provider would allow these credits to fulfill most of the requirements of para. 219 of Basle II as regards the legal form and economic substance of SLs. However, the independent entity would be created specifically to finance on-lending and not physical assets, as required by paragraph 219.

[72] An example of an innovative wholesale financing transaction in this area was concluded by SHARE, a leading Indian MFI, and ICICI Bank, India's largest commercial bank, in January 2004. See J. Meehan, 'Tapping the Financial Markets for Microfinance', Grameen Foundation USA, Working Paper Series, pp. 13-14. Available at www.microfinancenetwork.org/images/GFUSACapitalMarketsWhitePaper.pdf

Of course, treating private development finance loans as a separate class of corporate exposures would require some modification of the existing criteria of the Basle II Framework (paragraph 264) as regards the time period for which banks are required to have data for relevant loans in order to measure PD and the other credit risk components of the IRB. However, obtaining ratings for such loans prospectively and endeavouring to build on them an internal rating system should not prove an insurmountable obstacle. There are already a number of specialized entities which are dedicated to the provision of objective and reliable ratings for MFIs and microfinance credits[73] and their databases are available for commercial purposes.

MFIs obtaining funds for lending under the above scheme would be subject to a number of conditions. End-lenders would be obliged to account for the destination of the borrowed funds and to build databases about the profiles of their borrowers and the nature and repayment rates of loans given out of such funds. Although the flow of information would come from the end-lenders, there is no serious reason to worry about its quality. End-lenders would have a strong incentive not to lie about the default rate of their private development finance loans and the destination of funding so obtained; if found cheating they would be expelled from the scheme or denied further loans by the wholesale provider. In addition, the World Bank could be actively involved in the building of these schemes and the structure of the rules and incentives of their operation at the initial stages.

Large international banks already use the more sophisticated *advanced* version of IRB, which enables them to set aside less regulatory capital for their loans and securities

[73] *e.g.*, Microrate (www.microrate.com) and The Microfinance Rating and Assessment Fund, which offer over 150 reports with rating statistics about MFIs and microfinance loans in a very large number of countries. Available at http://www.ratingfund.org/fund_statistics.aspx

portfolio. Thus, the use of wholesale methods to resource private development finance providers coupled with lower capital adequacy requirements means that very large international credit institutions would have the right set of incentives to enter the market for the provision of credit to the poor. Lower capital charges would allow such loans to become a business opportunity for large credit institutions, which would also lower the interest rates charged, as the high monitoring and transaction costs that such loans typically entail would continue to be borne by the end lenders. Therefore, the present proposal may, to some extent, boost credit flows to developing countries redressing some of the aforementioned concerns discussed regarding the impact of Basle II on developing countries.

Another advantage of the separation of private development finance loans from other forms of microcredit is that it would enable some MFIs and other credit providers to specialize in the provision of such loans enhancing their credit ratings, given the high repayment rate of such credits. Securing higher credit ratings would enable these institutions to attract loans from large domestic banks in the developing world that will use the *standardized approach* under Basel II. As mentioned in the previous section, the *standardized approach* assigns lower regulatory capital charges to higher rated counterparties. MFIs that found commercial funding at advantageous rates either because their credit ratings had been raised, or because they obtained such funding from centralized schemes or wholesale providers that would utilize the private development loans facility, would free up local and international resources and donor money. These funds could then be used for aid to the very poor and to subsidize mirofinance loans that belong to the category of ‘consumption loans’, as divided above, where the risk of default is much higher perhaps unsustainable for profit driven organizations.

4.2. A Global Licensing Regime for International Investment Funds

Hedge funds seem to cause systemic problems during any kind of market turmoil and often require the same kind of liquidity support as that offered to banks. For example, hedge funds required liquidity support both during the bond markets downward spiral of 1998, which led to the rescue of the Long-Term Capital Management (LCTM), and during the current crisis, when hedge funds proved to be particularly 'vulnerable to mutually enforcing funding and market liquidity spirals'. Hedge funds' selling to meet margin and other funding requirements, fuelled severe price declines in the market for structured credit securities,[74] which in turn reinforced investors' loss of confidence, further sales, and thus further funding pressures.[75] The systemic implications arising from such trading are due to the high leverage of hedge fund positions and their illiquidity, even temporary illiquidity.

Accordingly, the systemic importance of global hedge funds and their widespread involvement in credit markets, as well as their role in exacerbating the present crisis, underline the urgent need to design a suitable regulatory regime dealing with these highly geared investors.[76] Arguably, the relevant regime may only prove successful if it has a global reach. Attempts to solely license and regulate hedge funds on a national or regional basis will prove ineffective due to the highly integrated nature of global capital markets and of hedge fund activities within them. Apart from safeguarding systemic

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[74] IMF, Global Financial Stability Report, 'Containing Systemic Risks and Restoring Financial Soundness', April 2008, pp. 32-33.

[75] *Ibid.* 3.

[76] This paragraph partially draws on my earlier paper 'Financial Regulation, Behavioural Finance, and the Global Credit Crisis: In Search of a New Regulatory Model', May 2008, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1132665

stability the relevant regime could be so calibrated as to also facilitate private investment in very poor countries.

In this mode, it is suggested that an independent International Investment Funds Authority (IIFA) must be established that would deal with the licensing and supervision of the prudential aspects of the operation of systemically important international investment funds (IIFs). The same authority should supervise the investment conduct of such funds on the basis of a mandatory global code of investment conduct.[77] Funds engaging into investment and trading activities with an international focus shall be brought within the IIFA scheme and comply with attendant licensing and supervisory requirements, based on the size of their balance sheet and the ratio of fund's gearing. Admittedly, such a scheme would prove totally ineffective if Sovereign Wealth Funds were not also brought within the regulatory reach of the IIFA.

The scheme would work on the basis of a global common passport and participating funds would have unrestricted access to domestic and international markets, subject to relevant local/regional FDI, conduct of business, takeover and substantial acquisition rules and other securities regulations. The funds that would opt to stay outside the scheme could be legally disbarred from undertaking significant (above a specified threshold) trading and/or investment activities on markets supervised by national regulators that would participate in the scheme. This would place non-participating funds at a considerable competitive disadvantage over licensed funds. In keeping with suggestions for re-inventing and restructuring the mission and activities of the IMF, the Fund could be providing all necessary research and surveillance facilities to the new

[77] See IMF, Press Release No. 08/97, 'International Working Group of Sovereign Wealth Funds is Established to Facilitate Work on Voluntary Principle', 1May 2008 available at http://www.imf.org/external/np/sec/pr/2008/pr0897.htm.

entity for a fee. Also, the IMF could set up a pre-funded liquidity insurance scheme for international investment funds interested in entering the IIFA scheme.

Furthermore, international investment funds would be allowed to register with the scheme under three conditions:

(a) provide the IIFA with full access to information regarding the composition and structure of their balance sheets (but not to the composition of their membership, which is a sensitive issue, especially for SWFs);

(b) prove that they have (i) subscribed with a new (pre-funded) global liquidity/systemic risk insurance scheme for IIFs, administered by the IMF, or (ii) entered into pre-funded liquidity support/systemic risk insurance arrangements provided by central banks from a G 25 country or by a credible private organization. The more leveraged the positions that the funds wished to take the higher the systemic risk premium that the suggested liquidity insurance scheme would consider charging them; and

(c) invest the equivalent of an annual charge/fee for maintaining their license, on the basis of the (disclosed) size of their balance sheet, in private development projects of their choice in very poor countries.

The above conditions ensure that international investment funds are subjected to a reasonable and well balanced international regulatory regime, which, with minimum interference, both safeguards global systemic stability (through disclosure and liquidity insurance) and fosters development in poor and very poor countries.

5. A New Framework For International Financial Regulation

5.1 The Modification of the Basle Capital Adequacy Standards

Arguably, the largest constraint that MFIs face in order to grow in scale and become very significant players in the fight against poverty is lack of commercial funding. Subsidized financing, long an important source of funding, is now insufficient. The World Bank's

Consultative Group to Assist the Poorest estimates that less than 5% of total demand for microfinance is being met. According to some estimates the market demand for microfinance services is more than $300 billion.[78] Market supply today, by contrast, is only in the $4 billion range.[79] Despite the important and catalytic role played by the international donor community in promoting microfinance, this only allocates an incremental $1 billion per year in new financing, which falls far short of meeting demand. Viewed in this light, it becomes obvious that only access to commercial lending and the global financial markets may remove this restraint. However, and despite impressive progress over the recent years, MFIs still face major issues of creditworthiness, which inhibit credit flows to them. This according to Meehan is due to the fact that microfinance - in spite of its track record - has not yet been generally recognized as an asset class with a history of high portfolio quality and low correlation with major economic events in both domestic and international markets.[80]

All of the above obstacles could be well overcome by the implementation of the present proposal. The private development finance qualification/division ensures that the high repayment rate of such loans negates any credit control reservations. Also, the introduction of lower regulatory capital requirements for such loans and their centralized administration means that big global banks acquire sufficient incentives to enter the market for small private development finance loans. Finally, as local regulators would be very unwilling to act unilaterally fearing regulatory arbitrage, or conversely loss of reputation, only a global initiative setting the framework for uniform capital rules in this area would be effective.

[78] See Social Enterprise Associates, 'White Paper: The Business Case for Investment in Microfinance', September 2003, available at http://www.socialenterprise.net/pdfs/buscase_microf_inv.pdf

[79] See Meehan, n 72 above, p.5.

[80] *Ibid*. pp. 23-27.

5.2 A Global Regime for International Investment Funds and the Financing of Private Development Projects

Forcing international investment funds to invest in very poor countries the charge/fee (calculated at a ratio over their assets) they would have to pay to participate into a global licensing regime amounts to a global tax/subsidy in favour of very poor countries. However, as investment funds would be free to select the recipients of their investments it would lead to considerable development benefits. Also, the possibility of investment funds recouping their investment should not be discounted. First, the suggested scheme would help worthy low-scale investment projects to bypass the government owned banks whose lending has mostly political rather than development motivations.[81] Second, it would not be predicated on institutional reform, which is gradual and thus slow to provide benefits.[82] Third, foreign investment would be attracted for low-scale development projects without reliance on domestic securities markets which usually are volatile and shallow.[83] Fourth, since the licensed funds would be required to compulsorily invest their money in any of the very poor countries selected by the UN or the World Bank, they would concentrate on worthy business propositions from individuals and SMEs in very poor countries with a relatively higher level of political stability, functional institutions, and better prospects of peace and formation of civil society. Thus, a virtuous circle would be created, where private investment money directed to poor countries with relatively more sound institutions and comparatively more stable social and political lives

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[81] S. Haber and N. Maurer, 'Related Lending and Economic Performance: Evidence from Mexico,' 2004, mimeo, Standford University. Rafael La Porta, Florencio Lopez-de-Silanes, and Guillermo Zamarripa, 'Related Lending' (2003) 118 *Quarterly Journal of Economics* 231.

[82] W. Easterly, 'The Lost Decade: Developing Countries' Stagnation in Spite of Policy Reform 1980–1990' (2001) 6 *Journal of Economic Growth* 135–57.

[83] R. A. De la Torre, J. C. Gozzi, and S. Schmukler, 'Stock Market Development under Globalization: Whither the Gains from Reforms?', 2005, World Bank, mimeo.

offers an incentive to countries left out to follow the lead of their peers. Fifth, a market would be created in very poor countries for projects capable of attracting investment funds' money incentivising parts of the local population to acquire entrepreneurial skills and some form of financial expertise. Sixth, the kind of commitment required by the investment funds would mean their long term involvement and as a result the usual risks that deter foreign investors would become immaterial. Finally, in order not to lose money on their forced investments, international funds would use innovative hedging and financing techniques such as asset swaps and derivatives. The institutions underwriting those investments would naturally try to hedge their own positions buying in many cases the underlying investments. This would breathe life to local securities markets facilitating their development. Moreover, a certain 'buzz' would be created around very poor countries such as Mali, or Namibia, which would thus enter the 'radar' of the global investment community. These are normally countries not favoured by FDI providers, since FDI is mostly concentrated in the best performing emerging markets.

6. Conclusion

The goal of poverty eradication has been adopted by the international community of nations to be the paramount target of the 21st century. The global financial community not only has the tools but also the resources to commit to this effort. It should thus be provided with the right incentives to take an active part. International Financial Regulation standards, *prima facie*, target the facilitation of the global public interests of depositor/investor protection and systemic stability. Thus, it should not be unthinkable that a further policy objective that of facilitation of development and poverty eradication in poor and very poor countries complemented the said regulatory objectives. This paper has provided, in a forward thinking way, two reform proposals for International Financial

Regulation, which can serve all of the aforementioned objectives without compromising the attainment of any of them.

Finally, the countries, which would attract the private development loans and investment funds envisaged in the present paper, are those suffering serious economic and social injustices. These range from inequitable allocation of land that has resulted in the concentration of land ownership to very few hands to the foreclosure of access to business credit and investment for young entrepreneurs. Such dysfunctions result in the perpetuation of the dominance of the ruling classes through their control of the means of production and consequently of the political process inhibiting innovation and perpetuating corruption and inequality. The cathartic role of financial markets through their merit-based approach to the granting of finance should not be underestimated nor should its potential to place irresistible pressure on the old and invariably corrupt political and economic elites. On the contrary, international finance providers should be provided with the right set of regulatory incentives/obligations to achieve this goal and this is the overriding objective of the present paper.

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