BankTrack submission to the UN General Assembly's Commission of Experts on Reforms of the International Monetary and Financial System

(The Stiglitz Commission)

1) Financial Regulation

Through widespread political engagement over the last decade, the financial industry has effectively usurped the power and role of financial regulators and supervisors. The inadequacy of current regulations and regulatory structures is the result of financial markets' political influence via campaign contributions and lobbying power. Limiting banks and other corporations' capacity to promote their own interests in the political process is therefore imperative.

In this sense, society must regain control and correct banks redirecting them back to their primary role as financial intermediary: investing in the real economy and advancing socio-environmental sustainability. Banks need to earn their social licenses to operate and provide products and services which serve, not harm, public interest.

Rather than proposing a mere "facelift" to the currently flawed economic system, a new regulatory regime should seek boldly to transform the economic system into one that helps solve the pressing social and environmental problems the world is facing. In view of this, the BankTrack network proposes the following measures (also see "Reforming the Global Financial Architecture" for proposals regarding tax havens).

<u>Broad Principles:</u>

- *Bank supervision:* Sustainability-oriented standards should be incorporated into all bank supervision, including the granting of licenses, and the extension of central bank-provided credit and insurance.

- *A sustainable Basel Capital Accord*: Banking regulators should mandate the inclusion of environmental and social factors into risk assessment processes for bank financing activities. Sustainability criteria could be included to the Basel Capital Accords capital adequacy ratios.

- *Limit leverage:* The current crisis clearly illustrates that extraordinarily high returns are often linked to an excessive amount of leverage. As over-borrowing and the subsequent deleveraging are drivers of the current crisis, the use of leverage in investments and lending should be limited. For example, banks should have a leverage ratio in addition to stricter capital adequacy standards. Non-bank institutions, in addition, should also have capital and leverage requirements.

- *Regulate alternative investors,* such as hedge funds and private equity funds, and introduce significant new transparency and reporting requirements. For years, alternative investments were lightly regulated, under the rationale that predominantely wealthy, sophisticated investors participated in such funds which employ risky and speculative investment strategies. These strategies, we know now, also create systemic risk and foster instability. Today, however, pension funds, university endowments as well as public and private financial institutions have significant exposure to these funds, greatly magnifying their impacts on ordinary citizens and the global financial system. This requires much stronger regulation and control of the alternative investment space.

- *Curb derivatives:* It has become clear that derivatives are potentially dangerous products. As with other potentially dangerous goods -- for example pharmaceutical products -- regulators should demand robust testing before a product can be sold. Equally, derivatives should be checked for their long-term impacts and whether they serve a legitimate hedging purpose (i.e. help producers to anticipate and adapt to price fluctuations). Only legitimate hedging instruments should be allowed, and they should be standardized and traded in regulated exchanges.

- *Food and energy must not be treated like chips in a casino*: The need to curb speculative derivatives trading is particularly critical in food- and energy-related commodities markets. Huge swings in commodity prices and speculation-fuelled spikes in food and energy prices hurt the world's poor.

- *Eliminate the shadow banking system:* The circumvention of existing regulations ("regulatory arbitrage") led to the creation of a massive "shadow banking system," largely responsible for the expansion of unregulated, exotic securitized products and credit derivatives. The system should be eliminated by regulating all unregulated financiers and financial products. In addition, some financial practices should be banned altogether. It does not make sense to establish regulatory frameworks and reporting standards, while at the same time allowing financiers to circumvent them through off-the-book transactions. For example, banks should not be allowed to create any structured investment vehicles and/or special purpose entities which allow them to avoid regulation.

Bank specific proposals:

- *Green screening of customers:* To complement existing Know Your Customer (KYC) guidelines are anti-money laundering (AML) mechanisms used by banks to screen potential depositors, "Green KYC" guidelines should be developed, introduced and enforced, which would require banks to conduct environmental and social due diligence for both commercial depositors and borrowers, with the aim of prohibiting lending to corporations that do not comply with environmental and social standards.

- *Strengthening of anti-money laundering (AML) mechanisms.* Existing AML requirements should be tightened to halt the proceeds of corruption, illicit natural resource deals and tax evasion from entering the financial system. For example, AML requirements should apply to all financial actors and transactions, including hedge funds and private equity. The Financial Action Task Force should also launch a "name and shame" initiative focusing on those jurisdictions that are failing to implement their AML rules.

- *Transparency:* Banks should be completely transparent about their risk assessment processes, decision-making procedures, clients, and transactions. Banks should fully disclose their financing activities in sectors which have high environmental and social impacts, such as extractive industries and infrastructure. In light of widespread public distrust about banks' intentions, the issue is no longer how much transparency banks can allow, but how much secrecy they can afford. Such transparency is not just a idealistic aspiration, rather already a best practice among some ethical banks.

- *Reduce incentives for excessive risk taking*: Banks' perverse incentive structures, such as stock-options and short-term, volume-oriented bonuses, stimulated excessive risk taking and effectively led to greed-oriented decision-making at banks. For example, CEOs and bankers have compromised lending standards (including environmental and social policies), taken on too much leverage, and unscrupulously pushed risky products onto the public. Not only should bankers' executive compensation be drastically limited, but the role of bonuses in remuneration systems should be modified to reward long-term financial success and the implementation of environmental and social policies and programs.

- *Prohibit political contributions:* Political and campaign contributions from financial institutions should be prohibited and lobbying restricted.

2) Multilateral Issues

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3) Macroeconomic Issues and addressing the crisis

Today the world is in need of a "Green New Deal." Such a deal would not seek a superficial quick-fix of the economic system, rather aim to transform it into one that can actively resolve the world's pressing social and environmental problems. The fiscal spending necessary to stimulate crisis-affected economies entering recession must be directed at achieving social justice, the promotion of sustainable production and consumption systems, and the transition of the world's economies onto a low carbon path.

Banks, particularly those that are now being bailed out with tax money, have an important role to play in this economic transformation. It must be a role based on serving the public interest, rather than safeguarding the profits of the few. Given their power and important role, banks can and should deploy capital in ways that promote the restoration and protection of the environment and help create sustainable economies.

In the context of macroeconomic policies that support such a shift, banks can play a pivotal role in funding the transition to a low-carbon economy by moving away from fossil fuel-based energy projects into low/no carbon options and by accounting, reporting, and committing to reduce the greenhouse gas emissions in all their financing portfolios.

4) Reforming the global financial architecture

Broad principles

- *Inclusive process:* BankTrack strongly supports the development of a new global financial order to prevent future financial crises. However, new policies and institutions must be developed in a participatory and democratic manner, ensuring strong participation and support from developing and emerging countries. Large segments of their populations are being badly affected by the present crisis, even though they had no responsibility in creating it.

- *Elimination of tax havens:* Any reform of the global financial architecture must include strong measures against tax havens. Such secrecy jurisdictions are established not only to allow companies, financiers and individuals to evade taxes, but to avoid regulations as well. With tax havens resulting in capital flight of some US$500-800 billion per year from developing and emerging market countries alone, severely eroding the tax base of these countries, they have significant impacts on the world's poor. No jurisdiction should be allowed to continue with its tax haven status. As part of the effort to eliminate such havens, banks should be explicitly prohibited from establishing or conducting transactions with entities based in these jurisdictions.

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