

**LONG TERM INVESTORS CLUB – VENICE FORUM – OCTOBER 28, 2010**

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Distinguished Guests, Ladies and Gentlemen,

I would like to begin by quoting one of my favorite political philosophers. Niccolo Machiavelli opined in his seminal work, *The Prince*, that

*“There is nothing more difficult to take in hand, more perilous to conduct, or more uncertain in its success, than to take the lead in the introduction of a new order of things.”*

Machiavelli lived at a time of great intrigue and shifting political and economic fortunes. Our times, with the rise of the developing countries and threats to the established powers, are no less dramatic. Indeed, his insight of a “new order of things” is the challenge we all face as we emerge from the immediate consequences of the global financial and economic crisis. The crisis presents us with an opportunity to create a more stable and sustainable global financial system that can facilitate the long-term investment.

This can be achieved in part by establishing more comprehensive regulatory and supervisory standards, and I want to share with you some of my thoughts on this. But, I first want to stress the forces of change that have been accelerated by the global financial crisis and, how we need to grasp the opportunity presented by these changes, to build a stronger global financial system.

Our first challenge is to change the way we conceptualize the world: developing countries are now the key drivers of global growth and key players on the financial markets. I find it useful to think back to the time when the first international financial regulation was implemented with the original Basel accord in the late 1980s.

- At that time, developing countries accounted for just about 17 percent of global GDP. Today, the figure is over 30 percent.
- Back then, developing countries held 20 percent of total world international reserves. Today, they hold about 65 percent.
- Then, none of the banks from developing countries was among the world's 100 largest banks by market capitalization. Now almost one-third of the 100 largest banks are from emerging markets.
- And perhaps, the ultimate indicator of how much things have changed over recent years is this: the original Basel Accord placed a zero risk weighting on lending to OECD sovereigns. If only we lived in a world where that was still possible and sensible!

But, ladies and gentlemen, further changes are on the way. The global financial and economic crisis has subjected emerging economies to the most important real-time stress test imaginable and the larger ones have passed with flying colors.

Indeed, they are now the key drivers of global growth and they are likely to be for some time to come.

- Potential growth rates for emerging economies of around 6 percent now overshadow potential growth of only around 2 percent for advanced economies. And sometime in the next five years or so, emerging market economies will account for 50 percent of global GDP overtaking the G7.
- Emerging market debt ratios and fiscal deficits are less than half the level of developed countries; average debt to GDP for emerging market economies stands at only 33 percent while the gross debt level for advanced economies is expected to peak at 104 percent of GDP in 2013.
- The implications of these trends are not hard to discern: in a recent ratings simulation by Standard and Poor's, in the absence of policy changes, approximately 25 percent of today's AAA-rated sovereigns will lose their AAA status by 2016, 50 percent by 2020, and 100 percent by 2030.

The shifts in global financial clout have been recognized to some degree with the focus in the recent crisis response on the G20, rather than the G7. Indeed, institutions from several of the largest emerging market countries are represented on the Financial Stability Board and in the Basel Committee on Banking Supervision.

It is commendable that a considerable amount of effort and resources have been devoted to developing international standards and best practices. I am sure we will see this trend continue. But, I am concerned that the crisis response work of the G20 and the Financial Stability Board might have focused too much on developed economies with advanced financial markets and paid too little attention to the implications of their proposals for the increasingly important emerging markets.

Regulation, supervision, and standard setting must be addressed at the global level. If they are not, we will be placed in a situation where the “playing field” is far from level, and where differences among countries provide opportunities for regulatory arbitrage. Such arbitrage could seriously undermine our efforts to establish a more stable global financial system. Indeed, we can already see this happening: For example, in the aftermath of new standards to regulate derivatives in the United States, we see other financial centers in the developing countries preparing to become the new hosts of the global derivatives business—ready to exploit the next regulatory-induced arbitrage opportunity.

We can do better; we can do more.

Let me explain by looking at 4 of the latest developments with respect to the global financial markets’ regulations: Basel 3, credit rating agencies, SIFI (systemically important financial institutions); and International Accounting Standards. I will then conclude with some thoughts on the ways forward.

## 1. “Basel 3”

The development of a “Basel 3” Accord has been admirably swift compared with the extremely long gestation period of its predecessor, Basel 2. But, in practice, the agenda for Basel 3 has been driven by the needs of the advanced economies—and particularly the concerns of the United States, the United Kingdom, and the Eurozone countries. We should remember that more than 100 countries eventually adopted Basel I. Basel 3, to be truly effective, must serve the needs of developed and developing countries alike, otherwise it will fail in being effective in an interconnected global financial system.

The emphasis so far in Basel 3 has been on substantially tightening capitalization and liquidity requirements and redefining capital to ensure that it is truly loss-absorbing. The net effect of the changes is likely to be an effective manifold tightening of the ratio of capital to assets—perhaps by as much as seven - or even ten - times. This will require many banks to raise substantial amounts of new capital, if they are not to substantially curtail their activities.

But it is important to bear in mind that the capital markets of the emerging economies themselves may not be developed and deep enough to support the significant additional domestic capital-raising by domestic banks that may be required to meet these new standards. Moreover, if they instead look to international capital markets, they will likely have to compete with the advanced country banks and governments that will likely be making heavy demands on the international markets over the next few years.

Moreover, since the new Basel 3 rules do not recognize the low-margin and low-risk nature of trade finance business, higher capital requirements will likely raise margin requirements for the trade finance business to continue to be viable for commercial banks. Some estimates suggest that if the proposed Basel rules are implemented as currently drafted, and banks do not raise additional capital, trade finance lending could drop by as much as 6% a year, which could trigger a USD 270 billion reduction in international trade. This will have profound impact on emerging markets where trade finance is an important source of working capital.

## **2. Credit Rating Agencies**

The FSB and G20 have rightly focused on avoiding excessive and mechanical reliance by banks on credit ratings, and emphasized that they should carry out their own risk assessments on their assets. Too often banks and investors in the run up to the crisis did not look beyond the surface of the rating at the underlying risks. And with credit ratings enshrined in regulation and investment policies, this led to increased instability in the financial system.

That said, smaller, less sophisticated banks will continue to have minimum capital requirements based on external credit ratings. The lack of credit ratings even for large corporations was a major challenge for the implementation of Basel II in many developing countries, as was the lack of credit data to validate internal models.

Regulators should be careful that in reducing excessive reliance on ratings in the advanced economies they do not also inhibit the development of new rating agencies in the developing countries. The growth of rating agencies in developing countries might help in the creation of more locally knowledgeable risk assessments and provide a needed diversity of points of view. For example, China has announced that it is setting up a semi-official credit rating company that moves away from the mainstream developed-country pricing convention by charging investors rather than issuers to assess creditworthiness.

## **3. Systemically Important Financial Institutions (SIFIs)**

The present global focus on supervision of Systemically Important Financial Institutions (SIFIs), resolution of cross-border financial entities, and the operation of supervisory colleges is of crucial importance. While these mechanisms and initiatives try to resolve several important issues, the focus is mostly on the operations in the larger economies. The driving force is the significance of the operations in a host jurisdiction to the home jurisdiction. But I would emphasize the importance of adequately capturing a situation where the operation of a cross-border entity may be 'fairly significant' from the host perspective but is perhaps 'irrelevant' from a home perspective. As you would imagine, this can be the case in many developing countries.

#### **4. International Accounting Standards**

The ongoing commitment to establish international accounting standards is crucial. Both IASB and FASB are committed to achieving a single global standard, but the process of convergence is slow and the outcome and timing are still uncertain. The differences are substantial. The European-dominated IASB proposes an anti-cyclical accounting mechanism that the US FASB is reluctant to accept, whereas FASB is much stricter than the IASB on the use of fair value accounting. Developing countries should have an equal seat at the debating table on these issues. And, at a minimum, they need to have assurance that these bodies, particularly the IASB, have a transparent funding mechanism that does not compromise these bodies' independence.

A closely connected issue that I am passionate about is the role of auditing professionals, especially in the financial services sector. As we know, many of the banks that sought financial support from governments in the midst of the financial crisis had previously received unqualified audit opinions. It is clear that there is an ongoing need to improve audit quality in order for the audit function to be effective in contributing to market discipline. The audit market in most countries is highly concentrated and dominated by the so-called Big 4 international audit firms, particularly at the high end (that is for audits of larger and publicly listed corporations).

This oligopolistic market structure, with none of the 'Big 4' from a developing country in sharp contrast to the Banks that they are auditing—is somewhat reminiscent of the challenges we face with the rating agencies as well as with those systematically important financial institutions that are too big to fail. In developed and developing countries alike there is a need for the audit profession to move beyond its current emphasis on performing a narrow statutory role towards a wider fiduciary one that reinforces the goals of regulators and hence financial statement users—that is investors like you from around the globe that are interested in global investment opportunities.

## Conclusion

**Let me conclude my talk by saying that economic changes also mean changes in the equilibrium of powers.** The economic crisis has demonstrated the importance of multilateralism. Facing the abyss, all countries have worked together to save the economic system. The G20, which started as a finance ministers' grouping after the Asian crisis and became a heads of government club after the collapse of Lehman brothers in 2008, has shown it is capable of acting quickly to instill trust. That said, my fear is that the will to work together may dissipate as the worst effects of the crisis recede. What is needed is the collective effort of agents of change—especially long-term investors—to promote a constantly improving multilateral framework, including for global regulation and global standard setting.

The recent round of capital controls in a number of bell weather developing countries—Brazil, Thailand and India— provide some evidence that countries are resorting to financial unilateralism.

If the new standards do not take developing countries' concerns sufficiently into account, there will be little incentive for developing countries to adopt the new standards. Without their active participation, these new standards will not succeed for any of us. The global financial crisis has brought home to all of us, the interconnected nature of the global financial system.

Machiavelli is right: to take the lead in the introduction of a new order of things is difficult and perilous—but working together—intelligently and cooperatively—I am certain we can succeed.