Critical Issues in the Financial Industry

SOMO Financial Sector Report

Myriam Vander Stichele

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General introduction
What the report is about

The private financial industry plays a pivotal role in the functioning of many economies in the world. Banks, insurance companies and other less well-known financial service providers intermediate capital flows for governments, corporations and individuals, which affect people's lives and the choices available in society.

By raising, allocating and pricing capital and providing risk coverage, they have a major influence on:

- who in society gets access to financing and protection against risks;
- what activities by governments, corporations or individuals get financed or protected against risks;
- how financial services benefit the rich or the marginalized, sustainable development or environmental destruction.

The private financial sector has several types of financial services that affect societies as well as the international economy. Regulating and supervising financial firms and their diverse services is difficult due to the complexity of financial 'products' and risk management, and due to the speed at which financial firms facilitate huge amounts of capital to flow around the world. Moreover, the private financial industry has successfully argued for national and international free markets and legal frameworks that prevent too much intervention by national and international authorities.

After crises like the Asian financial crisis in 1997-98, there was a lot of talk about reform of 'the' financial architecture. It is often overlooked that the dominant players in international financial system are private financial services providers, including the 'institutional investors'. Because there is much less public knowledge about financial firms than about governmental financing institutions like the World Bank, this financial sector report focuses on private financial firms including banks, insurance companies, investment banks and pension funds. The report intends to provide basic information about:

- the mechanisms and the operation of private financial services (chapter 1),
- the structure and the major players in the financial services market, and trends and strategies in the financial industry (chapter 2),
- important issues and concerns for developing countries, based on a case study of Indonesia (chapter 3),

- initiatives taken around corporate social and environmental responsibility (chapter 4),
- how the private financial industry is regulated and supervised at the international level (chapter 5),
- how trade in financial services and investment by financial firms is regulated by the WTO agreement on services (GATS) and what the risks are for developing countries (chapter 6).

This report focuses on trends, structures, regulations and corporate responsibility initiatives at the international level. The scope of the report did not allow for analysis of each country. Only an Indonesian case study by Business Watch Indonesia on the financial services industry is included to provide a useful developing country insight.

Each chapter strives to indicate the problem areas in every financial sub-sector. The focus is on those aspects that negatively affect society, developing countries, poverty eradication, and sustainable development. These are indicated as "*critical issues*". The conclusions of each chapter review the main critical issues and topics.

In this way, the report would like to inform and analyze problems surrounding the private financial industry for organizations, individuals and institutions which:

- are involved with corporations, big projects and privatization, and their financiers, which destroy the environment and violate human rights;
- are campaigning about trade agreements, such as the GATS agreement, in which opening of the financial services market is on top of the agenda without any democratic scrutiny;
- want to free the world of unstable international capital flows and complex financial services that undermine entire economies and people's lives;
- want to solve debt problems of developing countries, which reduce government budgets intended for eradicating poverty, social improvements and promoting environmentally friendly development;
- want to avoid the widening gap between rich and poor in all countries and work on alternatives to the current globalised free market economy;
- understand what goes on behind corporate scandals such as Enron and Parmalat.

The report is published by the Centre for Research on Multinational Corporations (SOMO), a non-profit research institute that advises non-governmental organizations and trade unions in the Netherlands and worldwide.

Research for this report was based on information from literature, data bases, NGO analysis and input at workshops in Cancun (12 September 2003), The Hague (19 November 2003) and Amsterdam (13 January 2005), and last but not least the sector, country and corporate reports commissioned to Business Watch Indonesia. The expertise of SOMO researchers

and writing by Myriam Vander Stichele lead to the analyses and results of this report. Thanks go to Martin Koehler (Campagna per la reforma della Banca Mondiale), Peter Wahl (WEED), Johan Frijns (Bank Track), and others who commented and supported the writing of the report. In beginning 2005, the report was updated with the assistance of Jante Parlevliet to incorporate most important new events.

SOMO's research of the financial sector is part of a four-year program of research of sectors of importance to civil society, poverty eradication and sustainable development, financed by the Ministry of Foreign affairs in the Netherlands. Financial support for researching the financial sector also came from NOVIB (NL).

Myriam Vander Stichele

Amsterdam, April 2005

Glossary

This report explains many words used in the financial services industry, mostly in chapter one. A word that is explained for the first time in the report is underlined. Below are some general terms used throughout the report.

Assets
Anything that has commercial or exchange value and is owned by a business, institution or individual, for instance shares or real estate.
Bailing out
Financial support by governments to banks or other financial firms that are in financial distress and could go bankrupt, possibly disrupting the whole economy.
Bond
An interest-bearing security issued by governments, banks or companies, which obligates the issuer to pay the bondholder a specified sum of money, usually at specific intervals, and to repay the principal amount
Credit risk: the chance that the debtor will not repay the loan or other form of debt (e.g. a bond).
Collateral: something of value that is given as a guarantee for repayment of a loan or other form of debt. Often it concerns real estate but many other assets can be used, including land, part of a business, or financial assets. In case the borrower fails to repay the loan on the agreed terms, the bank will have the legal right to seize the collateral.
Debt finance: with this form of finance, the financiers lend money to a company, government or project. This can be in the form of a bond or a loan. The returns of the loan and bonds are normally fixed.
Deposit: a sum of money lodged at a bank or other depository institution. The money can be withdrawn immediately or at a agreed time ('time deposits'). Sometimes deposit earn interests, especially if it concerns a time deposit.
Derivative
A contract which specifies the right or obligation between two parties to receive or deliver future cash flows, securities or assets, based on a future event.
Equity finance: in this form of finance, financiers buy a share in the company or project and are thus a partial owner. Their returns depend on the success of the firm/project.
Equities
Ordinary shares, i.e. ownership interests possessed by shareholders in a corporation, as opposed to bonds.
FT
In references means: the Financial Times
FTFM
In references means: Financial Times Fund Management (weekly review of the investment industry)

Institutional investors
Investors with large amounts of funds under their management, such as pension funds, insurance companies, mutual funds and bank trust departments.
Principal
Amount of a loan, separate from interest to be paid.
Securities
Bonds, shares or stock, and derivatives.
Securitization
Process of bringing together in a pool debt instruments (e.g. loans) which generate predictable cash flows, then selling to investors new securities backed by the pool.
Stock
Is the equivalent of the UK term share(s).
Share
Units of ownership in a company, issued by a company as a means of raising long term capital; shareholders receive some part of the company's earnings through dividends; "voting shares" carry the right to vote at company meetings.
Reserve requirements: requirements on the amount of funds a bank has to hold in reserve against deposits made by their customers. This money has to be held in the vaults of the bank, or the respective central bank.
Underwriting
Introducing new shares on the stock market and assuming the risk of buying the new issue of shares or bonds from the issuing corporation or government entity and reselling them to the public; the underwriter guarantees to buy any shares of a share issue which are not bought by the public, which creates public confidence.
Syndicated loan: loans for large, possibly risky commercial or government projects provided by a group of banks and other financial institutions, called a bank consortium or a syndicate.
Option: a contract between two parties that offers the buyer of the option *the right* to buy (or to sell) an asset (e.g. a financial security) from (to) the contracting party at a agreed upon price, within a certain period of time.
Future: a contract between two parties in which the buyer of the future party *is obliged* to buy (or to sell) an asset (e.g. a financial security) from (to) the contracting party, at a agreed upon price, within a certain period of time.

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Some figures to compare

Gross Domestic Production (GDP) in 2003[1]

Gross domestic product of the economically richest country, the US	$ 10, 949 bn ($ 11,0 trillion)
GDP of the reported poorest country, Kiribati	$ 0.055 bn ($ 55 million)
Total GDP reported in the world	$ 36,460 bn ($ 36.5 trillion)

Gross National Income (GNI) per capita 2003[2]

GNI per person in the richest country reported, Luxembourg	$ 45,740
GNI per person in the poorest country reported, Ethiopia	$ 90
World GNI per capita	$ 5,510

FDI[3]

Total world foreign direct investment (FDI) in 2002	$ 651 bn
Total FDI to developed countries in 2002	$ 460 bn
Total FDI to developing countries in 2002	$ 162 bn

AID[4]

Total official overseas development aid (ODA) in 2002	$ 58 bn
Additional annual aid needed to achieve Millennium Development Goals	$ 40-60 bn

Debt[5]

Total debt of all developing countries in 2003	$ 2,554 bn ($ 2.6 trillion)
Total debt by all developing countries to private creditors	$ 595,1 bn
Developing countries' use of IMF credit in 2003	$ 106,9 bn

Trade[6]

Total world exports of merchandise in 2003	$ 7,579 bn ($ 7.6 trillion)
Total world exports of commercial services in 2003	$ 1,729 bn ($ 1.7 trillion)

Financial markets in 2003[7]

Total value of equities (world stock market capitalization) in 2003	$ 31,202 bn ($ 31 trillion)
Total world value of public and private debt securities in 2003	$ 51,305 bn ($51 trillion)
Total value of assets managed by commercial banks (bank assets) in 2003	$ 47,834 bn ($ 48 trillion)
Value of US mutual fund industry in January 2004[8]	$ 7,537 bn ($ 7,5 trillion)
Value of US hedge fund industry in January 2004[9]	$ 795 bn
Notional value of global amounts outstanding of over-the-counter (OTC) derivatives by June 2003[10]	$ 169,678 bn ($169.7trillion)
Total recorded claims on offshore centres in the second quarter of 2003[11]	$ 1,800 bn ($ 1.8 trillion)

Profits of financial firms

Total net profit[12] of the 41 financial firms that belonged to the 100 biggest global companies in 2002-2003	$ 166.9 bn
Total net profit of Citigroup, the world's top financial firm, in 2004[13]	$ 17.0 bn
Commissions paid by migrant workers for transferring earnings home, according to US Treasury registration in 2001[14]	more than $1bn.

Pensions

Total pension fund assets of the world's top 5 pension markets in 2003[15]	$13,077 bn
Pension funds are world wide under funded by 20%	$1,500 bn to $2,000bn

1 World Bank, Quick Reference Tables, Total GDP 2003, at www.worldbank.org
2 GNI differs from Gross National Product (GNP) in that it includes a terms of trade adjustment. See: World Bank, Quick Reference Tables, GNI per capita 2003, at www.worldbank.org
3 UNCTAD, Development and Globalization. Fact and Figures. 2004, p33, at www.unctad.org
4 OECD, OECD Report Shows Rising Aid Flows but More Effort Needed to Reach Monterrey Goals, 28 January 2004.
5 World Bank, World Development Indicators 2005, table 4.16, at www.worldbank.org. Developing countries here refers to World Bank's low and middle income countries
6 World Bank, World Development Indicators 2005, tables 4.5 and 4.7, at www.worldbank.org
7 IMF, Global financial stability report, April 2005, p. 163
8 Grace Toto, Monthly statistical review, SIA Research Reports, 20 September 2004, p 27, at www.sia.com
9 Kyle L. Brandon, The State of Hedge funds: 2004, SIA Research Reports, 20 September 2004, p 6, at www.sia.com
10 BIS, Quarterly review, March 2004, p. A99
11 BIS, The international banking market, in Quarterly review, December 2003, p. 16
12 Forbes 2000 list, March 2004, at: www.forbes.com : based on a composite of sales, profits, assets and market value; including figures of net profits in 2003 and 2002.
13 Citigroup, Annual Report 2004, available at www.citigroup.com
14 J. Authers, Mexicans send more than $ 1 bn back home in July, in FT, 19 September 2003.
15 Watson Wyatt, in S. Targett, Pension gloom is lifting, in FTfm, 19 January 2004, p. 2

Chapter 1
Financial services: what they are, some trends and critical issues

Introduction

The private financial industry, or "financial services sector", makes money by raising and allocating capital, and by providing protection against many kinds of risk.

The various financial services and the ways in which they work will be explained[1] in this chapter. The latest trends, problems and some critical issues relating to sustainable development and poverty eradication will also be outlined for each branch of financial service.
Some financial services may seem obvious, whilst others are much more complex and less transparent to the general public or civil society organizations.
Chapter 2 will give more insight into which firms provide the various financial services, and the structure and the trends in the financial services market. Issues related to developing countries, corporate responsibility, regulations and liberalisation of these financial services are also explained in separate chapters.

The overview below is organized categorically with the services the financial industry offers. These financial services categories are also used in the free trade agreements, including the agreement on services in the GATS agreement of the WTO (see chapter 6).

1.1 Banking

1.1.1 Retail banking and commercial banking

Retail and commercial banking refers to banking services open to the households and small companies. In contrast, *corporate banking* focuses on large, corporate and institutional clients ('wholesale clients') only.

Commercial banking
There are different kinds of retail banks. The biggest group are the commercial banks, which service both households and small and medium enterprises (SME's) and wholesale clients. Typical services of commercial banks to households and SME's are acceptance and repayment of deposits from which banks make commercial, consumer and mortgage loans. In addition, they provide different kind of payment services like bank cards, credit cards and e-banking. The services offered to big corporate clients are similaralthough the type of services provided by corporate banking divisions of financial institutions are much more extensive.

Other types of retail banks
In the retail sector, in addition to commercial banks there are also some other financial institutions where you can keep a deposit (sometimes also referred to as 'thrift institutions'). In the US especially, *Savings and Loan's (S&L)* banks are an important banking institution. They obtain funds through deposits, and use these mainly to provide long-term mortgage loans. *Mutual savings banks* operate similarly. However, their organizational structure is quite different, since the depositors *own* the bank. Finally, *credit unions* are small cooperative deposit institutions that are often organized around a union or a firm. They obtain funds by issuing deposits and use these to make particularly consumer loans.

→ Trends and critical issues

Market Segmentation
Studies show that 20% of the customers at retail and commercial banks generate as much as 200 percent of the profits whilst the remaining customers actually undercut profits.[2] In response, many banks in western countries in the 1990's decided to divide up their services around the customer, rather than around products or channels, according to the profits made from various client types.[3]
Clients, regardless of whether they are received in person, through the internet or call centres, are then dealt with according to a pre-set level of services, fees, and privileges.[4] Services to the 'poor' have been drastically cut whilst services to small and medium-sized enterprises (SMEs) are much less than to those for the larger corporations.

Closing branches and opening redesigned branches

Market segmentation has also resulted in closing and streamlining branches in most western countries. Those remaining branches focus on selling financial products, which earn more profit (i.e. loans) from richer clients. Call centres and automatic tellers, which replace branch staff, often leave the client wondering if "there's anybody out there?". In the Netherlands, the amount of bank branches was reduced by 40% in 5 years, i.e. from 7 000 in 1998 to 4109 in 2003.[5]

Many banks have been losing clients due to the downgrading of retail services but in the last year or so in some cases, client contact has been re-valued and steps have been taken to improve human-to-human contact. Clients of Barclays and HSBC in the UK and others should watch out for the new branch trend, which is all about "eye contact" and offering a "library" setting, where you can sip coffee and read promotional brochures. Even though the redesign is aimed at increasing customer satisfaction, cutting costs to increase revenues means you will still have to do many transactions yourself.[6]

Reducing direct services for the poorer

In line with market segmentation and cost cutting or profit opportunities, banks are pushing or obliging customers to use cheaper automated services or automated channels such as the internet or automatic money distributors (ATMs) for transactions on one's personal account. For example, in the Netherlands cash dispensers on the street must be used to withdraw Euro 500 or less, which is a problem for many including the elderly.
Many European banks in 2001 intended to switch the 80% of the least profitable clients to automatic channels for low added-value transactions, and at the same time sell to these clients different products through the internet.[7] One tactic to persuade people to use the automated services is to offer better interest rates on deposits made on the internet, even though e-finance is not yet fully secure.

Sometimes banks exclude the very poor[8] from services by, for example, identifying city areas, or "red-lining" areas, on the map considered poor, where banks refuse to provide certain financial services. And within these areas low-income households do not have access to mortgage loans.[9]
In developing countries, the very poor often have no access to saving accounts or they have to pay for them. Those already excluded from society, the marginalized and poor, are often excluded even further due to their lack of access to basic financial services and most countries don't have laws obliging banks to provide access to basic services.

Cross selling
Banks distribute other financial products to clients through existing branches, including insurance products and policies, and mutual funds.

Customer's choice?
Theoretically consumers can freely choose and change their retail banks but in some cases it is not possible to retain account numbers when changing banks, which makes changing banks less interesting. New laws in some Western countries allow customers to keep their account number if they switch, which is intended to increase competition and improve customer customer service.[10]

Run on the banks
When clients loose trust in their bank, fearing that it will go bankrupt, they run on the bank, to get their money out. Since banks do not actually have all their clients' savings in the vaults available for full withdrawal at any one time, clients' 'running on the bank' could result in the bank collapsing or exacerbating an wider, existing banking crisis.
The risk of a run on the banks is still a problem in developing countries as was the case in Argentina during the financial crisis from 2001 onwards and in Zimbabwe in January 2004.[11] In some countries, foreign banks are often trusted more, but it is the richer people who can afford their more expensive services. Not all countries require banks to have a deposit insurance system, which guarantees the repayment of at least some of the clients' savings.

Transfer of migrant remittances
The cash sent home by migrant workers, in many developing countries, exceeds the capital inflow from foreign direct investment. Traditionally these transfers were sent by money order, which had high commission fees. In 2001, the US Treasury registered more than $1bn commissions made by migrant workers.
The surge in electronic transfers has allowed more financial firms to enter into this oligopolistic financial service sector, thus increasing competition, which has lead to a drop in commission fees. At the same time, migrant workers can more easily send smaller sums of money back home.[12]

1.1.2 Lending of all types and related services

For many banks, offering loans is a significant business and is one of the ways the bank actually creates money. Loans can take many forms (credit cards included) and can go to individuals, companies, other banks (or inter-bank lending), large projects, governments or governmental organizations.

Mortgage banking
When a bank sells a loan for real estate, sometimes combined with insurance and mutual funds, they are selling a mortgage. The bank's revenue comes from the commission fees and servicing the debt (loan servicing) by way of interest payments, and sometimes from the resale of the loan to other investors.

Project lending
Project loans refer to loans for big projects by governments or corporations for the construction of infrastructure including oil pipelines, powerhouses and dams. These loans often contain loan covenants or agreements between the lender and the borrower about what the borrower should or should not do, such as regular reporting, adequate insurance and asset reserves.

→ Trends

Syndicated loans
Syndicated loans are loans for large risky commercial projects or for governments and are financed through a group of banks and other financial institutions called a bank consortium or a syndicate. The bank coordinating the consortium and the syndicated loan could be different from the banks' providing the loans in the consortium.

Credit risk mitigation
Banks have mechanisms, through credit derivatives and credit securitization (see below), which they use to spread out the actual risks of the loans and credit. Risk mitigation instruments are used by banks which concentrate credit in certain sectors of their expertise and are vulnerable to heavy losses should the particular sector take an economic downturn. Risk mitigation instruments are considered by some as being one of the reasons Brazil was affected by the Asian financial crisis in 1997-98. Credit risk mitigation instruments are contracts that are mostly traded[13] between bankers and investors. The credit derivative market was estimated at $ 40 bn (outstanding notional value) in 1996 and $ 1.2 trillion at the end of 2001. The massive growth is expected to continue and to reach an outstanding notional value of $ 4.8 trillion by the end of 2004.[14]

Credit derivatives
Relatively new to the commercial banking sector, but on the rise over the past 5 years, a credit derivative[15] is a contract between two parties that allows for the use of a derivative to transfer credit risk from one party to another. The derivative is based on a credit, either a loan or bond in most situations.
The derivative contract stipulates the fees the two parties pay each other, depending

on the kind of derivative and the risks (e.g. non repayment of the loan) covered. The protection buyer, most often the bank, remains the owner of the original loan.
The most common credit derivatives are credit default swaps[16] which are agreements where credit risk and fees of a third party are transferred from one party to the other. The first party in the swap is a lender and faces credit risk from a third party. The counter-party (or the protection seller) in the credit default swap agrees to insure the default risk in exchange of being paid regular periodic payments (i.e. essentially an insurance premium).
If the third party defaults, the second party assuming the risk will have to purchase from the first party the defaulted asset. In turn the protection seller pays the protection buyer the remaining interest on the debt as well as the principal.

Other forms of credit derivatives are total-return swaps, and credit-spread put option contracts. The number of types of credit derivatives that are traded among protection buyers and risk sellers is ever increasing.

Securitization

Securitization involves the packaging of debt (like loans or mortgages), which generates predictable cash flows, in a pool and selling these to investors in the form of securities. Securitization is a relatively new but fast growing form of debt financing. Over a period of 20 years, securitization became one of the largest sources of debt financing (or credit provision instrument) in the US and is also on the rise in Europe and Asia.

The securitization of (bad) loans and other debt instruments means the credit risks is removed from the bank or loan provider and is spread among the buyers of the securities. As a consequence, it becomes unclear exactly who assumes the risks. However, the point is that the bank that provides the loan, does not have to deal with bad debts[17].

Project finance

Project finance refers to finance especially directed to big, mostly infrastructure projects like oil pipelines, hydroelectric dams and telecommunication infrastructure. After massive privatization and deregulation of industrial sectors, since the early 1990's, private sector financing of these projects has grown enormously.
It is a form of credit that responds to the particular characteristics of large projects. The initial costs of the big projects are very high, while the benefits can only be reaped in the longer term. All kinds of risks are involved (financial, environmental, political etc.), and therefore project finance has evolved to be a very complex issue. Finance for big projects can take two forms: equity and debt. If the risks of the projects are high, a substantial percentage of the finance is provided through equity arrangements, that is, those financiers "own" the project, and thus also will bear the costs in case of a failure of the project. Other financiers often require a high level of equity finance, because the existence of a substantial group of shareholders will increase the real commitment to the success of the project.
If the risks are perceived smaller, there is normally more debt finance. Debt finance again, can take two forms: loans and bonds. *Project loans* are made by commercial banks and normally contain loan covenants or agreements between the lender and the borrower about what the borrower should or should not do, such as regular reporting, adequate insurance and asset reserves.

Increasingly, projects are also financed through *project bonds*. Banks then assist the company or government in attracting private funds, by underwriting project bonds. (for underwriting, see section 1.2) Like with project loans, in the issue of project bonds the terms of the agreement are included in a bond covenant. Although governments have left the financing increasingly to the private sector, they remain involved in the design and the conditions of the projects. Local governments can be involved as a contracting party that will buy the infrastructure after the project has been finished. Host governments of the construction companies can be involved when their Export Credit Agencies (ECA's, see section 1.4) offer insurance for the payment of their activities. Also, taking into account the enormous risks involved in some projects, participants often require the involvement of multilateral development banks like the European Bank for Reconstruction and Development or the International Finance Corporation (the World Bank's private arm) to back the project. As a result, project finance often takes the form of hybrid public-private partnerships.

Social movements are increasingly concerned with the impact that financial lending, to companies and for projects, has on the environment and human rights. Current project lending often results in unsustainable practices because financiers do not produce reasonable environmental and social impact assessments of the projects they are financing. The lack of sustainability criteria and regulation combined with the lack of transparency for those individual 'savers' (who are interested in knowing how the bank is using their savings) and channels for those savers to voice their concerns also leads to unsustainable practices. This issue is further discussed below (Chapter 4).

→ Critical issues in lending services

Credit to small and medium entreprises (SME's) lacking and too expensive
Most financial firms see lending to SMEs as a high risk and administratively costly, which mean SMEs have less access to credit and the interest rates they pay are higher than what larger corporations are offered. Yet, SMEs are often the most dynamic and innovative segment of many countries and provide the bulk of employment. This problem is sometimes recognized at the national or international levels but it has not been successfully resolved.
To promote economic growth and reduce escalating poverty, delegates at the Summit of the Americas in January 2004, called for the promotion of small credits to individuals and small producers.[18] Ironically, the Summit also called for more free trade. It is exactly the fierce competition within the financial service sector, as a result of free trade, that has lead to SMEs being denied credit due to their high costs and perceived risks. For example, in Mexico, the entry of foreign banks has not lead to the improvement of the banking sector as many had hoped. Foreign banks, especially Spanish and US ones, now control 80% of the banking sector. Although rich clients in generally are being served well, households and SME's have a hard time getting loans from these banks. This situation has led the Mexican central bank and politicians to publicly raise concerns, since foreign banks are often also harder to regulate than domestic ones. Under the current climate, it is unlikely that more credit will become available to SMEs without government intervention and support. The World Bank has started trainings, with Citigroup, to promote the financing of SMEs in Latin America

Minorities have less access
Research has revealed that African-Caribbean businesses have extra difficulties in the UK accessing finance due to discrimination and a lack of trust.[19] Some banks around the world promote ethnic banking to attract the minority and immigrant clients, however gaps remain between bank policies and implementation.

Predatory lending
In some countries, banks and other financial firms aggressively sell easy loans with high interest rates designed specifically to exploit vulnerable and unsophisticated borrowers. People in metropolitan areas in the US -including minorities, low and middle income borrowers, women and others excluded from mainstream credit- are particularly targeted and victimized by predatory lending and high interest rates, which further marginalizes these groups in society.[20] Existing laws do not protect these vulnerable members of society but rather sanction predatory lenders.

Credit cards

Credit cards provide easy access to advanced payment and credit at home and abroad. They make payments easier for the business sector and those who travel because they avoid having to carry large amounts of money or foreign currency. However, they have also severely increased indebtedness. The interest rates, which are paid when payment is not immediate upon receiving the bill, are higher than for credit from banks.

The level of personal indebtedness due to credit cards has reached crisis levels in various countries including the US and UK because credit card holders purchase items they can't afford otherwise. In South Korea where credit cards have been made readily available and consumption has been encouraged by governmental incentives, many clients were unable to repay their debts when the economy slowed down (US$ 5.8bn of unpaid bills in September 2003).[21] The government has had to intervene at the end of 2003 in order to prevent credit card providers from collapsing, thus affecting the whole South Korean banking system.[22]
At the same time, credit cards are marketed in increasingly attractive ways. They target specific groups like the young, who they hope will fall into debt at an early age, thus remain lifelong credit card customers. Visa designed a mini-credit card for young Asian consumers that attaches to a necklace or a bracelet.[23] In order to attract customers, affinity credit cards are offered and allow customers support charitable causes through their payments.

Non-banking financial services

Increasingly companies that do not offer financial services in their core business (i.e. supermarkets) have started selling credit products as well as credit card services. For example, in Canada the big chain supermarkets now have 'banks' on site, which can arrange a loan, a mortgage and take care of your savings. They are getting into the financial service industry because they want to keep their shopping customers and create a 'one stop shopping/banking' experience.

Debt market

When developing countries have problems paying back their loans, sometimes the debt is written off from the lending banks' books (through bad loan provisions), and/or sold by the lender, at a reduced price, to another financial service provider, who then tries to recover the whole loan. This means that developing countries are pressed to repay their loans while the lenders have already written off or reduced the value of the loan.
Banks and other international financial firms that lend to developing countries come together in informal networks like the "London Club" when repayment problems occur. They collectively look with the defaulting developing countries at repayment

strategies, but generally this benefits the banks the most.

Credit risk mitigation products create new risks

Credit risk mitigation products, like credit derivatives, transfer the credit risk away from banks to third parties. Perhaps this is why banks survived the rough financial patch from 2001-2002 where loan defaults increased because the economy slowed down and the stock markets dropped, and where the financial capacity of many individuals and corporations was weakened.

However, regulators and experts worry that these credit mitigation mechanisms could destabilize the banking system because:

- The access to credit risk mitigation instruments might encourage the credit providers to take more risks, or to be less prudent in assessing and monitoring borrowers after the credit contract is signed.[24] Too many bad loans might increase banks' risks and lead to destabilizing the banking system[25], the opposite of what risk mitigation instruments attempt to do.
- Currently supervisors are afraid of unchecked, concentrated accumulation of credit risk.[26] It is not fully clear to regulators where all the risks are being transferred to, and the possible consequences. Especially insurance companies are active buyers of credit derivatives, and thus indirectly sell banks protection against credit loss. Mutual and pension funds have also heavily invested in these instruments[27]. Defaults on loans will now thus potentially endanger the financial position of these investors (and the households whose money they manage).
- The pricing of credit derivative contracts are complex to calculate and document, and all the potentially important factors might not be included in the model that calculates the risk,[28] upon which the derivatives are based, resulting in some unexpected and heavy losses for the buyer.

More borrowing through low interest rates

Banks providing consumer credit and loans for housing or business profited in 2003 when the interest rates in many (western) countries were at a record low.
Low interest rates means credit is cheap and therefore more people tend to take out loans. Banks profit from high lending despite the relatively small profit margins from the difference between interest rates banks provide for savings accounts and the interest rates they earn from lending. The problem is that when interest rates increase, the rates for existing loans will also increase and the cost for servicing the debt increases. If lending has been arranged without a careful assessment of an individual or company's payment capacity in a worse case scenario, the banks might be left with bad loans.[29] This could undermine the bank's profitability, which undermines services for clients, the bank as a whole and potentially the whole

economy.

Micro-credit financing
Because large national and foreign banks are not interested in providing small amounts of credit, micro-credit schemes have begun to flourish in poor and low income areas.
The spreading of the micro-credit institutions, like the Grameen Bank, indicates that there is a great demand for small amounts of credit and their payback success rate indicates that low-income people can be a good credit risk. Alternative banks and investment schemes try to provide the capital micro-credit institutions require. The World Bank and even mainstream banks have bourgeoning interest in micro credit. For example, ABN Amro opened a micro-credit division in Brazil. It has however been faced with the problem of selling the micro-credit product (loans) to weary and suspicious entrepreneurs in the informal economy. ABN Amro wants the micro-credit project to be profitable within 2 years.[30] There are many dilemmas when large donors and mainstream bankers and investors get involved. The benefits and the disadvantages have to be carefully weighed in order to judge whether this mainstreaming is the best way to support poverty eradication.

Lending practices that undermine the economy: "Tanzi finance"

Financing of companies is changing from a system whereby repayment of loans and interests is done through cash flows, to a more speculative financing system whereby only interest can be paid through cash flows. In adverse circumstances, the companies have to sell some of their assets to repay loans. There are more and more cases whereby the companies are unable to meet their interest and principal repayment obligations from their cash flows ("Ponzi finance", after an Italian swindler called Charles Ponzi). They need to constantly raise new funds, often through hidden or innovative systems, which can cause the company to collapse under its debt burden ("Tanzi finance" after the owner of Parmalat, the collapsed dairy multinational).

This more speculative financing is made possible through banks and other financial firms that seek to make profits from more and more financing mechanisms, and increase their leverage on the economy from the constant need for more finance.

An economy dominated by such speculative 'ponzi financing' supported by financial firms becomes fragile and susceptible to a financial crisis. Such an economy is dependent on continuing asset price inflation and larger amounts of credits. Small raises in interest rates or declining company incomes might cause problems and compel companies to sell their assets. When too many companies are in such financial trouble, the economy collapses as in the 1930s. Authorities can intervene, as the US has been doing for instance when the stock market crashed (1987) or imploded (2001-2002), and during the saving and loans crisis (late 1980s). But such intervention is encouraging more 'Ponzi finance' to a point where too much debt is beyond salvation.

In the case of the collapse of Parmalat, special schemes –often designed by financial firms- were used to hide the debt from investors, such as: "bank loans rendered safe with credit default insurance, asset-backed securities collateralised with fake invoices, credit-linked notes which allowed the issuer to bet on its own creditworthiness, bonds which by secret covenant varied the coupons payable according to the company's interest cover, liabilities sliced up and distributed in collateralised debt obligations, and a myriad of finance company subsidiaries registered in off-shore tax havens".

Source: M. Vander Stichele, based on E. Chancellor, The perils of Tanzi finance, 22 February 2004, at www.prudentbear.com

1.2 Services related to securities and asset management

Financial firms profit, i.e. make money, through financial products dealing with securities including the issuing, trading and managing of securities. In addition, financial firms trade and manage various other assets such as savings, foreign currencies, real estate, commodities and gold.

1.2.1 Investment banking

Unlike traditional banks, <u>investment banks</u> do not accept deposits from, nor provide loans to, individuals.

a. An investment bank is an institution that acts as an underwriter or agent for companies or governments issuing securities (bonds and shares). The services of an investment bank support the introduction of new shares to the (stock) market.
   - By <u>underwriting</u>, the investment bank buys all the new securities from the issuer (a company, a government) at an agreed upon fee, thus the issuer is

guaranteed a certain minimum amount raised from the issue, while the underwriter bears the risk. The underwriter then resells the new shares directly to the market or to another investor. The underwriter guarantees to buy any shares which are not bought by the public (which creates public confidence). The profit for the underwriter is in the difference between the price paid to the issuer and the public offering, which is called the underwriting spread.

- The investment bankers' role begins with pre-underwriting counseling and goes on with pricing of the securities, stabilising the price of the issue during the offering, and often continues after the distribution of securities is completed, in the form of ongoing expert advice and guidance, often including a seat on the board of directors of the company, and stabilising the price of the security during the distribution period. Investment bankers can also form an underwriting group, which pools and therefore distributes the risk.
- In other arrangements, investment bankers market a new issue without underwriting it, acting as agent, and taking a commission for whatever amount of securities the banker succeeds in marketing.

b. Investment banks play a large role in facilitating mergers, acquisitions and corporate restructuring through advice (in return for high fees) and financing.

c. Investment banking also deals with converting loans and other assets into securities (securitization).

The investment banking industry is roughly divided between those clients with more than $ 1 bn in revenue, those in the middle market, and those in the smaller market with revenues of around $ 25 million.

→ Trends

Less business after the dotcom bubble burst

During the economic and stock market downturn of 2001-2002, fewer businesses were interested in issuing new shares, which resulted in less income for investment banks. Just prior to the slump, investment banks were increasingly selling new shares particularly from those IT (information technology) companies, which helped create the dot.com bubble. In 2004, after three years of retrenchment, investment banking saw a rise in business again, party due to an increase in equity underwriting.[31]

More bonds

Issuing corporate bonds has been on the rise as investors are weary of the unstable income from stock markets in recent years.[32] Moreover, bonds have become a major instrument for corporations to raise capital rather than going to the bank for loans.

Companies that were at edge of bankruptcy have been issuing junk bonds which were bought by investors willing to take high risks of losses in case of bankruptcies, with sometimes high returns if the companies recovered.[33]

Slow down and rise of mergers and acquisitions (M&A)

Many investment banks strongly promoted multi-billion dollar M&A, which during the boom years inflated the stock market, and earned these investment banks huge profits. Some financial conglomerates expanded their investment banking operations during the 'high' times, at the expense of retail banking.

The benefits of M&As are not always obvious as many companies are left with massive debts that are difficult to repay in an economic downturn (e.g. Vivendi), while research shows that problems with merging corporate cultures and management systems is known to contribute to more than 60% merger failure rate. Recent corporate scandals at Ahold and Parmalat are, in some circles, considered a consequence of expanding too quickly through M&A. Recently, mergers and acquisitions have been on the rise again. In 2004, M&A were at the highest levels since 2000, and this trend is likely to continue in 2005.[34]

Prospectus with insufficient information

Investment banks offer a share prospectus to the public when shares are issued. Due to problems of insufficient information for potential investors to assess the price and value of the shares, more and more regulations have been legislated to guarantee that investors are warned against the potential risks of losses.

The role of banks in the collapse of Parmalat

Parmalat has been one of the world biggest dairy and food groups, with headquarters in Italy. Its rapid expansion worldwide was first financed by loans from Italian and international banks. Once the debt became too high, Italian and international banks arranged for issuing Parmalat bonds. In December 2003, Parmalat could not repay its financial obligations and it became slowly clear that it had been hiding losses and financial malpractices which are estimated at more than Euro 12 bn.

Beginning 2004, Citigroup, Bank of America, Deutsche Bank and Morgan Stanley were being accused of colluding with Parmalat executives in a scheme to hide the dairy group's massive debt in order to inflate the value of the company's securities and bonds underwritten by the banks.[35] The banks lay blame on the accountants' wrong financial reports, which inform banks for their decisions.[36] In total, some 20 investment banks were involved in 40 bond issues mostly through unregulated trusts in the Netherlands. They raised around $ 9 bn for Parmalat in 10 years from large and small investors.

An Italian executive of Bank of America is under investigation for having provided false documents that informed accountants about an account that did not exist, and having set up trusts that bought up the unsubscribed portions of private bond placements (to increase their value).[37] Parmalat had different trusts in off shore centres.

Italian banks were by law not allowed to sell bonds to individual investors if those bonds were issued only for institutional investors. However, the Italian banks were allowed to include those Parmalat bonds in their mutual funds, which were bought by individual investors.[38] When Parmalat collapsed, many Italians saw the value of their savings disappear.

Beginning 2004, some banks started to write off some of Parmalat's debt. Citigroup has set aside $ 242 million for credit and trading losses (after taxes) related to Parmalat in 2003. The total credits to Parmalat amounted to $ 653 million[39] but Citigroup had transferred the credit risks to others for about half the amount.

In 2005, investigations were still taking place. Italian prosecutors were planning to bring to trial Citigroup, Morgan Stanley, Deutsche Bank, UBS and the asset management arm of Banca Intesa, for misleading investors and regulators in providing false information on Parmalat’s financial position.[40]

→ Critical issues

World Bank bonds

Many investment banks underwrite World Bank bonds, which are bought by institutional investors including pension funds or funds managed by banks. The World Bank gets 80% of its funds from the selling of its bonds. Many civil society groups criticize World Bank’s “structural adjustment” programs that make World Bank loans to developing countries conditional to all kinds of questionable policies. A special network has been established to boycott the World Bank bonds issues on private capital markets[41].

Conflicts of interest between investment banking side and analyst side of banks

Banks that underwrite and deal in issuing securities are often the same banks that provide asset management services and advisory services to individuals or institutional investors who buy securities. It has become apparent, after years of rising stock markets, that some investment banks that assumed this dual role have been misleading investors with biased research in order to win clients (see box).[42]

Some CEOs have been offered better-priced securities of new issues if they bought additional banking services from the investment bank. Remember having issued new shares, underwriters occasionally become members of the board, which suggests closeness between the underwriters and the board of directors.
Investment banks, with inside knowledge of corporations, also reap the rewards of high stock prices as well as of dumping shares in due time before they loose their value, while the shareholding public is often left holding worthless paper.

Bursting of the dot-com bubble
The stock market decline over 2001-2002 set the stage for growing queries regarding how investment banks valued shares and how analysts from leading financial conglomerates advised them. It was the collapse of energy trading company Enron at the end of 2001 that set off alarm bells due to falsification of balance sheets and corporate cover-ups by one of the biggest auditors Andersen.
The scandal opened a floodgate of investigations into the overall standards and practices of the American financial services industry, which drew into the fold the big auditors and rating agencies. The world top investment banks such as Citigroup, Goldman Sachs, J.P. Morgan and Morgan Stanley were fined huge amounts of money, paid in 2003, together totalling more than $ 1.4 bn[43], for conflicts of interest and generally misleading investors in the US (see box). The banks had to restructure their operations and sever the analyst division from the investment bank division by erecting a "Chinese Wall" to ensure the two service divisions and employees never collude, and avoid further conflicts of interest and corporate crime. Also in Europe, new rules and ways of operation for analysts have been discussed.

Scandals at financial firms

Manipulating the stock market[44]
Citigroup, Goldman Sachs, J.P. Morgan, Morgan Stanley, Merrill Lynch and other top banks paid a fine of US$ 1.43 bn to the US Securities and Exchange Commission (SEC) in April 2003 for the following malpractices in their investment bank services:
Conflict of interests: banks' securities analysts under pressure from colleagues to give favourable advise to investors to buy shares from companies that were worth much less but that were clients of other units of the bank. The favourable advise was a means to get, from those companies, new highly profitable mandates for the investment bank unit to introduce new shares or give advice on mergers and acquisitions.
Flipping: allocating new shares to a limited number of investors, and then selling those scarce and highly demanded shares to the public, with high profits.

Laddering: the investment bank underwriting or introducing new shares requires brokers to buy the new shares shortly after their introduction in order to keep their value high. In return, the brokers are allocated extra new shares during the next introduction of shares. This kept the value of shares, especially high tech shares, artificially high.
As a result of manipulating the stock market, shareholder wealth was reduced by 45% between March 2000 and end of 2002, the equivalent of half of US GNP in 2000.[45]

Manipulating bond markets

In the beginning of 2005, it became known that Citigroup had been involved in a major financial scandal in August 2004. It had sold eurozone bonds worth of €12 bn, causing the prices to fall dramatically. Traders of the bank later bought some bonds back at € 4bn, and this operation is estimated to have made the bank a €17 million profit. Citigroup's actions prompted criminal investigations in Germany, and possibly inquiries in other countries follow. Citigroup has apologized for the impact the trades had on financial markets, but claimed the deal "did not violate any applicable rules or regulations".[46] In March 2005, German prosecutors claimed they could not legally establish a charge against Citigroup, since had to prove "an intent to deceive", and this had not been possible. Under a new German law on investor protection, which was recently introduced, it will probably become easier to punish comparable actions[47].

Undue privileges to rich clients ("spinning")

Investment banks that introduced new shares gave CEOs of their client companies preferred access to the new shares (from which the CEO could make personal gains) in return of new investment banking mandates. For instance, in January 2002 Credit Suisse First Boston[48] paid US$ 100 million to settle charges of this malpractice which has also been reported around the world at many other banks.

Bank malpractices at Bank of America (BoA), just an example[49]

Failure to provide documents to the supervisors: the SEC fined a $ 10 m penalty in March 2004 because the bank provided misinformation and delayed or failed to produce documents requested by the SEC for its investigation of illegal trading by the bank.
Alleged illegal trading in equities: the BoA was investigated beginning 2004 for allegedly taking advantage of knowing future equity price movements that would follow the publication of equity research briefings made by the bank's own staff. By trading itself in equities just before the publication of the research briefings, it could take advantage of its (insider) knowledge and make extra profits.
BoA is being investigated by the SEC for allowing a client, a hedge fund, rapid trading practices by lending its software to the client (see below: mutual fund scandals).
Parmalat: BoA was the house banker of the collapsed Parmalat and was involved in fraudulently hiding Parmalat's huge debt through false statements (see box about Parmalat scandal).

Developing countries pressured to sell too many bonds
Governments of many developing countries issue bonds to finance their deficits and development plans. They are advised and sometimes pressured by investment banks. After the 1997 financial crisis and after the IMF programme was completed in 2003 the banks began to pressure the Indonesian government to issue higher volumes of bonds, but the government hesitated for fear of destabilizing the recovery with more debt.[50]

Banks issue government bonds even in times of financial difficulty or crisis, which raises questions as to whether banks properly assess the repayment capacities of these governments. If the debts become too high and governments cannot repay the bonds in due time, bond investors are pressuring to have payment of their bonds prioritized. With no international agreement on orderly bond debt restructuring or cancellation, the economy and poor people of a country suffer most from the bond repayment obligations.

1.2.2. Private equity firms[51]

Like investment banks, private equity firms raise funds for companies from private investors. In contrast to the traditional operations of investment banks, they do not raise money on public stock markets, but through direct intermediation between companies and investors. Wealthy individuals or institutional investors like pension funds can invest their money in a private equity fund, which the management directs towards companies. Many large (investment) banks now have their private equity divisions. Their activities can be divided in two main categories:
- Buy-outs: the buying of (parts of) companies that they perceive to be undervalued by other investors, often because of troubles the company is facing, Private equity firms then buy those companies, reorganize them with the aim of selling them at a higher price.
- Venture capital: the finance of starting companies often in fast-growing sectors.

→ Trends & Critical Issues

Major growth
The private equity market has grown enormously since the 1990s. In 2001, global private equity investments market were at just below $ 100bn; in 2004, they had risen to just over $ 300 bn. European investments accounted for half of the investments, the US followed.[52]

What about accountability?
Through buy-outs, private equity firms buy firms of the stock market and get direct control over the management of companies. What happens in the company owned by

a private equity firm is much less public than publicly listed companies, for example due to the absence of disclosure requirements for privately owned firms. Some have expressed their concerns over the lack of accountability as a result. The private equity management can change the staff and personnel much easier than would be possible in a company listed at the stock market, since there are no shareholders they have to explain there policy to.[53]

1.2.3 Research, trading and brokerage

All kinds of firms are active in the intermediation of buyers and seller of securities. For example, analyst houses and various research departments from financial firms sell their services to investors who trade in securities or other assets including currencies, gold and commodities. Financial firms also sell various trading services including executing orders to trade and clearing securities trading.

Stock exchanges
It should be remembered that stock markets are also privately owned companies. Worldwide, there are hundreds of exchanges. In practice, a few of them dominate global markets, including the New York Stock exchange, the NASDAQ, the London Stock Exchange, Frankfurt's Deutsche Börse in, Euronext and Tokyo's Stock Exchange [54]. As a result of the globalisation of capital markets, and the increased competition from purely electronic trading, there have been incentives for stock markets to cooperate or merge with others. The Amsterdam, Paris and Brussels stock exchanges already merged into Euronext. In the beginning of 2005, there has been much speculation on what is going to happen with the London Stock exchange; Deutsche Börse and Euronext were contesting a takeover.

→ Critical Issues

Risks of stock exchange consolidation
The consolidation in the stock exchanges is said to bring more liquidity through larger markets, and so increase efficiency. However, some have expressed their concerns about the current mergers and takeovers. For example, some fear that through a takeover of the London Stock exchange, competition on the European continent between different stock exchanges will disappear, so that the prices for – especially smaller - securities traders could increase. There should thus be more supervision on stock exchanges at the European level, to guarantee a level playing field[55]. The British Financial Services Authority expressed its concerns over a possible takeover, since the London exchange could be moved to another jurisdiction. In that case, other regulations would apply, and this could jeopardize the current safeguards in place that protect both investors and companies listed on the exchange[56].

Brokerage

Brokerage houses and brokers within financial firms are intermediaries between a buyer and a seller and usually charge a commission. A broker who specializes in stocks, bonds, commodities, or options acts as an agent and must be registered with the exchange where the securities are traded (i.e. requires a license).

→ Trends and critical issues

Bias and market players

The research and analysis divisions of banks played an important role in overvaluing and promoting certain securities, thus artificially inflating the stock market, which has been dropping in a "slow crash" since end of 2001 (see box above).

Profit even in bad times

Banks that offer brokerage services even profit when the stock market falls due to the commissions they receive for selling orders from investors. During the Asian financial crisis, the profits from securities' trading divisions of Dutch banks actually increased.[57]

High salaries & bonuses

The exorbitant salaries and bonuses of those in the securities business have been increasingly criticized, but to date, have never been addressed through regulation. The difference between what traders and investors earn (those jobs which are securities related) and those workers providing basic public services, upon which a society is based, like teaching and nursing, reflects a serious, ethical imbalance.

Security lending

Securities are leased or lent to investors who then try to make a profit by trading the leased security within the time of the leasing. Often leasing is done with borrowed money, which can result in huge losses if the trading is not profitable. In the Netherlands, for example, at the peak of the stock markets, there were 700.000 lease contracts outstanding, totaling an amount of € 6,5 billion. Many investors faced enormous losses when the stock markets collapsed. Total losses have been estimated at almost € 3 billion. The duped investors claimed they had not been sufficiently informed about the risks informed. After a lawsuit, two financial firms involved in the lease sales, had to pay almost € 1 billion compensation to the investors.[58]

1.2.4 Derivatives services

Financial firms earn fees and are paid premiums for designing and trading in derivatives. Derivatives are speculative contracts, whose value is derived from the future trade in an underlying commodity, security or other financial asset. Examples of derivatives are futures, options and swaps.

Derivatives bet against what a contract will be valued in the future. It offers for instance protection against changes in commodity prices. Depending on the derivative, traders and buyers take into account the performance of the asset, interest rates, currency rates and various domestic and foreign indexes.
Because derivatives are both physically and temporally several stages removed from the actual underlying commodities or financial instruments, to the outsider, they can be very complicated in nature. Research found that institutional investors have an insufficient understanding of the way companies use financial derivatives.[59] Banks offer completely custom made products by which the client is free to determine the derivative, using variations in underlying currency, time to maturity, and payout structure (exotic options).

Options
On option is the right, but not the obligation, to buy (call option) or sell (put option) a specific amount of given stock, commodity, currency, index or debt at a specific price (the strike price) during a specific period of time. For stock options the amount is usually 100 shares. Each option has a buyer (called a holder) and a seller (known as the writer).
The buyer of such a right has to pay a premium to the issuer of the derivative (i.e. the bank) and hopes the prices of the underlying commodity or financial asset to change so that he can recover the premium cost. The buyer may choose whether or not to exercise the option by the set date.

In practice, most call and put options are rarely exercised and investors sell or buy options before expiration, speculating on the rise and fall of premium prices. For instance, when a put option is exercised (e.g. at $50 a share) and the price of the underlying asset is much lower in the market (e.g. $30 a share) at that time, the one with the right to sell can sell and than re-buy the underlying asset at a lower price, making a profit (e.g. $20). Often, option traders lose many premiums on unsuccessful trades before they make a very profitable trade.

Futures
A future is a contract to buy or sell a specific amount of commodity, a currency, bond or stock at a particular price on a stipulated future date. A future contract obligates the buyer to purchase or the seller to sell, unless the contract is sold to another before settlement date, which happens if a trader speculates to make a profit or wants to avoid a loss.

Currency swap
Simple currency swaps (swaps can be done with varying degrees of complexity) involve two parties exchanging specific amounts of different currencies, as well as the interest payments

on the initial cash. Often one party pays a fixed interest rate while the other pays a floating exchange rate. At the maturity of the deal the principal amounts are paid back.
It allows the party, which is to receive currency in the future to calculate exactly what to receive and avoiding exchange rate fluctuations. Swaps are also used to tap into new capital markets, sell currencies on the international market and borrow funds.

"Over the counter" (OTC) trading in derivatives
Over the counter derivatives trading is an exchange directly between the buyer and seller. It is not listed on the exchange and is not traded through third parties.

→ Critical issues

Volatile business
Unexpected movements in the underlying value can negatively affect the value of the derivatives. Derivatives became notorious in 1990s when a number of mutual funds, municipalities, corporations and leading banks suffered large losses because unexpected changes in interest rates affected the value of derivatives. The trade in derivatives can have enormously destabilising effects on local economies, because the use of derivatives allows speculators to move enormous funds without actually owning them. In 1997, speculators used derivatives to launch an attack on the Hong Kong dollar peg to the US dollar. They did this by buying up large amounts of both foreign exchange derivatives and equity derivatives with the aim of driving up interest rates and driving down share prices, and ultimately breaking the peg, making them enormous profits. In the end, the peg didn't break due to Hong Kong authorities' intervention in the equity and foreign exchange markets[60].

Lack of regulation
Much of the trade in derivatives takes place in over the counter (OTC) markets, in which there are often no transparency requirements in place. Governments and market participants have thus no way of finding out manipulation practices or other malpractices. In addition, derivatives can be used to evade tax law and accountancy standards by manipulating the exact flows of payments in reporting earnings[61].

1.2.5 Hedging

Hedging is investing in a particular way in order to reduce the risk of adverse price movements in a security or asset. Hedging has been praised for helping companies avoid unexpected financial shocks.

Hedge funds

Hedge funds are funds operated by an investment company, which use very speculative strategies to obtain the highest possible return on their investments. They invest in all kinds of very sophisticated financial assets, and then sell parts of this portfolio to investors by issuing shares, much like any other company sells shares to the public. In practice, hedge funds are thus only accessible for wealthy individuals and institutional investors, in contrast to so called mutual funds who are accessible to regular households as well.
There is no formal definition of hedge funds, and between the thousands of hedge funds that exist today, there are important differences. However, some general characteristics of hedge funds can be identified[62]:

- Hedge funds get their name from the first hedge funds' strategy to hold some securities for a long-term period, and sell other securities after a very short time. This combination is supposed to "hedge" the fund from risks associated with changes in market prices.
- Hedge funds use *sophisticated strategies* to increase the returns on their investments. They invest in all kinds of financial assets like bonds, shares and foreign currencies. In addition, they make extensive use of derivatives, financial instruments whose value is based on the performance of other (financial) assets (e.g. futures and options). Many hedge funds make these investments with borrowed money. By using derivatives and borrowed money, hedge funds are highly "leveraged". This means that they finance their operations more by debt than by money they actually own.
- They apply extremely *high minimum investment requirements*. Most hedge funds set extremely high minimum investment amounts, ranging from $250,000 to over $1 million. In 2003 the mean minimum investment requirements of global hedge funds were $630,414[63].
- Customers of hedge funds pay the management a fee based on the assets they have put into the fund (around 1-2%). In addition, they pay the management a fee based on the performance of the fund (around 20%). Fund managers normally also make significant investments in the fund. Often, hedge funds also invest in other hedge funds to increase potential returns ("fund of hedge funds").

→ Trends and Critical issues

Industry has grown enormously

Hedge funds have grown enormously since their rise in the 1950s. Increasingly, not only wealthy individuals but also institutional investors like pension funds have invested in hedge funds or less speculative hedge instruments offered by financial firms in search of better returns than those from traditional mutual funds. In 1994, total US hedge funds assets were US $ 99 billion, ten years later this was US $ 795 billion. [64]

Risky strategies
Hedge often take large risks on speculative strategies, including in markets with sharply declining prices. Because they move billions of dollars in and out of markets quickly, they can win enormous amounts, but of course they might also *loose* them. If they loose money, they often loose the money of banks they borrow from. The most notorious example of this was the 1998 failure of the US based 'Long Term Capital Management' (LTCM) fund. To avoid a systemic financial crisis, the US central bank intervened, injected billions of dollars in the fund and took over its management.

Hardly any regulation [65]
Hedge funds are exempt from many of the rules and regulations governing regular investment funds. They are often managed in the US or another European country, but 'domiciled' in offshore centres, i.e. small countries and islands where there are no regulations in place, and no taxes to be paid. Important offshore centres for hedge funds are the Bermuda, Caribbean and the Canal Island Guernsey. Hedge funds are in practice thus not required to publish data on their trading activities and their creditworthiness like any other financial institution.
After the notorious LTCM collapse, international bodies like the IMF, the Basle Committee and the Financial Stability Forum, increasingly started to discuss possible regulations. More recently, the SEC (the US Securities and Exchange Committee) has been discussing more concrete regulation proposals.

No sustainability indicators
Hedge funds do not pay any attention whatsoever to the social and environmental impacts of their investments.

Hedge funds, some controversies

Hedge funds are important speculators on financial markets. Speculation means that an investor trying to make profits by gambling on changes in the price of a security. When he buys an asset, a speculator thus doesn't intent to keep it, he just buys it in order to sell it at a higher price in the near future. Examples include currency speculation: an investor (or fund) expects the value of a certain currency (say the Euro) to increase in a month time, and therefore buys huge amounts of euros. When indeed that price has risen, he can sell the euros at a higher price.

Because of the enormous amount of funds they manage, hedge funds often also aim to *influence* prices by using their market power. Hedge funds can coordinate their actions, and persuade other market actors to follow them.
Market manipulation is an illegal activity hedge funds have sometimes found guilty of. It means that they try to *influence* the prices by spreading misleading information that will probably affect other investor's demand for a security. This change in price can lead to enormous profits for the funds.

Adverse impact on local economies

Hedge fund's impact on local economies can be enormous. For example, if hedge fund managers expect a currency to depreciate, they can start to sell their holdings of the currency in question. Often, other market participants follow the funds with high reputation, and this further drives down the prices of the currencies. Central banks are often not able to counteract these speculative forces. Because their gigantic size, and their influence on other market actors, hedge funds can make or break currencies. A notorious example of this was the attack of the hedge fund manager George Soros on the English pound in 1992. By speculating on a depreciation of the currency, the fund forced the British currency out of the European system of fixed exchange rates. Other examples include the speculative attack on the Thai Baht and other South Asian currencies 1997, which led to dramatic aggravation of the Asian crisis.

Frauds at hedge funds

Hedge funds have sometimes been blamed of manipulating market prices, which disadvantages smaller investors. For example, they make other investors believe a company is doing very well, and this will make the price rise. After this, hedge funds sell their holdings of these securities and make a huge profit. Retail investors are duped by this, since they only see the value of their holdings plunge. There also have been cases of funds misleading their own investors.

1.2.6 Asset management

Asset Management (also called money management, investment management) is simply the process of managing all kinds of investments, budgeting, financing and taxes. An important part of asset management takes lace at pension funds, mutual funds and insurance companies, as described below.

Financial firms earn fees by providing services (investment advice, investing funds, derivatives) to corporations, wealthy individuals and institutional investors regarding the management of their capital and other assets. Their job is also to insure their clients get the highest rate of return.

1.2.7 Pension funds

Pension provision is organised in different ways. Sometimes retirement benefits are paid from contributions of current employees (so-called pay-as-you-go financing).
In other systems, mainly in the US, and European countries like the UK and the Netherlands, funded schemes are more common, in which contributions are accumulated in a fund until the person retires. A pension fund can be set up by a company, governmental institution or labour union. The management first collects pension benefits from workers and their employers, and invest this money in all kind of assets. Because the funds have collected money of up to millions of individuals, they are major players on financial markets.

The fund managers make actuarial assumptions about how much they will be required to pay out to pensioners and then try to ensure that the rate of return on their portfolio investments equals or exceeds that anticipated pay-out need. Pension funds or pension insurance companies often delegate the actual investments to financial firms such as investment houses or banks

→ Trends & Critical issues

Dominant players on the market
Pension funds buy all kind of securities on the international markets. Their purchase of shares has helped create a bubble of high share prices partially because the pension funds have hundreds of billions of dollars to invest. Once the stock market starts to fall, the pension funds try to reorganize their portfolios, which contributes to the rapid decrease in share values (since they move so much money at once).

Losses due to stock market decline
In countries such as the UK or the Netherlands, regulators do not restrict pension funds from investing heavily in the equity market (unlike in Germany). This means that large portions of Dutch and British pensions are invested in listed, both domestic

and foreign, companies. With the fall of stock markets, pension funds have lost billions of dollars and Euros in the last few years and now many cannot guarantee that they will pay out 100% of the promised pensions to their contributors in the future. Pension fund supervisory authorities have had to intervene to force pension funds to come up with strategies to ensure all future payment obligations. Consequently, pension funds have been switching to the bond market, which is a more secure source of income for their long-term obligations.[66] Additional income for pension funds generated by increasing the contributions made both by employees and employers is decreasing workers income and companies profits. Some pension funds however are restructuring and merging while another strategy has been to turn to hedge funds and corporate bonds, which could bring higher yields but which have also a high risk of failure.[67]

Little attention to ethical indicators
Pension funds have traditionally cared little about investing in securities of companies that are considered ethical or environmental, i.e. have a positive effect on the environment or that respect labour rights and human rights (see chapter 4). In the Netherlands, for example, only 1% of pension funds' money is estimated to be directed to sustainable investments.[68]

1.2.8 Mutual funds

Mutual funds are funds operated by a bank or an investment company that invest their money in a group of assets, including shares in various companies, bonds, options, futures, currencies, or money market securities in accordance to a stated set of objectives.
They then sell parts of this portfolio to investors- households but also institutional investors - by issuing shares much like any other company sells shares to the public. A mutual fund can be more attractive to investors than individually composing a portfolio of assets. This is the case since their money is managed by professional asset managers, and their portfolio is very diversified to reduce risks. A management fee is charged for these services. All shareholders share equally in the gains and losses generated by the fund.

→ Trends

Booming business…
Banks and investment funds have created a variety of mutual funds that invest in specific countries or sectors. The increasing prices of the stock market had attracted a lot of individual and institutional investors to buy units of mutual funds, providing banks and mutual funds with high income from the management fees.

Losses after the stock market bubble

Lower stock prices in 2002-2003 decreased the value of mutual funds substantially. In some cases investors have lost up to 50% of the value of their units. Some mutual funds and banks providing those services lost a significant source of income, which resulted in some mutual funds closing down completely. In 2003-2004 the mutual fund industry started to grow again. As of December 2003, the mutual fund business in the US was valued at US$ 7,000 bn and 8,000 bn beginning April 2004.[69]

Scandals at mutual funds[70]

The following practices are calculated to have cost the individual US investors (95% of the population) $ 10 bn:

Late trading and market timing: transactions after 16 hours, the official closure of trading mutual fund shares, which allows advantages to be taken by price differences between old share prices and new prices of the next day, or between different international stock exchanges in different time zones.

Rapid trading and market timing: mutual funds have allowed big investors, mainly hedge funds, to rapidly trade of shares of international mutual funds in a way that takes advantage of discrepancies in asset values across time zones. This siphons off profits at the expense of long-term investors. Although these practices are not necessarily illegal, 22 US mutual funds have been investigated by the US Securities and Exchange Commission in 2003 and have changed staff. The highest fine had to be paid by Alliance Capital, $ 250 million. Bank of America is also under investigation.[71] Individual fund managers have also been sentenced. Just one fund manager was able to make a profit of $ 600,000.

Improper sales practices: Morgan Stanley had to pay a $ 2m fine for improper incentives (such as exotic travel trips and tickets for Rolling Stone concerts) to its sales staff to push their own mutual funds to clients over other mutual fund products (non proprietary funds).

Too high fees: the costs for managing mutual funds were untransparent and mutual fund charged clients too much for it.

As a result of the malpractices in the US, the European securities supervisor (CESR) conducted a survey on the situation at European mutual funds. They didn't find major malpractices, however, the report concluded there were "issues of regulatory concern". For example, fund managers said they were sometimes approached by investors to allow market timing and late trading, and in the absence of clear procedures and responsibilities, the existence of those practices could not be excluded[72].

→ Critical issues

Destabilising impact on local economies

Because of their size, like hedge funds, mutual funds' investment decisions have an enormous impact on local economies. In the mid 1990s, mutual funds bought heavily into securities of emerging markets. This dramatically affected the upturns and downfalls of those economies. It is the quest for short-term gain or quick profit which motivates funds and traders to buy and sell quickly, regardless of the impact on the societies in countries in which they invest and the long-term benefits which are lost. For example, the appetite for investments in emerging market countries (EMCs), was dramatically curtailed by the Asian Crisis of 1997, the Russian default and subsequent near financial meltdown of 1998, the resulting problems in Brazil and elsewhere, and the collapse of the Argentine economy (2001-2003). When mutual funds and traders in securities quickly withdrew securities from countries in financial crisis, their actions further decreased the value of all securities. This was the case in South East Asia, and this helped exacerbating the overall financial crisis.

The lack of transparency in pricing (see box)

The lack of transparency and clarity between the cost of to manage the fund and the management fee charged to clients has lead to various pricing scandals. Fund managers are also increasingly under investigation for not abiding by trading rules including trading after the cut-off time (late trading). These scandals have lead to lawsuits and indictments because of overcharging, which have made some mutual funds more accountable to investors.

Growth of 'ethical investments'

So-called green funds and ethical funds are popping up all over the place. Mainstream mutual funds are also increasingly offering these ethical investment options. This growth highlights an increased attention of investors for sustainable development. Growth of these investments can also be facilitated by government regulations. For example,
in the Netherlands,[73] investors are exempt from interest and dividend income tax coming from green funds that fulfil environmental criteria laid down by the government. The tax exemption is intended to compensate the lower interest rates and dividends of those green shares, and the system seems to work fairly well. In fact, Dutch green funds, worth around a billion Euros, have been so popular that there have not been enough green projects to finance. Investors have to queue-up before joining the green fund, which indicates that citizens do invest in green funds if they have the choice, and that a tax incentive can create a strong demand for such funds.

But … lack of clear indicators

Marketing ethical investments is a 'growing trend' as the general public learns more about the connections between the stock market, pension funds and other investments. However, clear, widely adopted standards or green funds and ethical funds do not exist. Therefore green fund managers, and governments in some cases, are setting their own terms of reference. Most mutual funds managers continue to focus only on the bottom line, or the company's financial and economic performance rather than its contribution to environmental sustainability or commitment to human rights. Civil society groups thus continue to be critical of many 'so called' ethical or green investment assessments.. (For further analysis, see chapter 4)

1.2.9 Trust services

Banks can provide trustee services and services for the formation and management of companies that are either special purpose companies, holding, trading, finance or royalty companies belonging to an international group, or privately owned offshore companies. Normally the shareholders, management and statutory seats of such companies are spread over, at least, two countries.

Trustee services include services necessary to fulfil all legal and other requirements to keep a company in good standing however, most of these companies, which are provided by banks, are created to evade tax. They are mostly "post box companies" in countries with relaxed tax regimes and little investigative supervision or regulation.

→ Critical issues

Trustee services are invisible but have major impacts

Bechtel:
Bechtel formed a consortium that was officially based in the Netherlands. In reality the consortium was just a "post box company" managed by ING Group's Trust services in the Netherlands. This consortium bought the privatized water services of Cochabamba in Bolivia. Following the intense civil unrest and protests due to the rising water prices privatization was reversed. The consortium tried to win compensation through the investment protection provisions of the bilateral investment agreement between Bolivia and the Netherlands.

Parmalat:
Trustee services are often seen as purely administrative support for a 'staff-less' company (i.e. postal address only). However in the case of the scandalous Parmalat (Italian milk and food conglomerate) the trust units were both in off shore centres and in the Netherlands. Those companies in the Netherlands were responsible for issuing billions of Euros in bonds, which, now we know, will not be repaid. The Parmalat trustee service responsibilities proved difficult to clarify.

1.3 Rating services

A rating agency is a company that is specialized in evaluating the capacity to repay debt ("creditworthiness") of companies and governments. Most often they give ratings to debt instruments like corporate and sovereign bonds, but it can also concern commercial loans. The rating is expressed by a code, ranging from AAA as the highest creditworthiness, and C or D as the lowest. Rating agencies earn their money by charging a fee to the companies and governments they rate, and by selling their findings to the public. Currently, there are over a hundred credit rating agencies operating worldwide. However, in practice, three of them dominate the market: Standard's & Poor, Moody's and Fitch Ratings. All three of them are based in the US.

Currently, investors often don't even accept bonds from companies and governmental institutions that don't have a rating from one or more of the major rating agencies. Companies and governments who wish to borrow on capital markets thus are completely dependent on private firms who will rate their creditworthiness. Given this dependence on having a rating, borrowers are willing to pay substantive amounts of money for this. For borrowers, the fees for obtaining a rating can be over a million US dollars.

→ Trends and Critical issues

Increasing power

The role of rating agencies has increased especially since corporate and sovereign bonds got more common. With borrowers heavy reliance on their ratings, many companies and governments are very concerned about the judgements of ratings agencies. A change in ratings can make or break investors' confidence, and will enormously raise borrowing costs. Some institutions' financial portfolio is directly dependant on ratings of the big rating firms. For example, pension funds are often only allowed to hold bonds rated at investment grade, which is not below Baa/BBB (see box). A lowering in rating can thus have an enormous effect if institutions like pension funds have to sell those assets. In the future, the power of rating agencies will only increase when a new international regulatory framework for banks will be in place ("Basel II"). According to the Basel II framework, banks can use ratings of private rating firms' or public institutions like ECA's to determine how risky loans will be, and thus how much interest borrowers will have to pay. (see chapter 5)

Conflict of interests

Private rating agencies get paid to give a company or state a rating. Rating agencies stress that it is in their own interest to remain completely independent, since their sound reputation is key in attracting business. However, in the absence of many competitors, conflicts of interests may still arise.

Failure to adequately rate borrowers
Rating agencies have often proved not to be able to anticipate decreasing or improving creditworthiness of borrowers. A major example was the collapse of companies like Enron and Parmalat. According to rating agencies just prior to those companies' collapse, bonds of those companies didn't contain much risk of default. Only after it became public in how bad a financial state the firms were, did the agencies lower their rating. For example, Standard & Poor, one of the major rating agencies, continued to give Parmalat a high rating until December 2003, despite the fact that the 10 billion Euro fraud was becoming public knowledge. The same happened during the Asian crisis. Prior to the crisis, ratings were at reasonable levels. When the crisis erupted, rating agencies dramatically lowered the ratings of the countries concerned, which according to many further aggravated the crisis because more investors immediately pulled out of the region. In case of South East Asia, the financial crisis could possibly have been mitigated if rating agencies warned creditors and the foreign banks of the approaching lack of capacity to make repayments in foreign currencies.

No sustainability indicators
To date, rating agencies do not include any information about a company's environmental and social behaviour in their rating assessments. There exist specific rating agencies that aim to take these social and environmental issues into account, and give a company a rating on this basis (such as SiRi company, see chapter 4). However, they rate all kinds of companies on sustainability grounds, but do not combine this with an assessment of their capacity to repay debts. Thus, they will not have a substantive impact on creditors looking for information on creditworthiness.

1.4 Insurance services

Insurance is a promise of compensation for specific potential future, unexpected losses in exchange for a periodic payment.

Agreeing to the terms of an insurance policy creates a contract between the insured and the insurer. In exchange for payments from the insured (called premiums), the insurer agrees to pay the policyholder a sum of money upon the occurrence of a specific event. In most cases, the policyholder pays part of the loss (called the deductible), and the insurer pays the rest. Examples include car insurance, health insurance, disability insurance, life insurance, and business insurance.

Premiums are determined on the probability of risk as well as competition with other insurers. Generally, insurance spreads out the risk (of potential claims from individuals and companies) to a larger group whose sums are better able to pay for losses.

Insurance policies are often sold to individuals and companies through insurance agents who are licensed representatives of one or more insurance company, or through independent insurance brokers who search for the lowest cost for the client by comparing competing insurance companies.
Forms of insurance to individuals include:

- Personal property insurance: Such as automobiles, homes; the insurance policy specifies which property, accidents and casualty perils, theft and other damages are covered.
- Life insurance: Guarantees payment to the beneficiaries when the insured person dies. The insurance policy spells out whose life is insured and which beneficiaries will receive the insurance proceeds.
- Health insurance: The policy specifies which medical treatments and drugs are reimbursed.

Insurance services to corporations protects against:

- Liability: e.g. of board members, environmental damage
- Property damage to, and loss of e.g. computers, transported goods
- Losses that endanger the continuity of the company's activities: e.g. of computer data
- Fraud and other financial problems
- Extra payments for employees: e.g. for long term illness, accidents, absenteeism, pensions, unfair dismissal, sexual harassment, discrimination
- Transport
- Blackmailing

Reinsurance is the sharing of insurance policies among multiple insurers and selling securities on the market. Reinsurance companies (e.g. the German Munich-Re) are specialized in insuring the insurance industry.

Export credit insurance
A special form of insurance is the insurance of export payments. All industrialized countries have one or more export credit agencies (ECA) that will pay for potentially missed export earnings. In recent years, many of those agencies have been privatized.
If a company is exporting to another country, and will receive the money only after the export has been finalized, it can request an export credit at a commercial bank. If the bank is not sure whether it will receive the payments for the goods exported to the country in question (e.g. when it concerns poor countries), the bank can get an insurance against this risk.

→ Trends & Critical issues

Disappearing reserves

The European insurance sectors are facing the same problems as the pension funds, namely lack of funds. European insurance companies invested heavily in the equities and derivatives markets but with the economic downturn over the last few years, insurance companies lost a significant portion of their assets, which has affected their ability to pay out for claims (see also chapter 2).

The situation is so critical that governments concerned about the solvency of insurance companies (one Germany insurer already went bankrupt) are increasing supervision and tightening regulatory systems, which is a sign that even big European private insurance companies take too many risks and need more regulation and supervision.

Insurance companies are still vulnerable especially if the stock market and the economy continue to weaken.[74]

Action on climate change

Increased claims for environmental damages due to erratic weather, has meant that some insurance companies have begun specializing in climate change related damages. They have an important analysis and databank capacity on climate change phenomena. Some (e.g. re-insurer Munich-Re) educate others in the financial industry about the importance of quelling climate change.

Targeting the rich in developing countries

Western insurance companies enter developing countries and sell private health insurance products to those who can afford the policies, in many cases leaving the government and domestic private insurance companies burdened with the poor patients. The question remains if the presence of Western insurers in poor countries help increase general access to health insurance?[75]

Equity funding

Equity funding is an investment, which combines a life insurance policy with shares in a mutual fund. The fund shares are used as collateral for a loan to pay the insurance premium, giving the investor the advantages of insurance protection and investment appreciation potential. These advantages disappear if the value of the mutual fund does not increase.

Scandals in the insurance industry

In 2004, investigations of the New York attorney-general Eliot Spitzer revealed some major scandals at US insurance companies and brokers. These brokers are the intermediaries between buyers and sellers of insurance products and make money by charging both parties a commission. It became apparent many US insurance brokers and insurance companies were collectively betraying customers by charging too high premiums. Insurance firms offered brokers so-called “contingency-commissions” – commissions that are only paid if the broker delivers a certain amount of clients to the company. This has lead to many manipulations, as brokers have eagerly accepted these offers, and have sometimes even threatened to destroy an insurance company if they didn’t get extra commissions.

Among the companies found guilty was Marsh & McLennan, the biggest insurance broker worldwide. In 2003, income out of contingent commissions accounted for $ 845 million of the groups turnover. Since the end of 2004, the company has had to change its business model and doesn’t accept the contingency commissions anymore[76].

The world’s biggest insurance company, American International Group (AIG), has also been under heavy investigation. It became apparent that there had been many irregularities in the company’s financial reporting. The chief executor, Maurice Greenberg, already had to resign. In addition to these reporting practices, AIG has also been accused of market manipulation. Just prior to AIG’s takeover of American General in 2001, Greenberg is said to have pressured traders of the New York Stock Exchange to buy AIG shares in order to boost the stock price.[77]

Private risks turned into developing countries’ debt[78]

When a developing country importer fails to pay for its imports, the exporting firm or bank who provided an export credit, will be compensated by the ECA concerned, minus a small percentage of own risk. In case the ECA also fails to get this money back, they will simply add this amount to the developing countries’ official foreign debt. In this way, private risks are being transferred to developing countries’ and of course, eventually its taxpayers.

The share of ECA debt of total official debt is enormous; in 2002 it is estimated to account for 34 % of total external official debt to aid receiving countries ($ 368,503 million of $ 1,064,718 million). Sometimes, ECA debts are even based on controversial exports such as weaponry. In this case, industrial countries’ exports of weapons to developing countries have to be paid for by the importing country (and eventually its taxpayers, who have often been the victim of the use of these weapons).

Many civil groups have been pressing for reforms of ECA’s, and for debt relief of the ECA debt. Aid organizations point out that it is crucial that this debt relief that Western governments do not deduct the ECA debt relief from the official development aid (ODA) budget, as is often the case in many industrialized countries. They state that cancellation of debt that arose from private sector risk should never reduce the budget for true development aid.

1.5 Conclusions from the perspective of poverty eradication and sustainable development

1. Financial services focus on big companies and the rich

Most "products" of the financial services' firms service large companies and investors, not individuals and governments. A key strategy at banks is to target their services at the most profitable clients or institutional investors and companies, leaving the less wealthy at a severe disadvantage. At the same time, they create huge debts by companies and individuals.

In some countries, 'market segmentation' has resulted in the closing of branches and the exclusion of poor clients through a reduction of basic services and the compulsory use of computerized transaction services. Small and medium enterprises, which are vital to the economy, are treated less favourably than those big corporations that are offered better interest rates.

That banks are driven by profit and increasing pressure from international competition, means that poorer clients could require more legal protection against limited and poor quality service. Market forces will not 'naturally' help poor clients when they are at such a structural disadvantage.

2. Governments are clients of the financial industry

The financial industry is heavily involved in government debt through loans, syndicated project lending, debt derivates, trading in debt and underwriting and trading in government bonds.

The funds for conditional lending to developing countries by the World Bank come largely from bonds underwritten and traded by investment banks. Financial firms often jointly fund projects supported by the World Bank. This dependence of financing by private financial firms might challenge the regulatory independence of governments, especially in developing countries.

3. Manipulating financial markets

The financial industry played a significant role in creating the stock market bubble, which slowly crashed from 2001 to 2003. The industry was instrumental in increasing stock value through services such as:

- investment banking (new shares on the stock market),
- analysis, research and advisory services for those investing in the stock market, including pension funds,
- trading and brokerage in securities, including derivatives and share lending,
- mutual funds for both small and large investors, making investment in equities more accessible,
- selling hybrid financial products in which, for instance, loans and insurance were combined with investments in equities.

In addition, financial firms were manipulating share prices by releasing wrong advise to benefit companies that were or could become their clients. The seriousness of the fraud is evident from the US$ 1.4 bn fine by the Securities and Exchange Commission to large US banks. Some mutual funds also over charged clients and traded illegally.
In bond markets, market manipulation is also not unusual, as the Citigroup scandal highlights (see box 1.2.1 ‘scandals at financial firms’).
The heaviest burden of the fall-out from the artificially high value of the financial market has been on individual investors (including pensioners), pension funds, insurance companies, and companies from the developing countries.

4. The efficiency of the financial industry far from accomplished

Some major failures of the financial industry disclosed over the last decade are:

- Concentration at European banks: A recent study showed that European banks are not very well diversifying their portfolio to reduce risks. They often have a small number of big clients they concentrate their activities on, and in case of a default, this could easily endanger a bank’s financial position[79].
- Some **pension funds** invested heavily in the stock market and with the crash, cannot now guarantee fully delivering peoples’ pensions. Should pensions in developing countries be privatized and subject purely to unstable market forces?
- Financial reserves in the **European insurance industry** have been reduced to dangerously low levels due to over-investment in the stock market and far-reaching crises including, environmental disasters, terrorist attacks and corporate scandals.
- **Rating agencies** often failed to provide warnings on financial problems at governments and companies. Artificially inflated ratings encouraged the financial industry to continue investment in governments and companies with dubious financial state of affairs.
- When **mutual funds and traders** in securities quickly withdrew securities from countries in financial crisis, as was the case in South East Asia, their actions further decreased the value of all securities thus exacerbating the overall financial crisis. It is the quest for short-term gain or quick profit which motivates funds and traders to buy and sell quickly, regardless of the impact on the societies in countries in which they invest and the long-term benefits which are lost.
- **Investment banks** increasingly underwrite bonds from loss-making companies and many small investors are loosing their money. The investigation of the role of large banks in the hiding of Parmalat's debt of more than Euro 12 bn, is a clear example.

5. Unknown effects of little known financial services

The financial industry is trading in and designing new and more complex financial products, which are less and less transparent and difficult to monitor. Increasingly, the risks involved with these speculative services are becoming more unpredictable for both the consumer and the authorities.

For example, the increased popularity of credit derivatives, which transfer banks' lending risks to speculators and institutional investors, including insurance companies, is a trend closely monitored by the authorities. Passing off or selling risk, particularly with credit derivatives, is potentially the basis for financial crisis, which should be a concern for civil society and the authorities.

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[1] Except otherwise indicated, the explanation of the financial terminology in this chapter is based on, or taken from: J. Downes, J. Elliot Goodman, Dictionary of finance and investment terms, (Barron's Financial Guides), Sixth Edition, 2003; R. Lister, L. van der Deijl, A handbook of commercial and economic terms, English-Dutch, (Intertaal), 2001.

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Chapter 2
Insights in the financial industry: trends and strategies

Introduction

The financial services described in the first chapter are provided by the private financial industry. Most of these financial firms do not provide the whole range of financial services.

Although all banks and insurance companies have started to operate at national levels, some of them are now important players at the international level. Some financial conglomerates are established in many different countries, including developing countries. Others are the main providers, worldwide, of certain financial services and dominate the international market.

This chapter identifies the major international financial corporations, explains the big players' strategies and analyses trends in the international financial services markets.
The analysis intends to provide an insight into the problems these international players and international financial services markets cause to civil societies and economies, particularly in developing countries.

2.1 Performance of the financial services industry

The financial industry has changed dramatically in the past ten years. Important shake-ups have affected its performance.

Bigger, faster, more

- Bigger financial corporations were formed by mergers and acquisitions or takeovers (either friendly or hostile).
- Faster transactions were created via new technologies and the internet.
- More diverse financial products were sold by one single financial conglomerate, such as insurance and securities.

The changing functioning of financial firms was given a boost with the ratification of the Gramm-Leach-Billey Act (1999) in the US. The act allowed US banks to expand beyond their traditional roles of collecting deposits and writing loans[1] and become "allfinanz" firms as was already possible in European and Asian countries. The liberalisation of financial services, which allows foreign financial firms to provide services through ownership of domestic banks or through trans-border transactions, has also contributed to the changes (see chapter 6).

Downfall … and upturn in profits

In 2001 and 2002, banks suffered heavy losses from the economic slowdown. Many financial products, including mortgages and trading in securities, were linked to the value of the stock market. The economic downturn forced banks to write off billions of dollars in exposure due to the many real estate and commercial loans that went sour. Bankruptcies at corporate giants like Enron and WorldCom have also burned large banks such as J.P. Morgan Chase.

As people put more of their cash into mutual funds and securities rather than deposit accounts, all banks became increasingly dependent on fee-based services such as securities trading. In 2001, the top 1000 banks in the world recorded a fall in profits of 30%. However, profits began to recover in 2002 due to the strength of the US banks. Their growth in 2002 was due to increasing commercial and retail banking services, and underwriting or trading in governmental and corporate bonds[2] at a time that corporate lending, investment banking for big business and trading in securities had dropped.

The total pre-tax profit of the top 1000 banks in 2002 was US$ 252.4 bn, which was more than the GDP of countries like Belgium, Sweden and Austria, and most developing countries, in the same year. Peak profits had been recorded in 2000 when total aggregated return on capital reached $ 317 bn.[3] The 210 US banks accounted for 49% of the profits of the top 1000 banks in the world. In contrast, the 83 German banks only contributed to 1.1% of the profits of the top 1000 banks. The top 300 European banks had pre-tax profits $120.2 bn by July 2003.[4]

Top banks recorded high profits again in 2003 and the first quarter of 2004, amongst others from tight expense control, strong retail and commercial banking, diversification of services and renewed activities in securities.[5]

Serious financial problems at European insurance companies

The insurance industry was in very bad shape by 2002, especially in Europe where billions of Euros were lost (see insurance companies at the end of the table below about World ranking of the largest financial corporations). It led to a German life insurance company filing for bankruptcy (Mannheimer Leben) in 2003, which had not happened for 50 years.[6]

European insurance companies suffered heavy losses from 2001 onwards for a combination of reasons, namely:

- The steep fall in the value of equities in which insurers had invested heavily (unlike their US counterparts) as capital reserve.

- The terrorist attacks starting on 11th September 2001 which led to heavy insurance claims.
- The impact of SARS.

Because of regulatory requirements, the insurers had to sell off their holdings but the uncertainty around the amounts to be sold and the timing of the sales precipitated price declines, further destabilising the stock market as a whole. The result was trading equities out of the need for capital, which is a dangerous phenomenon, one that also led to stock market drops in 1987 and 1998.[7]

The serious need for capital by insurance companies was an abrupt change from the past situation where the insurance industry was a provider of capital.

In order to alleviate shrinking capital reserves, and raise capital, the insurance industry responded in a variety of ways:

- **Raising premiums**: increasing their prices for insurance coverage.
- **Restricting insurance cover**: increasingly, more and more scenarios and/or events are not covered by insurance contracts leaving people and companies with little or no coverage for some risks. The result is that more often individuals and companies have to pay themselves the cost of certain events. Clients have found that risks that were once covered by their policy, now are not, and are becoming dissatisfied.
- **Issuing stocks and bonds**: insurance companies are raising cash by issuing equities and bonds. In 2003 insurance bonds were worth more than $ 9.6 bn,[8] but given the current unstable state of the whole industry, it is unlikely more bonds will raise much.
- **Pension insurance gap**: pension funds that invested in shares saw the value of their assets change with the ups and downs of the stock market. 2003 saw signs of economic recovery from the three years of losses previously, however a gap to cover all future obligations still exists. The global pension fund gap is between $1,500 bn to $2,000 bn, so on average, pension funds are still underfunded by as much as 20% and it could take up to 5 years to close the gap. Another "problem" for pensions is that people are living longer and therefore draw on their pensions for more years than previously.[9]
- **Shift in business**: the insurance industry has shifted business from life insurance coverage to annuity products. This fundamentally changes the way life insurance firms do business, as they concentrate on managing the investment risk, rather than on the mortality risk of an individual. As a result, insurance firms now compete more directly with financial services firms.[10]

Technology changes that move the sector
Technology has had a major impact on changes in the financial industry in the way it sells products and in the way it operates, both internally and externally. Technology is vital to the workings of the many complex products (e.g. derivatives) and transactions (security trading).

Electronic transactions have more than doubled since 1995 and they are expected to double again by 2005. Internet banking is becoming more and prominent, as both large and small banks offer web sites where customers can access accounts and buy financial products. Several web-only banks have also popped up, including NetBank, Egg plc. and ING Direct.[11]

However there are still some technical problems to be solved including:
- safety and security in e-finance on the internet,
- coordinating different software between different divisions,
- coordinating the technological integration after a merger or acquisition.

2.2 Structure of the financial industry: rankings of top financial firms

The following rankings and tables provide an overview of those dominant companies in the financial services sector worldwide. They are the financial conglomerates that buy, sell and trade the most financial products described in chapter 1 above. They are also the strongest proponents of deregulating of the financial markets and liberalisation financial services (see chapter 6).

2.2.1 World rankings

The ranking of the financial industry is complicated by the various ways to work out rankings and the constant restructuring of the industry. The table of the ranking of the largest financial firms in Euros does for instance not include the takeover of FleetBoston by Bank of America (nr. 2 in the world, ranked by net profit) in late 2003. These merged US financial firms will however not take over Citigroup as world number one. The combination of J.P. Morgan Chase who decided to buy Bank One for $58 billion in January 2004 is likely to become the second-largest bank in the US.

Table: *Banks* ranked by market capitalisation (US$ bn, 2005)

Rank	Company	Home country	Market value (US$ bn)
1	Citigroup	US	255.3
2	HSBC	UK	178
3	Bank of America	US	117.5
4	Wells Fargo	US	97.5
5	Royal Bank of Scotland	UK	90.2
6	UBS	Switzerland	85
7	JP Morgan Chase	US	81.4
8	Wachovia	US	62.3
9	Barclays	UK	61.3
10	BNP Paribas	France	59.3

Source: Forbes 2000 list, April 2005, at: www.forbes.com

Table: *Banks* ranked by assets, 2005

Rank	Company	Home country	Assets (US$ bn)
1	Citigroup	US	1,264.03
2	Mizuho Financial	Japan	1,115.90
3	Sumitomo Mitsui Financial	Japan	868.42
4	Mitsubishi Tokyo Financial	Japan	827.48
5	J.P. Morgan Chase	US	792.70
6	Barclays	UK	791.54
7	HSBC Holdings	UK	757.60
8	BNP Paribas	France	745.09
9	Bank of America	US	736.45
10	HVB	Germany	705.36

Source: Forbes 2000 list, May 2005, at: www.forbes.com

2.2.2 A short analysis of the world top financial conglomerates

Citigroup, the first truly global allfinanz conglomerate, dominates each ranking. Citigroup's large size was created in 1998, in anticipation of more bank deregulation in 1999, when Travelers Group insurance bought retail and commercial bank Citicorp and created Citigroup. It is now active in more than 100 countries in all kind of financial activities.

Bank of America is less internationally oriented than Citigroup with a presence in 30 countries (incl. the US, 5 in Latin America and 7 in Asia)[12]. It has the most extensive network of bank branches in the US.

All of the top financial firms are the result from a series of mergers and acquisitions, trying to use the network of one firm to reach clients for the other firm (e.g. **J.P. Morgan Chase** was formed by bank Chase Manhattan buying investment bank J.P. Morgan in 2001).

Japanese banks are still highly ranked according to assets. Large mergers took place last decade such as Dai-Ichi Kangyo Bank, Fuji Bank, and Industrial Bank of Japan which merged to form Mizuho in 2001. In 2004, Mitsubishi Tokyo Financial Group and UFJ Holdings, struck an agreement to merge. This merger will lead to the world's biggest bank in terms of assets. . However, experts state that Japanese banks are the weakest, together with the German banks, of the developed countries. This is the case since the Japanese banking system has serious non performing loans problems, and have suffered heavy losses in recent years ($39 bn in 2002).[13] In the Forbes ranking (that also takes sales, profits and market value into account) the first Japanese bank on the list is Sumitomo Mitsui Financial at rank 396. In 2004, the position of Japanese banks slightly improved; instead of losses like in the years prior the 113 Japanese banks in the Forbes 1000 list managed to make net profits aggregating to $14,9 bn.[14]
New comers in the future might be **Chinese banks** as some are currently being (partly) privatised and bought up by foreign financial firms. The International Commercial Bank of China (ICBC) is the largest commercial bank in China and would rank in the top ten commercial banks worldwide based on assets.[15]

In terms of quality, the Hongkong and Shanghai Banking Corporation (HSBC) won the Global 2004 Bank of the Year Banker Award and the 2004 Global Bank award. Citigroup wan different other awards such as the Global Finance Magazine's awards for Best Global Corporate Bank and Best Global Exchange Finance Bank.

Many of the above mentioned financial firms are also high in ranking of the world's biggest companies in all sectors. Again, Citigroup ranked first as the world's largest multinational measured by a composite of sales, profits, assets and market value in March 2004. Twelve (60%) of the 20 biggest companies in the world were financial firms. Of the 100 biggest global companies, 41% (41) were financial firms with a total net profit of US$ 166.9 bn.[16]

Table: Ranking of all financial firms according to Forbes 2000 list of the world largest companies (US$ bn, March 2004)

World company ranking	Name	Country	Category	Sales ($bn)	Profits ($bn)	Assets ($bn)	Market value ($bn)
1	Citigroup	United States	Banking	94.71	17.85	1,264.03	255.30
3	American Intl Group	United States	Insurance	76.66	6.46	647.66	194.87
6	Bank of America	United States	Banking	49.01	10.81	736.45	117.55
7	HSBC Group	United Kingdom	Banking	44.33	6.66	757.60	177.96
9	Fannie Mae	United States	Diversified financials	53.13	6.48	1,019.17	76.84
11	UBS	Switzerland	Diversified financials	48.95	5.15	853.23	85.07
12	ING Group	Netherlands	Diversified financials	94.72	4.73	752.49	54.59
14	Berkshire Hathaway	United States	Insurance	56.22	6.95	172.24	141.14
15	JP Morgan Chase	United States	Banking	44.39	4.47	792.70	81.94

World company ranking	Name	Country	Category	Sales ($bn)	Profits ($bn)	Assets ($bn)	Market value ($bn)
18	BNP Paribas	France	Banking	47.74	4.73	745.09	59.29
19	Royal Bank of Scotland	United Kingdom	Banking	35.65	4.95	663.45	90.21
20	Freddie Mac	United States	Diversified financials	46.26	10.09	752.25	44.25
25	Wells Fargo	United States	Banking	31.80	6.20	387.80	97.53
27	Barclays	United Kingdom	Banking	33.69	4.90	791.54	61.33
28	Morgan Stanley	United States	Diversified financials	33.00	3.64	580.63	64.81
34	Deutsche Bank Group	Germany	Diversified financials	58.85	1.53	792.49	50.23
36	HBOS	United Kingdom	Banking	32.68	3.09	571.76	52.87
39	Banco Santander Central	Spain	Banking	28.70	3.28	442.24	56.78
40	Merrill Lynch	United States	Diversified financials	26.64	3.47	485.77	57.52
41	Wachovia	United States	Banking	24.47	4.25	400.87	62.35
47	Lloyds TSB Group	United Kingdom	Banking	24.48	2.87	406.99	48.11
48	ABN-Amro Holding	Netherlands	Banking	23.64	3.98	704.95	39.29
50	American Express	United States	Diversified financials	24.17	3.00	175.00	68.89
52	Bank One	United States	Banking	21.04	3.40	290.01	58.38
53	AXA Group	France	Insurance	90.10	1.00	456.13	41.39
54	Société Générale Group	France	Banking	35.52	1.61	526.54	40.61
56	Goldman Sachs Group	United States	Diversified financials	22.84	2.54	394.14	50.12
57	BBVA-Banco Bilbao Vizcaya	Spain	Banking	24.10	2.81	288.80	44.67
59	MetLife	United States	Insurance	35.79	2.24	326.84	26.34
62	Allstate	United States	Insurance	32.15	2.73	134.14	32.90
67	Washington Mutual	United States	Banking	18.01	3.88	275.18	39.69
68	Crédit Agricole	France	Banking	31.77	1.12	531.01	38.80
73	Munich Re	Germany	Insurance	45.85	1.14	191.33	26.63
77	US Bancorp	United States	Banking	14.57	3.73	189.29	52.88
79	Royal Bank of Canada	Canada	Banking	18.82	2.28	305.01	31.82
86	Natl Australia Bank	Australia	Banking	15.34	2.69	269.94	36.51
90	FleetBoston Finl	United States	Banking	14.22	2.13	196.40	47.19
92	UniCredito Italiano	Italy	Banking	16.53	1.89	223.60	33.53
96	Fortis	Netherlands	Diversified financials	52.51	0.56	507.98	30.19
98	Aegon Insurance Group	Netherlands	Insurance	17.75	1.63	266.59	23.49
99	Dexia	Belgium	Banking	19.62	1.36	368.37	21.64

Source: Forbes 2000 list, March 2004, at www.forbes.com: measuring based on a composite of sales, profits, assets and market value; including some figures of net profits in 2003.

→ Critical issues

Citigroup the top player
Citigroup's domination of the financial sector is significant. Citigroup's net profits in 2002 and 2003 exceeded those of the second bank ranked by net profit, Bank of America, by more than 60%. The sales of Citigroup are the same as those of ING Group but Citigroup makes almost 4 times more net profit. This puts pressure on the other financial firms to try and achieve ever-higher profits while continually expanding. Citigroup might become the model and benchmark for others.

American and European financial firms dominate
The top 100 financial firms are completely dominated by those from the US and Europe. It raises the question how much capacity banks from developing countries might have to compete internationally against these large players.

Financial groups dominate world ranking
The fact that more than 40% of the 100 top world companies are financial firms indicates how their current strategies are successful in making profit. The net profit of all these 41 top financial firms is just less than the GDP of Denmark and more than the GDP of for instance Hong Kong China, Greece, Finland, Thailand and most developing countries.[17] The financial sector is more than other sectors able to raise in the ranks of top world multinationals. In a world where stock markets and share values are globalised, this puts constant pressure on companies to increase profits.

2.2.3 Regional rankings

Top European banks
The major European players at the top financial markets in Europe are HSBC (UK), France's Crédit Agricole, Royal Bank of Scotland and Deutsche Bank. ING Group (NL), UBS (Switzerland) and HBOS (UK) are also top players in Europe.[18]

Increasing presence of Western banks in Africa, Asia and Latin America
In Latin America, Africa and Asia, analysis shows that the top players are still banks from their own region. But more and more Western players are taking a share of the market.

For instance, foreign financial firms that have become important in many Latin American countries are Spanish Banco Santander, Banco Bilbao de Vizcaya (BBV) and Banco Central Hispanoamericano, as well as HSBC (UK), Bank Boston (US), Sudameris (FR) and ABN Amro (NL).[19] Citigroup became the dominant player in Mexico.

A small company profile of a large financial conglomerate: Citigroup[20]

Citigroup has dominated the financial services world for the last five years,[21] with net profits at $ 17 bn in 2003. Citigroup's profits rose 17% compared with the year 2002.[22] Citigroup's net profit in 2002, if compared with countries' GDP, would rank 76 in 2002 with Serbia and Montenegro at 75 and Belarus, El Salvador, Panama and Kenya among the countries following.

Operational in more than 100 countries, well ahead of all others, it has the greatest distribution capacity in the world. The group brings together banking, insurance and investments in one corporation to offer a diversity of financial products.

Ambitions?

Citigroup was the first financial corporation to have establishments in all EU countries for corporate banking activities even though it was American.[23] As explained to the Financial Times, Citigroup has the ambition "to reach top ranking for every product it sells and in every category it services in all regions". Citigroup wants to increase revenue across the globe by an additional $ 130 bn a year from potential fees for its corporate and investment bank business. Citigroup's CEO recently said the future strategy would be to make smaller rather than larger acquisitions, with a focus on 'fill-in' deals, which are small by his company's standards. Previous 'fill-in' deals include extending Citigroup's consumer banking reach, or for example the purchase of Poland's Bank Handlowy and Mexico's Banamex. It is still up in the air as to whether the Bank of America and FleetBoston merger will challenge Citigroup to take up larger-scale acquisitions in the financial retail sector.[24]

Size and outreach

To get to a grasp of the financial strength of the Citigroup, here are some figures: At the end of 2003, Citigroup's assets totalled $ 1.264 trillion,[25] the company has 275,000 employees,[26] there are 200 million customer accounts in more than 100 countries, the company is the largest provider of credit cards in North America, and it has more than 3000 branches worldwide, not counting the 766 branches in the US.

Domination? Examples

Biggest global underwriter of bonds in 2003; arranged $ 41.9 bn in bond sales in 2003 fourth quarter alone.
The top company in global equity offerings at the end of 2003; arranged $10.6 bn in initial public offering of shares (IPO) deals.[27]
Number 1 derivatives dealer.[28]

Ranking of banks in Asia is dominated by four Chinese banks, followed by the Hongkong and Shanghai Banking Corporations (HSBC, headquartered in the UK) and National Australia Bank.[29]

The positions in the 2003 top 100 Sub-Saharan banks are occupied by the "big five" South African banks: Standard Bank Group, FirstRand Banking Group, ABSA Group, Nedcor, and Investee. The major shareholder (14%) of Standard Bank is the Old Mutual Group[30] with activities in South Africa, the US, the UK and some other countries. Standard Bank is the only South African bank with significant presence in the rest of the continent. Other major Sub-Saharan African players are based Mauritius or Zimbabwe. Foreign banks with a significant presence in Sub-Saharan Africa are Barclays (UK), Fortis (B-NL, via Banque Belgolaise), BNP (F) and Société Générale (F).[31]

2.2.4 Sectoral ranking

Project lending mostly done through European banks[32], as opposed to project bonds
Most project lending comes from European banks which financed US$ 70 bn in global projects in 2003. Forty one billion US$ was allocated to European projects, mostly for infrastructure in the energy sector. American banks are not very active in for project loans because the profit margins are too small.

Table: World top financiers of project financing through credit

Rank	Bank	Country
1	Crédit Agricole/Crédit Lyonnais	F
2	Royal Bank of Scotland	UK
3	BNP Paribas	F
5	Société Générale	F
…	Barclays	UK
…	WestLB	D

Source: Het Financieele Dagblad, Kredietverlening aan grote projecten klimt uit het dal, 23 January 2004; based on data from Thomson Financial

Increasingly, projects are financed through bonds. In Europe, bond project financing grew to $9 bn from $2 bn in one year. American banks beat the ranking for project financing through bonds. In 2004, the best project-financing award from The Banker went to Citigroup[33].

Table: World top project financiers through bonds in 2003

Ranking	Bank	Country
1	Citigroup	US
2	Credit Suisse First Boston (CSFB)	Switzerland
3	Lehman Brothers	US
4	…	
5	ABN Amro	NL

Source: Het Financieele Dagblad, Kredietverlening aan grote projecten klimt uit het dal, 23 January 2003; based on data from Thompson Financial

Governmental institutions seeking project-financing advice are turning to accountants rather than banks to cut costs. The top global advisors for project financing are:

Table: World top global advisors for project financing

Ranking	Advisor
1	Ernst & Young
2	PriceWaterhouseCoopers
3	…
	KPMG
5	ABN Amro

Source: Het Financieele Dagblad, Kredietverlening aan grote projecten klimt uit het dal, 23 January 2003; based on data from Thompson Financial

American investment banks dominate the global market
The top global players in investment banking are American financial firms, which include Citigroup Global Markets (formerly Salomon Smith Barney), J.P. Morgan Chase, Goldman Sachs and Morgan Stanley. The 2004 Banker Award for both the best Bond House and best Equity House of the Year went to Morgan Stanley. Goldman Sachs received the 2004 Banker Award for the best activities in supporting and financing mergers and acquisitions (M&A House of the Year).

The high fees make investment banking a very attractive business but many global players from other countries have difficulties in competing with these US banks in their investment bank activities. Since 1995, Japanese investment banks have been largely driven out of all capital market services.[34]

Table: Investment banking companies ranked by sales

Rank	Company	Country
1	Citigroup Global Markets	US
2	J.P. Morgan Chase	US
3	Goldman Sachs	US
4	Morgan Stanley	US
5	Merrill Lynch	US
6	Credit Suisse First Boston	Zwi
7	Lehman Brothers	US
8	Bank of America Securities	US
9	UBS Investment Bank	Zwi
10	Deutsche Bank	D

Source: Hoover's Industry snapshots, Investment banking, [15 January 2004].

2.2.5 Global concentration in some financial services sectors

Still many domestic financial firms compete with the large world players for various products. However, in some financial services sectors, a few big players dominate the business and prevent other financial firms to compete or enter the market. Such 'concentrated' or oligopolistic sectors include:

- **Credit derivatives market**: Trading in the credit derivatives market is concentrated among a small number of financial firms[35]. Especially the investment bank arms of commercial banks such as Citibank and Morgan Guarantee Trust do a large part of the intermediation between buyers and sellers of credit risk protection. Most of the trade is done in London and New York. Commercial banks are the main issuers of credit risk derivatives (and thus net buyers of credit risk protection), while commercial banks,insurance companies, hedge funds and pension funds account for most of sales of credit risk derivatives.
- **Rating agencies**: Three rating agencies that analyze creditworthiness are each most used and respected around the world.: Standard and Poor's corporation ('S&P'), Moody's Investors Service and Fitch Ratings. All of them are US based.
- The top 10 **property and casualty insurance companies**, including State Farm, Aviva, American International Group, and Zurich Financial Services account for almost half of all premiums written. A decreasing number of local firms are left to fight for the remaining scraps of market share.
- European and American investment banks in South-East Asia have established a oligopoly in two services in the regional capital markets:
  - underwriting in the primary market and distribution of new share issues (investment banking),
  - trading in securities and bonds and consulting in the secondary market, i.e. the market that deals with equities trade after the original issuance.

- From 1998-2001, American and European investment banks held 74% of financing through capital markets, i.e. from shares, in five South East Asian countries.

Concentration also tends to take place at the national level. Countries that have been deregulating tend to have more and more mergers and acquisitions resulting in consolidation and foreign take-overs. Financial services then tend to concentrate in a few companies, as is the case in Hong Kong, Belgium and the Netherlands.

2.3 Trends and strategies: financial service companies

Information technology, deregulation and liberalisation have dramatically affected the financial services industry contributing to two important trends namely, consolidation and increased competition at both the national and international levels. These two trends impact societies and economies, especially in relation to poverty eradication.

2.3.1 Consolidation[36]

'Consolidation of financial services' means that financial services worldwide are increasingly concentrated in the hands of a few corporations as described in the structure of the financial industry above. Consolidation is seen as the single most important factor transforming the financial services industry since almost a decade. Many experts predict that consolidation will continue and within 5 to 10 years, there will be only five to ten top financial conglomerates in the world.

In search of more profit opportunities, most consolidated financial firms did not so much expand organically as grow through mergers and acquisitions or takeovers that were either friendly or hostile. Such consolidation took place at national level and more importantly at international levels with '<u>cross-border consolidation</u>' by trading and investing in financial services in many countries around the world. Also, many financial services categories such as retail banking and insurance, were increasingly being brought under one corporate roof which is called '<u>cross-category consolidation</u>.'

The strategies behind consolidation are:

- Increasing the number of customers and beating competitors by selling various financial products through one distribution channel (<u>one stop shopping</u>);
- diversifying products and customers to avoid risk (like putting too many eggs in one basket, if the basket breaks, the whole business might be lost) and to finance a loss-making part of the business with the profits of another part of the business (<u>cross-subsidization)</u>;
- maintaining a large capital base as buffer to absorb losses and absorb the growing cost of technology;

- increasing the quality of service and products to gain the trust of the customers;
- increasing profitability not to loose out against competitors.

The causes of consolidation are also political:
- Governments (some under pressure from the IMF and World Bank) have opened up their financial services for trade and investment by foreign competitors. Once foreign financial firms take a share of the domestic market, domestic companies try to expand their market by going abroad.
- Governments have removed restrictions preventing different kinds of financial services to be part of one financial corporation. In the US, the Glass-Steagall Act (of the 1930s) and the Bank Holding Company Act (1956) were withdrawn.
- State banks in developing countries are being privatized and state aid to financial institutions is stopped e.g. in the EU due to rules of the European Single Market.
- The introduction of a single currency such as the Euro has stimulated cross-border activities and consolidation.
- The new capital accord agreed upon by Western central bankers regarding capital reserves to cover loans ("Basel II": see chapter 5) will prioritize large banks. This is the case because large banks will be able to use an internal risk management system, and have to putless capital aside than smaller banks without such systems. Smaller banks will have to use a standard approach that requires to put aside much more capital than the larger banks. Smaller reserves make the larger banks more profitable.

Liberalisation in trade and investment in financial services often leads to national banks being unable to compete with internationally operating banks. As a result of consolidation, the numbers of medium-sized banks and large national financial firms (as opposed to mega conglomerates) can decrease even if they are the largest in a country. In most OECD countries, consolidation has worked against existing medium-sized financial companies through merging or being acquired by larger banks. In countries like the Netherlands and Belgium consolidation has lead to a financial industry market dominated by 5 financial groups.
Where governmental rules have not allowed consolidation however, foreign takeovers have not taken place, as is the case in Italy or Germany.[37]

Consolidation continues
Citigroup once declared it wanted one billion customers in ten years[38] and now has 200 million customer accounts worldwide, which is the clearest example of cross-category and cross-border consolidation. The merger of Bank of America (US) and FleetBoston (US) at the end of 2003 is another example of increasing competition and pushing smaller firms out of the market. It was also seen as the start of a new wave of consolidation.

The more mergers and acquisitions, the more consolidation intensifies. When J.P. Morgan Chase (US) decided to buy Bank One (US) in January 2004 to become the second largest US bank after Citigroup, analysts wrote: *"Citigroup was for the last two or three years head and shoulders above the competition …We think Citigroup will now be prodded to do a deal",* while Citigroup had indicated it had only plans to make smaller strategic purchases.[39] Consolidation across boarders is however often complicated by national legislation, different currencies and corporate cultures.[40]

One of the reasons why foreign banks are allowed to take over domestic ones is because the foreigners promise to inject capital, better allocate resources and supply solid management. This is especially attractive to developing countries, particularly during or after a financial crisis.

Experts expect that, in the future, small financial firms with a clear local or regional focus or high specialization might still make enough profit to keep their independence from mega conglomerates and continue to exist.

The new battlefields
Consolidation will continue because new markets are opening.

China, perhaps the most interesting and the most lucrative market, is opening up after Western financial firms successfully lobbied very extensively during China's accession negotiations to the World Trade Organisation (WTO). Many top financial firms have already acquired parts of those Chinese banking divisions as allowed under the agreement.[41] Foreign banks, such as ABN Amro, tend to target rich clients.[42] Many Western financial firms are involved in the restructuring of the Chinese banking sector. Citigroup has bought a big share of many of the non performing loans (NPL) of the four big Chinese state-owned banks. Morgan Stanley and Goldman Sachs have arranged joint ventures with Chinese banks[43]. Obviously, they all hope to get a market share in this huge, fast-growing economy.

Consolidating through mergers and acquisitions is rampant in **Central and Eastern Europe** where regional and European banks are trying to extend their market share. The biggest players are Austrian and Italian.[44] Austrian banks have a clear strategy of making acquisitions in Central and Eastern Europe. The Bank Austria Creditanstalt[45] is protected against political upheaval through the World Bank's Multilateral Investment Guarantee Agency (MIGA) Political risk insurance might be necessary when taking over privatised banks. Privatisation of state banks, including peoples' banks at the post office which have always intended to give access to everyone, is taking place throughout the region. Some bigger banks from Central and Eastern Europe are also taking over smaller ones and those in neighbouring countries.

Only 25-30% of **Russian** adults have bank accounts leaving the rest of the country stuffing money in their mattresses.[46] It remains to be seen how far Western financial firms will adapt to Russian circumstances and can be trusted by Russians. Before the 1998 Russian financial crisis, foreign banks promised much but did deliver little.

When participating in national and regional consolidation, financial conglomerates increasingly focus on core business in core regions. They are continuously selling off inefficient or unprofitable units and buying new ones in their core business or region. And where financial conglomerates cannot acquire or takeover and win a sufficient market share, they tend to sell units off because each firm strives to achieve the top spot in its core business and its core regions.

→ Critical Issues

Big is not always better
Large, diversified financial companies operating in many countries are more difficult to manage and control. Different financial services have different risks (banking risks are not the same as risks in insurance) and new management might lack the necessary expertise.

Mergers and acquisitions can fail
Merging different corporate cultures is not always smooth or successful. Research shows that in general more than 50% of corporate mergers and acquisitions fail.

Risky business
It is risky creating financial firms that are difficult to monitor and “too big to fail.” Bankruptcy of such conglomerates is often prevented even if the banks are mismanaged. To prevent shock waves throughout the economy when the conglomerate falls into trouble, governments become the “insurer of last resort” or hold deposit insurance schemes. This means tax payers pay the bill and losses are ‘socialized’, while on the other hand, profits are privatised.

Banks get political power
Generally, the concentration of economic power in a few consolidated banks increases their political power. Governments are also dependent on financial conglomerates for loans and bond underwriting. The political power of the financial industry is evident from the lobby against debt restructuring (see chapter 5) and in favour of international liberalisation of financial services in the GATS (see chapter 6).

Conflicts of interest
While integrated banking brings benefits like reduced costs, product diversity and cross-subsidisation of different activities within the financial company, it also brings conflict of interest between the different services for which some investment banks have been indicted (see chapter 1: Scandals at financial firms).

Complicated regulation
Cross-border and cross-category consolidation complicates the work of financial regulators and supervisors at national and international levels. The growing number of financial conglomerates, particularly those active in several countries require proper handling (both preventive and corrective) by the regulatory and supervisory financial institutions as well as effective coordination and cooperation between supervisors within one country, and between the national supervisors in different countries. At the moment, an ideal regulatory environment, which functions at the various levels, does not exist (see chapter 5).

Little evidence of knowledge transfer
Contrary to what is mostly argued[47], experience shows that a foreign takeover of a financial service provider does not always lead to a transfer of knowledge and skills to local banks. Most foreign banks tend to attract the more experienced personnel from domestic banks and other foreign banks in the host country than they lose personnel to those local banks. China has experienced the brain drain on the domestic banks when foreign ones enter the market (see chapter 6).

Will prices, eventually, increase?
High concentration of economic power leaves governments and customers little choice, which might lead to an unnecessary price increase. During the first phase of competition prices should fall, but later, when only a few players dominate the sector, tacit price-fixing will drive prices back up. This is not a hypothetical scenario. Secret price-fixing has occurred repeatedly, even if it only seldom comes to light, as it did recently in Germany. Authorities reported that the insurance companies Allianz, Gerling, HDI, Axa, Aachener, Münchener, Gothaer and Victoria, illegally price-fixed as their industrial customers found out. Allianz board member Hagemann has now admitted: “There were informal contact groups.”[48]

Encouraging risky lending
Consolidation combined with strong competition among financial services leads to difficult dilemmas. It may enhance the efficiency and lending of the banks and lower prices for consumers and the whole economy. But more competition also tempts banks to engage in riskier lending (as was the case in the Asian financial crisis), and

other practices that destabilise the banking industry, which has very costly repercussions for the whole economy.

Problems in implementing competition policy

Increasing consolidation also leaves difficult dilemmas for financial supervisors and the implementation of competition policy. In small countries, competition policy officers might block mergers and acquisitions to prevent domination in the domestic financial market. At the same time, allowing a domestic financial firm to become dominant might be the only way to avoid takeovers by foreign financial firms. Sweden and the Netherlands have allowed for the creation of a few "national champions". The Dutch banks have subsequently become important international players.
Top ranked financial firms active in financial sectors where only a few operate might engage in anti-competitive activities such as price fixing (directly or indirectly by following the others' price changes), and anti-competitive cross-subsidisation. However, at the global level, there is no broad competition authority that deals properly with global anti-competitive practices. Intervention from the national country might not be sufficient to tackle the problems.

Only out for profit

Consolidation takes place where profit will be made. Foreign financial firms consolidate in developing countries to try and win a significant part of the market share and earn profits. They will not invest or waste time in a country where there are no profits to be made.

High technology costs

Merging technologies of two financial firms after takeovers and within consolidation phases is expensive and complicated. The various parts of the financial firm need to match and integrate systems with other solutions used across the bank. Coping with the many changes the financial industry faces[49] is a huge challenge. At the same time, large middle market banks have started offering improved global payment services as increasingly small and medium sized industries find business overseas, making the very small business market underserved.[50]

Increasing intra-firm cross-border flows

Transactions and lending around the world, between different parts of the same company, accounted for a major increase in capital flows during 2003.[51]

2.3.2 Competition

Consolidation is the financial industry's way of dealing with increasing competition. Governments, regulators and supervisors worldwide try to create and maintain a free market with many competitors, all in the name of efficiency and lower prices. However, the financial service sector does not only compete but has been cooperating among themselves through increase strategic alliances and consolidating.[52]

Competition nevertheless remains fierce. The struggle is always for quicker and short term profit which leads to strategies for more efficiency, lowering costs, expansion of profit making clients and markets, and "killing" the competitors. The results are, as explained in chapter 1, as follows:

- **Cost cutting in services** such as closing branches, standardization and automation of services.
- **Cost cutting in personnel**, which often leads to firing people and sometimes to lower labour conditions.
- **Market segmentation**: divides up level of services according to the wealth of the client.
- **Focus on the richest clients and scale down services to the poor**: some financial firms chose to focus on a few very lucrative services like investment banking or high technology transaction processing, and offer no lower-margin traditional banking operations.
- **Shifting focus**: When people started to put more of their cash into mutual funds and securities rather than deposit accounts, banks of all sizes became more dependent on fee-based services. Once the stock market bubble burst, the fee income from underwriting, acquisition deals and trade in securities had diminished so much that financial conglomerates turned their attention again to retail banking and branches.
- **Cross-selling**: offering a diversified packet of financial services to woo and keep clients.
- **Cross branding and 'cooptition'**: Some financial have started to distribute financial products for their competitors without operating them. For example, Deutsche Bank is selling the mutual fund products of its rival Fidelity.[53] The larger and more diversified financial firms are increasingly working together in cooperative technology ventures for all kind of consumers. For instance, Merill Lynch and HSBC set up a joint venture for online wealth management service.[54]
- **Outsourcing**: to reduce costs, financial firms start to outsource some of their internal operations, e.g. IT activities, or some of their financial products to other (financial) firms, often in emerging markets like India[55].
- **High costs for technology**: In order to offer the most attractive services and manage the diversified and geographically spread products and operations, financial

firms need to constantly invest in new technology while having to cut costs in other parts of the firm.

→ Critical issues

Cherry picking by the foreign financial industry
Rich clients, the best managers and personnel are often cherry picked by foreign companies. Providing mainstream clients with good service is not a strategic focus. The rich get the best, which can be particularly pronounced in developing countries where the poor are excluded from foreign financial services (see chapter 6 on liberalisation of financial services and GATS). Arguments of 'efficiency' on behalf of the authorities and financial industry mostly benefit the wealthy and the largest corporations

Standardization and automation
Automation in practice can marginalize the poor and seniors who have no access to internet or computers, or who do not know how to use the machines. Also older people often fear they will be attacked when taking money on the street. Poor and young people are often targeted to take out easy, small loans through non-personal standardised products. When they have problems with repayment, banks exclude them from other services.

Need for more supervision and regulation
According to experts advising central banks[56], when competition affects economic stability, normally the appropriate safeguard is sound prudential regulation or good corporate governance, rather than limiting competition. Research indicates that many countries do not have the necessary regulatory and supervisory systems to address many new problems that arise from the competition. Moreover, regulators' and supervisors' instruments are mostly assessing the risks of financial instability, with too little focus at the impact of competition on universal access, quality of service to the poorer clients and good financing of small and medium-sized producers.

Moral hazard
Moral hazard is one of the most serious problems at both the national land international levels.[57] To stay competitive, banks take many risks, as was the case in South East Asia when competition for new lucrative markets lead Western banks to increase their highly risky lending in the belief that governments would intervene if loans defaulted.
States want to protect their citizens against bankruptcy and banking instability, and prevent people from loosing their savings and being affected by a devastating economic crisis. At the same time, governmental risk protection mechanisms -such

as deposit insurance systems- tend to encourage banks to take excessive and dangerous risks. But when losses result from excessive risk taking, financial firms get "bailed out" at the national level by government safety nets and at the international level by the IMF. Both are done with money from taxpayers', not from the risk takers or the banks that caused the problems.
The balance between protecting innocent citizens against major financial risk and allowing risky activities of financial companies is the task of national and international financial regulators and governments. There is however still much work to be done in developing a financial architecture, which is fair and balanced (see chapter 5).

Unequal competition in developing countries
When foreign banks enter a new market, their national competitors are often much less advanced and although increased competition stimulates efficiency, some domestic banks just cannot compete as is the case for investment banking. In developing countries, but also in places like Japan, many people simple don't trust national banks and put more of their trust, and savings, into foreign banking services.

The risks of increasing interdependence
The large complex financial conglomerates have become more interdependent, which means the whole financial system and economy, or systemic risk, is at stake should one conglomerate face troubles.
Interbank loans, syndicated loans, group underwriting, trading derivatives over the counter (OTC) with other financial firms, re-insurance, cross branding, outsourcing, and payment and settlement systems are all examples of increasing interdependence. Combined with consolidation, financial services become increasingly more clustered and confusing.

2.3.3 Shareholder value

Many financial firms are listed on the stock market. Their shares are therefore in the hands of individual investors and mutual funds, both of which could be other financial firms. Cross ownership /cross shareholdings, in the Netherlands for example, is notorious and raises questions about real competition and corporate independence.

Share price and share value, regardless of whether the goal is to maintain or increase the value, is a constant, fundamental concern of the top management of all listed companies, including those in the financial services sector. When the value of shares falls too low, a company can be subject to a take over (friendly or hostile) by another bank that buys up the "cheap" shares. For example, ABN Amro became a world player after consolidation took place in the Netherlands but feared that low share value put it at risk of being taken over. In early 2000, the CEO said that the new strategy would focus on shareholder value and increase profits annually by a minimum of 12.5%! At the height of the economic boom the bank was indeed able to record a profit of Euro 2.5 bn in 1999, or a 40% increase in profit compared with the year prior.[58] Even then, thousands of people were laid off. When the stock market dropped and the economy slowed down at the end of 2001, the CEO had to adapt his strategy. Nevertheless, his salary was increased.

Shareholder pressure is an important element in the management of (financial) firms. Shareholders and investors often want to see short-term gains and press for more efficiency. When cost cutting strategies are announced and people get fired, often at the behest of shareholder pressure, investors react enthusiastically and share value increases. This scenario is a disincentive for management to focus on the social or environmental impacts of the company. Shareholders, therefore, are the most influential stakeholders in a company.

2.4 Conclusions and critical issues

1. Unequal competition

The top world players in the financial industry are US and European banks, insurance and 'allfinanz' firms. Japanese banks do no longer belong to the top as they were 10 years ago. It becomes very difficult for the financial industry of other countries and regions to become part of the world players and 'to enter to world market' in financial services. Specific sub-sectors such as investment banking and rating agencies are concentrated world wide in the hands of a few, often US, financial firms. As a result, many domestic banks cannot compete against these specialized firms when they enter their countries. While there is still a large choice of commercial banks in some countries (Germany, Italy), other countries (e.g. the Netherlands, Sweden) have their financial industry concentrated in the hands of a few.

2. Citigroup is the biggest of all

The biggest world player of the financial industry has for some years been head and shoulders above the others: Citigroup. Citigroup's net profits in 2002 and 2003 exceeded those of its nearest contender by more than 60%. Citigroup’s strategy of activity in all sorts of financial services and in more than 100 countries worldwide, as well as its profit-.making strategies, is influencing the profit expectations of the other world wide financial firms.

3. On top of the world's multinationals

Compared to other multinationals, Citigroup is first on the Forbes 2000 list that measures companies based on a composite of sales, profits, assets and market value. Financial conglomerates take 60% of the top 20 companies in the world and more than 40% of the top 100 companies. This shows the profit making capacity of the international financial industry while it remunerates its managers and traders with excessive pay.

4. Current key trend of consolidation diverts efforts towards sustainable development

The single most important factor transforming the financial services industry since more than five years is consolidation. This trend is expected to continue and result in only five to ten top financial conglomerates in the world within a decade. Top financial firms are now acquiring many banks and other financial services in many countries. China, Central and Eastern Europe and Russia are the new regions to be part of this trend. Domestic banks, however large, that are not consolidating across sectors or across borders are expected to loose out. The fierce international competition among the top financial industry to win the battle of consolidation has lead to many cost saving and focus-on-the rich strategies.
The marginalization of the poor customers and the lack of attention to sustainable development are thus part of the current key strategy within the financial industry. Making the financial industry more instrumental to sustainable development and poverty eradication might be difficult and contrary to consolidation that bends the sector to bigger, faster, more.

5. Risks need more attention

While the positive aspects of consolidation -more efficiency, lower prices and more choice of new products - are highlighted, the (potential) negative consequences are still not solved. Will financial firms become too big to fail and need intervention with taxpayers' money when they mismanage? Will they become too big to compete and reduce choices or abuse their market power e.g. by fixing prices among themselves? Already many forms of strategic alliances and interdependence enhance the effects of consolidation contrary to the 'free markets' which governments want to create.

6. Mismanagement of risks

The financial industry has gone through some rough years in 2001 and 2002 due to the falling stock markets. Especially the loss making at the European insurance industry was cause of concern. This means that the stability of the financial sector has been made too dependent on the value of the stock market and that financial firms had mismanaged their risks. If continued, this could have severe consequences. This mismanagement, together with the recent scandals, calls for more regulation and supervision, which also should be the case when they further expand to developing countries. The new upsurge in profits in 2003 might take attention away form these risks.

7. Focus on shareholder value, not on society

Consolidation has increased the focus on high shareholder value of the financial industry. High shares mean less chances of being taken over. The constant focus on shareholder value leaves little attention to sustainable development in the societies in which financial firms operate. Not surprisingly, the industry stated in 1999 that the interests of society should be taken care of by governments while they focus on share holder value maximization (see chapter 4 for further developments on this issue). The latter makes the shareholders the most influential stakeholders while they have little interest in sustainable development and poverty eradication.

8. What will the future bring?

Possible scenarios for the future of the global financial industry are, without being mutually exclusive:

- The trend towards globally active universal financial service providers continues with more cooperation among the few left. At the same time, mid-sized banks disappear and the non-profit making countries and poor clients are less and less served.
- (Small) specialized financial firms survive: emergence of more functionally specialized financial firms within a segment of the financial industry that survive the competition of the large universal players.
- Continued consolidation but a more radical form of specialization through the gradual 'deconstruction' of the supply chain via the outsourcing of certain activities (e.g.

Internet services) to both financial and non-financial parties.

- risks become too high and financial conglomerates destabilize economies; regulators and supervisors -under pressure from public opinion- become more active to discipline and undo the consolidation of the financial industry.

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Chapter 3
The case of Indonesia

Introduction

There are some issues in the private financial sector that are particular to developing countries and which are important from a perspective of poverty eradication and sustainable development. This chapter is a summary of a case study of the financial services sector in Indonesia by Business Watch Indonesia[1] and raises some specific critical issues.

3.1 Domination of the banking sector compared to other financial services

In Indonesia, as in many developing countries, the banking sector dominates the private financial sector. Not many other financial services are offered. Rarely are insurance services provided to individuals and companies. So, the banking sector is an important motor for business life and economic development.

Table: Map of the financial sector in Indonesia in 2002

Rank	Sector	Controlling market share (%)
1	Banking	90.46
2	Insurance Company	3.38
3	Pension/Pension Fund	3.01
4	Multi-finance company	2.31
5	Securities Company	0.65
6	Pawn shop	0,20

Source: Business Watch Indonesia, based on InfoBank, Nr. 292 - August 2003, Vol.XXV.

3.2 The role of banks in servicing the poor

3.2.1 Weak support for small and medium sized enterprises

Small and medium sized enterprises (SMEs) provide the greatest number of jobs in developing countries and are an important stimulus to national economies. However, lending to SMEs is only a tiny part of private banks' lending portfolio. Also, interest lending rates charged to SMEs are often higher than those offered to larger firms because SMEs are considered riskier. In Indonesia, total annual credit delivered to SMEs between 1998 and 2003 was never more than 21%. During this period, the credit offered to SMEs increased after regional decentralization, allowing for regional governments to develop their own lending policies.

Table: Credit delivery to SMEs compared to Total Bank Credit

Year	Credit delivered to SMEs	Total Delivery Credit	Credit delivered to SMEs	Total Delivery Credit	Total (%)
	(Million Rp.)		(USD Million)		
1998	43.870	487.426	5.223	58.027	9.00
1999	37.240	225.133	4.433	26.802	16.54
2000	55.840	269.000	6.648	32.024	20.76
2001	61.160	307.594	7.281	36.618	19.88
2002	60.840	365.410	7.243	43.501	16.65
March 2003	62.080	376.141	7.390	44.779	16.50

Source: Business Watch Indonesia, based on Monthly Report of Bank Indonesia, May 2003

In Indonesia, state banks, rather than private ones, most actively offer credit to the SME sector. In March 2003, 55.4% of the total credit to SMEs was provided by the national state banks, and 18.5% by regional state banks. Private banks provided 25.9% (down from 29.8% in 1998) of the credit to SMEs in the same period.
This contrast between private and state banks lending practices vis-à-vis SMEs is often not discussed in terms of the privatization of banks (see below).

3.2.2 The role of banks and the poor

The Indonesian case study research shows that only 14.3% of loans for small and household handicrafts comes from banks with the rest coming from individuals, family and money lenders.

Table: Source of main loans by SMEs and household handicrafts (1999, Million Rp.)

	Bank	Cooperative	Non-Bank Financial Institution	Venture Capital	Individual	Family	Others	Total
Total Enterprise	64,275	14,603	9,122	2,040	138,992	58,733	163,035	450,800
%	14.26	3.24	2.02	0.45	30.83	13.03	36.17	100

Source: Business Watch Indonesia, based on Statistic of Small Industry and Household Handicraft, Central Bureau of Statistics or Badan Pusat Statistik (BPS), Jakarta - Indonesia, Year 1999

Few SMEs and household handicrafts take loans from banks because:

- they are not interested or unwilling to use banks to get loans;
- they lack collateral;
- they do not know about or understand the procedures and are intimidated or untrusting;
- they do not meet the requirements.

Remember, many small companies exist within the informal economy and therefore are not integrated in the Indonesian banking system. The advantage is that those in the 'informal' sector were protected from the financial crisis in 1997-98 because their assets were not tied up in the banks.

→ Critical issues

To what extend can the banking system stimulate the alleviation of poverty through SME loans? Or are other financing instruments are more efficient?

3.2.3 Foreign banks give little or no credit to poor

Foreign banks provided 0.005% of their total credit to SMEs in Indonesia in 2002 and beginning 2003. This reflecting a downward trend as total SME credit by foreign banks was 0.28% in 1998. Contrary to examples in Latin America and arguments from the World Bank that claims that market opening increases efficiency, in practice there seems to be nothing gained by SMEs in Indonesia.

Micro-credit organizations, established because national banks did not service the very poor, provide very small loans to people, mostly women, without collateral. Formal banks claim the costs to administer such loans are too high. The success of such examples of Grameen banks is however a proof that the poor can be a good credit risk. The micro-credit schemes in Indonesia are supported amongst others by the World Bank. Citigroup is also supporting micro-credit NGOs through its Grameen Trust and it's Community Programme in Indonesia (Citibank Peka)[2] while its regular commercial financial services focus on the big cities and richer Indonesians.

3.2.4 Neglecting poor regions

One of the problems with the financial industry is that they only set up in areas and regions where the economy is already strong and where it can make profits. This means that the majority of bank credit allocation is concentrated in the capital Jakarta and in the 5 biggest and most developed provinces. The area of Jakarta was still the biggest recipient of credit in 2003 (39% of all credit in Indonesia), but the amount lent was about half of the credit allocated to Jakarta in 1998. The credit to Jakarta in 2003 was still three times that allocated to East Java, the second ranked recipient of bank credit.

Table: Annual credit delivery (compared to overall national credit)

Province level 1	1998	1999	2000	2001	2002	2003	Change '98-
DKI Jakarta	71.1%	60.7%	43.6%	39.1%	39.1%	38.73%	-32.40%
East Java	7.5%	8.6%	14.0%	14.7%	13.4%	13.52%	6.06%
West Java	5.8%	8.3%	10.4%	11.1%	10,6%	10.12%	4.29%
Central Java	3.2%	4.7%	5.7%	6.9%	7.0%	6.76%	3.54%
North Sumatra	2.4%	3.2%	4.4%	4.7%	4.8%	5,20%	n.a.

Source: Business Watch Indonesia, based on Monthly report of Bank Indonesia, May 2003

The figures do not show that foreign banks also establish operations and provide credit in the regions that are the most economically advanced. Citigroup for instance, has eight main offices in Jakarta and four throughout the rest of the country.[3]

3.2.5 Increase in consumer credit rather than investment credit

The BWI Indonesian case study indicates that between 2001 and June 2003, banks have been focusing more on channeling credits to the consumer sector. Consumer credit has increased 117% since the end of 2000 and held 22% of total credits by June 2003, up from 14% of total credits, at the expense of credit for business investment.

Some banks allocate in total much more credit to the consumer sector than to the investment sector. PT Bank Tabungan Negara, a state bank, gives 95 % of its credit to consumer credits. The Bank of America operating in Indonesia only gives credit for consumptive purposes.

Indonesian banks mostly give credits for business investment to those who have already been running a business. So the proportion given for new investment is very small. Even though encouraging consumption can stimulate economic growth, investment for business is also crucial for the Indonesian economy to recover from the stagnation which resulted from the 1997-98 financial crisis.

Table: List of the banks with the largest consumption credits (June 2003)

	Bank	Credit Modal Kerja (credit for working capital/cash) (%)	Credit for investment (%)	Consumption (%)	Status
1	PT Bank Rakyat Indonesia	56.97	9.51	33.52	State bank
2	PT Bank Tabungan Negara	4.61	0.25	95.14	State bank
3	PT Bank Danamon Indonesia	45.23	22.63	32.13	bank taken over
4	PT Bank Negara Indonesia	50.62	35.13	14.25	State bank
5	Citibank N.A.	63.95	0	36.5	Foreign bank
6	PT Bank Central Asia	70.17	16.05	13.78	bank taken over
7	PT Bank Permata Tbk	35.24	37.26	27.49	bank taken over
8	PT Bank Mandiri	52.41	44.41	3.18	State bank
9	Bank International Indonesia	28.40	46.91	24.69	Recapitalised bank
10	PT Bank NISP	28.02	47.55	24.43	Recapitalised bank
11	HSBC	74.67	10.62	14.71	Foreign bank
12	Standard Charterd Bank	77.25	0	22.75	Foreign bank
13	ABN Amro Bank	82.51	0	17.49	Foreign bank
14	PT Lippo Bank	76.67	11.76	11.57	Recapitalised bank
15	America Express Bank Ltd	70.18	0	29.82	Foreign
16	Deutsch Bank AG	91.31	4.62	4.07	Foreign
17	The Bank of Tokyo-Mitsubhisi Ltd	91.74	7.73	0.52	Foreign
18	The Chase Manhattan Bank N.A	98.39	0	1.61	Foreign
19	Bank of America, N.A	0	0	100.00	Foreign
20	The Bangkok Bank Corp. Ltd	79.15	20.73	0.13	Foreign

Source: Business Watch Indonesia, based on Investor Magazine Edition, Nr. 84, Year-V, 20 August – 9 September 2003.

3.3 Deregulation and the lack of regulatory and supervisory capacity

Regulating financial services is complex and requires human and financial resources to draft legislation, implement and enforce regulations. Deregulation and the relaxing of banking rules in Indonesia, starting in 1988 and promoted by the IMF and World Bank, made it easy to set up new banks. As a result, there was a great increase in new banks and branches.

The 1997-98 financial crisis exposed the fact that many of the new banks were run by businessmen with no banking knowledge or experience. To make matters worse, these businessmen used the banks to finance their own businesses, violating lending limits while manipulating the books.

With no supervisory authority intervening and so much corruption and bad governance, some banks with bad loans were liquidated or restructured by the state that put money into some of those banks that could be saved. The government paid out huge amounts of cash, taxpayers' money, in the restructuring process, money that could have been better spent on the many human, social and environmental costs of the crisis.

The financial sector restructuring process was supposed to be finished at the end of 2003 when the IMF program ended but new regulations and supervisory institutions were still being debated in Parliament at that time. In the rush to complete the restructuring many bad loans were liquidated with not enough compensation for the government's input.

The challenge is to ensure that the government does not provide more blanket guarantees for bad loans and bad banking activities, that corruption is halted and banks remain outside of politics. The financial sector's institutional framework in Indonesia is still unstable and creating the right framework is, politically and economically, difficult.

3.4 The critical roles of lending by foreign banks

3.4.1 The role of lending by foreign banks in the financial crisis

The South East Asian crisis was not caused only by the corrupt system and lack of regulatory and supervisory capacity in Thailand, South Korea and Indonesia, but also because foreign banks lent credit in foreign currency. Some foreign banks did even not have offices in these countries but they risked making short-term loans to banks and companies in these South East Asian countries. They wanted to take a slice of the market and they assumed the governments would intervene in case of problems. The domestic banks and Indonesian business people also happily took loans from foreign banks at much lower interest rates than from their domestic counterparts.

However, once it became apparent that the reserves of foreign currency needed to repay the short-term loans, were insufficient, the Thai currency crashed and each country followed. The governments first took IMF loans to support the local currency and prevent devaluation. Remember liberalizing capital flows and financial industry instruments leads to capital flight and speculation in times of financial crisis, and the devaluation of local currency against the foreign currency. Many of the loans from foreign banks were made in foreign currency. When the local currency crashed, foreign currency became way too expensive and default on loans in the foreign currency was inevitable. But the loan the government took out to boost up the local currency had become more expensive to repay after the devaluation, which meant that the government of Indonesia with a double burden of loan repayment in foreign currency. It needed to pay for bailing out the private banks as well as debt to the IMF, which means the

Indonesian authorities had less to spend on anti-poverty projects and improving their capacity to govern. At the same time, financial and political restructuring to date, has not resolved many problems of corruption.

3.4.2 Odious governmental and private debt

Western governments and international governmental organizations, including development banks and the IMF, alongside private banks were lending to the corrupt and dictatorial Soeharto regime for years. Before the fall of Soeharto's regime in 1996, governmental debt was US$ 55.3 bn, of which $ 1 bn was due to private banks. After the financial crisis and the collapse of the regime, Indonesia's official debt was US$ 77.9 bn (2003) of which US$ 2.3 bn was due to commercial loans.[4]

The Soeharto government had also raised money from private investors by issuing bonds. The bond market is interesting to foreign institutional investors including pension funds and mutual funds. By the time the Soeharto regime collapsed, most of the bonds issued in the 1970-80s were repaid but new bonds issued had been issued in 1986 and 1996 (including the "Indonesian Yankee bond").[5] By September 2003, the total amount that the government had to repay to bond investors was US$ 736 million.

In addition, the total external debt by Indonesia's private sector (banks, companies, etc.) was around US$ 53.6 bn in September 2003.[6] At that time, external debt by Indonesian private and state owned banks was estimated at $ 4.4 bn, part of which was owed to foreign banks. Indonesian 'non-bank' financial companies had to pay an estimated $ 2.9 bn to foreign creditors. The private sector also issued securities that were bought by foreign investors, totalling an estimated $ 1.3 bn in September 2003.

Civil society organizations have called for the cancellation of government debt after the collapse of the corrupt Soeharto regime.[7] If there is no debt cancellation, the citizens and the new regime will bear the debt burden and will have to repay loans, which were unethical and very risky ('odious debt'). Corrupt regimes often misallocate loans and cannot repay but civil society feels the lenders should bear the burden of this odious debt, and not the population.

Research shows that the foreign banks also make loans to corrupt companies, projects and banks in Indonesia, which are risky and unethical. Full repayment of this private debt could result in following through with projects that are very detrimental for the environment and population, in order to generate the profits to make the repayments. The foreign currency needed to repay the private debt also undermines an economic and monetary policy that prioritizes domestic needs.

Total Indonesian governmental and private debt, and securities, that are due to foreign creditors and foreign investors was estimated at $ 132.7 bn in September 2003 - higher than the year before.[8] The private and governmental lending institutions do not agree with cancelling or writing off governmental debt. The Paris Club, which is a forum where governments and the international financial institutions negotiate the restructuring or cancellation of the debt of developing countries, has discussed some rescheduling and restructuring but not debt cancellation.

The foreign and international governmental institutions that are owned debt from Indonesia belong to the Consultative Group of Indonesia. Negotiations on rescheduling the government's debt from private banks have taken place at the London Club, a group of international commercial banks. Members of the Consultative Group had pressured the private sector to also reschedule private debt of Indonesia. In August 2002, the London Club put forward an agreement with the Indonesian government to reschedule US$ 1.3 bn in private debt.[9] The London Club's steering committee listening to the official arguments included the five major creditor banks:

- Bank of Tokyo-Mitsubishi,
- BNP Paribas SA,
- Commerzbank Aktiengesellschaft,
- Hongkong and Shanghai Banking Corp. (HSBC), and
- Mizuho Corporate Bank Ltd.

Eventually all the commercial banks involved in the private debt of the Indonesian government had to give approval.[10]
The London Club would however not reschedule the repayment of the "Indonesian Yankee bond" because of a particular clause included in the conditions of the bond.[11] Orderly debt restructuring and equitable sharing of risks between issuers, underwriters and investors of bonds has so far not been successful and there are no debt cancellation instruments currently even available at the international level.[12]

Civil society hardly monitors governmental debt to foreign bond owners and foreign banks but the truth is, very little information is even transparent. Usually, creditor banks form a consortium that negotiates with an indebted bank or company to restructure the terms of repayment of the debt, aiming at the full repayment.

The Indonesian government's willingness to repay odious debt is due in part to its concern about its credit rating. Standard & Poor and Moody’s grade countries for creditworthiness. While debt rescheduling with the Paris club tends to upgrade a rating, rescheduling with the private creditors more often leads to downgrades from the rating agencies.[13] The lower the grades, the more the government and the private sector pay in interest rates to banks for new loans.

At the beginning of 2004, investment banks were pushing the Indonesian government to again issue $1 bn in new bonds. The government was reluctant to follow the advice, preferring to err on the side of caution.[14] Both sides have clearly different interests at stake: the government would increase its debt and probably decrease its spending to the population or increase it in the long term, while the investment banks get income from underwriting bonds but risk their reputation in case of default of repayment.

3.5 Private project and company financing carried over to governments

The private financial industry has provided financing for Indonesian companies and projects in the mining sector, the pulp and paper industry, and logging and palm oil plantations. Corruption, environmental devastation and ensuing social upheaval, in each of these sectors, have been rampant. The loss of old forests, species and biodiversity has been increasingly documented.

Private banks, both domestic and foreign, and other financial firms have used different instruments to finance these companies and projects, including:[15]

- syndicated loans for project lending,
- bank credit facilities for activities and expanding a business,
- securitization of loans, and,
- underwriting new bonds and securities, and trading in project bonds and securities.

The World Bank and ECAs, export credit agencies, have also provided financial support to these devastating projects and corrupt companies. This financing from governmental bodies has stimulated private financiers to join the financing of these Indonesian projects or companies.[16]

ECAs have been created to provide guaranteed credits and loans to Western companies looking to send exports to developing countries. Now, they also provide guaranteed investments to (exporting) companies in developing countries.

The guarantee of repayment, in case the investment or export goes wrong, is given to the exporting companies as well as to banks that finance the exporting companies.
In other words, the governments, through taxpayers' money, assume the risks taken in developing countries by the Western financial industry. In the case of Indonesia, many ECA-guaranteed projects and exports went wrong, not only financially but also because they turned out to be very destructive to the environment and harmful to the population. The ECAs guaranteed that the Indonesian government had to repay the bad loans, which increased Indonesia's governmental external debt by $ 17.5 bn![17]

What is an Export Credit Agency (ECA)?

An export credit agency provides government-backed export credits in the form of loans, and guarantees or insurance for loans and investments. ECAs support exports and direct investments in developing countries and emerging markets by corporations based in the ECA's home country. Usually overseen by the finance, trade, or economics ministry, an ECA uses taxpayer money to make it cheaper and less risky for domestic corporations to export or invest overseas. Some ECAs are privately owned but entrusted with handling credit guarantees of the government. Almost all industrialized countries have at least one ECA. Like department stores that provide credit so people without cash will buy the stores' products, rich countries (through their ECAs) provide loans and credit to developing countries, so that they will buy the rich country's exports.

Many ECAs offer direct loans, or, when commercial banks or exporters provide the loans or credit, ECAs provide guarantees or insurance -essentially promises to reimburse the banks or exporters and cover most losses. ECAs offer lower interest rates, premiums, and fees than the private market would--and can also back transactions that the private market would refuse. But for developing-country borrowers, ECA-backed loans are still at higher interest rates than many loans from other official sources like the World Bank or the International Monetary Fund (IMF), or other development banks and aid agencies. The results include debt for poor countries and increased sales and foreign investment opportunities for multinational corporations based in wealthy countries.

Few people recognize the scale and importance of ECAs' role in the global economy. One ECA enthusiast calls them "the unsung giants of international trade and finance." In 2001, ECAs covered $ 455 bn worth of business transactions with export credit insurance and $ 17 bn with investment insurance. In comparison, the entire World Bank Group's commitments in 2000 came to only $19.3 billion, and all official development assistance commitments from the global North to the global South amounted to only $62.2 billion. Furthermore, despite recent downturns related to the Asian financial crisis and September 11 attacks, export credits to developing countries have been growing over the long term, while development assistance has declined or remained stagnant.

Indeed, the increasing role of ECAs in the global economy -directly backing hundreds of billions of dollars of international trade and investment and leveraging much more in purely private flows- raises the question of the extent to which government intervention through ECAs has actually driven the process of economic globalisation.
Not only are ECAs by far the single largest part of public financial flows from North to South, but they are also the least examined, the least transparent, the least accountable, and, in some ways, the most harmful.

Among the issues critics of ECAs raise, are that they:

- lack basic safeguards against environmental destruction, breach of human rights, and corruption,
- undercut governments' developmental and environmental policies and multilateral agreements,
- contribute heavily to developing countries' debt burdens,
- have little or no transparency or accountability,
- provide corporate welfare by passing business' risks and losses on to taxpayers,
- contribute significantly to arms trade, expansion of nuclear power, and global warming,
- support destructive projects that even the World Bank would not touch.

Source: CIEL, Export credit agencies and the WTO, November 2003; Business Watch Indonesia based on http://www.foodfirst.org/pubs/backgrdrs/2003/w03v9n1.html

Domestic banks, state owned and private ones, in Indonesia have been financing many corrupt and destructive Indonesian companies. Some Indonesian banks were plagued with corruption themselves. The Asian crisis in 1997-98 rendered loans to, and securities of, these bad performing companies worthless. In order to avoid a total collapse of the banking system and the wider economy, the government of Indonesia was forced, also by its donors, to restructure domestic banks. The government assumed much of the bad debt and created the Indonesian Bank Restructuring Agency (IBRA) to deal with restructuring the debt and recuperating the assets related to the loans. However, the IBRA recuperated much less than the amount of money invested by the government in recapitalizing failing banks and assuming the bad debt. As a result, the reckless and corrupt lending by domestic banks, sometimes financed by foreign banks, lead to a huge budget deficit. State spending for recapitalization and debt restructuring has been at the expense of spending to meet the social needs of the country.

3.6 Privatization

3.6.1 Privatization of the banking sector

Many banks in Indonesia have been inefficient, poorly managed and corrupt,[18] had low profit margins, and offered bad service. They include under-performing state banks that were supposed to ensure universal access and fair service for all citizens while at the same time allocate money for the benefit of the development of the domestic economy in situations where private banks don't. This situation in Indonesia has parallels in other developing countries.

In the case of Indonesia, it became clear after the financial crisis that the state banks were recklessly run while foreign owned banks were more prudently managed.

Table: Bank Categorization in Indonesia after the financial crisis (1999)

Groups of banks	Category A	Category B	Category C	Total
State owned banks	-	-	7	7
National private banks	32	62	34	128
Take Over banks (BTO)	-	-	4	4
Local Govt. Dev. Banks	12	10	5	27
Mixed banks (Domestic and foreign)	12	16	4	32
Foreign Banks	10	-	-	10
Total	71	78	59	208

CAR: Capital Adequacy Ratio or bank health indicator
Category A: good business prospect; adequate capital reserves more than 4%
Category B: business prospect not good; adequate capital reserves less than 4% and more than -25%
Category C: there is little business prospect; adequate capital reserves less than -25%.
Source: Business Watch Indonesia, Sector report, table 8.: based on information from Bank Indonesia Annual Report, 1999

The IMF has pressed, as loan conditions, for the privatization of banks due to the poor performance of these Indonesian state-run banks. The privatization of state banks was done by finding investors for strategic alliances and by selling shares to the public. However, shares and assets were sold at rock bottom prices, far below the amount of money injected in these banks by the government before privatization. In the new strategic alliances, the government often lost control over the privatized bank.

3.6.2 Financing privatization by the financial industry

The IMF, World Bank and donors have been arguing for the privatization of public services including telecoms, postal, energy, health, education and water precisely because many developing country public services are a mess and are hugely loss-making, offer poor service, are inefficient and significantly contribute to budget deficits and rising debt.

The benefits of privatization are subject to hot debates. Proponents ignore[19] those cases where prices have increased, distribution is more limited and excludes the poor, and where governments loose control over resources needed to fulfil basic human rights obligations such as universal health care and water distribution.

While the benefits and results of privatization are still debated in Indonesia,[20] private financial firms have supported privatization by:

- providing debt restructuring services[21] before the public services are offered for sale,
- giving advice to companies that want to buy the privatized companies,
- providing loans to companies (often transnational corporations) that are buying up the privatized public services, and

- issuing shares and bonds[22] for privatized companies.

3.7 Critical issues related to labour in the private financial sector

In the context of poverty eradication, the financial industry could play a role in providing jobs and good labour conditions. Indonesia's experience shows that the industry's contribution might not be better than in other sectors while the presence of foreign banks might make things worse.

3.7.1 Lay offs

Privatization and restructuring after the financial crisis led to massive lay offs. It is estimated that in Indonesia around 5600 workers were made redundant when 16 banks were liquidated in 1997. Given the low confidence in the banking system and the economy, not many jobs were created afterwards.

3.7.2 Not respecting labour laws

In many industrialised countries the banking sector is a fair employer with relatively high salaries and good-working conditions compared to many other sectors, but this is not usually the case in developing countries. For example, Bank Negara Indonesia (BNI), Indonesia's second largest bank violated the regulations and law pertaining to 'contract' workers, which is common practice in Indonesia. Temporary contracts did not become permanent contracts after three years, as required by law. Employees with temporary contracts have no protection of their labour rights and an unclear status.

3.7.3 Discrimination between foreign and domestic employees at foreign banks

There is evidence of discrimination between local and foreign employees when foreigners move into management positions in developing countries. When Standard Chartered Bank took over management of Bank Bali in Indonesia, wages and lifestyle of the expatriate management was dramatically higher than for local staff, despite a worsening economic situation of Bank Bali. In addition, discriminatory allocation of bonuses by Standard further offended many domestic employees and managers of Bali Bank.

3.8 Conclusions: critical issues for developing countries

The case study of the financial sector in Indonesia revealed some particular critical issues of the financial services sector that are particular for developing countries:

1. Low financing levels for small and medium-sized enterprises, particularly by foreign banks.

2. Reluctance by small or informal producers and the poor to take a loan from a bank.

3. Concentration of presence of national and foreign financial services in the economically better developed regions and the political centres.

4. Changing focus of banks to consumer credit rather than credit for investments in the economy.

5. The lack of regulatory and supervisory capacity, aggravated by corruption, has resulted in huge amounts of bad loans being taken over by the authorities, and to the restructuring of the financial sector; this has cost billions of dollars in taxpayers' money that could not be spent on needs of the poor and the environment.

6. Lending by foreign banks to banks and companies in developing countries can be large and be too risky, resulting in a financial crisis.

7. The Western financial industry is involved in the external debt of developing countries through loans, underwriting governmental or company bonds and company shares. While the debt owed by the Indonesian governmental to commercial banks and to bondholders is far below debt owed to other (international) governmental organisations, the external debt by the Indonesian private sector is relatively high compared with the external debt by the government. Together, the huge external governmental and private debt has an important influence on foreign exchange management and economic development (e.g. focus on exports for foreign exchange earnings rather than for domestic consumption).

8. Developing countries are dependent on Western credit rating agencies to obtain new loans.

9. (Governmental) agencies that provide financial guarantees for trade with and investment in developing countries protect foreign lenders and investors against non-payment, while the financial burden is left with developing countries, further increasing their external debt.

10. Privatization of national banks allow the domestic and foreign private financial industry to take over the whole financial sector of the country. In this way, Indonesia becomes part of the consolidation wave of the top world financial firms.

11. Financial firms provide several services to support and finance privatization of essential services even if the benefits for the population is controversial and not guaranteed.

12. There are different problems related to labour in the private financial industry:
    - Non-respect of labour laws.
    - Discrimination between domestic and foreign staff of a financial firm.
    - Corruption scandals result in (innocent) employees to be laid off to restructure the troubled bank.

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[1] The financial sector study by Business Watch Indonesia (BWI) is published separately of this financial sector report and contains much more details of the issues described in this summary. The sector and country studies about the financial sector can be viewed in English on Somo's website www.somo.nl, or a copy of the report can be requested from SOMO or Business Watch Indonesia (BWI). Information and data mentioned in this chapter comes from the BWI case study except otherwise referred to.

[2] http://www.citibank,com/indonesia/gcb/english/peka/index.html

[3] www.citibank.com/indonesia/gcb/english/services/branch.html

[4] Bank Indonesia, Public & private sector external debt, [November 2003], at www.bi.go.id

[5] Bank Indonesia, Indonesian government bonds in international capital market, 7 November 2003, at www.bi.go.id

[6] Bank Indonesia, Public & private sector external debt, [November 2003], at www.bi.go.id

[7] See by INFID: www.infid.org

[8] Bank Indonesia, Public & private sector external debt, [November 2003], at www.bi.go.id: this amount includes the figures mentioned in the paragraphs above.

[9] Indonesia credit rating upgrade "imminent", S&P says, at www.bi.go.id/iie/news.asp?New=57

[10] Indonesia credit rating upgrade "imminent", S&P says, at www.bi.go.id/iie/news.asp?New=57

[11] Japan Credit Agency, Indonesia's Official External Debt Rescheduling Agreed, April 15, 2002 (viewed a thttp://www.jcr.co.jp/topics/indoe.htm : 'at the London Club… the Yankee bonds due 2006 will not be included in the debts to be restructured under "comparability of treatment" provision in the agreement."

[12] Government gearing up for London Club meeting, in The Jakarta Post, 16 april 2002, view at http://www.nafed.go.id/news/index.php?artc=163

[13] Indonesia credit rating upgrade "imminent", S&P says, at www.bi.go.id/iie/news.asp?New=57; Government gearing up for London Club meeting, in The Jakarta Post, 16 april 2002, view at http://www.nafed.go.id/news/index.php?artc=163

[14] S. Donnan, Jakarta set to appoint banks for bond issue, in FT, 19 January 2004.

[15] For further explanation, see chapter 1.

[16] I. Altmeier, F. Irawan, S. Fried, R. Noor, Summary: Double destruction - The role of ECAs in Indonesia's forests: from pulping the people to looting for palm oil while destroying US jobs, May 2002, at www.eca-watch.org/problems/

[17] Bank Indonesia, Public & private sector external debt, [November 2003], at www.bi.go.id: estimates for September 2003; the ECA debt was US$ 16.9 bn in June 2003.

[18] Business Watch Indonesia, sector study, chapter 1.3.2.: in Indonesia, some of the banks were owned by the former president Soeharto's family such as Bank Andromeda, Bank Industry and Bank Jakarta.

[19] See for instance examples of problems in many developing countries reported in Social watch report 2003 - The poor and the market, Uruguay, 2003.

[20] NGO warns of unrestrained privatisation of public service, in The Jakarta Post, 14 February 2003.

[21] See the case study of ING Group in Indonesia at www.somo.nl

[22] Business Watch Indonesia, sector study, chapter 1.3.2.: underwriting by international investment banks for telecommunication company Indostat and State Gas Company

Chapter 4
Corporate Social Responsibility initiatives in the financial services sector

Introduction

The private financial sector has an important role in discussions about corporate social responsibility (CSR) and corporate accountability. By intermediating financial flows, many financial firms raise, allocate and price capital as well as provide risk coverage for businesses.

Increasing attention of the role banks play in business operations or large projects that lead to human rights violations and environmental degradation has helped to open the discussion of 'accountability' of these financial firms. The private financial sector, however, includes a diverse group of sub-sectors, ranging from commercial and investment banks, asset management institutions, reinsurance and direct insurance groups.
Apart from overall CSR initiatives covering all corporations in all sectors of the economy, there are many specific initiatives that aim at setting voluntary CSR standards for the financial sector. Some of these CSR initiatives cover all the activities within the financial services sector, while others relate to some particular sub-sector financial activities such as insurance.

Most of these **private sector specific CSR initiatives** can be divided into three areas:

1. How financial firms operate in-house: the social and environmental aspects of their own operations such as labour and work conditions, recycling and energy consumption.

2. How policies, services and products of financial firms impact society: the social, human rights and environmental impacts of, for instance, projects financed by banks or bonds issued by an investment bank. CSR initiatives relating to the impact of financial services can also cover the way in which financial firms operate, e.g. the terms an insurer uses to assess the risk of a company. These initiatives often focus on how CSR principles are managed (not what their actual effects are).

3. How financial firms actively promote sustainable development: financial firms can be pro-active and support socially and environmentally friendly developments, e.g. by designing new products that favour better social or environmental practices. Such products might be, for example, loans with lower interest rates for companies with a proven social and environmental record. Financial firms can also advocate for more sustainable practices among their colleagues within the whole financial industry.

This report does not include a fourth area, charitable initiatives by financial firms. SOMO views that charitable activities would not be necessary if CSR would cover the core business of any company and if all firms paid enough taxes.

Once CSR initiatives are underway and guidelines determined, **reporting** by financial firms on the social, environmental and/or sustainable development aspects of their activities and the implementation of the CSR principles to which they subscribe, is necessary. Reporting initiatives of financial firms are described at the end of this chapter. They reveal that most do not disclose the concrete social and environmental impacts of their financing activities, but rather promote in-house policies and new 'sustainable' products, which makes evaluating the effectiveness of many financial CSR initiatives impossible. Full reporting could however take CSR a step further to full implementation and external verification.

This report does not assess the many different codes of conduct, business principles or mission statements made by the different banks themselves. Neither will this report review all the national initiatives underway, for instance by branch organizations of the financial industry.

This chapter gives an overview of CSR initiatives at the **international level** that are specific to the financial sector. This chapter is divided per sub-sector in the financial services industry (for definitions see chapters above) but starts with those CSR initiatives relating to all financial services.

4.1 CSR initiatives and guidelines covering all financial services

There have been several international efforts to draw up CSR guidelines that would apply to all activities of the financial services industry. In practice, guidelines are voluntary and only apply to those in the industry that signed up to such initiatives.

Important allfinanz CSR initiatives, sponsored by only part of the financial industry, are the EPI-finance project, the UNEP Statement by Financial Institutions on the Environment and Sustainable Development, a statement by CEO's of financial firms belonging to the World Business Council on Sustainable Development (WBCSD) and The United Nations' Global Compact's supplement on the financial sector.

In 2003, NGOs drew up The Collevecchio Declaration, which proposes a radically different approach to corporate social responsibility in the financial sector than earlier industry driven CSR initiatives.

4.1.1 UNEP Finance Initiative[1]

From 1992 onwards, the United Nations Environment Program started to engage financial firms and institutions in a dialogue on economic development, environmental protection and sustainable development, through its Finance Initiative[2] (UNEP FI).
The mission of UNEP FI is to work with financial companies and institutions to identify, define and promote good and best environmental practice in their internal and external operations.

UNEP FI is a collaboration of more than 200 commercial and investment banks, insurance and re-insurance companies, fund managers, multilateral development banks and venture capital funds. UNEP does not manage the project and does not hold the budget. NGOs are not the main partners of the initiative. NGO involvement has been permitted occasionally, usually after letters of protest.

UNEP FI originally included two distinct parts: (a) the Financial Institutions Initiative and (b) the Insurance Industry Initiative. Each of these initiatives is based on a related statement of commitment to sound environmental and sustainability management principles. (for the Insurance initiative and statement, see below).
The two initiatives were merged to become the UNEP Finance Initiative during the UNEP FI Annual General Meeting in October 2003. Participants of the initiative still sign either of the statements, depending on their core activities.

The “UNEP Statement by Financial Institutions on the Environment and Sustainable Development”[3]

This statement was established in 1992 and revised in May 1997 to include other financial institutions than just banks. It focuses on the commitment of financial enterprises on environmental sustainability in the three areas of their activities.

a. **Internal operations**, including energy consumption, resource efficiency and waste recycling. These issues are frequently used to gain support from the company’s management and to ‘green’ the office culture, because some gains can be shown through cost reduction.
b. The Statement emphasizes that **identifying and quantifying environmental risk** should be part of the normal process of risk assessment and management. It supports the precautionary approach to environmental management.

c. The Statement promotes the **development of products and services** that will actively promote environmental protection.

The Statement intends to promote environmental responsibility in the financial sector. The Statement recognises the need that signatories conduct internal reviews and measure their activities against their environmental goals. It promotes information sharing with customers and other stakeholders; research; dialogue with other financial corporations and sharing best practice with them; and work with UNEP to review their success in implementing the Statement.

In addition to the two statement, the UNEP FI has three key working groups:

1. **Climate Change:** experts of banks and insurance companies join in this group to assess the role finance can play in reducing greenhouse gas emissions, and promoting renewable energy and inform policymakers on their findings.
2. **Investment:** this program aims to provide a platform for sustainability of investments by e.g. institutional investors, especially in emerging markets. The working group has also designed sustainability indicators for capital markets.
3. **Environmental Sustainability Management and Reporting (SMR):** this program offers guidelines and a discussion forum for SMR, and collaborates with the Global Reporting Initiative (see later in this chapter) on environmental performance indicators for the financial sector.

Each working group:

- includes 15 to 20 companies,
- is chaired by one or two of the companies,
- aims at exchanging views, developing common approaches and facilitating better understanding of environmental trends and their implications for financial services

In addition, UNEP FI currently has **two projects**:

1. **Finance and Conflict**: this project attempts to analyse the role financial companies have in sustaining conflicts, and consequently seeks to asses in what ways financial enterprises can help promoting peace instead of conflict[4].
2. **Water**: this project focuses on the role financial institutions could have in creating water sustainability. It aims to assess potential risks and opportunities of engagement in the water sector and water related domains.

Besides these thematical groups, the UNEP FI also has established five regional task forces: Africa, Asia-Pacific, Latin America, North America and Central and Eastern Europe. Those regional groups are supposed to work closely together with the general working groups and projects.

Mostly through **annual meetings**, UNEP FI aims to stimulate discussions among decision-makers and staff of financial firms around the world.

→ Critical issues

The UNEP Financial Initiative has some serious shortcomings. The statements are not binding, and thus are no more than an expression of good intention. There is no external verification mechanism of the implementation of the statement by the signatory financial firms. According to observers, peer group pressure does not take place as expected, which means that it is difficult to deal with the free riders. Moreover, the commitments in the statement are not very far-reaching nor strongly worded, which casts doubts about the meaningfulness and impact of the statement[5].

4.1.2 The EPI-Finance 2000 initiative to develop environmental measurement indicators

In 1999 and 2000, 11 financial corporations with headquarters in Germany and Switzerland developed indicators to measure the environmental performance of financial firms.

The set of Environmental Performance Indicators for the financial industry (EPI-Finance 2000[6]) applied the new environmental performance evaluation standard of the International Standards Organization (the so-called "ISO 14031") 14031 as a guideline.

The EPI indicators are categorized by 'Management Performance Indicators' and 'Operational Performance Indicators,' and focus on primarily on direct environmental effects of financial firm's behaviour. The project did not consider 'Environmental Condition Indicators' indicators that measure more indirect environmental impacts, for instance associated with a project's credit line. The financial firms developing the indicators decided it is methodologically problematic to measure such environmental changes because they see it as their client's primary responsibility to document these changes.[7]

The EPI-Finance 2000 proposes indicators covering **four categories** of financial services:

1. commercial banking,
2. investment banking (which here also covers project financing),
3. asset management,
4. insurance.

And indicators **relating to**:

a. integrating environmental issues into the core business, including operational activities,
b. development of environmental products and services for financing or insuring environmental pioneers and innovations.

Because financial institutions rarely know their clients' eco-balance, the guideline drafters decided it was not possible in 2000 to develop universal indicators for environmentally oriented products and services. Rather, each financial firm should define, for itself, an environmental quality standard, which it is supposed to use to determine environmentally oriented products and services.

The EPI-Finance 2000 report identified the environmental relevance of financial services[8] as described in the table below.

Table: The environmental relevance of financial services

Business sector	Product and services with particular environmental relevance	Products and services with less environmental relevance
Commercial Banking	Corporate clients Mortgage lending	Letter of credit Guarantees Lombard loan Interbank business
Investment Banking	Corporate Finance Project Finance Trade Finance	Trading
Asset Management	Shares Funds Real estate (provided that it is contained in "Assets under Management")	Money market Interbank business
Insurance	Corporate clients (Environmental-) third party liability	Life insurance

Source: EPI-Finance 2000, Environmental performance indicators for the financial industry.

4.1.3 WBCSD Working Group Finance

In 2001, the World Business Council on Sustainable Development (WBCSD) was approached by a group of banks, insurance, and reinsurance companies and asked to start a project on:

- the impact of sustainable development on the financial industry,
- the criteria on which a sustainability strategy for the financial industry should be based.

Based on a series of stakeholder dialogues, the Financial Sector Project released a position paper[9] in Johannesburg during the World Summit on Sustainable Development at an event organized with the UNEP Finance Initiative (2 September 2002). The chairmen of 11 financial firms that were member of the WBCSD Financial Sector Project:

a. argued that integrating sustainable development into their businesses is crucial for continued success,
b. outlined the major issues from a business perspective, namely integrating sustainable development into the core business and management systems as well as in relationships with different stakeholders; promoting sustainable development issues with other companies in the financial sector; creating innovative financial products and services that promote a sustainable society,
c. recognised the influence and responsibility of financial companies as drivers for change towards sustainable development in the sector, however it was noted that the limits of this influence needed to be further explored,
d. encouraged the sector to be more transparent in its financial reporting.

4.1.4 UN 'The Global Compact' Financial Institutions' Initiative

The UN Global Compact is a CSR initiative applicable to all business sectors, expressed in 10 voluntary principles on human rights, labour rights, environment and anti-corruption. The initiative was started by Kofi Annan, Secretary General of the UN, in an attempt to integrate social and environmental issues in business practices.

In the beginning of 2004 financial institutions in particular were invited to join the initiative, and in June of that year 18 financial institutions (among which banks, insurance companies and asset managers) designed a set of recommendations and guidelines especially directed to the financial sector, published in the report "Who cares who wins. Connecting Financial Markets to a Changing World". [10]

In the report, the financial firms made recommendations to all sorts of financial market participants, ranging from stock exchanges, pension funds, investors, financial advisors, financial institutions and regulators. The main recommendations are:

- **Analysts, asset managers, brokers, investors** and **pension funds** are recommended to screen investments on Environmental, Social and Governance (ESG) factors and urge companies to pay more attention to these issues.
- **Financial institutions** are recommended to include these ESG indicators more systematically in their research and investment decisions.
- **Companies** should themselves also pay more attention to these issues in their business activities.
- **Consultants and financial advisors** are recommended to create more demand for research on ESG performance, and work on improvement of reporting on those issues.
- **Regulators** should provide a clear, predictable regulatory framework. A minimum degree of disclosure on ESG issues is necessary to improve the financial analysis. **Stock exchanges** are recommended to require listed companies to disclose

information on ESG issues.

- **Accountants** should facilitate standardisation.
- **NGO's** can play a role in providing the public and financial sector with objective information on companies' performance.

4.1.5 Wolfsberg principles

The Wolfsberg Principles[11] are a set of guidelines to combat money-laundering activities. The guidelines were designed and endorsed by a group of 12 commercial banks, the "Wolfsberg group", called after a gathering at the Swiss Chateau Wolfsberg in 2000. Members of the Wolfsberg group are: ABN Amro, Santander Central Hispano, Bank of Tokyo-Mitsubishi, Barclays, Citigroup, Credit Suisse, Deutsche Bank, Goldman Sachs, HSBC, JP Morgan Chase, Société Générale and UBS.
The group has developed the following statements and guidelines:

- Wolfsberg Anti-Money Laundering Principles for Private Banking (published in October 2000, and revised in 2002). These principles state that banks will only accept money of clients "whose source of wealth and funds can be reasonably established to be legitimate".[12]
- Statement on the Suppression of the Financing of Terrorism (January 2002). Since not all funds to finance terrorism derive from criminal activity, regular Anti-money laundering policies do not suffice to mitigate terrorism. The banks' state that they want to work with governments to prevent financial services to terrorist groups, detect suspected terrorist financing, and share information with government entities.
- Wolfsberg Anti-Money Laundering Principles for Correspondent Banking (November 2002). Corresponding banking refers to the services offered by a domestic banks, e.g. a bank account, to foreign institutions. For example, the Principles state more attention is to be paid to the correspondent banking client's domicile, ownership and management structures and business and customer base.
- Statement on Monitoring, Screening and Searching (published in September 2003). In this document, the Wolfsberg Group aims to identify means to adequately monitor, screen and search financing of terrorist and other criminal activities.

4.1.6 The Collevecchio Declaration by NGOs

A group of NGOs concerned with the damaging environmental and social results of projects financed by banks and other financial firms drew up new guidelines and principles for the financial sector.

The Collevecchio Declaration on Financial Institutions and Sustainability constitutes the most comprehensive set of guidelines of the CSR initiatives up to 2003. The declaration outlines civil society's expectations from the financial sector to advance sustainability. These expectations go far beyond current practice and are radically different from the financial industry's current thinking, practice and CSR initiatives. The Declaration aims for real improvements on the impact financial services activities have on societies and environment.

The declaration was released[13] in January 2003 and was endorsed by over 100 civil society groups by the beginning 2004.

The Collevecchio Declaration states the six key guiding principles NGOs are calling on banks and other financial firms to adopt. It also outlines the immediate steps necessary to implement the principles. NGOs expect financial firms to adhere to these six major principles, throughout all levels of their activities and transactions.

Principle 1.
Commitment to sustainability at the level of core business
Steps to be taken immediately

a. Measure environmental and social impacts of the financial firm's range of activities including lending, investing, underwriting and advising.
b. Strive to continuously improve management and evaluation systems related to environmental and social impacts of the activities financial firms finance.
c. Foster sustainability operations and products, transfer financial support away from damaging activities to sustainable alternatives (e.g. renewable energy rather than pipelines projects), and advocate sustainable practice within the wider financial industry.
d. Implement sustainability objectives and capacity building with and for staff.

Principle 2.
Commitment to adopt the precautionary principle and 'Do No Harm' approach
Steps to be taken immediately

a. Use sustainability procedures including project screens, which asses impacts at the environmental and social levels.
b. Adopt internationally recognised sustainability standards relevant to the project or company to which financial services are provided (e.g. Forest Stewardship Council standards).

Principle 3.
Commitment to responsibility
Steps to be taken immediately

a. Bear full responsibility for the impacts of transactions and risks taken.
b. Recognise financial firms' role in developing country debt crises.

Principle 4.
Commitment to accountability to their stakeholders
Steps to be taken immediately

a. Engage in public consultation with the aim of taking the views of the stakeholders, especially those affected by financial services, including when they say NO to a transaction.
b. Support rules on stakeholder rights.

Principle 5.
Commitment to transparency
Steps to be taken immediately

a. Issue annual corporate sustainability reports with information pertaining to all levels of business including sub-sectors and subsidiaries.
b. Disclose information on completed or pipeline transactions.

Principle 6.
Commitment to Sustainable Markets and Governance
Steps to be taken immediately

a. Recognise and support the government's role in policy and regulation.
b. Discourage inappropriate financial practices such as use of tax havens and currency speculation whilst encouraging decisions based on longer-term time horizons.

The Collevecchio Declaration is being by used as a base for NGOs to assess and make recommendations for other declarations, codes and CRS initiatives currently being put forward by the financial industry (see below: Equator principles, reporting initiatives). NGOs working with the Declaration meet regularly to update, develop and coordinate their work under the umbrella named "BankTrack".[14]

NGOs are aware that not all improvements can come from the financial industry itself. The Collevecchio Declaration (see principle 6) calls on the financial industry to support regulatory changes that make it possible for the sector as whole, to advance sustainability. This call warns against lobbying of the financial industry against governmental social and environmental regulations for the financial industry, which could undermine CSR initiatives. Friends of the Earth-US issued recommendations aimed at improving regulation and public policy.[15]

4.1.7 Further developments and critical issues

Various CSR initiatives covering all financial services refer to **continuous development and changes of guidelines**, and the need to improve transparency. Yet, most fail to call for external verification.

So far, many initiatives focus on the environmental aspects of sustainability and corporate social responsibility with **less attention to social, labour and human aspects.** While the labour conditions in European banks might be fine, in developing countries, this is not always the case even at branches of Western banks, as was revealed in case studies researched by Observatório Social in Brazil[16] and Business Watch Indonesia[17]. Gender issues should also be part of the corporate social responsibility because of the domination of women employees at the lower job level and domination of men and masculine culture at the (top) management levels.

The problems surrounding financial firms **disclosing information** on the implementation of CRS initiatives has been the focus of many NGOs campaigns. Many banks refuse to release information arguing client confidentiality and business competitiveness. However, some ethical banks and even the Bank of Scotland release fairly extensive lists of projects and clients, which shows that more transparency is possible.[18]

4.2 CSR aspects in retail and corporate banking

Banks' lending services to individuals, governments and companies have lead to many civil society actions directed at particular banks[19] as well as the wider industry.

4.2.1 Project financing

Project financing is the target of many CSR initiatives. Projects that are considered 'high risk' are precisely those where CSR problems are most likely to occur.

Risky project areas:
- financing projects that harm tropical rainforests e.g. palm oil plantations,
- financing mining operations,
- financing oil and gas operations,
- financing trade in 'blood diamonds' originating from rebels in conflict areas,
- financing investments in countries that gravely violate Human Rights (e.g. Burma)

NGOs have undertaking campaigns against financial firms for their role in financing such risky projects. In response, some financial firms have developed sector specific guidelines for project financing. For example, ABN Amro developed the "ABN Amro Risk Policies on Forestry and Tree Plantations". However independent, external verification of the implementation of these guidelines is still not in place.

Various groups of NGOs are involved in developing environmental and social standards for projects including dam and mining projects. They promote these standards at international governmental sector forums such as the Forest Investment Forum and the World Commission on Dams. These same standards should be used by the financial industry in their risk assessments before financing these types of projects[20] and before providing financial services to corporations in the related sectors. Project financing is a small part of the activities of many large banks.

4.2.2 Equator Principles by banks

The Equator Principles[21] are a set of voluntary commitments, designed by a group of banks, which are similar to those environmental and social safeguard policies already being used by the International Finance Corporation (IFC), the private financing arm of the World Bank.

The IFC convened a meeting of banks in London in October 2002 to discuss environmental and social issues in project finance. At the meeting ABN Amro, Barclays, Citigroup and Deutsche Bank decided to develop a banking industry framework to be used to assess environmental and social risks in project financing. This led to the drafting of the Equator Principles, which uses the IFC standards as a basis in lending procedures for big projects. Banks do not actually sign a statement. Instead, they 'adopt' the text and promise to implement the framework in their organization.

By adopting the Equator Principles, the banks state that they will only provide loans directly to projects if they have fulfilled certain conditions. Some conditions are:

- Based on the safeguards of the IFC, the bank identifies the risk category of a project: A, B and C. Categories A projects involve very risky projects, projects in category B are less risky, and in category C projects, the risks are minimal or to be neglected;
- For all Category A and Category B projects, the banks have to complete an Environmental Assessment (EA). The preparation of the EA is supposed to be consistent with the outcome of the categorisation process and satisfactorily address key environmental and social issues that have been identified during the categorisation process;
- For all category A projects, and for category B projects if applicable, borrowers have to have prepared an 'Environmental Management Plan' (EMP) which draws on the conclusions of the EA. It includes plans for mitigation, monitoring, management of risk, and schedules.
- If necessary, an independent environmental will be appointed for additional monitoring and reporting;
- Finally, the principles only apply to projects over $ 50 million dollar. According to the Equator banks website[22], projects below this threshold represent only 3% of the total project finance market.

The banks that endorsed the Equator Principles in June 2003 were mostly those banks which had been under pressure by civil society actions. The first 18 banks that signed the Principles covered 74%, or $ 43 bn, of all project financing loans. In 2004, the Principles are predicted by legal experts to become the prevailing standard for addressing social and environmental issues in project finance transactions.[23] In the beginning of 2005, 28 banks had endorsed the Principles.

→ Critical issues

No further steps?

Some banks confided with NGOs that in reality it is difficult to take further steps if other banks do not also apply those principles. However, Citigroup agreed beginning 2004 to implement higher environmental standards, for example, related to endangered ecosystems and zones with social fragility, illegal logging, climate change and renewable energy. Rainforest Action Network called Citigroup's move the strongest articulated environmental policy of any private financial institution.[24]

Downgrading the IFC standards?

Just when the Equator Principles were finalized[25] (April 2003), the IFC Ombudsman identified various implementation problems with IFC's environmental and social safeguards. As a result, the IFC started an overall review of its environmental and social safeguard policies and standards in 2004. NGOs monitoring the process fear that the financial industry, which has been asked to provide input, will push to weaken IFC policies. IFC is aiming to change its principles 'performance standards' instead of 'safeguard policies'. This could be problematic, because then banks can will only try to satisfy the listed standards, instead of actually trying to warrant the interests of stakeholders. If the IFC standards will be weakened, this would also endanger the Equator Principles, since they are the standards on which the Equator principles are based.

What difference in practice?

To date, it is not clear whether using these principles make a difference in practice when banks screen new projects. Due to fierce international competition, banks decide quickly about buying into a syndicated loan project. The extra times it takes to assess sustainability aspects might result in competing banks stepping into the lucrative project (although, if all banks adopted and abided by the principles, they all must make the additional assessments).

Already during the early stage of implementation (January 2004) NGOs have begun to question whether those banks, which signed up to the Equator Principles even use them.

The principles seem not to prevent banks from financing the same kind of projects that in the past have proven to be environmentally destructive.[26]

Five projects have already been identified where signatories of the Principles are financing[27] highly problematic projects, which violated IFC policies. The controversial projects include the Baku Tbilisi Ceyhan pipeline[28] (ABN Amro is coordinator of the syndicated loan) and the Camisea gas pipeline in Peru.[29]

And for those projects that are 'assessed' using the Equator Principles, NGOs have no way of verifying whether and how the banks actually implement the procedures. Do they use models? Checklists? As there is no disclosure mechanism, there is no way of verifying, at this point, how the principles are implemented.

4.2.3 Beyond the Equator Principles

NGOs in BankTrack said that despite the problems, the Equator principles are an important first step in reforming project finance.

In their first comment on the Equator Principles[30] (June 2003) BankTrack outlined **outstanding critical issues in the CSR debate**:

1. *No-go areas*: The "Do no harm" principle in the Collevecchio Declaration calls for an explicit commitment to categorical prohibitions for the most socially and environmentally egregious transactions. The Declaration also emphasizes a precautionary-based approach rather than one based on mitigation.

2. *Scope of applicability and effectiveness—too limited:* NGOs recognise the limitations of the current CSR initiatives in the financial sector as they mostly apply to project finance only, and only pertain to direct loans. Banks should review the environmental and social impacts of different segments of their activities and develop appropriate policies. For example, mining and forestry are often very sensitive sectors but are not commonly financed by project financing and syndicated loans but for instance through open account credit to mining or forest companies.

3. *Lack of accountability and transparency*: There is no mechanism for ensuring that endorsing banks actually implement CSR standards. Banks refer to their commercial interest to retain "bank secrecy" and refuse to provide civil society organisations with insight in which projects they are financing or which companies they financially support. It would be relatively easy for banks to disclose all of their investments and projects, so that NGOs can independently monitor and scrutinize projects. The lack of transparency requirements prevents endorsing banks to use peer pressure and prevents the public to monitor implementation of CSR.

4. *Weak on social issues:* the standards of the International Finance Corporation (IFC) are, compared with those of the World Bank, relatively weak on social issues, and the Equator Principles reflect this weakness. For example the late January 2003 version of the Equator Principles referenced "human rights," but was replaced by "socially responsible" in subsequent versions.

5. *IFC standards are not best practice:* NGOs hope that the adoption of the Equator Principles will not delay the adoption of best practice sector standards such as the World Commission on Dams guidelines, the forests policies proposed by WWF-Friends of the Earth[31], and the categorical prohibitions used by some export credit agencies such as the U.S. Overseas Private Investment Corporation.

6. *Recourse and responsibility:* The Principles put most of the responsibility on the borrower, and there is currently no mechanism for affected communities to have recourse to the bank in cases where standards are not being met or implemented. In contrast, the IFC itself has a Compliance Advisor Ombudsman, which investigates complaints from affected communities affected on alleged non-compliance with IFC's own policies.

Due to the many concerns about the implementation of the Equator Principles, in January 2004 BankTrack put forward a detailed statement[32] on precisely how banks should implement the Equator Principles (EP).

Five sets of recommendations on how to implement and expand the Principles are related to:

- The full integration and implementation of the EP in the banks' operation, including making themselves assessments of the social and environmental impacts.
- Integration of the EP in the banks' relations and agreements with borrowers.
- Commitment to transparency and external verification.
- Commitment to independent accountability mechanisms.
- Commitment to move beyond the current scope of the principles and meet best practices.

Ideally, other institutions including rating agencies, institutional investors and pension funds, should use the Equator Principles when they have to assess a bank or other financial firms.

4.2.4 Integration of environmental and social aspects in regular corporate financing

Most banks take no consideration for social and environmental factors when providing loans and financial services. Environmental factors are mostly only taken into account if they affect the client's credit-worthiness.[33] If the client takes environmental risks, like damaging the soil through the production processes, the bank might be affected. In this scenario, the property, which is used as collateral is being partially or wholly devalued if the production process damages the environment. Moreover, an environmental scandal can affect the bank's reputation.

Some retail and corporate banks have begun taking a pro-active approach to promote sustainability by offering environmentally oriented products such as 'eco-loans' that provide favourable conditions for environmental pioneering or innovating projects.

4.2.5 Retail banking

Some ethical banks have special saving products that promote sustainable development. For instance, clients can let the interest paid on their savings account be transferred to environmental or development NGOs.

Until now, in CSR debates, little attention has been paid to the social role banks perform in society, and as a consequence their responsibilities in providing services to a broader public. There do exist some good initiatives of banks that acknowledge their social role, and have as a consequence taken steps to improve access to credit:

- Some banks have committed themselves to keeping branches open outside of urban areas, to support to the elderly and the rural population.[34]
- The importance promotion of credits to SME's has also been identified and followed up by some important institutions. For example, the European Bank for Reconstruction and Development (EBRD) has a special program to stimulate finance to SME's in East European countries.[35]
- Increasingly, some mainstream banks have set up micro-financing activities . For example, ABN Amro did so in Brazil in 2003 and Citigroup financially supports micro-credit schemes in Indonesia. With micro-credit, small entrepreneurs are provided with very small credits, which is generally believed to be a very good mechanism to combat poverty. The UN have designated 2005 the "International Year of Microcredit", a project coordinated by the United Nations Capital Development Fund (UNCDF) and the United Nations Department of Economic and Social Affairs (UNDRSA). The project is sponsored by Citigroup, ING Group and Visa.[36]

4.2.6 Alternatives

Even thought banks have paid increased attention to CSR issues, too often these initiatives are used as mere Public Relations and charity, and are not considered as banks' core credit activities. Some civil society groups have therefore developed ideas on ways to arrange credits, without reliance on the commercial banking sector. The credit unions already present in many countries, are an example of such an alternative to commercial banks. Some NGO's have proposed more far-reaching systems. For example, the Strohalm Foundation stimulates the use of Local Exchange Trading Systems (LETS) in which small companies and consumers cooperate. The profit of such systems is that people are less dependant on a bank, and that there they don't have to pay any interest.[37]

4.3 Asset management and socially responsible investment

Different financial service providers are involved in asset management:

- Banks and investment firms assist corporations, wealthy individuals and institutional investors by managing their capital and other assets to get the highest rate of return.
- Insurance companies manage assets in order to have enough financial reserves to service potential insurance claims.
- Pension fund managers invest to increase their capital to guarantee payment to pensioners who paid contributions.
- Mutual funds invest in company shares to increase the value of their funds and provide high returns to their clients.

An important part of asset management (managing money) is buying equities that are expected to earn high returns in the short or long term. These investments allow companies listed on the stock market to operate and expand their activities.

4.3.1 Investing in companies - socially responsible investment (SRI)

Asset managers have traditionally only focus on high returns when they select a company to invest in. Rarely, if ever, did they use criteria beyond those which assess the **financial viability** and **profitability** of companies. Their investments could, and do, support companies whose activities are exploitative, destroy the environment and violate human rights.

Due to many actions, discussions and initiatives by civil society groups and trade unions there has been increased pressure asset managing institutions, including pension and mutual funds, to review the corporate social responsibility of companies in which they invest and withdraw their capital from companies which violate human rights and destroy the environment.
Different strategies can be used to screen companies on social and environmental criteria[38]:

- **Exclusion** mechanism: certain sectors/companies will simply be excluded from the investment portfolio (e.g. nuclear energy, weapon industry, tobacco, pornography);
- **Targeted investments**: investments will be specifically directed towards sectors/companies/projects that have a social value added (e.g. education, recycling, healthcare, renewable energy);
- **Best-of-class** approach: investments will be directed towards companies that are performing well on social and environmental issues *compared to* other companies in the same sector;
- **Engagement**: investors will use their shareholder power to engage companies into better social and environmental policies.

As a consequence to this increased attention to socially responsible investments, a large industry has evolved around the research of and ranking of companies on SRI grounds. Since research on environmental and social performance can be costly for individual investors, these firms make it easier for asset managers, institutional investors a means to include these indicators in their choice of investments.
Research institutes include SiRi company, an international network of private research organizations. These institutes often also establish rankings of companies.

Other SRI research include ‘sustainability rankings’ like the Dow Jones Sustainability Indexes[39] (e.g. the Dow Jones Sustainability World Index) and the FTSE4Good Index Series[40].

SiRi
The Sustainable Investment Research International Group, (SiRi) is an umbrella organization for private research organizations in different countries, which supply information to the largest asset managers, insurance companies, pension funds, banks and social investment institutions of the world.[41]

The member organisation of SiRi in the Netherlands is the 'Dutch Sustainability Research BV' created by Triodos Bank, PGGM (pension fund), and MeesPierson (a private banking branch of Fortis). It cooperates with Triodos Advisory Services BV.

The SiRi database contains **profiles of 600 large international companies and 4 000 other companies worldwide.** [42] SiRi claims that each profile contains over 350 data points and analysis, and "that all major stakeholder issues are covered including community involvement, environmental impact, employment relations, customer policies, human rights issues and corporate governance.” For each issue, SiRi describes and analyses the company's policies, management systems, reporting standards and impacts together with particular strengths and weaknesses. In addition, SiRi Global Profiles contain information on controversial business practices such as armaments, tobacco, animal testing or GMOs.

"These profiles allow comparison between companies, sectors and markets over the whole range of socially responsible investment issues of concern to professional investors."[43]

4.3.2 Mutual funds and ethical funds: is there a difference?

To date, SRI information is not often used by mainstream investment and mutual funds managers. Instead, this information is especially used by “ethical funds” that buy up shares from companies that are screened for their records on environmental and social responsibility.

Either by using external research, or their own, ethical funds in Anglo-Saxon countries tend to exclude weapons and tobacco companies immediately. European ones tend to seek out companies that play an innovative role on providing a substantial contribution to corporate responsibility or sustainable development.

SiRi's overview[44] showed that as of June 2004, there were 354 European green, social and ethical funds, or 13% more than in the 12 months prior. SRI assets dropped by 16% from €14.4 billion at the end of 2001 to €12.2 billion at the end of the second quarter 2003. In 2004, assets under management accounted for €19 billion.

The shares of companies that are most often included in European green, social and ethical funds are Vodafone, Pfizer, Johnson & Johnson, Citigroup, GlaxoSmithKline, Microsoft, Royal Dutch Petroleum (Shell), Astrazeneca, BP and Nokia. However, several of these companies have been the target of civil society initiatives due to their irresponsible and destructive activities. Ethical, social or green funds seem to often include companies which are subject to NGO protests.[45] For instance, the 'ING Bank Duurzaam Rendement Fonds' includes Royal Dutch Petroleum (Shell), American Express, Bank of America, Johnson and Johnson, BP, McGraw-Hill Companies, Suncor Energy, Medtronic, Bristol Myers Squib, Societé Générale. Independent research has criticized ING’s investment criteria.[46]

→ Critical issues

No official mechanism exist to decide whether it is appropriate for SRI to include transnational corporations as ‘ethical’ whose activities to date are known to cause social and environmental destruction while thwarting corporate social responsibilities.

SRI research institutes, to date, only focus on large companies listed on the Stock Exchange. Do ethical fund managers have the capacity to identify small sustainable companies that are not listed on the stock exchange? More analysis should assess the difference of selection between ethical funds from large banks and those funds from alternative banks such as Triodos Bank.

4.3.3 UN norms for responsible investments for institutional investors

In the context of UNEP FI's asset management working group, in 2004 UNEP FI announced their "Responsible Investment Initiative", as part of UN's Global Compact Initiative. In 2005, the UN will convene a group of leading institutional investors to draft a set of Investment Principles, while a group of experts will provide advice. In 2006, the plan is to build support and capacity from within the investor and policy-making communities globally.

4.3.4 Pension fund management

Institutional investors and especially pension funds wield huge amounts of weight on the capital and investment markets.

Civil society[47], church groups and some trade unions increasingly have been pressuring pension funds to invest in companies with high CSR standards, or in ethical and green investment funds. In the UK, investment in SRI assets went from zero in 1997 to £ 80 bn in 2001.[48] A 2003 report on the 250 largest UK occupational pension funds showed that 90% included social and environmental considerations in their Statement of Investment Principles, however only 11% of the funds included either screening, a preference approach or both in their socially responsible investment policies.[49] In the Netherlands, still only 1% of total assets is directed to SRI portfolios.[50]

One of main problems with pension funds is that the people who pay the contributions (employees) and the people who receive the payments (pensioners) have no information about how their pension is invested nor do they have any say in the matter. Banks and other financial advisory companies have much more say in the management of the pension funds' assets. In other words there was, and still is, little stakeholder participation.

Another problem is that governmental regulation is focused on guaranteeing future payments to all pensioners who paid contributions, not on ethical criteria. Such governmental regulations can even undermine efforts to use ethical criteria. Pension funds that withdraw their shares from exploitative companies might loose highly profitable shares that help to meet the requested income for the future.

→ Critical issues

There is now a fierce debate by governments and firms that offer pension insurance on how income to pensioners can be guaranteed. The right to a pension is under threat because accumulated savings decrease in value due to market downturns and mismanagement of private pension funds which has shrunk the needed reserves. Because of this financial trouble of pension funds, equity considerations and ethical and environmental criteria get even more in the margin. Will Western pension rights prevail over progress towards sustainable development?

4.4 Insurance and Corporate Social Responsibility

Insurance allows individuals and companies to undertake activities by providing financial and other support in case of loss and damage. It allows individuals to rebuild their lives after theft, fire and health problems and enable companies to engage in risky business (i.e. transport) or pay for employees who are ill.

From a corporate social responsibility perspective, the questions are:
- Which individuals, companies and activities does an insurance company support by providing its products?
- What are the effects of its operations and its products on human rights, the environment, labour, consumers and society at large?
- How do insurance companies manage their funds?
- Do the insurance products promote sustainable development?

4.4.1 Responsibility on social aspects not yet developed

In conducting this research SOMO has found little evidence of international initiatives focusing on the *social* responsibility of the insurance industry except those related to asset management (see above). The insurance industry business owns and manages a huge amount of assets in order to pay for potential claims for insured clients. Equities (company shares), bonds, property, real estate, art and other valuable items are examples of various insurance company assets.

Consumers' rights, such as the right to be informed, are legislated in Western countries. Insurance companies have broader social responsibilities however, related to human rights, labour and consumers rights to access to basic services:

a. Universal access to basic services such as health insurance
Some basic principles of the International Covenant on Economic, Social and Cultural Rights (CESCR) are non-discrimination and providing the highest standard of basic needs. Private health insurance increases access to medical care and help reach the highest possible standard of health care. On the other hand, private health insurance is often only accessible to the rich. Companies offering private health insurance are expanding in developing countries but some experiences such as in Kenya[51] show that private health insurance companies focus on rich clients and deny poor clients their services. If the rich opt for private health insurance, governments in developing countries have less income to care for the remaining citizens who are mostly poor with no choice but to stay with the government's

health care plan. This undermines the whole notion of universal access and non-discrimination.

A socially responsible insurance strategy would mean adopting practices and activities that avoid the exclusion of the poor and especially women, older people, disabled, ethnic minorities and those in remote areas.

b. Labour

To date, there is little known about the working conditions of insurance employees, agents and brokers in developing countries. It is also unknown whether employees are duly informed when their insurance company is involved in mergers and acquisitions (see OECD Guidelines, IV Art. 6).

There is no debate yet regarding whether insurance companies should assess a company's labour record prior to selling it insurance products.

c. Other ethical issues , as identified by the Global Reporting Initiative[52] (see 4.6)

- Medical screening of clients and genetic testing: excluding clients based on their medical record and sometimes genetic inheritance about which they have no influence, undermines the very principle of insurance as a safety net for people with unequal chances;
- Transparent commissioning and handling of claims; in 2004-2005, the insurance industry has been overshadowed by scandals whereby in the US it came to light that many US insurance brokers and insurance companies were collectively betraying customers by charging too high premiums. Insurance firms offered brokers commissions that are only paid if the broker delivers a certain amount of clients to the company. As a consequence brokers steered tenders so that clients choose products from insurance companies giving the broker the highest commissions.
- Responsible marketing (best advice)

4.4.2 Environmental issues in CSR initiatives

The increasing number of claims from a damaged environment and from disasters due to erratic weather patterns has alarmed the insurance industry and forced it to accept that they must incorporate environmental considerations into their policies.

Risk is always the starting point for insurance companies and 'the environment' is still looked at in many different ways.
Some insurance companies recognise that damage to the environment can result in the insured person or company having to stop operations, which is a risk of loss of income. For

the insurance company, this might result in loosing that person or company's premium or even in having to pay out a claim.
Other insurance companies recognise the role of their own activities in supporting sustainable development.
Some insurers go further to promote sustainable development through interaction with other economic actors of the insurance industry and consumers.

Some insurance companies are starting initiatives to manage and reduce the risk of adverse impacts on the environment ("environmental risk"[53]) such as contamination of land, negligent of bad management of waters or hazardous facilities, and emissions that increase climate change. The **criteria and measures** they use are:

1. Attention to environmental risks in core activities including:

a. *Risk management:* techniques to calculate risk and price insurance products, which include environmental risks factors such as the use of chemicals, the location of the insured industry, community acceptance, the risk of pollution.
b. *Prevention of loss and damage:*
    - Measures of loss prevention as condition for insurance coverage.
    - Clients are required to use environmental risk control methods.
c. *How insurance claims are handled.*
d. *Design of insurance products:*
    - Contract terms and conditions, such as lower insurance premiums for environmentally positive behaviour by the insurer (e.g. If the car covered by the insurance travels a low number of kilometres).
    - Pricing of insurance contracts based on environmental risk management of the insured companies rather than categories of companies.
e. *Support for environmentally positive operations:* for example, insurance for the wind power generation business, insurance covering bicycle breakdowns and train delays.[54]

2. Environmentally friendly management of internal operations, including energy, water and paper usage, responsible travel and properties; related issues include the training of employees and communication practices and reporting on environmental data.

3. Commitment to apply national and international environmental regulations.
On the other hand, some insurance companies provide insurance products for liability arising from environmental damage such as pollution and compulsory clean up operations.[55] This might encourage companies to continue to pollute even if they have to pay an insurance policy fee.

4.4.3 UNEP Finance Initiative on insurance focuses on environment

In 1995, various insurance, re-insurance companies and pension funds outlined a "Statement of Environmental Commitment by the Insurance Industry" [56] By December 2003, the Statement was signed by 84 companies and 3 associations in 25 countries.[57] The signatories acknowledge the role they can play in managing and reducing environmental risks and the skills their industry has to measure and respond to risks. On the basis of this statement, the UNEP launched an Insurance Initiative to fund research and organize awareness meetings and workshops.
In 2003 the initiative merged with the UNEP Financial Institutions Initiative, into the UNEP Financial Initiative.

Similar to the UNEP Statement by Financial Institutions, insurance signatories want to achieve sustainable development through the market within a regulatory framework and accept the precautionary principle. They want governments to take the leadership in defining and enforcing long term priorities “values”.

Through the statement, insurance companies commit themselves to pay attention to environmental risks in their core activities. These activities include risk assessment of potential clients, loss prevention, product design, claims handling and asset management. Internal operations and property will be managed "in a manner, which reflect environmental considerations". This is a weaker commitment than made by the Financial Institutions on Environment and Sustainable Development.

The signatories promise to make periodic reviews of management practices and to integrate changes in environmental management in core activities and in communication with employees. They encourage researching creative solutions and claim to strive to adopting best practices in environmental management within the industry and suppliers. They promise to create measurable environmental goals and standards for undertaking regular internal environmental reviews. Within the limits of “commercial confidence”, relevant information will be shared with stakeholders.

4.4.4 Example of individual or branch CSR Initiatives

Besides the UNEP-FI insurance initiative, there is no major international CSR standard for the insurance sector. Some individual insurance companies have been involved in smaller initiatives. For example, some insurance companies are offering micro-insurance services in developing countries. The Dutch Interpolis, for example, cooperates with local organizations in developing countries like Sri Lanka and the Philippines to establish mutual micro-insurance schemes. These small organizations are stimulated to become self-sufficient in the future, so that the local community can help itself within their own social structure[58]. In addition, often national insurance branch organisations have developed their terms of reference for CSR policy.

4.5 Investment banking

Investment bankers are intermediaries between the issuer of securities and the investor, as well as advisors to the company issuing the securities. Only a few examples of CSR initiatives in investment banking could be identified for this research report. There are however many ways by which investment bankers have an effect on sustainable development or could actively promote it. For instance, by screening the social and environmental record of companies and governments before deciding to underwrite their new securities. There are no clear signs that banks use CSR criteria in their decision to underwrite or in the prospectuses they publish to inform future investors.

Investment banks can be affected by the bad social and environmental practices of their clients. By underwriting, a bank assumes the risk of buying all the new securities from the issuer and reselling them to the public. A bad reputation from social and environmental damages caused by the issuer could reduce the value of the new securities, and thus provide a risk to the underwriter.

4.5.1 CSR issues from the Global Reporting Initiative

The Financial Services Sector Supplement on Social Performance Indicators of the Global Reporting Initiative (GRI) (see 4.6) have identified the following CSR issues of investment banking:

- Debt of developing countries
- Investment bankers issue debt instruments such as bonds for developing countries. This can help raise money for developing countries but can also increase the debt burden by these countries as they have to repay the bond with a set (high) interest rate at a certain date. If the issuing is done while the country is already in financial problems, the repayment might easily become problematic and lead to a difficult process with bondholders to reschedule or write off this debt. This has been the case in many developing countries.
- Financial support for projects, companies or governments with considerable critical social or environmental behaviour.
- By underwriting securities unselectively, investment banks may continue or increase the malpractices implemented by their clients.
- Bribery and corruption, e.g. in order to obtain investment banking contracts.
- Control over corporate governance of recipients of investment bank services.
- Number of poor country clients.
- Innovative products that apply special ethical and sustainability criteria.

4.5.2 Issuing bonds from the World Bank

Investment banks operate not only as underwriters for bonds by developing country governments but also for financial institutions like the World Bank. The World Bank gets 80% of its funds for loans to developing countries from the selling of its bonds. Most of the World Bank bonds are bought by institutional investors such as pension funds. The latter are confident that there is little or no risk that World Bank will not repay the bonds because of the governmental backing and high rating (AAA) of the World Bank.

World Bank loans to governments, with the money raised from the bonds, have been made conditional on major macro-economic restructuring programmes. Many civil society groups see these programmes as increasing poverty and undermining sustainable development. Civil society groups from Haiti, South Africa, Ecuador and Europe have campaigned to boycott the buying of World Bank bonds. In response, many civil society groups world wide are encouraging citizens to request their pension funds and other asset managers not to buy World Bank bonds.[59]

4.5.3 Emissions trading

The UN Framework Convention on Climate Change, through the Kyoto Protocol, introduced international emissions trading, a market mechanism whereby countries buy and sell their ‘right’ to pollute based on a credit scheme.

Financial firms are involved in emission trading in various ways, partly because there is money to be made but several firms also intend to offer new products that hedge against the risks of emissions particularly in the derivatives market.[60]

4.6 Reporting initiatives by financial institutions

Reporting on the above described initiatives so far remains at the firm level (do financial firms recycle, turn the lights off?) and at the level of monitoring management (did financial firms develop the criteria and if so, how are they managing the implementation?). This is a serious problem for assessing the concrete impact of corporate social responsibility and accountability of a financial firm.
Most information is kept secret due to ‘client confidentiality’ and ‘competition,’ which means CRS and sustainability results are underreported. With so little information, external monitoring and verification is impossible.

4.6.1 Social performance reporting through the GRI Financial Services Sector Supplement

The Global Reporting Initiative (GRI) is a foundation that aims at offering companies a framework for sustainability reporting. This set of guidelines is for voluntary use by companies for reporting on the economic, environmental, and social dimensions of their activities, products, and services. Companies of all different sectors are supposed to be able to use the GRI guidelines. There is a central document for all sectors ("the Guidelines"). Developed in a multi-stakeholder process, the general GRI guidelines intend to be globally applicable with standardized reporting, which means comparing companies will be possible. In addition, GRI has developed "technical protocols" that help companies in implementing the guidelines in practice. Finally, for some industry sectors GRI has developed specific "sector supplements". For the financial sector, a pilot version for a supplement for *social performance* has been published in 2002.
In cooperation with UNEP-FI, GRI has also been working on a supplement for *environmental performance* indicators for the financial services sector. This supplement was published in March 2005 (see 4.6.2).

4.6.1.1 Social Performance indicators

The social performance indicators started as a pilot version[61] in 2002, and are ready to use. They are based on an initiative already developed by a financial industry group, the Social Performance Indicators initiative[62] ("SPI-Finance").
The GRI Financial Services Sector Supplement on social performance contains performance indicators as well as management performance indicators. The latter describe the quality of engagement on corporate social responsibility (CSR Management).

The indicators are qualitative and quantitative, but take into account that quantitative indicators will always need some qualitative interpretation.

The performance indicators for the financial services sector's social impacts cover the following **areas**:

1. **Internal** social performance, including relationships with staff's families.
2. **Society** in general, such as performance towards communities and countries in which the business operates.
3. Impacts of products and services on **clients, as well as on people who are indirectly influenced** by financial services.
4. The social performance of **suppliers** (towards their staff and society), as well as performance of the financial firm towards those suppliers.

The management and operational performance indicators[63] for reporting are organized under the following **eight aspects**:

1. Management Systems: management of sensitive issues in all financial operations such as bribery and corruption and anti-money laundering.
2. Internal Performance: human resources policies towards equal opportunities (banks are well known for employing many women in the lower paid jobs and few at the top), stress and ergonomics (SRI syndrome policy due to frequent use of computers), remuneration for senior management, and for achieving CSR criteria.
3. Suppliers: screening of major suppliers for their social performance.
4. Society: the economic value created by a company's activities and its contribution to GNP.
5. Retail Banking: avoidance of social exclusion through access to financial services, innovative products and financing to deprived communities; lending with considerable social impact; marketing practices (e.g. of speculative of highly indebting products).
6. Investment Banking: issuing of debt instruments for developing countries and other aspects of developing countries' debt; financial support projects with considerable critical social impacts; bribery and corruption; control over corporate governance of recipients; number of poor country clients; innovative products that apply special ethical and sustainability criteria
7. Asset Management: responsible marketing and advice; screening of portfolios against social criteria; innovative products that apply special ethical and sustainability criteria
8. Insurance: medical screening of clients and genetic testing; transparent commissioning; level of access by women, old(er) people, disabled people, ethnic minorities, and people living in geographically remote or disadvantaged areas; innovative products with special social benefit that are not yet offered by the market.

4.6.1.2 NGO criticism

A group of environmental NGOs that published the Collevecchio Declaration criticised the GRI's Financial Services Sector Supplement on social performance because it was not based on an extensive and transparent multi-stakeholder process. Southern NGOs were not heard during the development of the indicators whilst the indicators were determined by the involved financial firms. The Supplement “focuses too much on internal corporate responsibility aspects”[64] while the product and client side are far more important. Financial corporations have the responsibility for the environmental and social impacts of the activities they finance even if this entails indirect or complex financing operations.

Additional missing indicators in the GRI's Financial Services Sector Supplement on social performance from the perspective of SOMO's research includes:

- The social impact of developing countries' indebtedness to private financial firms or to holders of bonds or other debt instruments issued by banks;
- The lobbying and political activities of financial firms against rules that promote environmentally and socially progressive financial products and operations; or the lobby against measures that limit developing countries' or poor people's indebtedness;
- The lobbying activities of financial firms to open up markets in developing countries (e.g. in current GATS negotiations of the WTO) without a commitment to increase the social and environmental benefits of such market opening;
- Financial operations and products that contribute systematically to economic or financial crises at the national and international levels with huge social consequences (job losses, etc.); examples are operations in speculative products, quick moves out of a country for asset management purposes;
- Providing services to clients to evade taxes such as presence in taxes havens, which reduces governmental budgets to provide public social services;
- The social impact of mergers, acquisitions and restructuring of companies, which were advised and financed by private financial firms (mostly through investment banking); at least investment banks could first evaluate if the companies involved respect ILO Conventions and OECD guidelines for multinational enterprises before offering their services (e.g. information to employees in due time before mergers take place);
- The link between social and environmental performance is absent (environmentally damaging activities can have a direct social impact and vice versa); the Supplement on social performance reporting indicators needs to be integrated with environmental performance indicators (see below).

4.6.2 Environmental reporting indicators

4.6.2.1 Corporate initiatives

The set of environmental performance indicators for the overall financial industry developed by the EPI-Finance 2000 project (see above) were primarily designed for internal use and not for reporting, but they can serve as a basis for "external communication". The set calls, for instance, for concrete figures such as the number of loans for projects that are environmentally pioneering or innovative. UNEP and the WBCSD welcomed the set as a meaningful benchmark.

4.6.2.2 UNEP FI / GRI Initiative on environmental performance

Since September 2003, UNEP-FI and GRI have been building on the work completed in the social arena, and worked to develop *environmental performance indicators* for GRI's financial sector supplement. A multi-stakeholder working group developed the indicators. The working group had ten representatives from the financial industry, and ten representatives of NGO's and sustainability rating agencies. GRI and UNEP facilitated the process.

The financial supplement for environmental performance emphasizes three indicators for **direct environmental impact** about which financial firms should report (these were already adopted in the GRI's 2002 general Guidelines):

- Total material use
- Total waste by type and destination
- Indirect green house gas emissions

In addition, the supplement presents thirteen indicators to report on a firm's **indirect environmental impact**, grouped in the following categories:

- **Policy**: what policies does the firm apply to its core business lines?
- **Systems and Processes:** e.g. what processes are in place for assessing and screening environmental risks in core business lines, for monitoring clients' implementation and compliance with aspects raised in risk assessment processe.
- **Engagement:** e.g. what interactions does the firm have with clients/business partners?
- **Environmentally beneficial products and services:** what is the total monetary value of specific environmental products and services broken down according to the core business line?
- **Activity statistics:** value of portfolio for each core business broken down by specific region and sector.

4.6.3 Reporting on sustainable credit activities by banks

The VBDO in the Netherlands has been assessing four major Dutch banks (Fortis, ABN Amro, ING Group and Rabobank) by looking at sustainability and transparency aspects of the banks' credit activities (August 2003).[65] Some major conclusions of the research report are:

1. Because there are no existing criteria among civil society and in national laws about sustainable credit activities, banks have themselves to define sustainability and develop criteria. In addition banks have to develop testing, measuring and reporting methods to apply the sustainability criteria to credit activities.

2. Sustainability aspects are being taking into account by banks in their credit activities only from a perspective of risks for the bank's reputation and risks of being (financially) held responsible by society.

3. Reporting by the four Dutch banks in 2001 gave no clear or concrete information if and how sustainability criteria are used in their credit activities; the very small percentage of credits which were earmarked as sustainable (0.2% by ING, 0.4% by Rabobank) are striking.

4. Optimal instruments[66] to assess and monitor the sustainability of credits are difficult to implement. Such instruments could for instance be:
   (i) a sustainability report of every credit, which can be obtained by the public after request; or
   (ii) a sustainability certificate for each credit by the government or the Central Bank.
   One of the problems is the wish and need for confidentiality by the banking industry.

5. The two options for monitoring the sustainability of credits which seem to be feasible and acceptable by the four researched banks are:
   (i) a management system that monitors how sustainability assessment and testing of credits are being implemented, and
   (ii) external certification of such management systems.

6. The use by banks the GRI Sustainability Reporting Guidelines together with the Financial Sector Supplements on social performance indicators and environmental performance indicators would provide sufficient monitoring information, provided they make available concrete information about criteria, indicators, monitoring methods etc. with figures and percentages.[67]

4.7 Conclusions and critical issues

1. Many possibilities, disappointing results

The initiatives of corporate social responsibility (CSR) indicate many areas where the financial industry can:

a. avoid its negative social and environmental impact, and

b. support changes towards more sustainable societies through its core business.

In most of the financial services, these initiatives are not taken into account. For example, the US$ 8,000bn mutual fund industry in the US invest hundreds of billions in securities of companies without any screening for their social and environmental behaviour. In Europe, ethical funds are only 0.36% of total assets managed on the continent and the companies most listed in those ethical funds have often been subject to criticism for non-responsible behaviour e.g. Shell, Citigroup.

Recent scandals at investment banks (conflicts of interest) and mutual funds (unauthorised trading) which transferred huge illegitimate amounts of money to management at the expense of the investing client, indicates that much still needs to be done about basic ethical and decent behaviour in conducting the core business.

2. Wide range of CSR initiatives

At the international level, the financial industry has come up with different CSR statements that have been signed by some of the top world banks and insurance companies. Some are vague and general in wording, such as the CEO statement of the Business Financial Sector Project of the World Business Council on Sustainable Development, while others are more precise and to the point, such as the Equator Principles for project lending and the GRI Financial Services Sector Supplement on social performance. In their Collevecchio Declaration, NGOs go much beyond existing corporate initiatives and request total commitment in all activities of financial firms. The Collevecchio Declaration is the only worldwide CSR framework covering the full financial industry (although not much about insurance) that can be used by civil society to screen private sector initiatives.

The kind of financial services that are best covered by CSR initiatives are project financing, and asset management i.e. ethical investment by mutual funds and pension funds. The insurance industry receives least attention from civil society while that industry's asset management, pension insurance and insurance contracts can have a major influence to stop unsustainable activities and support individuals and companies to behave in a more sustainable manner.

3. Too little attention to social aspects

Social aspects, issues particular for developing countries such as Third World debt, as well as supply chain responsibility are less covered by the CSR initiatives than environmental aspects. References to respect of human rights and the core labour standards of the ILO are lacking in many corporate CSR initiatives.

4. The financial industry does not allow for external assessment of CSR initiatives

So far, it is impossible to assess whether the many CSR initiatives have made any concrete improvement for society or have reversed environmental degradation, social unrest or breaches of human rights. The existing CSR initiatives have not produced the necessary external verification tools such information disclosure, impact assessments, independent reporting, built-in continuous stakeholder accountability, etc. No tools are offered to civil society to assess whether implementation takes place in practice or has any real impact, and to address the financial industry to redress the problems it (helps) create. Breaches of the Equator Principles revealed by NGOs and the free rider problems of other CSR initiatives highlight the need of verification and redress tools.

A particular CSR problem for the financial industry is the lack of transparency argued on the basis of bank secrecy, client confidentiality and protection of competitiveness. Much more needs to be done than the current CSR initiatives that monitor and report only about management. Options for more transparency in which governments and official supervisors are involved, need to be explored. Without transparency there can be no verification by stakeholders.

5. NGO cases reveal what needs to be changed

NGOs that have campaigned against banks involved in destructive project financing have achieved some progress with major financial firms such as: the Equator principles that were initiated by banks being put under campaign pressure; Citigroup's environmental policy statement; sector policies at ABN Amro; Barclays refusal to participate in financing the Caspian pipelines. More cases brought forward by civil society will help to reveal what is needed and what needs to change. This is an on-going and fluid process.

6. Important dilemmas

The dilemma's facing NGOs that put pressure on financial firms to stop financing certain projects, companies, governments of institutions are:

- whether NGOs have enough power and capacity to pressure the financial industry, one by one and collectively, in changing the negative effects of all financial services, or whether they should seek alliance with other stakeholders and/or the government.
- whether financial firms should decide which corporations to finance, or whether laws -supervised by the authorities- should set the criteria about how the private

financial industry should select the companies and projects to be financed. The financial industry does not want to judge the companies it financially supports (except for the potential financial risks that undermines its profitability) and want to rely on regulations. On the other hand, NGOs do not expect that governments will take sufficient steps and expect more direct effects from undermining the financing of destructive corporate activities.
Responsibility, of the financial firm and of the government, is clearly a matter for debate and political attention. In 1999, the lobby of the financial industry (the Institute of International Finance) was still of the opinion that their only mandate was to make profit and increase shareholder value, and that social and financial stability responsibilities were for the government. Has this changed in practice?

7. Involvement of more stakeholders needed

NGO actions will also promote the much needed involvement of more customers, an important segment of the stakeholders. According to research by the Dutch consumer organisation ('Consumentenbond'), the banks' clients are not yet interested in CSR principles[68] and better reporting from their banks.
CSR initiatives and reports might start drawing attention to the social and environmental behaviour of the financial industry to another group of stakeholders: the financial firm's shareholders. Shareholder value needs to be looked at in ways other than simply 'The Bottom Line' or 'Share Price'. Shareholders need to know that ruthless profiteering is not viable in the long term and that they have a choice about where they can invest their money and earn their pensions.

8. Main elements for CSR initiatives and codes for the financial industry

What first needs to be addressed for further development of financial CSR initiatives is the lack of a definition for **sustainable development** which is internationally recognised by the financial sector and upon which screening, bench marking and reporting by the financial industry can be based. This would allow for standards to be developed and adopted that would make monitoring and comparison between the different financial corporations possible.

Overall, CSR issues that are specific for the financial industry that should be included in any CSR initiative are:

a. Transparency, verification and accountability tools.

b. The social and environmental aspects of the financial industry's own operations, which should include respect of ILO, Human Rights and gender equality conventions for own staff, sustainable energy use, training of staff on sustainability issues, etc.

c. Responsibility for the impact of their financial services regarding:
   - **Company and project financing**: by using
     - existing overall international standards such as core ILO and Human Rights conventions, OECD guidelines and CSR initiatives, and
     - International standards specific to the sector of the company or project to be financed e.g. Forest Stewardship Council standards, standards of the World Commission on Dams.

   - **Universal access, quality of services**, discrimination or exclusion of poor customers and small producers, and undue indebtness of poor customers and poor countries: by using the Covenant of Economic, Social and Cultural Human Rights.
   - **Macro-economic and financial instability**:
   the financial industry should limit its speculative products and services, short term interest strategies in mutual funds, lack of commitment to support countries in which they operate, lobbying for opening up financial sector markets while adequate regulations are not in place.
   - **Other ethical issues**:
     - lobbying against governmental rules that protect societal interests,
     - abuse of market power: see OECD Guidelines relating to competition policy, transfer pricing and mergers,
     - abuse of unique market positions e.g. by investment banks or mutual fund managers,
     - lax attitude towards money laundering and corruption,
     - support of tax evasion,
     - support of apartheid vs. support for black empowerment.

d. Pro-actively advancing sustainable development through:
   - the design of financial services (e.g. better financial terms for sustainable behaviour),
   - choice of financing (e.g. renewable energy in stead of pipelines),
   - specific services to support the poor (beyond micro-financing), and
   - choice of strategies (e.g. reverse increasing consolidation and competition).

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1 Information on UNEP-FI was taken from the UNEP-FI website: www.unepfi.org
2 This description was taken from: Summary of the UNEP FI 2003 Global Roundtable: Sustaining value - A meeting on finance and sustainability: 20-21 October 2003, in Sustainable Developments, IISD, Volume 91, nr 1, 23 October 2003 p. 1-2; for reports of UNEP-FI meetings and the different areas of work, see: http://unepfi.net
3 See http://www.unepfi.org/signatories/statements/fi/index.html
4 See http://www.unepfi.org/work_programme/finance_and_conflict/index.html)
5 For NGO concerns on the UNEP-FI initiative, see www.banktrack.org
6 "EPI-Finance 2000": Indicators measuring the environmental performance of financial institutions, at www.epifinance.com where the full report can be downloaded: Environmental performance indicators for the financial industry.
7 Environmental performance indicators for the financial industry, p. 12.
8 The categorisation used in this table is not the one used in this SOMO report.

9 See http://www.wbcsd.org/DocRoot/5PV72pFXVXcIqJX88UlC/20020925_finance.pdf

10 See http://www.unglobalcompact.org/content/NewsDocs/WhoCaresWins.pdf

11 This description is taken from the Wolfsberg Principles website: www.wolfsberg-principles.com; Mark Pieth & Gemma Aiolfi, The Private Sector becomes active: the Wolfsberg Process, at: http://www.wolfsberg-principles.com/pdf/wolfsbergprocess.pdf

12 Wolfsberg Anti-Money laundering Principles on Private Banking, article 1.1, at www.wolfsberg-principles.com

13 Environmental NGOs taking the initiative were amongst others: Friends of the Earth, Wilderness Society World Wildlife Fund (WWF), Campagna per la Riforma della Banca Mondiale, Berne Declaration and others

14 See www.banktrack.org

15 See www.banktrack.org; see also chapter 5, annex to the conclusions.

16 For a short insight, see www.somo.nl, and www.observatoriosocial.org.br

17 Full report to be published at the beginning of 2004 by BWI and SOMO

18 Bank Track, No U-turn allowed: NGO recommendations to the Equator banks, 23 January 2004.

19 See for instance actions against Citigroup, the largest financial services provider in the world, on website of different NGOs and one particularly focussing at Citigroup (e.g. http://www.ran.org/ran_campaigns/global_finance/)

20 See for instance www.banktrack.org

21 See http://www.equator-principles.com/principles.shtml

22 See http://www.equator-principles.com/faq.shtml

23 J. Sohn, NGO spotlight shifts to private sector, in Environmental Finance Magazine, February 2004.; see www.equator-principles.com for details and figures.

24 Rainforest Action Network and Citigroup announce enhanced Citigroup environmental policy, press release by Citigroup and Rainforest Action Network, 22 January 2004.

25 See: www.brettonwoodsproject.org/update/

26 At the SOMO workshop on CSR and the financial sector (The Hague, 19 November 2003), it was revealed that during a conversation between NGOs and a bank that had adopted the Equator Principles, the bank admitted that if current controversial projects would be screened using the Equator Principles, the projects would be approved.

27 See Bank Track letter to the 'Equator Banks', Amsterdam 10 December 2003.

28 in Turkey, Azerbaijan and Georgia, see www.baku.org.uk; see Evaluation of compliance of the Baku Tbilisi Ceyhan pipeline with the Equator Principles, October 2003.

29 See www.amazonwatch.org

30 See: www.banktrack.org which replaces the www.financeadvocacy.org website

31 See: www.panda.org

32 Bank Track, No U-turn allowed: NGO recommendations to the Equator banks, 23 January 2004.

33 This can for instance be seen from the indicators of the EPI-Finance 2000 report: Environmental performance indicators for the financial industry, p. 24

34 For example, in the Netherlands a committee of commercial banks and consumer organisation is trying to improve accessibility of financial services outside of urban areas, called “Maatschappelijk overleg betalingsverkeer”, see Erica Verdegaal, Winkels, consumenten en banken kunnen niet zonder elkaar. Knelpunten en oplossingen bankdiensten in kaart gebracht, in DNB Magazine, De Nederlandsche Bank, no. 1, 2005

35 See EBRD website: www.ebrd.org

36 See the ‘international year of Microcredit’ website: http://www.yearofmicrocredit.org/

37 See http://www.strohalm.net/en/site.php

38 Based on a presentation of VBDO (Dutch Organization of Investors for Sustainable Development, www.vbdo.nl) on SOMO workshop, January 13th, 2005, Amsterdam.

39 See http://www.sustainability-index.com/

40 See http://www.ftse.com/ftse4good/

41 More information at: www.siricompany.org

42 www.siricompany.com (There were more than 1000 profiles at the end of 2002)

43 www.sirigroup.org/services.shtml

44 Green, social and ethical funds in Europe 2004, SiRi Group - Avanzi, Milano, November 2004, at http://www.ecodes.org/documentos/archivo/Fondos_Europa_2004.pdf

45 To assess the behaviour of these companies from a NGO CSR perspective, see for instance www.transnationale.org

46 http://www.bijsluiterscore.info/P_INGBank_DuurzaamRendementFonds_028.htm

47 For example, the UK Just Pension’s; see: www.uksif.org

48 Ibid.

[49] EIRIS, Responsible investment: EIRIS reveals SRI practices of top pension funds, press release, 19 May 2003.

[50] Christel Witteveen, Groot geheim. Het beleggingsbeleid van pensioenfondsen, in People, Planet Profit, Volume 3, no 2, Winter 2004/5

[51] Challenges for the South in the WTO Negotiations on Services - Summaries and Conclusions from Three Case Studies: Health Care (Kenya), Electricity (Colombia), Tourism (India), published by SOMO and Wemos, January 2002 (see: www.somo.nl)

[52] GRI, Financial Services Sector Supplement: social performance, November 2002, at http://www.globalreporting.org/guidelines/sectors/GRIFinancialServices.pdf

[53] See: Risk, the environment and the role fo the insurance industry, prepared by the UNEP FI Australasian Advisory Committee on Insurance, EPA VICTORIA - UNEP Finance Initiatives, January 2003, p.5-7.

[54] this insurance is developed in cooperation with BUND, the German section of Friends of the Earth: Fourth International Conference of the UNEP Insurance Industry Initiative: Natural capital at risk - sharing practical experiences from the insurance and investment industries. Executive summary report, UNEP, September 1999, p.13.

[55] See: Risk, the environment and the role of the insurance industry, prepared by the UNEP FI Australasian Advisory Committee on Insurance, EPA VICTORIA - UNEP Finance Initiatives, January 2003, p.16-18, 32-36.

[56] See http://www.unepfi.org/signatories/statements/index.html

[57] See http://unepfi.net/iii/signatories_country.htm ; the figures relate to December 2003

[58] See www.interpolis.nl; Interpolis, Micro-insurance in developing countries, at http://www.mian.nl/docs/00355%20Micro-insurance.pdf

[59] See for instance: http://econjustice.net/wbbb/

[60] For more details, see CEO Briefing on emissions trading, January 2004, at http://unepfi.net

[61] Non-final version but ready to use, test and provide feed back.

[62] The SPI-Finance companies that were involved were: Co-operative Insurance, Credit Suisse Group,Development Bank of Southern Africa, Deutsche Bank AG, Rabobank, Swiss Re, The Co-operative Bank, UBS AG, Westpac Banking Corporation, Zürcher Kantonalbank, Interpolis, Rheinland Versicherungen, Swiss Life, XL Winterthur International (see Social Performance Indicators for the Financial Industry (SPI-Finance 2002))

[63] See annex: indicators of management performance relate to policies and activities, and operational performance relate to results of policies and activities.

[64] Letter (16 December 2002) to GRI by Berne Declaration, Campagna per la Riforma della Banca Mondiale, Euronature, Friends of the Earth, Mineral Policy Institute, Rainforest Action Network, Power Shift, Wilderness Society World Wildlife Fund United Kingdom.

[65] R.F. Faber, Duurzame kredietverlening - Transparantie van duurzaamheid bij het rentmargebedrijf van banken, VBDO Onderzoeksrapport, August 2003 (see www.vbdo.nl)

[66] See: Ibidem, p. 7.

[67] For full overview of the VBDO's recommendations on this issue, see: Ibidem, p. 11.

[68] Consumentengids, December 2003.

Chapter 5
Governmental regulations at the international level

Introduction

The behaviour of the financial industry is influenced by regulations and implementation of these regulations (supervision). Almost all binding rules and supervisory mechanisms are still based at the national or EU level. However, many international institutions try to influence national regulation and supervision even though their means of enforcement is often limited to cooperation and peer pressure.

In the light of the growing trend towards internationally operating financial services providers, this chapter identifies the major institutions at international level which deal with the regulation and supervision of the behaviour of financial firms in the area of banking, insurance and securities. Because it was beyond the scope of this report to analyse each of the different national regulation and supervision systems, this chapter identified some national trends worldwide.
In a second part, this chapter attempts to assess the impact of the consolidation of the financial industry in relation to financial stability and the institutions that promote financial stability.
In the following chapter 6, the international regulations about trade in financial services under the WTO are analysed.

5.1 Trends of regulation and supervision at national levels

Many countries have systems to regulate and supervise banks, and other financial services, in order to prevent that the risks taken by the financial industry would have negative effects on society. However, regulation and supervision also have a decisive influence on the development and structure of the financial services sector in each country. This explains why the structure of the banking industries continues to differ greatly across countries in the West, ranging from very non-concentrated banking in a few countries (e.g. Germany) to highly concentrated in other countries (e.g. Australia, Belgium, Canada, France, the Netherlands and Sweden).[1]

National differences in regulation and supervision

The clear differences[2] that can still be observed in bank regulation and supervision in various countries depend on:

> (a) whether the national authorities follow a **liberal approach** and allow national or international mergers and acquisitions of their banks (with differences in preferring domestic banking consolidation or acquisitions of national banks by foreign ones), or whether they want to stick to a more **rigid and regulated approach** and restrict foreign or national take-overs. Banks in countries with the latter approach are now assumed to have low levels of consolidation and to face increasing international competition from larger financial corporations, resulting in the challenge of being acquired by foreign financial corporations, or hardly play a role of importance internationally.
>
> (b) the attitude of the regulators in situations where banks are confronted with real or emerging problems: authorities can adopt a **proactive and strict approach**, whereby they set high standards of prudential control and take the tough measures to resolve the problems at an early stage; or they can follow **a passive and/or soft approach** (for political or cultural reasons). The latter approach is typical for Japan, resulting in a continuing weak financial system with a huge amount of bad loans, weak capital reserves, low profitability and demands for government bailouts.

The significant regulatory differences between the EU and the US have lead to intensive discussions. For instance, the European financial services industry fears that European regulation tends to open up the market for US services while the US is having a "regulatory revival" that harms the European financial industry.[3] This might lead to bilateral informal discussions and solutions in which the rest of the world is not involved to make their case.[4]

Liberalisation trends in developing countries

In many developing countries, regulation has changed from hands-on regulation to more indirect regulation. Governmental fixing of interest rates and control over allocation of credit is seen as the cause of inefficiency, unfair lending and services, and low interest rates that encouraged capital flight. Under pressure from the World Bank, the IMF and the international liberalisation paradigm, controls on interest rates were relaxed, restrictions on capital flows and foreign financial service providers removed, the banking system restructured and given more capital.[5] At the same time, a financial "safety net" was promoted by which each country would have prudential regulation and supervision, a lender of last resort and deposit insurance. As could be seen in the case study of Indonesia (chapter 3), deregulation was not always accompanied by good supervision and regulation, and was undermined by corruption. Even if good standards of regulation and supervision are in place, many developing countries have been struggling with lack of qualifications, sufficiently equipped personnel, and support by the legal system.[6]

Difficulties in supervision

Supervisors and regulators still do not have everything under control. This is shown amongst others by the credit card crisis in South Korea since the end of 2003. Too much unpaid credit was leading to the collapse of the main credit card company, which could have severe consequences for the South Korean banking system and the economy. The government was intervening, thus abandoning the principle that private banking should be left to the markets even if they fail.[7] In different countries, including the US and Australia, supervisors are struggling with scandals of illegal, unfair or too risky practices by financial firms or some of their staff members.

Following (!) increasing consolidation of financial firms, some countries have reformed their supervision and are bringing the different financial industry sectors -banking, insurance, securities- under one supervisory institution or umbrella. This process is at different stages in many countries. For instance, Italy just started to discuss such a reform after the Parmalat scandal at the end of 2003. The challenge in such reforms is that such reforms do not get politicised and lead to battles between different authorities wanting to keep supervision.[8]

International competition undermines national regulation and tax income

Also, international fierce competition can make it difficult for regulators to create prudential laws or laws that protect consumers (e.g. obligation to lend to poorer buyers of houses). They will often be threatened by arguments from the national and foreign financial industry that new regulations will make the country and its financial industry uncompetitive compared to the financial industry based in other countries. For instance, when banks were closing rural branches in the Netherlands it was difficult for the government to legislate them to remain open. In the worst case, banks threaten to withdraw their operations from a country where they see legislation as undermining their profits.

International competition also explains the existence of offshore centres since some governments want to promote their financial industry and their financial markets. Offshore centres[9] are mostly small islands, such as the Cayman Islands, and small countries, such as Singapore. They offer bank secrecy, low taxes or tax exemptions for foreign capital. These offshore centres attract untaxed capital flows from other countries and are suspected of money laundering and transfer criminal money. Most internationally operating financial firms and accountancy firms have branches and services at, and related to, offshore centres; this provides an income for these industries and the offshore authorities. The US banking industry is the biggest user of offshore centres, especially the Cayman Islands and Jersey.[10]

Being put under pressure by international bodies and the EU, offshore centres' authorities are formally improving their handling of money laundering and money deposits from dictators while compulsory/binding measures at international level are still lacking.[11]

→ Critical issues

Many national supervisory and regulatory regimes are not yet ready to cope with increasing international competition and consolidation in the financial industry. This competition and consolidation can have a chilling effect on national efforts to appropriately regulate and protect consumers and poorer banking clients. This could explain why national regulators are not intervening sufficiently to deal with the many critical issues and problems explained in the previous chapters.

The few initiatives that exist to specifically encourage financing services and financial firms to reduce poverty and promote sustainable development mostly exist at national and EU level, not at international level. Examples are:

- Tax free green funds: mutual funds exempt from interest and dividend income tax e.g. in the Netherlands where green funds have been growing faster than in other countries.
- Disclosing ethical investment policies: laws requiring pension funds to disclose their ethical investment policies and practices, as was introduced in the United Kingdom.
- The US Community Re-Investment Act (CRA): requires banks to invest a certain portion of their portfolio in the local economy where the bank is based, especially supporting those consumers that are historically marginalized. The CRA has helped create an entire sub-sector of community development financial institutions in the United States, which specialize in providing access to capital and credit to low-income and distressed communities.[12]

5.2 Regional financial services markets and regulation

At the EU level, many changes in laws and regulations are being undertaken to create a single financial services market (European Financial Services Action Plan). By 2005, all financial services and financial markets are supposed to be liberalised to make different (sub-)sectors of the EU financial industry compete against each other.[13] In this context, the EU has been working on EU-wide supervision and regulation, including on financial conglomerates that combine banking, insurance and securities' services, and on eliminating tax evasion through tax havens and off shore centres. The new European financial institutions work in a decentralised way to refine and implement EU financial regulations[14]:

- The Committee of European Banking Supervisors (CEBS)
- The Committee of European Insurance and Occupational Pension supervisors

(CEIOPS)
- The Committee of European Securities Regulators (CESR)

Other regions and free trade areas are equally setting up regional regulatory and supervisory agencies. For instance, the Eastern Caribbean Central Bank covers 9 small island members[15] in the Caribbean region.

5.3 International regulation and supervision of corporate financial services

Different international institutions set standards for national regulators and develop measures to deal with cross-border activities of financial firms. Developing countries are not always member of these international institutions or standard setting committees. The standards, principles, agreements, guidelines and recommendations for regulation and supervision made by these institutions do not have the status of international law. Their status contrasts with the international binding agreements and rules of the World Trade Organisation and the enforcement through the WTO mechanism that settles disputes when members do not observe a WTO rule.

Many non-binding international financial standards may not yet be implemented, especially not in developing countries. This state of affairs needs to be seen not only in the context of increasing consolidation but also continuing worldwide arrangements to liberalize trade in financial services. Complex Western financial conglomerates get the right to operate in many developing countries even if international financial regulatory standards are not generally applied (see chapter 6 about GATS).

The financial services industry itself is interested in having more equal rules and supervision in all the countries in which it operates. This would create a "level playing field" whereby foreign financial firms enjoy the same opportunities to compete in all countries without being hindered by different requirements or preferences for national financial firms. On the one hand, the financial industry is often heavily involved in international standard setting bodies to stop any standard that would put too many restrictions on their international operations or be too costly to implement. On the other hand, the financial industry considers the current level of international regulatory coordination (see below in this chapter) as insufficient.

The major international institutions that deal with regulation and supervision of financial services are described in the following paragraphs. They are first mentioned in a short oversight[16] with basic references; the most important institutions are more fully described thereafter. The institutions that equally deal with the regulation and supervision of capital flows and international financial system are briefly mentioned in the final parts of this chapter.

Short oversight of international supervisory and regulatory bodies

Basel Committee on Banking Supervision (BCBS): The BCBS provides an important forum for regular cooperation among its 13 member countries on banking supervisory matters. The BCBS formulates broad supervisory standards and guidelines and recommends statements of best practice in banking, in the expectation that bank supervisory authorities will take steps to implement them.
http://www.bis.org/bcbs/index.htm

International Association of Deposit Insurers (IADI): The IADI promotes international cooperation and exchange of know-how among deposit insurers and other interested parties. It aims at contributing to financial stability by providing guidance for more effective deposit insurance and enhancing understanding of common interests.
http://www.iadi.org

International Association of Insurance Supervisors (IAIS): The IAIS allows insurance regulators and supervisors from more than 100 jurisdictions to cooperate. It is charged with developing internationally endorsed principles and standards that are fundamental to effective insurance regulation and supervision.
http://www.iaisweb.org

International Organisation of Securities Commissions (IOSCO): IOSCO brings national regulators together to develop and promote standards to regulate markets dealing in securities and futures. It also develops standards for effective surveillance of international securities markets. It provides mutual assistance to promote a rigorous application of the standards and effective enforcement against offences in order to safeguard the integrity of securities' markets.
http://www.iosco.org

Committee on Payment and Settlement Systems (CPSS): The CPSS monitors and analyses developments in domestic payment, payment settlement and clearing systems as well as in cross-border schemes by Central Banks and the private sector. The CPSS deals with the different systems that settle the transfer nationally and worldwide of several trillion dollars per day from interbank and other large value payments, transactions in securities (including lending of securities) and derivatives, foreign exchanges, central banks, and retail banking activities. The CPSS formulates broad supervisory standards and guidelines for best practice, in the expectation that bank supervisory authorities will take steps to implement them at national level. It has developed a common set of universal international standards for payment systems: the "Core Principles for Systematically Important Payments Systems", published in January 2001. It has so far failed to work out currency taxes such as a Tobin tax to slow down the billions of international speculative capital flows.

http://www.bis.org/cpss/

CPSS-IOSCO Task Force on Securities Settlement Systems: The CPSS and the Technical Committee of IOSCO set up a task force to jointly issue recommendations for securities settlement systems.
http://www.bis.org/cpss/index.htm; http://www.iosco.org

BCBS Transparency Group and IOSCO TC Working Party on the Regulation of Financial Intermediaries: Together both bodies made recommendations for public disclosure of trading in securities and derivative activities of banks and securities firms. They complement the surveys by both Committees on disclosure of trading and derivatives by banks and securities firms. Such surveys have been published annually since 1995. Both initiatives form part of a continued effort to encourage banks and securities firms to provide market participants with sufficient information to understand the risks inherent in their trading and derivative activities.
http://www.bis.org/bcbs/index.htm; http://www.iosco.org

5.3.1 Bank for International Settlements (BIS)

The Bank for International Settlements (BIS)[17] is an international organisation that was established in Basel (Switzerland) in 1930 and serves as a bank for central banks. The BIS currently has 55[18] member central banks. The aim of the BIS is to promote international exchange of expertise and cooperation on national and international monetary and financial issues. The different Committees of the BIS have agreed upon some arrangements to regulate and supervise particular banking issues in order to achieve financial stability. The committees determine their own agenda and operate independently from the BIS' governing bodies. The Basel Committee on Banking Supervision is the most important committee.

Developing banking supervisory cooperation and standards: the "Basel Committee"
The Basel Committee on Banking Supervision started in 1974 as a forum for regular cooperation between banking supervisors of 10 Western countries (G-10) and exists currently of supervisory authorities and central banks of 13, developed, countries.[19] It is referred to as the "Basel Committee" and has subgroups that deal with particular banking supervision issues (e.g. securitization). The Committee consults and exchanges know-how with supervisors of other countries that have important financial industries. It has a strong focus on strengthening prudential supervisory standards in so-called, non member, emerging markets. The Committee also has close links with the international banking industry, assuming that these links help to forge consensus. There are no particular consultative bodies with other actors of society but consultative papers often request for comments, by any one, by a certain deadline and informal consultations take place with private banks.

- **Arrangements to supervise nationally and internationally operating banks**

The Basel Committee has gradually developed common international standards of banking supervision that are to be implemented through national legislation. It has increasingly become a standard-setting body on all aspects of banking supervision and best banking practices. The Committee, however, has no international means of enforcement. The standards aim at preventing erosion of regulation when national authorities want to attract foreign investment in financial services or protect their financial services industry against foreign competitors. The Committee is concerned about intensification of international competition in countries with insufficient supervision.

The main important instruments developed by the Basel Committee are:

- <u>The Basel Committee's Concordat</u> embodying principles of effective banking supervision:
In 1975, after a crisis in the foreign exchange markets, the Concordat established the principle that the home country authorities would supervise some establishments of worldwide operating banks. The concordat was strengthened several times, for instance in 1983[20], and in the aftermath of one of the biggest ever collapse of a financial company, the Bank of Credit and Commerce International (BCCI) in 1991[21]. Especially branches of international banks are to be supervised by the authorities of the parent bank. Supervision of subsidiaries and other activities of banks' foreign establishments is to be done jointly by the host and home country authorities. In 1990, recommendations were made to improve information exchange between host and home supervisors because it was often inadequate.[22]

- <u>The Basel Committee's Minimum Standards for the supervision of international banking groups and their cross border establishments</u>:
These standards, agreed upon in 1992, provide the right of the home country supervisors to obtain data needed for the consolidated supervision of international banks and strengthen the host countries' authority to impose restrictive measures if the minimum standards are not met. Such prudential measures include imposing deadlines for meeting acceptable standards, obliging foreign branches to be restructured so as to have sufficient capital reserves, and even closing banking establishments.[23]

- <u>The Basel Committee's 25 Core Principles for Effective Banking Supervision</u>:
These 25 core principles were agreed upon in September 1997 after the G-10 also consulted authorities of "emerging markets". They represent the basic elements for an effective banking supervisory system in each country. Supervisory authorities throughout the world were invited to endorse the principles. By endorsing, countries agreed to have their supervisory arrangements reviewed against the principles.

- **Regulation of capital reserves for lending: the Basel Capital Accord and its renewal**

"Basel I": a major international standard of banking supervision

The supervisors of the Basel Committee agreed in 1988 on the amount of financial reserves they require all banks to put aside when providing loans. This agreement about the "capital requirements" by supervisors to their banking industries was called the "Basel Capital Accord" and was updated several times to avoid misunderstandings and major gaps. The aim was to address "credit risks" in order to avoid that banks would go bankrupt by a series of bad loans that were not being repaid. Because of competition, internationally operating banks were holding as less capital reserves as possible. The danger was that the banks' reserves were becoming too low to recover from major non-performing loans.

The **basic principles** of the Basel Accord are:

- A bank has to put aside 8%, or less, of the amount of the loan as a reserve, depending on the assessment of the risks of a loan.

- Banks have to make assessments in how far a loan will not be repaid based on three categories, i.e. governments, banks and corporations. For instance, a bank that gives a loan to a government in an OECD-country has to put no money aside because the risks of non-repayment are none according to the Basel principles. According to Basel I, banks have to put aside 8% of all loans provided to any corporation. In practice, however, loans to large companies are assessed to have less risks of non-performance and are therefore provided at lower interest rates by banks compared to loans to small and medium-sized companies.

Table: Basel I risk assessment framework

	% credit risk in OECD countries*	**% credit risk in non-OECD countries***
Official authorities (e.g. governments)	0%	100%
Banks: **-loans up to 12 months** **-loans of 12 months and longer**	 20% 20%	 20% 100%
Corporations	100%	100%

* 100% risk means banks have to put 8% of the amount of the loan aside as a reserve
Source: M. Metzger, Basel II - Benefits for Developing Countries, BIF Working Paper Nr. 2 /2004 (based on Basel Committee 1988)

- Banks that give loans to other banks have to distinguish between short term loans (up to 12 months) and long term loans. According to Basel I, the risk of providing short term loans to banks is much less (only 20% risk) than long term loans (100% risk in developing countries). Because the financial crisis in Asia (1997-'98) was caused amongst others by short term loans given by Western banks to local banks in South East Asia, the Basel Committee has started to draw up new principles according to which banks have to assess the risks of a loan.

By 1994, the original Basel Accord was being implemented in over 100 countries. The Accord Implementation Group was set up by the Basel Committee to share experiences and promote implementation.

"Basel II": a significant reform that affects the banking industry worldwide

In May 2004 the Basle member countries reached a consensus on a new capital Accord, dubbed Basel II, that will introduce some important reforms in banking sector supervision related to credit risk management. Basel II intends to make the banking system more stable and efficient by enabling banks to hold capital reserves based on a more sophisticated risk assessment of their credit provisions to others. The new accord is to be implemented by the end of the year 2006.

It has to be noted, however, that the exact implementation process is unclear. Already in the preparation phase, there was much controversy surrounding the new accord. Proposals proved to be heavily influenced by international operating banks, for instance through the Institute of International Finance.[24] Even before the text Basel II had been agreed upon, the US and China already announced that they would pursue other regulations for most of their (national) banks[25] so that not all banks will apply Basel II as originally conceived. The US House Financial Services Committee feared that Basel II will disadvantage smaller US banks who have no capacity to apply Basel II, and increase the concentration in the banking industry.[26]

As for the European Union, the EC is planning to implement to entire new accord into a third European Capital Adequacy Directive (CAD3), which will make the Basel II principles applicable to all European credit institutions.

As for less developed countries, the Basel Committee acknowledged that the adoption of Basel II might not be the first priority of supervisors in those countries. They should focus more on the implementation of pillar 2 and 3 of the Accord (supervisory process and market discipline), rather than on the complex reserve requirements of pillar 1.[27]

Box: The main elements of the new Basel II accord

The text of the new accord (Basel II) is a complex document of 250 pages. It is based on three pillars:

Pillar 1: New risk assessment mechanisms and resulting capital requirements:

New categories are introduced on how loans to governments, banks and corporations need to be assessed, as well as new minimum capital reserve requirements.
Different approaches to measure credit risk:
a "standardised approach" to measure the risks of a borrower, where banks for their credit assessments depend on corporate rating agencies (see chapter 1) that assess solvency; or
a bank can use its own risk estimation systems ("Internal rate based approach" or IRB approach) and comply with certain criteria and information disclosures, e.g. sufficient auditing.

Banks increasingly transfer their asset risks to outside investors through securitization, and therefore Basel II has introduced a securitization framework to assess the risks associated with this and to determine the resulting regulatory capital requirements. Again, the accord offers a standardized approach, and the option to use an internal rate based approach. The capital reserve requirements depend on the approach used.[28]
Introduction of capital requirements for operational risk, the risk associated with the internal processes of the bank. Basel II offers 3 different approaches, varying in complexity, to assess these risks.

A final element of the first pillar concerns the trading book. The trading book (in contrast to the banking book) gives an overview of a bank's financial instruments it holds for trading purposes. This balance has become much more important for banks, and clearer rules are introduced on how to treat trading book issues.

Pillar 2: Changes in the supervisory processes:

Banking supervisors get more power and scope to intervene and monitor risk assessment systems of banks.
Banking supervisors of the home countries and host countries of banks are required to improve their cooperation and information exchange and make concrete plans thereto, and decrease the burden of banks to implement supervisory requirements.[29]

Pillar 3: Market discipline through better disclosure of information by banks:

Banks have to publicise more differentiated data. The assumption is that when data indicate bad banking behaviour, e.g. too many risky loans, the clients and investors will react and put pressure on the bank.

→ Critical issues about "Basel II"

In the preparation phase of the new accord, the Basel Committee had already requested, and received, comments on its three consultative papers. There have been many articles by experts who have criticised the Basel II proposals. The definite version of the Accord has not taken account of many of these critiques. In the end, it seems that the major aim of Basel II is avoiding that Western governments would have to bail out the large consolidated Western private banks in case they fail.

The overview below sums up some problems for developing countries and safeguarding financial stability.[30]

Developing countries not represented

The Basel Committee that negotiated and designed the Basel II Accord did not have representatives of developing countries among its members. The Committee did hold regular meetings with a group of 13 non-member countries, including Russia and China, to review its work and comment upon it. However, the new capital accord Basel II failed to take account of the interests of developing countries who had no decision-making power in the design.

Loans to developing countries more expensive?

Governments, banks and corporations in developing countries will probably face higher costs for loans due to Basel II. First of all, this could be the case since they generally receive low ratings by rating agencies or by the banks' own risks assessment systems. Many companies or governments from developing countries have no rating at all. These lower or non-existing ratings do not always reflect actual creditworthiness of the corporations or governments and can reflect some bias in capital markets. According to the “internal ratings based” (IRB) approach in Basel II, banks do need to put more capital aside for such lowly or non-rated lenders. In practice, this would mean that higher interest rates will be charged for many loans to developing countries compared to the developed world.
Secondly, interest rates charged to the developing world as a whole could be too high because of the lack of diversification considerations, which Basel II has chosen not to include in its risk assessment mechanism. The economies of the developing world are normally less related to the developed world as a whole, so that they are much less affected in case of a crisis in the industrialized world. To avoid risks, banks should therefore not only diversify their credit portfolio among sectors, but also among the developed and developing world. There exist tools to assess investment risks that take those diversification considerations into account. However, the mechanisms adopted in the Basel II accord haven’t integrated them. As a result, the estimated credit risk of loans to developing countries could lay as much as 20% too high[31] and,

consequently charged interest rates could be much too high as well.
A positive consequence of the higher reserve requirements, on the other hand, could be that it would become easier for banks to reduce developing countries' debt burden by writing off loans. Since banks have already better covered for non-performance, by making higher provisions for a loan to a developing country, writing off such a loan would be relatively less costly for a bank.

International banks get competitive advantage
Banks that use their own risk assessment system have to use their system for all the loans they provide in all countries. The costs of introducing and operating own risk assessment systems are expensive and especially feasible for the top of internationally operating banks. Consequently, the different banks that operate in a particular developing country might use different risk assessment approaches with different capital reserve requirements. This would give international banks that use their own risk assessment system ('Internal rate based' approach (IRB)' with less capital requirements) a competitive advantage over domestic banks that use a standardised approach requiring higher loan reserves.

Too complex tasks for supervisors?
The question remains whether supervisors will be able to duly supervise the implementation of the banks' own risks assessment mechanisms (IRB approach). During the design of Basel II supervisors indicated that they did not fully comprehend these risk assessment systems.[32] Supervision of banks that use their internal ratings mechanisms will require supervisors to work closely together with those banks. The supervisory bodies will also have to invest heavily in their own expertise to ensure they can actually judge the banks' assessments. It is doubtful whether the regulatory regime is strong enough for this.[33]

Danger of financial instability not resolved
Short term loans are still treated more favourably than long term loans because of the much lower reserve requirements attached to the former. Although the Asian financial crisis has shown that short term loans can be the source of major financial instability, the new Accord hasn't taken this into account.[34] Another potential danger to financial stability lies in the possible procyclical effects of the use of external rating agencies for the assessment of risks. When a country is temporarily not doing too well, and rating agencies start to lower credit ratings, this could only aggravate the situation.[35]

Lack of assessing environmental and social risks of the borrowing companies and governments
One critique professional experts have not publicly raised is that assessing credit risks should also take into account the risks for sustainable development, i.e. the

environmental degradation, the social and societal impacts of the companies and projects that receive bank loans. The Basel II only has an obligation to banks to assess environmental risks that undermine the value of the collateral of the borrowing company.[36]

Other assessment mechanisms more useful[37]
There are other ways that would be helpful to prevent financial instability and bailing out. Such alternative system would be based on the systemic risks a bank poses to the international financial system: The more a bank is big and internationally interconnected, the higher the capital requirements should be; also, the better the bank is in predicting and assessing risks, the less capital reserves it would have to put aside. In addition, capital requirements should not remain the same at any time but be raised in times of financial instability and crisis.

5.3.2 International Association of Insurance Supervisors (IAIS)[38]

The IAIS was established in 1994 to promote cooperation and transfer of know how among insurance supervisors. It is charged with providing guidance and developing internationally endorsed principles and standards that are fundamental to effective insurance regulation and supervision. It strives to contribute to financial stability and coordinates with regulators of other financial sectors.

IAIS members are insurance supervisory authorities from more than 100 jurisdictions. In addition, there are 70 observers form professional organisations, insurance and reinsurance companies, international financial institutions, and other individual professionals.

The IAIS has 21 working parties meeting 3 to 4 times a year and dealing with particular issues of the insurance industry such as accounting, reinsurance, insurance fraud, electronic commerce, investments, emerging markets, disclosure and transparency.

Through its working parties, IAIS members have developed and approved several standards of which important ones are:

- The IAIS Core Principles and Methodology for effective operation of supervisory systems (2000): the principles were updated in October 2003 to add issues of transparency of the supervisory process, risk assessment, consumer protection and anti-money laundering.
- The Insurance Concordat (1999): covers principles to improve the supervision of internationally operating insurance companies and their cross-border business operations, including cross border insurance business that is conducted without foreign establishment (e.g. through internet). The concordat promotes cooperation

between supervisors from the home and the host countries.

IAIS's recent work on standard setting has focused on developing standards in the areas of:

- solvency;
- cross-border service provision;
- asset risk management;
- group coordination of financial conglomerates;
- reinsurance;
- market conduct;
- electronic commerce;
- accounting standards (whereby it works closely together with the International Accounting Standards Board, see 5.5)

In 2003 it also published a study about the risk of some 15-20 insurance companies buying credit derivatives (see chapter 1), and other issues of credit risk transfer between insurance, banking and other financial firms. The study was inconclusive as it indicated that it is difficult to gather all the relevant global data but suggested that credit derivatives were only a relatively small proportion of insurers' investments, and thus not posing major risks of transferring risks from the banking to the insurance industry.[39]

5.3.3 International Organisation of Securities Commissions (IOSCO)[40]

Since 1983, IOSCO has been bringing national securities regulators together to cooperate and exchange experiences in order to maintain "just, efficient and sound" securities markets. It has been developing principles and practices for sound regulation of securities markets and financial firms, and standards for effective surveillance of international securities markets. It provides mutual assistance to promote application of the standards and effective enforcement against offences.

IOSCO is recognised as being the international standard setter for the securities industry although it has no other mechanisms to enforce its resolutions, statement and standards than screening regulations, naming and shaming, and cooperation.

The ordinary members include securities regulators of over 100 jurisdictions. "Self regulating bodies" such as the stock exchanges (which are in private corporate hands) can become affiliate members or even ordinary members if coming from a country without governmental securities regulatory bodies. IOSCO has several committees according to regions and the development of the securities' market, including an Emerging Markets Committee.

The importance of IOSCO became clear during the South East Asian financial crisis in 1997-98. The "emerging markets" had seen the cross-border trade in their securities grow very rapidly, amongst others by deregulation, and trading by Western financial firms and mutual funds. When uncertainty about South East Asia's financial stability hit the securities markets, high volatility in securities trading followed from investors and banks selling off their shares in search of short term protection against losses. The financial firms that traded in securities gained from the fees of increased trading but the resulting volatility in exchange rates and devaluation in the South East Asian currencies and companies' shares was so severe that it contributed to the economic and social downturn of those countries.

In 1998, IOSCO issued the 'IOSCO principles', a document with 30 principles which securities regulators committed themselves to implement, aiming at:

1. protecting the investors,
2. ensuring fair, efficient and transparent markets,
3. reduction of systemic risk.

These "Objectives and Principles of Securities Regulation" have been recognized as key standards for a stable and well functioning securities market and were updated in 2002. Promoting these principles, which are not legally binding, is one of IOSCO's highest priorities, supported by a task force, and self-assessment mechanisms for its members.

The IOSCO principles were strengthened by the adoption of the “Multilateral Memorandum of Understanding Concerning Consultation and Cooperation and Exchange of Information” (“IOSCO MOU”), This agreement should enhance the enforcement of the principles and avoid the use of securities for criminal purpose. Many IOSCO members could not yet subscribe to the IOSCO MOU because they could not implement all the Principles. At the end of 2004, only 26 out of the 105 IOSCO members had signed the MOU. On the other hand, some members already had such cooperation agreements at bilateral level ("bilateral MOUs").

IOSCO followed the general line by supervisors and regulators after the financial crisis that more disclosure of information can avoid a financial crisis. For instance, in 1999 IOSCO issued "Recommendations for public disclosure of trading and derivatives activities of banks and securities firms" in cooperation with the Basel Committee on Banking Supervision.[41]

In September 2003, IOSCO issued a Statement[42] with general principles to guide securities regulators in addressing conflicts of interest faced by financial analysts.[43] This was a response after scandals had uncovered that securities analysts were advising investors to buy securities from companies which were clients from other divisions in the financial firm of the securities analysts (conflict of interest). Although IOSCO had recognised the role of regulators in deterring manipulation and unfair trading practices in its 1998 principles, IOSCO's statement came after the stock market bubble, inflated by this conflict of interest practice, had burst and many investors had lost their money and confidence in the stock-market (see chapter 1).

At the end of 2004, IOSCO announced the plan to press offshore markets to cooperate better with securities regulators. After frauds at for example Parmalat, the role of offshore markets in securities markets became apparent, and IOSCO expressed its concern that those offshore markets were standing in the way of effective market supervision. Only 1 offshore centre has actually signed the MOU (Jersey) but other offshore centres are pressed to follow in order to enable information exchange[44].

The implementation of IOSCO's broad and general principles was left to the national authorities and the financial industry itself. One measure of implementation was the total split between activities of securities analysts and investment banking, thus undoing some aspects of consolidation.

5.3.4 Supervising and regulating all-finanz firms

Each of the above mentioned institutions have tackled some of the problems that consolidation in the financial industry brings. In addition, the Basel Committee on Banking Supervision, IAIS and IOSCO established a Joint Forum in 1996. The Joint forum examines supervisory issues relating to financial conglomerates that combine banking, insurance and securities activities and that develop new financial services in which the distinctions between the three activities are blurred (e.g. loans combined with life insurance and investment in securities).

The work and the reports[45] of the Joint Forum focuses on avoiding instability in the financial markets and financial industry by:

- increasing the understanding the differences and similarities for supervisors of banking, insurance and securities activities (e.g. outsourcing in financial services and credit risk transfer),
- proposing supervision measures for consolidated firms, and
- stimulating cooperation among the relevant supervisors.

The Joint forum has only members of 13 Western countries. The Central banks authorities of these countries also meet in the Committee on the Global Financial System (see below).

Most of the official advise on consolidated financial firms given by experts to supervisors and regulators does not go beyond more cooperation between supervising and regulatory authorities, swifter action in case of potential crisis, and better information disclosure so that clients and investors can react when information show flaws in the operation of a financial conglomerate ("market discipline").[46]

→ Critical issues

No comprehensive response to consolidation strategies

The current international supervision and regulatory mechanisms have not come up with a comprehensive response to the trends and activities of internationally operating financial firms although the complexity of not only one financial conglomerate, but also the interconnectedness and interdependence of financial conglomerates, is still very difficult to oversee and different scandals indicate that financial firms do manipulate markets.[47] They were even not able to form an integrated international body to regulate and supervise the different worldwide activities of consolidated financial firms: the Joint Forum falls far short of what is necessary. Experts and studies by the above mentioned bodies indicate that supervisors and regulators are still left with important challenges[48] such as:

- **Uncertainty about the risks of consolidated financial firms**. What seems to be clear, however, is that if a large and complex financial firm became impaired, than the closing down of such a firm will likely to be disorderly and have broad implications on the economy.

- **Uncertainty about the future shape of financial sector consolidation**: consolidation might fully continue leading to a few dominating financial firms, or outsourcing and/or the creation of specialised financial firms might give consolidation a particular shape

- **Unpredictability and uncertainty about the threat to financial instability**: assumptions are that instability is likely to come from increased transborder and wholesale[49] activities, the swiftness of the capital moves, the worldwide interconnectedness in particular financial sub-sectors and the increasing interdependencies between the leading financial firms (e.g. through interbank loans, credit derivatives).

- **Insufficient information** is published by consolidated banks to their clients, investors and supervisors, which would enable the latter to see whether too many risks are being taken.[50] A review of the annual reports of fifty-four international banks in 2001 showed that they disclosed only 63% of the items considered important by the Basel Committee of Banking Supervision. While that was an improvement over the previous years, it was still far from sufficient. In particular, information about their techniques for mitigating credit risks (including the more speculative credit derivatives) was lacking, which makes it difficult to monitor from the outside their practices and expertise for avoiding bad loans, a major source of (in)stability.

- **Consolidation does not lead to spectacular increases of efficiency** while the consumers get less favourable conditions and SMEs get less loans from consolidated firms.

- **A small number of leading financial firms increasingly dominate some specific activities**, such as investment banks and payment and settlement services. Such domination might lead to abuse of market power e.g. higher prices, and to risks to the financial system e.g. if the payment services were to fail.

- **Continued difficulties to monitor the internal capital flows within a consolidated bank**. Payment and settlement flows increasingly become between a few parties or in-house transactions.

5.4 Regulation, supervision and decisions related to capital flows and the international financial system

In addition to standards on how to regulate and supervise the behaviour of financial services companies, there are international institutions that deal with issues to prevent the international financial system from collapsing and to ensure stability of international capital flows and financial markets. As capital flows and financial markets are the instruments of the financial firms, the themes under discussion and review in these institutions are sometimes closely related to regulatory and supervisory issues. The institutions described below deal much more with the wide ranging discussion about the "international financial architecture" that has regained importance after the Asian financial crisis in 1997-98 because it damaged many economies and citizens of "emerging markets". It is however beyond the scope of this report to deal with these institutions and issues in detail.

The discussions about the reform of the financial architecture are organised around the following issues[51]:

Macroeconomic policy and data transparency:
- monetary and financial policy transparency
- fiscal transparency
- data dissemination
- data compilation

Institutional and market infrastructure:
- insolvency
- corporate governance

- accounting
- auditing
- payment and settlement
- market integrity
- market functioning

Financial regulation and supervision:

- banking supervision
- securities regulation
- insurance regulation
- financial conglomerate supervision

5.4.1 International fora for discussing financial system stability

The issues to prevent an international financial crisis are mostly discussed in the following important international institutions. A short overview[52] in this report describes these institutions in short with references that allow further monitoring.

The Financial Stability Forum without enforcement mechanisms

The Financial Stability Forum (FSF) was convened in April 1999 to improve the functioning of markets and reduce systemic risk. It regularly brings together senior representatives of financial authorities (e.g. central banks, supervisory authorities and treasury departments) from 11 financially important countries[53]**,** 6 international financial institutions, 7 international regulatory and supervisory groupings, 2 committees of central bank experts and the European Central Bank. The FSF has no enforcement mechanisms but proceeds through information exchange, and international cooperation and coordination in financial supervision and surveillance. During its meetings, it assesses the state of vulnerability of the international financial sector.

<u>12 Key Standards for Sound Financial Systems</u>

The Financial Stability Forum has highlighted 12 standards as key for sound financial systems and deserving of priority implementation by all countries. While the identified key standards vary in terms of their degree of international endorsement, they are internationally broadly accepted as representing minimum requirements for good practice and resulting in beneficial effect on the stability of national and international financial systems. Some of the key standards are relevant for more than one policy area.

Table: Key standards promoted by the Financial Stability Forum

Area	Standard	Issuing Body
Macroeconomic policy and data transparency		
Monetary and financial policy transparency	Code of Good Practices on Transparency in Monetary and Financial Policies	IMF
Fiscal policy transparency	Code of Good Practices in Fiscal Transparency	IMF
Data dissemination	Special Data Dissemination Standard (SDDS)/ General Data Dissemination System (GDDS)(1)	IMF
Institutional and market infrastructure		
Insolvency	(2)	World Bank
Corporate governance	Principles of Corporate Governance	OECD
Accounting	International Accounting Standards (IAS)(3)	IASB (4)
Auditing	International Standards on Auditing (ISA)	IFAC (4)
Payment and settlement	Core Principles for Systemically Important Payment Systems Recommendations for Securities Settlement Systems	CPSS CPSS/IOSCO
Market integrity	The Forty Recommendations of the Financial Action Task Force on Money Laundering / 8 Special Recommendations Against Terrorist Financing	FATF
Financial regulation and supervision		
Banking supervision	Core Principles for Effective Banking Supervision	BCBS
Securities regulation	Objectives and Principles of Securities Regulation	IOSCO
Insurance supervision	Insurance Core Principles	IAIS

Source of table: http://www.fsforum.org

Notes:

1) Economies with access to international capital markets are encouraged to subscribe to the more stringent SDDS and all other economies are encouraged to adopt the GDDS.
2) The World Bank is co-ordinating a broad-based effort to develop a set of principles and guidelines on insolvency regimes. The United Nations Commission on International Trade Law (UNCITRAL), which adopted the Model Law on Cross-Border Insolvency in 1997, will help facilitate implementation.
3) Relevant IAS are being reviewed by the IAIS and IOSCO.
4) The International Accounting Standards Board (IASB) and the International Federation of Accountants (IFAC) are distinct standard-setting bodies in that they are private sector bodies.

Committee on the Global Financial System (CGFS)[54] is a forum of the rich

The CGFS, composed of the Central Banks of 13 rich countries, undertakes:

- systematic short-term monitoring of global financial system conditions,
- longer-term analysis of the functioning of financial markets, and
- the articulation of policy recommendations aimed at improving market functioning and promoting stability.

It has developed a list of general principles and more specific policy recommendations for the creation of stable securities markets. It has set up a Working Group on incentive structures in institutional management. The Working Group published a report in March 2003 about the evolution of the asset management industry (e.g. mutual funds, pension funds, insurance companies) and its impact on financial stability, as it is a financially important sector.

International Monetary Fund (IMF)[55] more active on financial crisis prevention

The work of the IMF is of three main types.

1. **Surveillance** that involves the monitoring of economic and financial developments, and the provision of policy advice aimed especially at crisis-prevention.
2. **Lending** to countries with balance of payments difficulties, providing temporary financing and supporting policies aimed at correcting the underlying problems; loans to low-income countries are also aim at poverty reduction but include harsh conditionality based on free market policies.
3. **Technical assistance** and training in areas of IMF expertise.

Supporting all three of these activities is the IMF's work in **economic research** and **statistics**.

The International Financial Committee that meets at the bi-annual meetings of the IMF attended by most Ministers of finance have been a key forum to take decisions, or obstruct decisions, on measures for the reform of the international financial architecture. A major problem is the lack of proper voting rights by developing countries, which is now being discussed with little progress.

Since the financial crisis of 1997-98, the IMF's work has more focused on crisis prevention. It improved the availability of important information (e.g. levels of countries' external debt, financing in emerging markets) and publishes twice a year the Global Financial Stability Report. In collaboration with other standard-setting bodies, it has developed international standards for data dissemination and transparency practices in fiscal, monetary and financial policies, and has contributed to the development of international standards for banking supervision.

The IMF has together with the World Bank implemented the Financial Sector Assessment Programme - FSAP which identifies strengths and vulnerabilities of a country's financial system and helps to deal with the latter. Under the programme, country reports are prepared with information on how a country implements financial standards and codes of best practice. In these country reports, the IMF also looks at the state of the financial industry and seems to favour consolidation of the financial industry at national level. In a report on the German banking system, the IMF called for a modification in banking regulations to allow merger processes that would do away with state owned banks and to accelerate consolidation in the sector.[56] The Financial Sector Reform and Strengthening (FIRST) Initiative is a US$ 53 million multi-donor program, supporting capacity building and policy development projects in the financial sectors in developing countries.

In its normal lending and advisory activities, the IMF is now much less insisting on (full) liberalisation of capital flows (capital account liberalisation) as it did before the Asia financial crisis. Too swift liberalisation of capital flows is increasingly recognized as contributing to financial crises.

As part of the Offshore Financial Centres Assessment Programme, IMF staff undertakes detailed assessments of the extent to which offshore financial centres meet the standards advocated by the international standard-setting bodies. It assesses any further action required to meet these standards such as technical assistance. It also collaborates with standard-setters and supervisors to strengthen standards.

The Organisation for Economic Cooperation and Development (OECD)[57] has unfamiliar code to liberalise capital flows

In general, the OECD promotes policies and efficient functioning of markets to achieve economic growth and employment in its member countries.[58] It encourages the convergence of policies, laws and regulations covering financial markets and enterprises.

The **OECD division on finance and investment** stimulates discussions on the many issues related to finance and investment. It publishes an annual report with data and trends about the profitability and health of the banking systems in 30 OECD countries.[59]

The **OECD division on insurance and pensions** is equally a forum to discuss and study issues and problems in those respective sectors. It includes the OECD Insurance Committee and the Group of Governmental Experts on Insurance Solvency.

The OECD Code of Liberalisation of Capital Movements came into force in September 1961 and was regularly updated, lately in January 2003. This Code has played a very important role in liberalizing capital flows, however this has gone unnoticed. Such liberalisation of capital flows allowed financial firms to expand their international activities without restrictions on their international capital movements.

The Code contains **obligations for OECD members to liberalise capital flows** related to:

- direct investment (FDI),
- securities (includes portfolio investment),
- services,
- loans,
- insurance,
- foreign exchange,
- payments for imports and exports, and
- personal capital movements.

It is based on **principles** such as non-discrimination between capital flows from OECD members, transparency and exceptions to liberalisation (e.g. in the case of financial problems).

Although the code is legally binding for OECD members it is not a treaty under international law. The ultimate decisions on its monitoring and application lie with the OECD Council. New members have to abide by the code but can be exempted from some obligations for some time to avoid financial disturbances. Implementing the Code has had an important impact on helping create the South East Asian financial crisis because it pressed its new member South Korea to remove restrictions on financial flows, which allowed risky, volatile and uncontrolled financial flows before and during the financial crisis.

Action against money laundering and tax evasion by the Financial Action Task Force on (FATF)[60] and OECD

The FATF, established in 1989, has set out a programme of forty "Recommendations" to combat laundering money from corrupt and criminal activities. The recommendations were updated in 1996 and again in 2002 in the wake of the 11 September 2001 terrorist attacks against the U.S., when 8 Special Recommendations were added to the original forty. The FATF monitors the progress by its 26 members in implementing measures to counter money laundering, reviews money laundering trends, techniques, and counter-measures, and promotes the adoption and implementation of the FATF Recommendations by non-member countries.

The FATF is based at the OECD that also attempts to deal with offshore centres because they facilitate money laundering and tax evasion, resulting in tax competition harming OECD countries. Many countries with tax havens and offshore centres have reacted disapprovingly to the OECD. While improving some of their regulatory oversight, they resist amending their low taxation policies. The Caribbean countries threatened to use the WTO when the US, Canada and Japan warned their financial firms to be wary of doing business with he Caribbean offshore centres. The latter considered these warnings as restrictions on trade in financial services with those centres.[61]

The exclusive G-7 and some input by developing countries in the G-20
Since 1986, decisions about exchange rates and international financial stability have for an important part been taken by the Finance Ministers of the Group of Seven richest countries in the world (G-7: Canada, France, Germany, Italy, Japan, UK, US). Russia joined the G-7 (G-8) and attends most meetings of the G-7 meetings of finance ministers.
This exclusive and non-transparent informal forum has been discussing many important issues that were also being discussed at other fora dealing with financial stability. It recently played an important role during the financial instabilities that started in 2001 after the September 11 attacks and the fall of the stock market. The financial reserves of banks and insurers that had invested in shares were dropping dramatically and the G7 leaders took the decision not to pressure banks and insurance companies to keep up the required reserves. Otherwise these financial firms would have been forced to sell their low-valued shares for other financial assets, resulting in massive sales of shares, which would have further decreased the value of equities at the stock market. Moreover, the Central banks decided to intervene by lowering interest rates and providing massive extra credit to the commercial banks.[62]

When the G-7 takes a decision to introduce a measure, or to intervene in the major exchange rates, this has wide ranging effects on other countries who have no say in the forum. Because the so-called “emerging markets” have the last two decades plaid an increasingly important role in financial flows and financial crises, the G-7 has decided to convene a Group of Twenty (G-20) to discuss issues of global financial stability between the G-7 countries and other countries with important financial flows or financial risks such as Argentina, Australia, Brazil, China, Mexico, Saudi Arabia, South Africa, Korea and Turkey.

5.4.2 State of the reform of the international financial system

Good ideas, little reform
The various fora mentioned above have identified and discussed many issues to avoid a financial crisis by misbehaviour of governments and the financial industry. On the one hand, standard setting for better regulation and supervision has progressed and the situation in developing countries has improved through technical assistance and monitoring programmes. Cooperation between different authorities, nationally and internationally, also made progress. On the other hand, many of the standards deal with past crises and only tackle issues that might lead to a financial crisis in the future. Some standards were developed after damage has been done (e.g. IOSCO did not prevent conflict of interest in securities trading).

Overall, real progress in applying the necessary restructuring measures is absent. In other words, many good ideas but little reform. Introduction of new measures to reform the international financial architecture has bogged down after an insolvency regulation for sovereign debtors (states) was removed from the agenda at the 2003 Spring meeting of the IMF. However, the quick steps taken against money laundering and bank secrecy after the 'September 11' attacks indicate that swift reforms in the financial architecture are possible if there is enough political will to do so.

Many challenges left for developing countries

For developing countries the following important problems in the financial system are still not solved. In case of a new financial crisis, their population and economies are likely to have to carry the burden of the devastating effects. The financial crisis in Argentina and Turkey are a case in point. Unresolved problems are:

Instability of capital flows

There is a political unwillingness, supported by the financial industry -and vice versa-, to restrict the billion of dollars flowing daily across borders through financial firms and financial markets for speculative and short term profit making. The discussions to introduce capital controls such as a “tobin tax” have made little progress. Most worryingly, the instruments used by governments to control and slow down cross-border capital flows are being taken away in trade agreements (e.g. during the negotiations for a bilateral trade agreement with Chile, the US pushed hard to remove the “Chile tax” which is internationally recognized as an important financial stabilization instrument). There is little political will to prohibit financial products from financial firms that are highly speculative and create uncertainty, such as credit derivatives. Still, short term capital flows are prioritised due to the Basel II accord (see 5.3.1).

No solution to a potential “moral hazard”

In the past, banks and other financial actors that undertook too risky operations that resulted in bankruptcies had to be bailed out by governments in order to avoid total destabilization of the financial system and the economy. In other words, taxpayers’ money was used to cover the debts and losses of commercial and speculative financial actors. At present, there has been made some improvement by adopting collective action clauses (CAC’s) in the issuance of government bonds under New York law. These clauses state that in case a government, which has issued bonds, is in financial stress, and a majority of bondholders agrees to restructure the conditions (e.g. the payment terms) of the bonds issues, a minority of bondholders can no longer block this process. In the recent past, bondholders have often take legal action to make states (i.e. taxpayers) repay their investments whatever the situation in the country. It is the question whether the introduction of CAC’s will have a real impact: their use is still voluntary under New York law, and normally it still takes 75% of all bondholders to agree on a restructuring.

There is no <u>lender of last resort</u> where governments can obtain temporary funds without (the wrong) conditions attached to solve a financial crisis due to misbehaviour of the financial industry. The current contingency credit line of the IMF is not functioning well as countries are afraid to use it.

Continued high debts in foreign currency by developing countries result from insufficient international debt cancellation mechanisms and unfair arbitration mechanisms to cancel or restructure governmental and commercial debt .

There is still quite some instability of exchange rates that damages income to developing countries as can be witnessed by the lowering value of the US Dollar compared to the Euro during 2003. At the same time **fixed exchanged rates** (e.g. pegging the value of a national currency to the value of the US Dollar), which caused the financial crisis in Asia, is still being used for instance by China that has been building up a huge reserve in US Dollars, much to the dismay of the US. What kind of exchange rate mechanism is the best?

Lack of information and understanding (models) to predict the next financial crisis, even in Western countries. For instance, there is no internationally publicly available information about all currency transactions of one particular bank.

New complex financial products, new technology, and new management techniques accompanying continuous expansion abroad by consolidated financial firms still poses unknown risks of financial instability and economic, social and environmental effects. Recently, banks started to use complex financial products that transfer the credit risks to others, for instance through securitization of (bad) loans and derivatives. This makes it unclear who ends up taking the risk of bad debt (in any case not the bank that provides the credit). Currently supervisors are afraid of unchecked, concentrated accumulation of credit risk.[63]

New important reforms such as the reform of the Basel Capital Accord (Basel II) take much longer than foreseen to agree upon and are seen in the interest of large international banks. The negative effects of Basel II on banks and provision of credit in developing countries is still hardly heard (see above).
Many developing countries give priority on macro-economic and financial sound policies that should keep investors happy, even if these investors are speculative or portfolio investors. At the same time, social and environmental needs of the population are being sacrificed.

Increasing importance of offshore centres
Offshore centres facilitate tax evasion and capital flight from developing countries through low tax rates and lax monitoring rules. In 2003, the importance of offshore centre activity

increased with recorded claims on offshore centres totalling US$1.8 trillion in the second quarter of 2003.[64]

The huge budget, current account and trade deficit of the US is being financed by issuing governmental bonds (mostly bought by Asian central banks such as Japan and China), rules that make transferring money to the US attractive (foreigners do not need to pay tax on interests in the US), and the strong investment banking and securities services firms that dominate globally.

Important role of the financial industry lobby

The successful lobbying of the financial industry plays an important role slowing down the regulatory reforms of the international financial system. The financial sector regularly dialogues with the authorities lobbying against new regulations and intervention. The financial industry says that if the authorities create one rule, escape routes and new problems will be created.[65] The sector also argues that complying with a lot of regulations is too expensive, which would cut deep into their profits.

The financial industry and investors are still hoping that, during the next financial crisis, they will be able to much better defend their own (short term) interests without international rules that would share the burden of a financial crisis.

The Institute for International Finance (IIF[66]) is an important lobby that represents the major global financial firms and intervenes in many of the above-mentioned fora. The IIF has openly argued against international measures that would prevent bailouts by governments and would share the financial burden when governments cannot repay their debt. In 1999, it declared that financial firms had the sole responsibility to increase shareholder value and create profit while it was the responsibility of the government to create financial stability and promote social objectives.[67]

Such corporate lobbying influences and reinforces the neo-liberal thinking of governments and financial authorities. As a result, many financial regulatory and supervisory authorities in the Western countries are reluctant to introduce measures that would intervene in the free market. The lack of support by the US often hinders new international measures to be taken, for instance on the insolvency regulation for debtor states. The US position is heavily influenced by the lobby of its financial sector industry that dominates world markets in many sub-sectors of the financial services.

Even at the UN Conference on Finance for Development (Monterrey, Mexico, 2002) all efforts to introduce issues of restructuring the financial system for development goals have been undermined by the US and other Western countries.

→ Critical issues

The lack of reform in the international financial architecture provides global financial firms ways to escape sharing the burden of a financial crisis they might help create. In case of a global financial crisis, the poor citizens and developing countries are still too unprotected.

The current system of improving international coordination, cooperation and non-binding standards seems so far to be working to avoid a world wide financial crisis. However, the insurance industry and the stock market were causing serious threats to financial stability in Western countries up to beginning 2004. The pension crisis was still not resolved by the time of finalizing this report (March 2004). Developing countries in financial problems, such as Argentina, have not been helped by the many foreign banks present in their country nor been brought to quick economic recovery by the intergovernmental financial institutions.

5.5 Relation of financial services with auditors

Banks and other financial firms that provide financial services to companies rely heavily on the financial reports of companies in order to assess the financial health of a company. These financial reports are provided and checked by auditors, who thus play an important basic role. There are, however, no auditing rules yet that are internationally enforceable but there are international standards that are being adopted and implemented, sometimes through national or EU law.
Since 2001, the accounting industry has been under much criticism for not being able to detect fraud and other practices that lead to the financial collapse of multinationals such as Enron and Parmalat. For instance, based on the wrong public financial reports from accountants about Parmalat, some 20 investment banks were involved in 40 bond issues. They raised around $ 9 bn for Parmalat in 10 years from large and small investors. Those who bought Parmalat bonds for covering their pension might never see their money back.[68]
Holders of Enron shares and bonds started a class action litigation because Citigroup mislead investors and helped hide Enron's debt. In June 2005, Enron agreed to pay $ 2 bn to settle the case.

As part of the efforts to create a European single market, the European Commission aimed to make all 7 000 firms listed in European exchanges use the same accounting standards. The standards were designed by the International Accounting Standards Board (see below) and are called the International Accounting Standards (IAS) & Financial Reporting Standards (IFRS). In 2003 and 2004, there was much discussion about the 41 draft standards published by the IASB. Especially the IAS39 was heavily debated. This rule covers accounting of financial instruments like derivatives. It states that those instruments should be valued at 'fair

value' (current value) instead of 'historic value'. Since fair values are much more volatile than historic ones, the balances of many financial firms would also show much more volatility.[69] Obviously, financial firms have heavily opposed the proposals. The EU financial industry put heavy pressure to make new reporting more suitable to their interests.[70]
From January 2005 onwards, use of the standards has been made obligatory.

International standard setting on accounting and auditing takes place at:

International Accounting Standards Board (IASB): The IASB is a privately funded accounting standard setter based in London. Board members have a variety of functional backgrounds from nine countries. They aim at developing a single set of high quality, understandable and enforceable global accounting standards that require transparent and comparable information in general financial statements. In addition, the board cooperates with national accounting standard setters to achieve convergence in accounting standards around the world. The IASB is responsible for developing and approving the International Accounting Standards (IAS).
http://www.iasc.org.uk

International Auditing and Assurance Standards Board (IAASB): The IAASB is a committee of the International Federation of Accountants (IFAC) that works to improve the uniformity of auditing practices and related services throughout the world. Therefore, it issues pronouncements on a variety of audit and assurance functions and promotes their acceptance.
http://www.ifac.org

5.6 Conclusions and critical issues

1. Standards not internationally binding

Different international financial bodies set standards to regulate and supervise the various activities of the financial industry. They provide guidance for regulators and supervisors who are encouraged to implement the standards at the national level.

The international financial standards are not legally binding by international law nor enforced through international mechanisms. Adoption of the financial standards by national financial authorities around the world depends on cooperation, exchange of information, and 'peer pressure' or name and shame. The regulatory and supervisory framework is therefore different in each country. At international level, there is no minimum of binding rules that regulate all operations of international financial firms in all countries.

Because the standards are not binding, some governments chose not to adopt high standards to prevent tax evasion in order to encourage their financial industry and markets to compete internationally. Such offshore centres manage 40% of the world's wealth.

2. Regulation and supervision of the consolidated financial industry is insufficient

The current international and national supervision and regulatory mechanisms have not devised a common view or comprehensive response to the swift developments of the cross-category and cross-border consolidation by global financial firms. Mega conglomerates, like Citigroup, are becoming too big to fail. Governments cannot afford to let them collapse because the effects on the wider economy would be devastating, even though the costs of intervention and insuring clients are high.

National coordination and integration of supervision on banking, insurance and securities activities is still unsatisfactory in many countries to supervise cross-category consolidation. Each country is setting up different systems and has different policies towards consolidation, which hampers effective international coordination to handle problems facing complex and internationally operating financial conglomerates.

At the international level, there is no oversight of all the transactions for each financial mega conglomerate separately, which means that no one body can fully assess the risk of such potentially volatile financial players. Even the Joint Forum, which was created especially to deal with conglomerates, does not have an urgent strategy on cross-sectoral and cross-border financial supervision and regulation. The current lack of cooperation between home country authorities and developing countries supervisors might hamper a comprehensive response across boarders to deal with a conglomerate collapse.

3. Too little too late

International financial bodies have improved cooperation between national supervisors and regulators, especially among national bank supervisors as a result of the work of the Basel Committee. However, they do not follow the speed of the financial industry developments and expansion into developing country markets. Progress is too slow, especially in the

insurance sector. Some standards and guidelines have only been created when the damage was already done by a major crises or corporate scandal (e.g. the Basel Core Principles, IOSCO on conflicts of interest). International banking statistics have also improved after each crisis and financial instability threat.
At the same time, progress in strengthening the financial architecture has been bogged down and stalled by the lobby of the major financial services sector, leaving the system even more vulnerable.

4. Developing countries lack the right to be heard, but are expected to comply

Many international standard setting bodies have no or little participation from developing countries, although 'emerging markets' are often consulted and targeted. The main decisions about capital flows and stability of the financial markets are still taken by bodies where developing countries have no real say (e.g. G-7, IMF) and where problems of developing countries are not sufficiently addressed.

5. Supervisors and regulators fail to adequately deal with risk

The so-called independent regulatory and supervisory authorities are beginning to rely heavily on the financial firm's own risk management procedures. This trend will dramatically increase when new, controversial, rules on assessing borrowers ('Basel II') will be finalized (due by mid 2004).

6. The lack of political will to prevent any financial crisis happening

Complacent about the prospects of a new financial crisis, officials and financial experts are reluctant to intervene in the market even if the consequences are grave for many who are already poor. Supervisors and regulators are under constant pressure from the financial industry and its lobby.
The international financial supervisory and regulatory bodies are ignoring the risks of too swift increase in unequal and unfair competition between foreign and domestic financial firms due to liberalisation of financial services. The negative consequences cannot always been dealt with through national regulation and supervision.

7. Civil society concerns ignored

The financial industry's powerful voice heard at the international standard setting bodies contrasts dramatically with the voice of civil society groups, which is barely, if ever, heard. The work of international supervisory and regulatory bodies is not transparent and to date has no system to involve all stakeholders. Public debates do not precede important decisions taken at those institutions.
Regulators and supervisors at international level have little interest in environmental or social issues, but rather in "maintaining a stable financial environment" and avoiding bankruptcies. Drafting of new banking supervision rules ('Basel II') did not incorporate risk assessment from a sustainable development perspective. The many international fora dealing with

financial instability seem to be hugely underestimating the risks and costs from environmental degradation, climate change and unfair globalisation that marginalizes the poor.
Consequently, there are no international regulations that compel the financial industry to support international agreements to eradicate poverty, and to promote sustainable development and corporate social responsibility. No wonder there is not enough money for sustainable development and CSR issues; all mainstream financial instruments have no binding obligation to prioritise sustainability: not in savings, credit, investments, or insurance.

8. International financial bodies need to widen their scope

Leaving the negative social and environmental effects of international financial sector consolidation and competition to national legislators and supervisors to deal with, is inappropriate. Protecting consumers, marginalized people and the environment becomes too complex and too costly, especially for many developing countries. International competition might put pressure on governments not to introduce new high standards. Moreover, many financial firms still see it as the responsibility of governments to achieve financial stability and societal objectives, while they prioritise profit making and increasing shareholder value. Current international financial operations and competition require international financial bodies and free trade negotiators (see chapter 6) to tackle the problems collectively. Financial authorities could do a lot at national and international level to redirect financial flows towards more sustainable activities through for instance[71]:

- new regulations on risk assessment, access and quality of services, and obligations to report and inform about ethical policies;
- new rights and obligations for investors, investment managers, governmental financing institutions and shareholders;
- tax incentives;
- subsidies and other policies to promote sustainable financial products;
- radical eradication of tax havens and bank secrecy,
- more leeway for alternative financing schemes.

Civil society groups will have to find new ways to dialogue with international regulatory and supervisory bodies in order to widen the latter's scope. They will also have to raise awareness among the public about these complex issues to boost public debates and support.

9. This report does **not cover the many alternatives** that have been conceived and developed in order to avoid the problems of the corporate driven financial sector. These alternative money systems are often used in times of crisis, as in Argentina, when authorities have failed, money is scarce and credit once offered by financial firms has dried up.

5.7 Sustainability and Accountability in the Financial Services Sector Regulatory and public policy recommendations

The following paper was released by Friends of the Earth – US concurrent with the launch of the Collevecchio Declaration (January 2003). The Declaration calls on financial institutions to support regulatory changes that make it more possible for the financial sector to advance sustainability.

Governments can and must play a key role in creating public policies and regulatory frameworks that increase the ability of the financial services sector to advance sustainability. In addition, governments must also improve accountability from the financial services sector itself, as a way of ensuring that financial institutions are responsive to the needs and expectations of the public.

Increase the ability of financiers to advance sustainability

As market makers and allocators of capital, financial institutions have a unique role and responsibility in advancing sustainability. Financiers can:

- Integrate environmental and social objectives into their financial strategies;
- Analyze the social, environmental, or development impact of potential transactions;
- Use their influence and price capital in ways that promote sustainable practices among their clients and investments;
- Proactively finance enterprises that reduce poverty, enhance equity and restore the environment.

However, financial institutions are often limited in their ability to implement these practices because of current laws, and because avoiding certain types of transactions can put responsible financiers at a competitive disadvantage compared to their more unscrupulous competitors. Also, faced with imperfect markets, financiers find it "cheap to do bad things, and expensive to do good things" because the costs of environmental degradation and ill public health are often externalized onto the general public. Such barriers can only be overcome by governmental action.

A. Integrating environmental and social objectives into financial strategies

Governments can take the following actions to help financiers align environmental and social objectives into financial strategies and decision-making:

- Changing the definition of fiduciary responsibility: In many countries, strict interpretations of "fiduciary duty" discourages investment managers and trustees from examining the social, economic and environmental dimensions of their investment choices. Regulators should clarify that consideration of environmental, economic and social issues is not in violation of, and in fact could advance the fulfilment of, fiduciary duty. Governments can also expand the definition of fiduciary duty to include the broader well-being of beneficiaries.
- Public investment policy: Government regulators should create socially and

environmentally responsible investment policies and objectives for public finance agencies and governmental retirement funds. For example, public export credit agencies should adhere to high universal environmental and social standards, and require co-financiers (e.g. loan syndicate partners and recipients of loan guarantees) to do the same.

B. Analyzing the social, environmental, or development impact of potential transactions

In order to implement investment, credit, or underwriting policies that promote sustainability, financiers must have access to information on a potential transaction's social or environmental impact. In particular, investors need comparable and robust social information for all companies their investing universe.

- Corporate disclosure laws: Governments should implement corporate social and environmental disclosure regulations in markets around the world. Environmental and Labour Ministries should create disclosure laws that obligate companies to report data such as toxic releases, or worker health and safety data. For example, in the United States, the Community Right to Know Act requires companies to disclose toxic releases in a national Toxic Release Inventory.
- Securities disclosure laws: National securities disclosure laws should require reporting of material environmental, social and other corporate responsibility data. For example, France currently requires disclosure of key environmental and worker health and safety data in company annual reports.
- Protection of civil rights: In order to perform adequate due diligence about the social, environmental, or economic impacts of a potential transaction, financial institutions often rely on civil society organizations as a source of information, particularly in markets where disclosure regulations are poor. Therefore, governments should support the preservation and promotion of civil and political rights and freedoms around the world, particularly in developing countries.
- International securities and accounting standards: The International Accounting Standards Board and the International Organization of Securities Commissions are currently working to harmonize corporate accounting and disclosure standards across major markets. The IASB and IOSCO should ensure that best practice in environmental and social financial accounting are promoted.

C. Using influence and pricing capital in ways that promote sustainable practices among their clients and investments

The following public policies could increase the ability of financiers to use their unique role as company shareholders and providers of capital in ways that promote sustainability:

- Shareholder rights laws: Shareholder rights are in part defined by state or national securities and/or company laws, which delineate the requirements for filing shareholder proposals for both domestic and foreign investors, including topics which are considered appropriate for shareholder action. For example, securities laws in the United States provide relatively strong rights to investors by allowing smaller shareholders to submit proposals, and by providing a degree of supervision from the Securities and Exchange Commission when companies and shareholders disagree about the appropriateness of a proposal.

- Incentives for sustainability: Regulators can create incentives for financial institutions to capitalize environmentally/ social beneficial enterprises, and for activities that generate income for the poorest. For example, the Netherlands has introduced tax-free green funds (exempt from interest and dividend income tax) to encourage Dutch citizens to invest in environmentally beneficial projects. Other incentives could include giving banks a small degree of flexibility in their capital adequacy requirements in return for prioritizing sustainable investments. The new Basel Capital Accord ("Basel II") could also integrate sustainability factors into its new methodology for evaluating banks' risk.

D. Proactively financing enterprises that reduce poverty, enhance equity and restore the environment

Financiers often find it difficult to practice "community investing," financing enterprises that reduce poverty, enhance equity and/or restore the environment. For example, financiers can provide direct financing for socially and environmentally sustainable ventures, purchase debt instruments in community development or micro-enterprise loan funds, or finance low-income housing, small, women- or minority-owned businesses.

- Bank regulation: Requiring commercial banks to lend to economically distressed areas may help create markets, institutions and financial products that promote community investing. United States example: The US's Community Re-Investment Act requires commercial banks to target a certain portion of their portfolio to investment opportunities in the bank's local economy, especially those consumers that are historically disenfranchised. Banks are also ranked on their compliance with the Act. The CRA has helped create an entire sub-sector of community development financial institutions in the United States, which specialize in providing access to capital and credit to low-income and distressed communities. Similar regulations could also be applied to investors such as collective investment schemes.
- Protect community investing from trade agreements: Common trade-related investment measures may harm the existence or effectiveness of community development financial institutions. For example, provisions for "national treatment" forbid governments from establishing or maintaining some investment preferences to promote development in impoverished or minority areas. The "national treatment" provision could nullify banking laws in the Philippines that reserve rural banking services to indigenous financial institutions, which often have particular capacities to serve the rural poor. Similarly, the US's Community Re-investment Act conditions the opening of new bank branches on a company's community re-investment record; this

could be challenged under the investment agreements to the WTO.

- Capitalize community investment vehicles: National and state governments can help capitalize community development financial institutions. For example, in the US, the Community Development Banking and Financial Institutions Act of 1994 created a fund to promote economic revitalization and community development by investing in and assisting community investment financial institutions through equity investments, capital grants, loans and technical assistance.

E. Minimizing Externalities and Market Distortions

In many cases, financiers are limited in their ability to shift their portfolios in ways that capitalize enterprises with superior environmental or social performance because those opportunities are not competitive given current market distortions.

- Stronger and better enforcement of environmental and social laws: Where there are lax or weak enforcement of environmental and social laws, there are fewer monetary sanctions or impacts for companies with poor social and/or environmental performance. Strong and well-enforced environmental and social laws can help send the right market signals to investors.
- Provide the right financial incentives: Aligning governmental subsidies, procurement and tax policy to create financial rewards for responsible corporate behaviour/ activities and disincentives for environmentally or socially harmful corporate behaviour/activities can help the stock market reflect the bottom-line benefits of corporate social responsibility. However, the ability of governments to align procurement policies with environmental, social or other public policy objectives may run afoul of "expropriation" provisions in international trade agreements.
- Create market imperatives: Government policies and sectoral objectives often create markets in and of themselves. For example, in Germany, France and other European countries, national authorities have committed obtain a certain percentage of its country's energy from renewable sources. Such targets and timetables create market imperatives that enhance the ability of financiers to set and meet their own goals for shifting their energy portfolio into more renewable investments.

I. Governance and Accountability in the Financial Services Sector

Currently, financial institutions are not held accountable for the downstream environmental, social and public health impacts of the transactions they finance. Similarly on the "upstream" side, small savers rarely have a to have a voice in the investment, credit, and underwriting practices of the institutions that manage their savings and investments.

- Increase lender liability: In most countries, lenders generally are not held liable for the environmental and social impacts caused by client misconduct. However, as long as lenders remain financially shielded from the environmental and social liabilities of their corporate clients, they will not fully value environmental and social issues when performing their due diligence and pricing capital.

- Crack down on predatory lending: In some markets, financial institutions engage in "predatory lending" practices which banks aggressively sell inappropriate loans designed to exploit vulnerable and unsophisticated borrowers. Regulators should pass and enforce strict laws designed to abolish such exploitation and sanction predatory lenders.
- Disclosure in and of investment products: In order to inform consumers in their choice of managed investment products, consumers need to know the ethical policies and impacts of such funds. Laws requiring the disclosure of a fund's ethical investment policies, proxy voting policies and practices, and even portfolio holdings can assist consumers in choosing or benchmarking investment products. In the United Kingdom, recent law requires pension funds to disclose their ethical investment policies and practices, if any.
- Democratizing investment funds: Governments should promote greater democracy in investment funds, including governance practices that provide for better participation of fund participants or beneficiaries. For example, new laws could oblige pension funds to elect a portion of their trustees from among their beneficiaries, or require mutual funds to integrate participant input into proxy voting policies.

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17 For more information see: www.bis.org

18 The list of members are: Algeria, Argentina, Australia, Austria, Belgium, Bosnia and Herzegovina, Brazil, Bulgaria, Canada, Chile, China, Croatia, the Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hong Kong SAR,

Hungary, Iceland, India, Indonesia, Ireland, Israel, Italy, Japan, Korea, Latvia, Lithuania, the Republic of Macedonia, Malaysia, Mexico, the Netherlands, New Zealand, Norway, the Philippines, Poland, Portugal, Romania, Russia, Saudi Arabia, Singapore, Slovakia, Slovenia, South Africa, Spain, Sweden, Switzerland, Thailand, Turkey, the United Kingdom and the United States, plus the European Central Bank.

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Chapter 6
Trade in financial services: liberalisation in the GATS Agreement and insufficient assessment of the risks

The General Agreement on Trade in Services (GATS) is the only agreement at the international level which regulates and liberalises trade in financial services as well as investment of financial services providers. The GATS agreement was negotiated in the Uruguay Round (1986-1994) and since 1995 had to be applied by all the WTO members (148 by mid 2005). GATS is part of the World Trade Organisation (WTO), including the WTO's decision-making and dispute settlement structures. Liberalisation of financial services is also dealt with in many regional and bilateral trade agreements but will not be analysed in this chapter; many points of analysis might however be the same.

The general principles and rules of the GATS agreement also apply to financial services. In addition, the GATS agreement has special instruments that only relate to financial services, as explained below.

This chapter also includes an analysis of the risks that financial service liberalisation and GATS rules entail for financial instability and wider society issues in developing countries. These risks are not widely or publicly discussed in the current GATS negotiations and brushed aside by Western financial services negotiators.

6.1 The GATS instruments to liberalise financial services

The GATS agreement has different ways to liberalise services, in casu financial services. First, it is necessary to clarify what kind of trade in (financial) services is covered by GATS, because it includes investment by foreign (financial) firms.

6.1.1 The rules of the GATS Agreement

6.1.1.1 The definitions of "trade in services"

According to the GATS agreement, trade in services can take different forms:

- Mode 1: cross-border movement of the **service** or "cross border trade": e.g. a financial firm established abroad is allowed to provide services to nationals such as banks deposits via internet banking.
- Mode 2: cross-border movement of the **service consumer** or "consumption abroad": e.g. an Indonesian art trader is allowed to take a loan from a bank based in the Netherlands.
- Mode 3: cross-border movement of the **corporate service provider** through investments or "commercial presence": e.g. a country allows foreign banks to buy up domestic banks or to open up branches in its territory.
- Mode 4: "cross-border movement of **persons**": e.g. a Brazilian manager of a Dutch bank is allowed to work at the offices of the Dutch bank in Amsterdam or New York.

6.1.1.2 Liberalisation of services under GATS

One part of the GATS agreement deals particularly with liberalisation of (financial) services, i.e. opening up markets to allow services and services providers to enter the country. A country can decide which (sub)sectors it liberalises, or "makes commitments" in, by adding them to its GATS list ("schedule"). For instance, a country can fully or partly liberalise its financial services under GATS. A country's GATS schedule specifies which (financial) sub-services are liberalised for which "modes", and can include exemptions to some GATS rules. A country can decide not to make a commitment in financial services by not adding financial services to the schedule.

The decision to open up, or not, certain services sectors is an important part of the GATS negotiations. A country receives "requests" from other WTO members, i.e. lists of services for which other countries demand market opening. A country then replies with an "offer", a list of services it is prepared to liberalise. Subsequently bilateral secret negotiations follow in which countries bargain between each other's offers and requests. Although this process is supposed to be a give-and-take exercise, this is in practice often not the case because power games and arm-twisting happen during the negotiations. At the end of the bilateral negotiations between the many WTO members, each country includes a schedule of services for which it grants new market openings in the GATS agreement and which is valid for all WTO members (Most Favoured Nation Principle).

6.1.1.3 The GATS rules and obligations that apply to financial services

The GATS agreement is based on the assumption that many barriers to trade in services and limitations on the operation of foreign services' firms come from government regulations, measures and administrative decisions. The GATS agreement has a set of rules and obligations that governments have to implement to allow foreign service providers to operate more freely. It includes the following disciplines, which also apply to financial services:

1. General obligations that a country has to implement even if it has not liberalised any (financial) services under GATS:

- treating all foreign (financial) services equally (Most Favoured Nation / MFN) (Art. II);
- transparency: openness and notification of all measures and new laws on (financial) services to other WTO members (Art. III);
- facilitate the increasing participation of developing countries in world trade in services through negotiating specific commitments and establishment of contact points by developed countries (Art. IV).

2. Specific obligations applying to (financial) services that have been liberalised, i.e. committed in the GATS schedule of each WTO member:

- due treatment of foreign services suppliers when taking administrative measures or giving authorization to supply a (financial) service (Art. VI.1.,2.,3.);
- ensure that standards, licensing and qualification requirements do not constitute a barrier to trade (Art. VI.4.,5.): more disciplines need to be negotiated;
- no restrictions on international payments for current transactions related to committed (financial) services (Art. XI), except in case of balance of payment problems (Art. XII);
- no measures that limit the operation or ownership of (financial) services e.g. limitation on the number of branches (market access obligations in Art. XVI);
- equal treatment of foreign and national financial service providers (national treatment according to Art. XVII);
- a GATS commitment to liberalize can only be reversed by a country after three years and in addition, the WTO trading partners can request compensation that needs to be negotiated (Art. XXI).

3. Continuous liberalisation negotiations

Under Art. XIX, the WTO members agreed to periodically start new negotiations to further liberalise the service sectors of each country, while respecting national policies. The first such negotiations started in 2000 and have been included in the Doha Round of negotiations (start November 2001). However, the negotiations started without duly implementing Art. XIX.3. that calls for carrying out an assessment of the experience in trade in services.

During the current GATS negotiations, leaked "requests" from the EU make clear that market opening mostly means eliminating national laws and regulations that are seen as barriers to trade or in fact just a barrier to make maximum profit by the foreign (financial) services firms.

Regarding GATS rules, difficult negotiations are still underway on domestic regulation (Art. VI.4.), emergency safeguard measures (Art. X), subsidies that can be allowed or not (Art.

XV), and procurement of services by and for governments (Art. XIII). Developed and developing countries have opposing interests, which constantly delays the negotiations and agreed deadlines.

6.1.2 The Annex on Financial Services

The Annex on Financial Services is fully part of the GATS agreement and provides some specification on how authorities can take measures relating to financial services. In addition, the Annex (Art. 5.) provides a non-exhaustive list of insurance, banking and other financial services that are subject to GATS rules and commitments.

The Annex describes which "services supplied in the exercise of governmental authority" are exempted from the GATS agreement (Art. 1), such as activities by central banks or by the public retirement systems.

Prudential carve-out

Art. 2 of the Annex specifies that WTO members can take measures for prudential reasons such as protecting investors and depositors, and ensuring the stability and integrity of the financial system even if such measures do not conform with GATS rules. However, prudential measures should not be abused to circumvent GATS rules nor commitments made under GATS.

In case of a financial services trade dispute, the WTO panel is assumed to have the necessary financial expertise.

The Annex (Art. 3) specifies how countries can make agreements to accept each other's prudential measures.

6.1.3 The GATS agreement includes a model for swift liberalisation

The financial services have received a special separate text belonging to the GATS agreement to promote their quick and full liberalisation through several means: The Understanding on Commitments in Financial Services. If a WTO member agrees to open up its financial services according to the 'Understanding', then it has to make the commitments as described below, with a right to schedule exemptions. All industrialized countries have accepted the Understanding as the basis of their commitments and see it as **a minimum** for others, but only very few developing and emerging market countries have joined in. In total only 30 countries have opened up their financial services according to this Understanding.

A model for extensive market access

The Understanding (Part B.) provides a set of market openings to be applied by WTO members that implement the Understanding. Such market opening relates to:

1. cross-border trade (mode 1) for a few insurance services and for services in support of banking and investment (e.g. advice),
2. the right of consumers to purchase abroad (mode 2) financial services mentioned for mode 1 as well as all other banking or financial services,
3. the right of establishment and expansion by all foreign service financial providers (mode 3), including through acquisitions, and the right of governments to impose some conditions,
4. the temporary presence of managers and specialists in financial services (mode 4).

Moreover, any new conditions to the above market opening may not be more restrictive than those already existing (standstill in restrictions - Part A.).

Members can include this set of market opening in their schedule or still choose to make up their own GATS schedule in which they open up some (financial) services to foreign suppliers.

Erosion of exemptions from GATS rules

The Understanding (Part. B.1.- 2.) invites WTO members not to apply exemptions which are allowed by the GATS agreement to financial services! This means that regulations about procurement of financial services by public entities should be in conformity with the principles of national treatment and most favoured nation while this is not necessary according to Art. XIII. The Understanding also requires each WTO member to list in its schedule monopoly rights provided to financial services and strive to eliminate them (while they are allowed under GATS Art. VIII) as well as list and eliminate financial activities conducted by a public entity for the account of the government (allowed in the Annex on Financial Services Art. 1.(b).(iii)).

Eliminating all barriers to trade in financial services

The Understanding (Part B.10.) also requires members to <u>remove any obstacle</u> to foreign financial services that remains even if all the provisions of the GATS agreement have been respected. Following on, the Understanding provides guarantees that foreign financial service suppliers:

- are permitted to introduce any new financial service (Part B.7.),
- are not hindered in the transfer of information (Part B.8.),
- have access to payment and clearing systems operated by public entities (except lender of last resort facilities) (Part C.).

Foreign financial companies see the lack of such guarantees as (non-tariff) barriers to their trade.

6.1.4 After the Uruguay Round: the Fifth Protocol to the GATS

At the end of the negotiations of the GATS agreement in 1994, some WTO members and especially the VS (read: its financial lobby) were not satisfied with the commitments made by WTO members on financial services. It was decided to continue the negotiations on financial services specifically, which lasted until the end of 1997. The Fifth Protocol to the General Agreement on Trade in Services contains the lists of countries that agreed upon more market openings for financial services than in 1994. Although the Protocol entered into operation in 1999, several members have postponed their acceptance of the protocol, amongst others Brazil.

6.2 Assessing the risks for developing countries

6.2.1 Liberalisation of financial services under GATS

6.2.1.1 GATS negotiations reinforce the interests of Western financial firms

The opening of markets for financial firms from the US and other Western countries has been one of the key forces behind the GATS negotiations during the Uruguay Round (1986-1994). Under pressure from its financial lobby, the US was unwilling to give most favoured nation (MFN) status to countries that did not open for US financial services, one of the reasons why exceptions to MFN were allowed. The US dissatisfaction with financial services market openings during the Uruguay Round lead to complementary GATS negotiations on financial services. The latter were concluded at the end of 1997 (see above: Fifth Protocol) after the US had been pushing much harder for market opening than the EU. The lobby of the world's major financial firms was strongly present behind the scenes and was even involved at the highest level through the Financial Leaders Group.[1] Afterwards, the EU negotiator, who had phoned them from the negotiating room according to a lobbyist, openly praised the EU financial lobbyists.
Especially the emerging market countries were under pressure to open up their markets even though the Asian financial crisis had already erupted in 1997. The WTO and others argued that liberalisation of financial services would not enhance the financial crisis but rather strengthen the 'weak' financial sector in crisis-stricken countries. Some observers claim that additional market opening was forced by the US in return of financial packages to help countries survive the financial crisis.

Again during the GATS negotiations that started in 2000, the basic negotiation position of the EU and other Western countries is to aggressively open up more markets for their financial services. The leaked requests of the EU to developing countries[2] read like a wish list of European financial firms by which all governmental measures that hamper their expansion and profit making would be removed. For example, a recurring demand in the EU requests is that developing countries give up their restrictions on full foreign ownership of banks such as compulsory joint ventures. The EU argument is that full ownership results in better allocation of resources than in financial firms that must involve local elements. However, increased full foreign ownership of banks raises many issues, as explained below. The ultimate examples of industry lobbying are where the leaked requests state "EU industry raises this issue" (e.g. in request to Thailand).

The financial services in 'emerging markets' and higher-income developing countries are again a major target of the EU requests, although the EU has also addressed financial service requests to 20 least developed countries and 30 low-income countries.[3] The US strategy is presumably the same or even more aggressive but details remained secret. The financial market of Russia, which is negotiating to become a member of the WTO, is an important target of the American insurance industry. The American Council of Life Insurers[4] stated that it would oppose Russia's accession unless Russia guarantees market access to foreign life insurance companies. Developing countries have little financial services to export so that the market opening demands of the Western financial firms dominate the current financial services negotiations.

The liberalisation negotiations on financial services in GATS fit neatly with the consolidation strategy of the world top financial industry (see chapter 2) and will reinforce it. The GATS negotiations do not only provide the financial industry with access to more markets and improved chances of full ownership of banks worldwide through mergers and acquisitions. The GATS agreement also guarantees that this liberalisation is difficult to reverse (Art. XXI) and that national measures that hamper profit making and consolidation are being restricted (e.g. Art. VI, XVI and XVII). The 'Understanding on Commitments in Financial Services' (see above) clearly underpins the interest of financial conglomerates that are engaged in cross-border and cross-sector consolidation. The EU requests many developing countries to open up according to this 'Understanding'.

6.2.1.2 Few instruments to deal with increasing concentration

As explained in chapter 2, some sub-sectors of financial services have a high level of concentration with a few companies dominating world wide, such as in investment banking, derivative services and rating agencies. Financial firms from emerging markets and developing countries have no capacity to compete in those concentrated sectors at the national or international level. In five East Asian countries, American and European banks have been able to dominate in capital market services[5] (incl. investment banking) and large syndicated loans.[6]
When opening up these financial sub-sectors, WTO members have to be aware that foreign firms will easily dominate. However, it might be too costly for national authorities to support the development of national service providers in these sectors.
Concentration of financial services leaves governments – which need private finance – and customers with too little choice. It opens the way to abuse of economic and market power such as tacit price-fixing and high prices that are detrimental to development. Secret price-fixing occurs but seldom comes to light as happened in Germany by the insurance companies[7] and in Kenya where a cartel of foreign banks fixed high interest rates.

The GATS agreement has only very weak instruments to tackle problems related to concentration and consolidation (see also chapter 2). GATS Art. IX recognizes that business practices may restrict competition and trade in services but does not contain real competition policy measures. Only when restrictive business practices occur at the national level by foreign service providers can the domestic authorities ask for consultations. The home country should only give "sympathetic consideration" to such requests and non-confidential information. Moreover, the negotiations on emergency safeguard measures to protect the local (financial) services industry from being overwhelmed by foreign services, are being opposed and constantly postponed by Western countries.

→ Critical issues

How far will consolidation go?
Further liberalisation under GATS is likely to increase consolidation and concentration. It is however not discussed up to what level consolidation will be allowed at international level. Will supervisory authorities intervene in trade policies when banks become too difficult to monitor and "too big to fail"? Financial firms will argue that further consolidation is the most important strategy in current international competition. In case the same few top financial firms will compete in all countries and thus form a worldwide oligopoly, can WTO members reverse their liberalisation under GATS without paying compensation?

6.2.1.3 The arguments behind liberalisation of financial services

In the literature[8] and in discussions, many arguments can be found in favour of, as well as against presence of foreign banks.

The arguments put forward by those in favour of liberalisation are:

- reduction in overhead expenses and profit-taking by domestic banks due to increased competition by foreign banks;
- increased efficiency and diversity of financial services;
- spill-over effects of foreign bank entry, such as the introduction of new financial services and of modern and more efficient banking techniques, and the improvement of domestic bank management;
- improvement in bank regulation and supervision due to the entry of new financial service providers and new financial services;
- less interference by governments in the financial sector, to cover up bad practices;
- training by foreign banks, resulting in more experienced personnel in the financial sector of a country;
- the presence of foreign banks stimulates domestic investment in the host countries;
- foreign banks may attract (other) foreign direct investments and enhance a country's access to international capital;
- well capitalized foreign banks may be able and willing to keep lending to domestic firms during adverse economic conditions, while domestic banks would probably reduce the credit supply;
- foreign bank entry leads to better lending terms (lower interest rates, lower fees, longer maturities) for all but larger firms.

The arguments put forward for those opposing foreign entry are:

- domestic banks are not able to cope with increased competition, and may stop operating, which can cause disruptions and political concerns about increased foreign control of the financial market;
- trying to cope with increased competition from the foreign banks and implementing new techniques may raise costs for local banks in the short term, which they would then finance by raising their profit margins, in turn leading to price increases for consumers;
- foreign banks get higher interest margins;
- foreign banks' entry into the market of loans to corporations does not decrease the margins and profits in the personal loan market;
- foreign banks will not provide additional credit during an economic downturn in a host country;
- foreign banks will leave the country when the profitability is too low, which can undermine stability in financial services;
- changes in economic conditions in the foreign bank's home country may have a negative effect on bank activity in the local market;
- foreign banks only provide credit to large and often foreign-owned (multinational) firms, and tend to lend less to small firms and poor consumers;
- domestic supervisory and monetary authorities often fear that their influence on banks' behaviour may diminish as supervision of foreign banks' branches is done by the authorities of the home country.

6.2.1.4 Experiences of financial services liberalisation in developing countries

The evidence of liberalisation of financial services in developing countries seems to be mixed. The literature provides mainly evidence from banking and some few other financial sub-sectors or from a particular perspective. Many data are missing to provide a full picture. In order to guide negotiators, economic models do not exist to assess the full impact of future financial services liberalisation. Moreover, no overall assessment of the experience in trade in (financial) services was carried out as GATS Art. XIX.3. calls for.

From the literature and research done by SOMO, the experiences of developing countries seem to be well reflected in the assessment of trade liberalisation in financial services made by China[9] which included the following issues.[10]

(a) Positive effects:

- **Improving efficiency, functioning and management**

Foreign banks have been improving the functioning of the financial system in China: they are promoting the competitiveness of domestic banks and bringing in new experience in risk management, internal controlling, incentive mechanisms, business innovation and accounting.
In Sub-Saharan Africa, experience of increased foreign participation in the domestic banking sector to date has shown such benefits as improved quality, pricing and supply of financial services and in risk management, accounting and transparency as well as increased competition.[11] Especially in poorer developing countries where the banking system is considered inefficient and unreliable, the entry of foreign banks is claimed to make domestic banks more efficient and avoid the high economic cost of inefficiency that prevent development, trade and investment.[12]
Research findings differ whether domestic banking efficiency increases by a large number of new foreign entrants or by (a few) new entrants with large market shares.[13]

- **Increased access to foreign capital**

In China, foreign financial firms have increased foreign capital inflows and the investment environment has improved.

- **Introducing new financial services and innovations**

Foreign financial services companies have provided more advanced services and financial innovations to consumers in China. In insurance, a major US insurance group (American International Group) introduced an insurance marketing system, stimulated the domestic insurance market, strengthened the idea of customer-oriented service among Chinese insurance companies, and promoted the development of the personal life insurance market.

(b) Negative effects:

“Cherry picking”

China has experienced that domestic banks loose especially rich clients (“high end consumers”) to foreign banks. Since such rich clients provide most of the profit for a bank (according to Chinese statistics: 80% of the profits come from the richest 20% of the clients), domestic banks are losing profitable clients and are left with the less profitable ones. This can further undermine their capability to compete with foreign banks, which in turn are not interested in serving poorer clients.

In Turkey, for instance, foreign banks have chosen aggressive strategies to only focus on large lucrative clients (e.g. multinationals, governments) and projects (e.g. privatization).[14] In Sub-Saharan Africa and elsewhere (e.g. India), foreign firms use their financial power and international status to focus on the most lucrative transactions and lure rich and middle class customers. These findings confirm a case study of the Dutch bank ABN Amro in Brazil, which showed that it was not more efficient than domestic banks which had survived many financial crises but many people trusted its status as a foreign bank which attracted richer people who were willing to pay more.[15]

An important question is whether this cherry picking by foreign financial firms mobilizes more domestic savings or rather increases capital flight.

Undermining poverty eradication

This cherry picking and market segmentation is undermining poverty eradication (see chapter 1) as foreign financial firms are hardly interested to expand their services to the poor. As was researched in Kenya[16], the situation is similar for foreign health insurance companies. These companies tailor their services to the wealthy city-dwellers who are already able to pay their hospital bills. They charge high premiums, unaffordable to poor patients. They refuse to accept patients who suffer from illnesses such as HIV/AIDS. This is in sharp contrast to the government’s public health insurance system, which is obligated to accept all patients.

The recent situation in some Latin American economies also highlights the risk that foreign banks will not offer their services to smaller clients like households and SME’s. Especially in Mexico, where foreign banks control 85% of the total banking sector but provide too little lending to local companies to stimulate economic growth. Politicians and supervisors have expressed their doubts on the past decision to open their banking sector up to foreign competition. Households and SME’s hardly have access to credit at reasonable rates. The government is considering legislation that will make it mandatory for banks to change their lending practices.[17]

→ Critical issues

GATS 'flexibilities' not used
During the previous GATS negotiations, Kenya agreed to liberalise its financial services without fully realizing that it was also subjecting the health insurance sector to the GATS rules. Article XVI prohibits governments from taking six specific kinds of measures to place limitations on companies, such as economic needs tests and restrictions on the number of service suppliers. During the negotiations, the Kenyan government could have reserved the right to impose a universal service requirement for foreign insurers only, but did not do so. The government can now require foreign companies to insure poor and vulnerable (HIV-positive or terminal) patients only if it also sets the same requirement for Kenya-based insurers, according to the GATS principle of non-discrimination and national treatment (Article XVII). Whether countries will impose universal service obligation is another matter, as it is considered to have an unfavourable impact on the financial firms' profitability and stability, and thus discourage investments.[18]

□ Widening the gaps

In China, the imbalance **of economic development** between the eastern and western **regions** is widening further as more foreign investments and their banking services flow to the more developed eastern part of the country. Taiwan equally experienced that foreign financial firms stayed in the capital areas and did not go to the non-profitable rural areas.[19]

When foreign banks are easily dominating the most lucrative services as is the case in South East Asia for investment banking and syndicated loans, domestic banks might **specialize** in catering to the credit needs of small and medium-sized firms and households. In such situation, liberalizing financial services may not result in the proclaimed improvement of competitiveness and efficiency of the domestic financial service industry through transfer of new sophisticated financial technologies.

→ Critical issues

Undermining lending to non wealthy borrowers
In case local banks do not survive the competition from large foreign banks, their expertise and capacity to borrow to small producers and poorer households will be lost. This can enhance the divide between small and rich producers, make poverty eradication more difficult, and have an impact on the whole economy.

Widening the gender gap
If cherry-picking is common practice by foreign financial firms, it has also gender implications in developing countries. Women constitute the majority of the poor and

are often very small producers or entrepreneurs. Although the female rate of repayment of loans is high, their lack of collateral means that they often have to rely on micro-credit systems for financing. If financial services liberalisation does not provide them with better access to finance while larger entrepreneurs are better financed, their fight against poverty might be undermined and the gender gap increased.

The experience of 80 countries between 1988 and 1995 shows that foreign banks in developing countries tend to have greater profits, higher net interest margins and higher tax payments than domestic banks.[20]

→ Critical issues

Transferring wealth from poor to rich countries
Foreign financial firms that make profits from richer clients in developing countries and transfer that profit abroad, are thus transferring some of the wealth from developing countries to the rich home countries. Moreover, Art. XI of GATS does not allow restrictions on profit repatriation.

□ **Brain drain from local to foreign banks**
In China, domestic banks are losing many capable senior executives and key personnel. This leads to a lack of experienced executives in domestic banks and further undermines the swift development and improvement of these banks. Such experience contradicts the argument that foreign presence of banks lead to transfer of know how.

(c) Challenging problems

□ **Swift expansion of foreign financial services**
During the second half of the 1990s[21], there has been a dramatic and very rapid increase in foreign ownership of banks and foreign **banking** activities in many developing countries and in China. Figures indicate[22] that the presence of banks from developed countries increased:

- by more than 59% in East Asian countries[23] between 1996 and 2001,
- by 364% in Latin America[24] during the period 1996-2000, and
- by 85% in Central and Eastern Europe[25] during 1996-2000.

In Tanzania, liberalisation for foreign banks increased their presence from 5% before 1980 (when policies where restrictive) to 76% in 2002.
The entrance of foreign **insurance** companies has also shown a dramatic expansion of these companies in a short period of time in China.
It is difficult to establish whether the GATS agreement on financial services (1997) had an influence on this large increase of presence of Western banks. There was a general trend towards opening up financial sectors during that period -which was reflected in some GATS

schedules[26]- alongside the strategy of many internationally operating financial firms towards global consolidation.

The EU (and US?) requests during the current GATS negotiations to eliminate restrictions on full foreign ownership in small or poor developing countries can easily lead to domination by foreign banks. What are the consequences for monetary and development policy when foreign financial service providers control more than 75% of the banks, as is the case of Tanzania, and more than 80% of private financial assets, as is the case of Mexico? Moreover, dominance by foreign banks makes these countries vulnerable to strategies of financial conglomerates that leave the country when profits decline. This makes it more difficult for the authorities to monitor the financial system.

→ Critical issues

Difficulties to keep up with the rapid changes
Rapid increase of foreign financial firms make it difficult for domestic financial firms to meet the fierce competition, while the supervisory and regulatory authorities have trouble keeping abreast of the developments and their risks.

Allocating more savings of developing countries to the rich countries?
Foreign financial conglomerates have more expertise on how to allocate domestic savings and capital in Western investments than the domestic financial firms in developing countries. It might be too costly for foreign financial service providers to fully explore new investment opportunities in the host country. When developing countries have liberalised their financial services and capital account, more of their savings get allocated to the North (e.g. Northern company shares) and not in domestic investments. In this way, domestic economic development opportunities are lost and the global imbalance of capital allocation reinforced. As more and more developing countries' banks are being privatised, governments have fewer opportunities to prioritise the financing of domestic (service) industries.

- **Little capacity to export financial services**

GATS has also provided for China's financial firms the opportunity to establish abroad, but Chinese financial services lack the competitive edge (and still need a lot of restructuring) to expand abroad to the extent that foreign financial services are capable of entering the Chinese market. This adds to a deficit in services trade, and to balance-of-payments problems.
In Africa, the insurance sector has so far remained underdeveloped and without the necessary backing from governments. Lack of capacity and expertise has prevented the sector from starting viable commercial relations among African countries and making them fully prepared for international competition at home and on international markets.[27]

Need for new regulatory and supervisory bodies

After opening up its financial services sector under GATS, China needed to introduce new regulatory bodies for supervising the insurance and securities' sectors, alongside those regulating and supervising the banking sector. This can strengthen the financial sector and its stability. However, given the required swiftness, cost and expertise, many developed and developing countries have not yet finalised their regulatory and supervisory reforms (see chapter 5). Note that in the West, regulators and supervisors have come to the conclusion that banking and insurance supervisory bodies are not adequate and need to be integrated because financial firms increasingly integrate banking, insurance and securities (see chapter 5: these reforms have not yet fully taken place in all developed countries).

How much progress in efficiency?

In Sub-Saharan Africa, the presence of foreign banks increases loans by both domestic and foreign banks, but the variability of the loan supply decreases. Foreign banks in Sub-Saharan Africa do not necessarily have fewer bad performing loans nor are they better capitalized than local banks – although better capitalization is often claimed as an advantage they enjoy, making them more resistant to financial crises. Foreign banks can out-compete locally owned banks in smaller economies because they can recover their high set-up costs from profitable operations elsewhere.[28]

The high presence of foreign banks Latin America[29] shows that the stimulus for domestic banks to increase efficiency through lower overhead expenses and less profit taking only works out in countries at the lower levels of economic development (e.g. Peru, Colombia, Ecuador and Bolivia), but not for the more developed countries such as Brazil. Note that "more efficiency" by local banks means "less profit". Less profitability and greater competition can avoid abuses but also lead to more risky lending practices by smaller local banks.[30]

Risks of financial instability

The risks of financial instability in developing countries resulting from financial services liberalisation and GATS rules are being analyzed below as follows:

1. too little awareness that new financial services require new prudential measures
2. foreign financial services increase cross-border capital flows and financial instability
3. GATS articles advance cross-border capital flows and capital account liberalisation
4. GATS articles challenge measures to deal with destabilising capital flows
5. GATS articles undermine prudential measures and regulations domestic authorities take
6. GATS articles affect the management of the financial industry and instability risks

6.2.2 The risks of financial instability in developing countries

While the GATS negotiations in financial services are about liberalisation of financial services, they affect the national (de)regulation of financial markets and financial services, as well as measures that manage large capital transactions ("capital account"[31]). The latter two sets of measures are nonetheless the domain of finance authorities and affect the financial stability and economic situation of a country, especially in developing countries. The experience with the recent financial crises in Asia and Argentina has indicated that capital account liberalisation has increased the risk of a financial crisis in developing countries that failed to develop a strong regulatory and supervisory framework prior to liberalisation. Foreign banks contribute to a financial crisis by using capital account liberalisation for imprudent short-term lending policies and “herding behaviour”, and by hoping –mostly successfully- that governments will support repayment of commercial debt.

Developing countries have already expressed their concerns that market opening and GATS rules might result in capital movements that create financial instability and affect governments' decisions to institute prudential measures to avoid a financial crisis. The devastating effects of a financial crisis should prioritize negotiators' attention to assess the risks and address the concerns. However, these concerns are not much publicly discussed and hardly acknowledged by developed countries. As the World Bank puts it: Access to financial services is what matters for development, not who provides it.[32]

6.2.2.1 Too little recognition of the need for new prudential measures

During the current GATS negotiations, many developing countries are not well informed what policy responses and prudential measures to take that avoid the risks of greater liberalisation of financial services. The WTO Committee on Trade in Financial Services discusses some of these issues, including experiences of the range of new financial measures and bodies introduced by some developing countries (e.g. Turkey, Malaysia, China). However, many developing countries have no capacity to participate in the Committee or to engage all relevant financial authorities back home.

There is no widely accepted conceptual framework to make econometric estimates of financial services liberalisation, and statistical data are inadequate to predict future impacts.[33]

Sudden intensification of competition by foreign new comers may encourage previously protected domestic financial institutions to take short-sighted risky responses[34], such as reckless lending. Also foreign financial firms might engage in risky strategies to gain new shares of the market. For instance, Argentina allowed large foreign ownership of banks that failed to lend to small and medium-sized enterprises. The lack of safeguards to lend to domestic firms prevented the Argentina economy to pick up after its first growth wave ended in the 1990s.[35]

In order to compete and attract more clients, financial conglomerates constantly introduce new and more complex, hybrid financial products. If countries liberalise under GATS according to he Understanding on Commitments in Financial Services (see above), the host countries have to give permission to "any new financial service" that foreign financial service providers introduce.[36]

New services might include banking through internet and e-mail, 'e-banking', which poses problems of supervision on money laundering and fraudulent activities, consumer protection and avoidance of systemic failure.[37]
Other new services might be derivative products and mutual fund management, instruments that involve a significant speculative component.

Regulators and supervisors in developing countries will be challenged to take the necessary measures and avoid the problems that occurred in Western countries, which are supposed to have the best regulatory and supervisory regimes. As explained above, Western countries had to revise regulations after problems of too much speculative investment by pension funds and insurance companies. They also had to impose fines for scandals of misusing knowledge, the creation of a stock market bubble and charging too high fees.

China's experience[38] with foreign financial firms shows that transaction techniques have become more complicated. As a result, China’s financial institutions are experiencing tremendous changes, which increases the risk of instability. China has gradually reformed its regulatory framework to adapt to international practice, but admits the administrative capacity of the regulatory authority still falls far behind that of many developed countries and that continuous reform and improvement is needed. This adds to the difficulties and the high costs of administering the financial system.

In the future, Basel II rules might transform financial services markets in developing countries (see above chapter 5). For instance, Basel II rules might make it more difficult for domestic banks to compete against international banks that enter their market under GATS commitments. Authorities will have to adapt to the situation and take necessary measures.

6.2.2.2 Foreign financial services increase cross-border capital flows and instability

One way by which foreign banks tend to import financial instability is by **lending in foreign currencies**. In China for instance, foreign banks have become important channels for bringing in foreign capital, by loans in foreign exchange amongst others. This has had a

major effect on China's monetary policy, and has strained the macro-regulatory mechanisms of its financial system.[39]
The payment and repayment of loans in foreign exchange increase the rate of inflow and outflow of international capital. When this results in an imbalanced exchange between local and foreign currencies, it puts the exchange rate and foreign exchange reserves under pressure, particularly if those loans are short-term. Too much demand for foreign exchange increases the balance of payments deficit and with it the risk of exchange rate and financial instability.

Other products that foreign financial firms introduce with financial market opening are for instance "capital market products" such as **investment instruments** (e.g. mutual funds, advise for management of a shares' portfolio). These instruments often offer domestic residents to diversify their investments in shares and bonds issued by companies abroad in addition to domestic ones.[40] Such services result in more cross-border capital movements and can move in and out swiftly, especially when no capital movement restrictions are in place.
New risk mitigation services and derivatives can also involve allocating money abroad. While such services diversify risks, they are also **speculative** and it is difficult to estimate by how much capital movements will increase and change direction.
When cross border capital flows reach significant volumes and a high velocity, or lead to a balance of payments deficit, they can increase financial instability in the host country. Speculative financial products can also import financial crises from abroad.

In addition**, cross-border e-banking** and buying foreign products -or even securities- through internet ("mode 1" under GATS), typically involve cross-border capital movements and foreign currencies. The lack of transparency in e-banking makes countries uninformed how it will facilitate large destabilising cross-border capital movements, especially in small countries.[41]

What is difficult to predict[42] is how branches or subsidiaries of foreign financial firms and their headquarters will **behave in times of financial crises** in developing countries. Would they panic and move out all at once at the first sign of crisis as they did in 1997? Or will they be able to resist the crisis with capital flowing in from the headquarters? In the current Argentinean crisis, foreign banks refuse to recapitalize their branches and subsidiaries.[43] Will they help transfer national savings abroad as in Argentina? Or will they provide capital from abroad to finance current account imbalances? Most East Asian countries have not been able to borrow in their own currencies, which means that they are continuously exposed to problems that triggered the crisis in 1997. Smaller economies such as in Sub-Saharan Africa are more vulnerable to capital movements which result in financial volatility and destabilization of domestic bank credit.

6.2.2.3 GATS articles promote cross-border capital flows and capital account liberalisation

Some articles of the GATS agreement play a role in increasing the risks of destabilising financial flows related to foreign financial service providers.

GATS Art. XI.1.[44] does not allow countries to restrict international transfers and payments for current financial transactions that are related to services in sectors that were liberalised under the Agreement. That means, first of all, that a country cannot prevent profit repatriation by foreign service providers in sectors in which a country has made GATS commitments. For instance, the EU requests from Chile in the current financial services negotiations that Chile eliminates the "restriction" that prior authorization by the Central Bank is required before transferring dividends from Chile abroad because this is in breach of Article XI. Thus, if a country has liberalised the financial sectors, foreign banks and insurance companies can transfer their profits abroad without reinvesting them in the country. In countries that have small economies and/or large foreign investors in all sectors, profit transfers affect negatively the balance of payments and exchange rate.

Moreover, Art. XI.1. has a special effect in relation to financial services provided by foreign banks, insurers, investment bankers and asset managers which have established themselves in countries that made GATS commitments in these services (Mode 3). These financial service providers might view cross-border financial flows as "related to" or essential to their services in cases such as:

- lending in foreign currency;
- buying securities abroad to balance the risks in pension fund management or to increase the rate of return of asset management services (e.g. mutual funds) for local clients or insurance companies;
- providing investment bank services related to foreign stock exchanges (underwriting shares of domestic firms listed abroad) or related to foreign companies (acquisitions abroad);
- offering international derivatives; and
- using international credit risk mitigation mechanisms.

Such cross-border capital flows can go beyond current account transfers and undermine management of the capital account aimed at avoiding financial instability and crises (see box). If certain capital account restrictions frustrate the transactions of committed services sectors, they could be challenged under GATS XI (see also below). In countries that have already liberalised their capital account, GATS commitments in certain financial sub-sector will increase instable capital flows. They might also discourage reversing capital account liberalisation where considered necessary to avoid financial crises. Developing countries that keep a high level of capital control are not likely to attract foreign financial firms as the latter avoid unpredictable local currency convertibility and capital withdrawals.[45]

Market opening in financial services and its impact on international capital movements and financial stability

Article XI of the GATS is intended to guarantee the primacy of IMF rules in the area of international capital movements. Obligations as to the liberalisation of cross-border transactions in the WTO are linked to the commitments to market access included in a country's schedule and are designed to prevent their frustration in practice through restrictions on the capital transactions necessary for their fulfilment. However, the decoupling in the GATS of market opening for financial services from liberalisation of capital-account transactions generally none the less leaves substantial scope for connections in practice. This is most easily seen for the hypothetical example of a country which enters into commitments to no limitations regarding Modes 1, 2 and 3 for all the activities mentioned in the Annex on Financial Services. To ensure effective implementation of such commitments the country would be obliged to undertake comprehensive liberalisation of capital-account transactions. Moreover a country - not the one just described in the hypothetical example - whose commitments were made through the Understanding on Commitments in Financial Services would also be making an open-ended commitment to the liberalisation of such transactions required by its obligation to "permit financial service suppliers of any other Member established in its territory to offer in its territory any new financial service". Although commitments as to market opening for financial services often carry associated obligations as to the liberalisation of capital transaction, the country making them will have to depend on guesswork for the estimation of the size of the capital movements which are likely to ensue.[46] The difficulty of reaching estimates here is increased by the pace of change in the financial sector, which is adding to the range of possible transactions under the different modes of delivery of the GATS.

Source: A. Cornford, The multilateral negotiations on financial services: current issues and future directions, 2003.

GATS Article XVI ("Market Access") includes **footnote 8** that commits a country to allow a number of cross-border flows when it has opened up its market for particular (financial) services: the country must allow *in*flows and *out*flows of capital that are considered "essential" for (financial) services in mode 1 (e.g. e-banking) and allow *in*flows "related" to mode 3 (i.e. foreign services provided by firms established in the country). Thus, countries can only regulate the *out*flow of capital except for mode 1, if they have not already deregulated capital flows by liberalizing the capital account as many developing countries have done.

So far, the interpretation and impacts of Art. XI.1. and footnote 8 of Art. XVI in relation to financial services are a little discussed area about which experts do not always have a clear answer. This is reflected in discussions that have taken place[47] in the WTO about opening up financial services that do not have a presence in the country but rather provide their services from abroad (mode 1). Financial "products" such as lending of all types and asset management provided by financial firms abroad can have a destabilizing effect because they involve cross-border financial flows in foreign currency. In the view of Brazil, the above mentioned footnote 8 of the GATS agreement could be tantamount to capital account liberalisation and deregulation of major transfers of money, even if a country has not fully liberalised its capital account system. Such cross-border capital transfers could affect the balance of payments and the whole financial stability of a country. The European Union, the US and other western countries downplay the importance of the impact of opening up Mode 1 in financial services, but too little research has been done to date on this issue.

6.2.2.4 GATS articles undermine measures to deal with destabilizing capital flows

Financial authorities need to have the capacity to carefully monitor changes in cross border capital flows that result from financial services liberalisation. They may want to take measures to prevent too much financial instability, especially in small countries where swift flows can have a major impact. But GATS rules do not only influence what cross-border capital flows are permitted, they also influence how restrictions on those flows are managed.

Formally, GATS does not prevent any country from taking prudential measures to protect depositors, investors or to ensure the integrity and stability of the financial system.
Art. XI.2. states that *"nothing in the GATS agreement shall affect the rights and obligations of the members of the international Monetary Fund under the Articles of Agreement of the Fund".* This legitimates controls over capital transactions since the IMF's articles continue to permit policy autonomy regarding such controls.[48] These rights and obligations, however, are subject to the condition that "*a member shall not impose restrictions on any capital transactions inconsistently with its specific commitments regarding such transactions".* In other words, IMF rights cannot undermine GATS commitments.

WTO members are allowed to **not** apply Art. XI.1-2. In case of serious balance of payment problems, **Art. XII** allows countries to restrict their market opening in (financial) services sectors (financial or other services sectors) for which they made liberalisation commitments, and to restrict cross-border money transactions related to committed sectors. However, a country that invokes these restrictions is bound to fulfil a number of **conditions**, including:

- use criteria of non-discrimination and least-harmful effects on foreign service providers;
- be consistent with the Articles of the IMF;
- limit the period the measures are in place;

- undertake consultations with WTO members.

Ultimately, the assessment of the IMF of the financial situation of the country determines whether the restriction measures are to be allowed (Art. XII.5.(e)).

6.2.2.5 GATS articles undermine prudential measures and regulations

Art. 2 of the GATS Annex on Financial Services (see above) permits domestic regulations and prudential measures that protect a country against financial instability and foreign exchange exposure. This article does not define prudential measures but stipulates that such measures are authorised to contravene other GATS provisions ("prudential carve-out"). However, the article states that prudential measures should not be used to avoid market openings or obligations under the GATS agreement. These conditions attached to the prudential carve-out measures may prevent countries from taking measures, which, while contravening GATS commitments, are nevertheless the most effective for dealing with financial instability.

The vagueness of what a prudential regulation may entail allows a WTO member to challenge a measure of another WTO member as being not a prudential measure, but rather a way to avoid GATS commitments or obligations. For instance, Western countries robustly challenge prudential measures by China during current negotiations and WTO reviews with the argument that they undermine financial services commitments.[49] In case of disputes brought before the WTO, a panel must in such case decide what prudential measure is permitted or trade restrictive to the foreign financial industry. Although the GATS Annex on Financial Services (Art. 4.) specifies that a panel must have the financial expertise necessary for the dispute, still, central banks and other regulators lose their full freedom to impose the prudential regulations they see as essential.

6.2.2.6 GATS articles affect the management of the financial industry and instability risks

GATS rules are oriented to protect foreign, in practice Northern, financial firms against governmental measures that limit their expansion and profit making. As a result, some GATS articles affect measures that especially developing countries have taken to avoid abuses and risks taken by national or foreign financial firms, or to strengthen the domestic financial industry before opening up to foreign competition.

Art. XVI on market access specifies six categories of measures which governments are not allowed to carry out for those (financial) services on which they have made GATS commitments. Governments sometimes use the prohibited measures in the financial sector (which is central to its economy) for economic, sovereignty or prudential reasons. Art. XVI prohibits:

- limitations on the number of service suppliers (Art. XVI.a.) or service operations (Art.

XVI. c.)
- limitations on the value of service transactions or assets (Art. XVI.b.),
- measures that require specific types of legal entity or joint ventures (Art. XVI.e.), and
- limitations on foreign ownership capital (Art. XVI.f.).

Governments can only carry out such limitations for committed financial sectors if they specify them as exemptions in the GATS "schedules" of their country.

Art. XVII on national treatment requires that foreign financial firms be treated not less favourably than national firms. One of the implications of this GATS principle is that official support for national financial firms in order to avoid financial instability, or to restructure after a financial crisis, also needs to be given to foreign financial firms. There could be a 'chilling effect' if national support is not given because of potential conflicts with Art. XVII.

Licensing, qualification requirements and technical standards are part of ensuring the integrity of the financial sector in some countries. They are being disciplined by **Art. VI.4-5 on domestic regulation** to ensure that they are not more burdensome than necessary nor trade restrictive. As the latter principles still need to be developed, current requirements and standards in financial services can be attacked as trade restrictive. This is already the case with the EC's requests for market opening for financial services to different developing countries (see below). Eight small island countries[50] in the WTO have heavily complained that footnote 3 of Art. VI.5. refers to international standard setting bodies while small and developing countries have no say in many of these bodies which impose costly regulation.

Interestingly, during the previous GATS negotiations, some countries have tried to safeguard their freedom to take the regulations they see as necessary. They made explicit references in their GATS 'schedules' to their prudential policy in order to be protected against any GATS provision or commitment.

6.2.3 Who will decide on what prudential regulation and capital account policies?

The contradictions between promoting trade and the interests of the financial service industry on the one hand, and strengthening the national and international systems, highlights many important issues that require an urgent answer.

6.2.3.1 The EU's attack on financial regulations of developing countries

The current GATS negotiations to further open markets for financial services are mostly done bilaterally between WTO members and based on 'request lists' and 'offers' (see above). These negotiations are in principle secret but the requests of the EU were leaked.[51] These texts demonstrate that the EU aims at eliminating many governmental regulations which it considers trade restrictive for its financial industry. Developing countries consider these regulations to be prudential or necessary for the country's economy or financial industry.

Discouraging the strengthening of the domestic financial sector

Malaysia[52] has explained to the WTO that it has a 10-year programme to strengthen its financial services sector after the financial crisis. The programme includes gradual liberalisation without undermining financial stability, and measures that limit access by foreign financial firms to the Ringgit. In its requests, the EU asks Malaysia[53] to remove the latter measures such as "the prevention applied to foreign banks from having access to local currency capital market".

Undermining domestic capital reserves

The EU requests to several countries to take away measures that compel banks to keep reserves in the host country and not by the international parent bank at international level (e.g. "allow branches to use parent's capital to meet prudential requirements", and "take fully into account the guarantee extended by the branch's head office or by another foreign bank for additional lending"). Such requests underestimate the need to allocate reserves in the host country. Especially in times of world wide financial crisis, the parent bank might not fulfil its guarantee for additional lending (as was the case in Argentina in 1994-1995[54]), might not have enough reserves for all its branches and subsidiaries world wide, or might have its requested liquidity in foreign currency (adding to the complexity of the crisis). It is easier and cheaper for financial conglomerates to keep capital reserves central rather than divided in the countries of the different branches.

Encouraging tax evasion and off shore centres?

The EU made a request to Thailand to take away its limitation that foreign banks with an offshore license cannot get access to the Thai market through full branch license. Most foreign financial conglomerates are operating in 'offshore centres' such as the Cayman Islands or Switzerland, which allow evasion of taxes and low cost transactions. As the amount of money passing through offshore centres is huge, transactions with these centres can be unreliable and volatile, and cause or transmit financial instability. How does this EU request match the EU's own policy to confront offshore centres?

Interestingly, the US, Canada and Japan warned their financial firms to be wary of doing business with he Caribbean offshore centres. The concerned Caribbean countries have threatened to use the WTO dispute mechanism because when they considered these warnings as restrictions on trade in financial services with those centres.[55]

Limiting the scope to regulate in favour of poverty alleviation

In its request, the EU raises questions about the requirement applied to all banks in Malaysia to provide quotas for low-cost housing and considers that it is a limitation that should be scheduled. This means that measures to provide poorer families with the financial resources needed for housing are not considered falling under the GATS "right to regulate", but rather as a trade barrier (read profit making restriction) that must be exempted from the GATS agreement (Art. XVI), and ultimately eliminated.

→ Critical issues

Regulations that oblige banks to finance or invest in poor communities are not popular with financial conglomerates. The EU request indicates that the secret bilateral GATS negotiations might be a way to put pressure on such regulations and ultimately to eliminate them. GATS rules might also undermine schemes that reserve rural banking services to domestic banks, such as in the Philippines.[56] The right to regulate in the GATS preamble seems to be open to interpretation, even for poverty related measures. This might be in contradiction with policies to achieve the UN Millennium Goals.

Exporting the problems of European pension fund managers?
The EU requests many countries to liberalise their pension fund management services. The European pension fund managers have however proven to be not very proficient by over-investing in the stock market and reduce their financial reserves for pensioners to a level that regulators had to intervene. At a time when many private pension funds are still in financial problems and privatization of pension funds is contested in Europe (Italy, France) it would be politically inadvisable for the EU to promote private pension fund management in developing countries.

→ Critical issues

Experience in Latin American countries shows that the benefits of pension reform and privatization have been overestimated, and that the administrative costs are high.[57] From a poverty perspective, the question is whether European pension fund managers will be cheaper, make additional pension insurance available to more poor workers or focus on the richest clients (cherry picking)?

The danger of secrecy and power plays in the GATS negotiations
So far is unclear how the different interpretations of necessary and prudential financial regulations will play out during the negotiations. The EU has claimed that regulatory and supervisory issues will be discussed during the bilateral negotiations but argues that its requests are targeting trade restrictions. How will the EU handle the IMF's assessment that the regulatory system in Thailand is not yet efficient enough and that further liberalisation entails systemic risks for that country?
During the secret bilateral negotiations, when the pressure to liberalise is the highest, it will be a matter of the having most (economic) power to push for, or resist, the removal of

particular prudential measures. Prudential measures might be overlooked when trade deals are made at the end of the Doha Round negotiations in order to achieve market access in GATS that balances off other concessions (e.g. in agriculture by the EU and the US). Harsh pressure to open up financial services takes also place during negotiations for new membership of the WTO, as was the case with China.

6.2.3.2 Should the WTO handle disputes on prudential regulation?

Beyond those bilateral GATS negotiations on commitments, the question is what role the WTO will or should play in prudential regulation. The negotiators have already discussed the 'prudential carve-out' (see above) of the GATS Annex on Financial Services. Some industrialised countries have proposed clearer definitions or closer links with international standard setting bodies[58] or with supervisory activities of the IMF[59]. This could entail that these standards or activities would be considered un-challengeable under GATS and others not. In contrast, developing countries are more interested in keeping a broad prudential carve-out that does not constrain their policy making.

One scholar (A. Kern[60]) puts the issue as follows: *"[There is a] need to define prudential regulatory standards in a manner that promotes a synthesis between trade and regulatory values. The issue becomes whether the WTO should play a role in this process, and if not which international bodies or organisations should be deferred to in setting international standards of prudential regulation. The absence of a definition in this area means that finding such a synthesis will be left to the adjudication proceedings of the GATS, and potentially within the legislative jurisdiction of the WTO. The evaluation will also cover the issue of the adequacy of the current international prudential mechanisms as benchmarks for assessing a member's prudential regulatory measures. This does not prepare for a promising integration of the financial systems. It only stands to disturb the constitutional balance of the international economic system by rendering GATS the de facto ultimate arbiter of international financial regulation." …"[T]he ambiguities surrounding the interpretation of the concept of prudential regulation and its scope of coverage in the 'prudential carve-out' of the Financial Services Annex will likely result in many trade disputes regarding the validity of prudential measures taken by members to ensure the protection of investors, policyholders, shareholders, and to promote integrity and stability of the financial system." …"[T]he WTO's dispute settlement mechanism is an inefficient mechanism to determine the right balance between free and open trade and prudential safeguards."*

One of the issues that have not been clarified is whether measures to restructure domestic banks after the Asian financial crisis, including injecting state money, are distorting competition and discriminating against foreign financial service suppliers. Already, the South Korean bank reform has been challenged in the WTO as a breach of the WTO Agreement on

Subsidies and Countervailing Measures, not under GATS! It raises questions about the coherence between the WTO and the work of the IMF.[61]

→ Critical issue

Danger of 'chilling effect' on Tobin Tax and other anti-speculative measures
The lack of clarity of what is allowed under the prudential carve-out of the GATS raises the danger of a chilling effect on new measures that prevent a financial crisis and its devastating effects on (poor) societies. For instance, in case a WTO member made financial services commitments and introduced a currency tax (e.g. "Tobin tax") to stop volatile cross-border capital flows, the tax could be accused by another WTO member of not being a prudential measure (as opponents of the Tobin tax argue) or restricting international transactions related to committed financial sectors (i.e. breaching of GATS Art. XI). Other WTO members might refrain from introducing such tax fearing challenges under GATS.

6.2.4 Little link between the GATS negotiations and national financial authorities

Notwithstanding the above described risks of financial instability and ambiguities about prudential measures, the GATS negotiations make hardly any connection between the functioning of the financial regulatory and supervisory system of a country on the one hand, and the "requests" and "offers" on financial services on the other. No international body is stopping requests for market opening in financial sectors, which are too risky in a particular country.

The GATS negotiations on financial services liberalisation have often not involved officials from the ministries and supervisory agencies working on reforms at the national level or at international level ("the international financial architecture"). Especially in the EU and other Western countries, the negotiations have been largely conducted by the ministries responsible for trade or officials interested in supporting the domestic (or EU) financial industry. This raises the question in how far countries liberalise financial services under GATS to complement other financial reforms aiming at a more efficient and diversified financial sector? "Trade [in the financial sector] should not be liberalised for trade's sake."[62]

The IMF and other international institutions have recognized that considerable and costly capacity building is often required to educate regulators, supervisors, legislators and the judiciary in order to create the appropriate framework for financial services. This means that opening up financial services can only be successfully implemented when accompanied by an orderly and well-designed policy and enough human and financial resources. The IMF has a programme[63] in place to monitor the reforms and the strength of financial-sector regulation and supervision in many developing and emerging market countries. But as the US representative put it during a WTO meeting of the WTO's Working Group on Financial Services, it is up to the negotiators of each country concerned to deal with the issue themselves.[64] The EU requests also show little coordination with the assessments of the IMF's programme. Developing countries wishing to liberalise financial services could be fully using GATS exemptions and flexibilities, but capacity to do so is often lacking.

GATS liberalisation provisions neglect wisdom gained after financial crises
Financial services liberalisation in line with all GATS rules and the 'Understanding' disregards the global recognition after the Asian financial crisis that the stability of national and international financial systems relies on the scale and sequencing of domestic financial reforms. A gradual and considered approach to the deregulation of financial services and financial flows is needed to make financial liberalisation beneficial for the economy.[65] While the World Bank, IMF and Western countries argue that financial services liberalisation increases financial stability and strengthens prudential soundness of developing countries, they recognize that a well-sequenced capital account liberalisation and domestic reform of the financial sector needs to be in place as well as appropriate regulatory and adequate supervision. The financial crisis of 1997-98 has even convinced the IMF that swift capital account liberalisation can lead to a financial crisis and that sequencing of such liberalisation is necessary.

The setting up or acquisition of more establishments by foreign banks undermines supervision by the host country while the lessons of the financial crises emphasise the need for more transparency. Foreign banks might shift key decision-making and risk management of their foreign establishments to the parent banks as is the case in emerging market countries.[66] This reduces information available to host country supervisors. Moreover, the Basel Committee (see chapter 5) agreed that the authorities of the home country of the bank supervise foreign establishments of banks, especially branches. Foreign supervisors might have ample experience in monitoring foreign branches but are mainly interested in avoiding bankruptcy of the bank[67] and less concerned about the needs of the country in which their banks operate. Although cooperation between home and host country supervisory authorities does exist[68], experience has learned that regulators and supervisors of countries in which foreign banks operate might not have all the information they need. Central bank officials have recently called for better cooperation between supervisors in order to avoid risks by liberalisation of financial services in emerging market economies.[69]

6.2.5 Too little coordination between GATS negotiations and international stability fora

There is a worrying deficit in concern about the GATS agreement in institutions which have competence regarding international finance regulation and supervision. Only a few (informal[70]) contacts and discussions have taken place between the GATS negotiators and international institutions such as the IMF, the Basel Committee on Banking Supervision, and the International Association of Insurance Supervisors. An EU official claimed he had difficulties to draw the attention of international supervisors' bodies to the GATS negotiations

The current GATS negotiations take place at a time when the reform of the international financial system announced after the Asian financial crisis has bogged down while far from finished. This underscores the importance of prudential measures and capital account management at the national level. The problem is that national measures and supervision might not be enough to deal with the effects of financial services liberalisation. Financial conglomerates connect many financial markets worldwide.
In East Asia[71], the increasing domination of Western financial firms in capital market services, that connect East Asia with the global capital markets, would not be a problem if there were enough prudential regulations at the global level. There is no effective system of liquidity provision that should enhance the stability and efficiency of the global financial system in which East Asian countries are embedded.
For developing countries, there is no effective mechanism of globally monitoring all services and transactions by particular financial conglomerates that are operating in their markets.[72] International mechanisms to deal with potentially destabilizing effects of increased international capital movements by foreign firms are still weak and not involving all countries.

No efforts to achieve more transparency in the financial services industry
Ironically, the GATS agreement makes greater transparency of government regulations and decisions a priority (e.g. Art. III, VI.3., VII.4., VIII.3.- 4., X.2) but it does not address the lack of transparency of financial conglomerates, which poses many problems to host country financial authorities.
Improved transparency by operating internationally banks is a key issue in the reform of the financial system. Lack of information about too much short-term foreign currency loans is seen as an important cause of the financial crisis. Publishing more information should increase “market discipline” in the financial markets because it allows investors and customers to better assess the bank’s state of affairs and, presumably, to act accordingly. In addition it opens up more opportunities to supervisory authorities to play their role. A review of fifty-four international banks in 2001 showed that the required disclosure is still unsatisfactory.[73] There is however nothing in the GATS agreement that requires governments to impose more transparency from the (foreign) financial firms whose ownership structures, services and transactions remain often hard to scrutinize for developing countries.

Need for more input from developing countries
There are thus overlaps between the work of the WTO and work in other international institutions regarding international financial stability and the reform of its architecture. It is

high time that the linkages and contradictions between the international and national efforts for financial stability and the GATS rules are fully discussed in many fora, based not on theory but on concrete experiences and situations in developing countries. Better participation of developing countries in international supervisory and standard setting bodies would enrich the discussion and, hopefully, cater for their needs. The aim should be to avoid any unforeseen consequences with detrimental economic, social and environmental effects, as was the case during the Asian crisis. Better insights in the risks for financial instability might allow all developing country governments to take the necessary accompanying actions within the GATS negotiations and outside, or to wait for further market opening until they have defined their financial needs and established the necessary mechanisms.

6.3 Summary with conclusions and critical issues

1. Prioritizing swift liberalisation

Opening markets for foreign financial services and investment by foreign financial firms has been a priority in past and current GATS negotiations. The limited provisions under the GATS agreement to deal with the special nature and systemic risk of financial services are subordinate to commitments to liberalise. The special appendix, the 'Understanding on Commitments in Financial Services', in the GATS agreement even provides a model for the swift and full liberalisation of financial services ensuring no trade barriers or obstacles to profit making by foreign financial firms are left.

2. GATS fits neatly with the interests of the Western financial industry

The top financial industry lobby in the West has been very active during GATS negotiations. The GATS agreement and current GATS negotiations fit neatly with the expansion ("consolidation") and profit-making strategies of the top financial conglomerates. In contrast, the GATS agreement has no provisions to strengthen universal access to financial services nor to tackle 'cherry picking', improve the quality of financial services to all customers, and increase financing opportunities for poorer individuals and entrepreneurs. The GATS agreement does not link up with intergovernmental declarations that promote sustainable development or poverty eradication or with corporate social responsibility initiatives.

3. Increasing competition and concentration

Increased competition following further GATS liberalisation is likely to reinforce and orient the financial industry toward high profit making, concentration and consolidation. The GATS agreement only has weak instruments (art. IX) with which to tackle market abuse and restrictive business practices that will follow concentration and consolidation.
There is no discussion within GATS on how far financial services concentration can go and on when financial conglomerates should not become 'too big to fail'.
The GATS agreement focuses on more transparency from governments but fails to improve the transparency of the complex financial industry. GATS should compel all signatories of GATS to legislate the transparency of financial firms operating in their country. This would somewhat enhance fair competition.

4. GATS reinforces the gaps between rich and poor

The liberalisation of financial services is claimed to improve efficiency in the financial industry and the economy. The experiences of liberalisation in developing countries show that there is much more at stake than increased efficiency, choice of products and access to capital.

- Foreign financial firms widen the gap between rich and poor by targeting the richest clients, the most developed regions and the best personnel from their host countries.
- This undermines the competitiveness and efficiency of developing country

banks that have more expertise to cater for the needs of the poorer clients or to invest in the domestic industry.

- As soon as developing country governments open their markets, foreign firms often rapidly take over a large part of the domestic financial industry.
- Due to rapid foreign expansion, host countries must spend additional resources for regulatory and supervisory measures to handle changes and risks.
- Profits made off rich clients in poor countries are siphoned off to the home countries in the North. GATS prevents government restrictions on profit repatriation.
- Foreign firms provide rich clients in poor countries with more opportunities to channel their money to the North and invest in Western companies.
- Host country governments have less leeway in directing the development of their domestic market, and have much less influence in integrating sustainable development practices.
- The EU has even been using the GATS negotiations to question developing country measures that support poverty alleviation.

5. GATS increases the risks of financial crisis

The liberalisation of financial services as such poses many threats to the financial stability of the host developing countries and the international system. GATS reinforces those threats, and both limits and challenges governments anz central banks to develop independent policy. While GATS is not supposed to liberalise capital flows, GATS liberalisation of financial services in practice does.

What is worrying is that Western negotiators brush aside concerns raised by developing countries while the risks of financial instability in developing countries are not fully analysed or discussed. The negative consequences felt by the poor and the environment due to liberalisation and GATS rules are so significant that reducing the risk of financial crises is paramount.

The risks to financial instability come from:

- **New financial services** can have significant destabilizing effects on a developing country's financial system. Increasing cross-border capital flows or risky financial strategies necessitate that the right regulatory and supervisory systems be in place.
- **GATS articles** promote cross-border capital movements and financial instability by limiting government restrictions on profit repatriation and capital flows related to committed (financial) services (see Articles XI.1. en XVI (footnote 8)).
- GATS rules permitting restrictions on unstable capital flows and (financial) services are limited by many conditions. These conditions prioritize the interests of foreign-service providers rather than the capacity of a developing country to deal with problems in its financial system.
- **The vagueness of financial prudential measures** which GATS permits leave many developing countries' regulations open to challenges by WTO disputes, or bullying by the hardliners during the secret bilateral GATS negotiations (the EU is doing this). The vagueness and questions of GATS interpretation could result in countries refraining from introducing national legislation for fear of future WTO disputes (i.e. the Tobin Tax)

6. Limiting policy space

In countries where the domestic financial sector needs improvement or is not yet capable of competing with foreign competitors, GATS articles XVI, XVII and VI limit the government's ability to make this a priority. Governments can set out exemptions to GATS articles which would allow regulators and central banks to maintain their policy space. However, the process to do so is complicated and difficult for some developing countries to negotiate.

7. Trade negotiators prevail

Too little coordination between the trade negotiators and the institutions responsible for the national and international financial system, is a problem in most countries. As a result, especially western GATS negotiators ignore the experience of previous financial crisis. Namely, the liberalisation of cross-border financial flows and financial services of developing countries needs to be gradual and well sequenced; building capacity and institutions to monitor the financial system is costly and takes time.
As well, lessons learned from the IMF Financial Sector Assessment Programme or other financial scandals in the West (e.g. mismanagement of pension funds' capital) have not informed the GATS negotiations. The latter continue without fully considering the difficulties in regulating complex financial conglomerates.

8. Where are the International financial safeguards?

No adequate safety nets or international financial safeguards against the increasing instability risks from GATS liberalisation exist. Some Northern countries have promoted the

use of international standards in the GATS. However, various southern countries feel these standards do not address their needs as they were originally developed by northern countries.
Better coordination between the GATS negotiations and the international financial stability institutions is necessary but with the reforms of the global financial architecture far from complete, it is most important to support capacity building and increased participation from developing countries at all these fora.

9. Need to change direction

Ideally, the current GATS negotiations in financial services should be stopped.
A different negotiation model should at least include the international standard setting bodies where developing counties have full representation, the UN and civil society groups. The aim of the new model would be to ensure that the financial service sector works for the poor and for small and medium business, and promotes sustainable development and issues raised by corporate social responsibility initiatives.
Any form of liberalisation of financial services, which does not serve the needs of the poor or does not promote sustainable development, is a dangerous strategy that increases global inequalities as well as increasing global instability.

Requests for financial services liberalisation from the west on southern countries are disproportionate and most countries economies' are not ready to be fully liberalised. There should be much more open public and political discussions to avert the risks identified in this report and stop unfair requests by the West. No commitments should be made during the bilateral GATS negotiations, unless there is a full guarantee by both sides that the necessary safeguards are in place, nor should the West insist on any such commitments in financial services.
If developing countries want to liberalise financial services under the GATS they should not make further commitments unless they get major concessions during the WTO negotiations in services and other areas so as to compensate for the risks of financial instability, higher regulatory and supervisory costs and reduction in domestic financial sectors.

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1 See www.uscsi.org/groups/finLeader.htm
2 See for instance the EU requests on financial services to Chile, Thailand, Malaysia at www.gatswatch.org; see also below in this chapter.
3 World Development Movement, Whose Development agenda?, April 2003.
4 ACLI, the largest trade association representing the US Life Insurers.
5 74% of the market in 1998-2001.
6 See: Yung Chul Park, Kee Hong Bea, Financial liberalisation and integration in East Asia, in Financial stability and growth in emerging economies - The role of the financial sector, Ed J.J. Teunissen & M. Teunissen , The Hague, 2003, p. 160-204: even the Japanese banks had to retreat from their top positions.
7 Frankfurter Rundschau, 31July 2003; see also above, chapter 2.
8 For an overview see for instance G. Bies, Financial liberalisation in Latin America, in Developing countries and GATS, Ed. C. Jepma, E. Kamphuis, Universtiy of Groningen (EC 134), 2003, p. 57-65.

9 See: WTO, Communication from the People`s Republic of China - Assessment of Trade in Services, document nr. 19, 21, 22. 26, 41, 43, 44 45, 47, 48, 49, 50; WTO, Report of the meeting held on 9 December 2002- 13 January 2003 (TN/S/M/5) 12 February 2003, document nr. 7.

10 Only the issues of poverty eradication and lending have been added by the author of this report. The issues raised by China have been illustrated by experiences found in the literature.

11 V. Murinde & M. Tefula, A foreign affair? How far does Africa need foreign banks? in Finance matters - Finance liberalisation: too much too soon?, id21 Insights #40, March 2002 (at: www.id21.org/insights/insighths40/insights-iss40-art02.html).

12 See for more examples: World Bank, Finance for growth: Policy choices in a volatile world, Policy research report, May 2001: summary of the report, at www.worldbank,org/research/interest/policyresrpt.htm

13 H. Huizinga, S. Claessen & A Demirgüç-Kunt, How does foreign entry affect the domestic banking market?, World Bank Working paper nr. 1918, June 1998: based on the experience of 80 countries between 1988 and 1995; G. Bies, Financial liberalisation in Latin America, in Developing countries and GATS, Ed. C. Jepma & E. Kamphuis, University of Groningen, 2003, p. 64: based on research in Latin America.

14 M. Karatas & M. Broadbent, Foreign banks in emerging markets: a Turkish success story, in id21 Society & economy, 29 April 2003 (www.id21.org/society/s7amk1g1.html): Turkey is not considered to be typical of emerging markets because foreign banks only control 2% of domestic banking operations (in Poland they control 36%) and 40% is still in hands of large public banks. Twenty-one foreign banks are operating in the country. The most successful foreign bank has first served multinational and government clients and was able to survive the financial crisis in Turkey (high inflation, volatile market) through adaptive and aggressive strategies and by segmenting the market amongst others to financing of the many privatization projects, focusing on corporate banking and credit cards, limiting its physical distribution network and careful selection of clients and sectors to which it provides services. In other words, foreign banks have the ability carefully select the most profitable sectors and clients and are not interested in full expansion all over the country, increasing the unequal development between the different Turkish regions.

15 M. Vander Stichele, Liberalisation in Banking Services Does not Have the Stated Effects - Summary of a case study of ABN Amro in Brazil, SOMO/Amsterdam, December 2001 (www.somo.nl).

16 Challenges for the South in the WTO Negotiations on Services - Summaries and Conclusions from Three Case Studies: Health Care (Kenya), Electricity (Colombia), Tourism (India), edited by SOMO & WEMOS, Amsterdam, January 2003 (see www.somo.nl).

17 See The Banker, Foreign banks must cherry-pick less to avoid Latin American wrath, January 3rd 2005

18 J. Marchetti (WTO Economic Affairs Officer, Trade in Services Division), letter of 25th June 2003.

19 WTO, Committee on Trade in Financial Services, Report of the meeting held on 6 October 2003, nr. 29.

20 H. Huizinga, S. Claessen & A Demirgüç-Kunt, How does foreign entry affect the domestic banking market?, World Bank Working paper nr. 1918, June 1998.

21 See: Yung Chul Park, Kee Hong Bea, Financial liberalisation and integration in East Asia, in Financial stability and growth in emerging economies - The role of the financial sector, Ed J.J. Teunissen & M. Teunissen , The Hague, 2003, p. 166-167, 178-179

22 The percentages are based on the table 2 from A. Cornford, The WTO negotiations on financial services : current issues and future directions, Paper for the Financial Markets Center, 2004, p. 10-11: they exclude banking entities from Japan; only countries for which figures for 1996 en 2000/2001 were available in the tables have been used.

23 Brunei, China (more than average increase: 171%), Hong Kong, Indonesia (more than average increase: 414%), South Korea, Malaysia, Philippines, Singapore, Taiwan, Thailand, Vietnam; the presence of Japanese banks are not included.

24 Argentina, Brazil, Chile, Colombia, Ecuador, Peru, Uruguay, Venezuela; (Mexico is excluded from these figures but is known to host many foreign financial firms).

25 Albania, Bulgaria, Croatia, Czech Rep., Estonia, Hungary, Latvia, Poland, Romania, Slovakia , Slovenia.

26 A. Cornford, The multilateral negotiations on financial services : current issues and future directions, 2003, p. 5, 11-12.

27 Africa`s insurance industry needs assistance, in Addis Tribune, 7 June 2002.

28 V. Murinde & M. Tefula, A foreign affair? How far does Africa need foreign banks? in Finance matters - Finance liberalisation: too much too soon?, id21 Insights #40, March 2002 (at: www.id21.org/insights/insighths40/insights-iss40-art02.html).

29 G. Bies, Financial liberalisation in Latin America, in Developing countries and GATS, Ed. C. Jepma & E. Kamphuis, University of Groningen, 2003, p. 64.

30 H. Huizinga, S. Claessen & A Demirgüç-Kunt, How does foreign entry affect the domestic banking market?, World Bank Working paper nr. 1918, June 1998.

[31] The capital account covers (among others) capital movements for investments while the current account mainly covers (the payment of) imports and exports of goods and services.

[32] World Bank, Finance for growth: Policy choices in a volatile world, Policy research report, May 2001: summary of the report, p. 4 at www.worldbank,org/research/interest/policyresrpt.htm

[33] A. Cornford, The multilateral negotiations on financial services : current issues and future directions, 2003, p. 20.

[34] Eichengreen, Toward a new international financial architecture: A practical post-Asia agenda, Washington (Institute for International Economics), 1999, p. 48.

[35] J. Stiglitz, Lessons from Argentina's debacle, in Sand in the Wheels (ATTAC Weekly Newsletter), nr 113, 16 January 2002.

[36] Art. 7 and Art. 11.D.3. of the Understanding on Commitments in Financial Services. Ironically, in the US, the Securities and Exchange Commission often scrutinises financial products before they are introduced.

[37] The potential problems were discussed in different meetings of the Committee on Trade in Financial Services held in 2003.

[38] WTO, Communication from the People`s Republic of China - Assessment of Trade in Services, 19 December 2002, document nr. 18- 49.

[39] WTO, Communication from the People`s Republic of China - Assessment of Trade in Services, 19 December 2002, document nr. 18-49.

[40] Yung Chul Park, Kee Hong Bea, Financial liberalisation and integration in East Asia, in Financial stability and growth in emerging economies - The role of the financial sector, Ed J.J. Teunissen & M. Teunissen , The Hague, 2003, p. 153

[41] A. Cornford, The WTO negotiations on financial services : current issues and future directions, Paper for the Financial Markets Center, 2004, p. 14.

[42] Yung Chul Park, Kee Hong Bea, Financial liberalisation and integration in East Asia, in Financial stability and growth in emerging economies - The role of the financial sector, Ed J.J. Teunissen & M. Teunissen , The Hague, 2003, p. 186

[43] L.R. Reynoso, Argentina: la justicia inhibida, la Argentina de pie, in Correos para la emancipacion, nr. 234, 12 February 2004.

[44] Art. XI.1.: " Except under the circumstances envisaged in Article XII,"(see further below) "a Member shall not apply restrictions on international transfers and payments for current transactions relating to its specific commitments."

[45] Yun-Hwan Kim, Financial opening under the WTO Agreement in selected Asian countries: progress and issues, Asian Development Bank, Economic and Research Department, Working Paper No.24, September 2002.

[46] On the basis of his personal assessment for the activities in the Annex on Financial Services an IMF observer attributes "major importance " to "capital flows for virtually all financial services delivered through mode 3 (commercial presence), as such presence by its nature implies some form of cross-border investment". Indeed, the only activities under the heading of banking and financial services (excluding insurance) to which he does not attribute such importance are financial leasing, provision and transfer of financial information, and advisory, intermediation and other auxiliary services. See A.Kireyev, Liberalization of trade in financial services and financial sector (analytical approach), IMF Working Paper WP/02/138, August 2002, pp. 10-14.

[47] See WTO - Committee on Trade in Financial Services, Report of the meeting held on 2 December 2002; IDEM, Report of the meeting held on 26 February 2003.

[48] A. Cornford, The WTO negotiations on financial services: current issues and future directions, Paper for Financial Markets Center, [2004], p. 6.

[49] WTO, Committee on Trade in Financial Services, Report of the meeting held on 1 December 2003, part D.

[50] WTO, Committee in Trade on Trade in Financial Services, Report of the meeting held on 6 October 2003, part D.

[51] See www.gatswatch.org

[52] WTO, Communication from Malaysia: Challenges in the financial services sector, 30 July 2003 (WTO document TN/S/W/17 S/FIN/W/28) discussed at meetings of the WTO Committee on Trade in Financial Services held on 7 July and 6 October 2003

[53] See www.gatswatch.org: EC requests to Malaysia, Financial services, p.3.

[54] M. Metzger (BIF Berlin), letter of 11 December 2003.

[55] Tax havens seek WTO intervention, in FT, 2 October 2 2000.

[56] Friends of the Earth - US, Sustainability and accountability in the financial services sector, declaration released in January 2003, p. 3.

[57] M. Queisser, Pension reform: lessons from Latin America, OECD Development Centre Policy Brief, nr. 15,1998, see also H. Reisen, Liberalization foreign investment by pension funds: positive and normative aspects, OECD Development Centre Technical Paper nr. 120, January 1997.

[58] For instance: the Basel Committee on Banking Supervision, the International Association of Insurance Supervisors (IAIS), International Organisation of Securities Commissions (IOSCO) and the Joint Forum on Financial Conglomerates. The Financial Stabiltiy Forum has classified 12 international financial standards as key standards for financial stability.

Developing countries are not always well represented in these international bodies whose standards might not always be fully adequate in developing countries. For further explanation: see chapter 5.

59 The IMF Financial Sector Appraisal Programme (FSAP): the programme assesses the vulnerabilities of a country's financial sector and actions to be undertaken.

60 Alexander Kern, The World Trade organisation and financial stability: the need to resolve the tension between liberalisation and prudential regulation, ESRC Centre for Business Research Cambridge University (Working Paper No.5), 2002, p. 5, 45.

61 A. Cornford, The WTO negotiatins on financial services : current issues and future directions, Paper for the Financial Markets Center, 2004.

62 N. Tamirisa et.al., Trade policy in Financial Services, IMF Working Paper N0.31, 2000, p.12.

63 The IMF`s Financial Sector Assessment Programmes (FSAPs) monitor domestic financial sectors in developing countries and provide technical assistance to strengthen them. The IMF's has also been monitoring and assisting the liberalization of capital accounts which has been seen as one of the problems leading to the Asian financial crisis.

64 WTO, Committee on Trade in Financial Services, Report of the meeting held on 26 February 2003.

65 Finance matters - Finance liberalisation: too much too soon?, id21 Insights #40, March 2002 (at: www.id21.org/insights/insighths40/insights-iss40-art00.html); see also: World Bank, Finance for growth: Policy choices in a volatile world, Policy research report, May 2001.

66 BIS, Foreign direct investment in the financial sector of emerging market economies, Report submitted by the Working Group established by the Committee of the Global Financial System, March 2004, 1-2.

67 Basel Committee on Banking Supervision, Principles for the Supervision of Banks' Foreign Establishment, May 1983, Art. IV: this is the basis of supervising establishments abroad, called the 'Concordat' and replaces the first version of 1975.

68 Basel Committee on Banking Supervision, Information flows between banking supervisory authorities, April 1990: is an addition to the Concordat because there was not enough cooperation (possible) between supervisors of home and host countries.

69 BIS, Foreign direct investment in the financial sector of emerging market economies, Report submitted by the Working Group established by the Committee of the Global Financial System, March 2004, 1-2.

70 See WTO, Committee on Trade in Financial Services, Report of the meeting held on 7 July 2003, (S/FIN/M/41), nr. 2: an informal meeting took place between (the chair of) the Committee on Trade in Financial Services and the Basel Committee on Banking Supervision and the International Association of Insurance Supervisors on 27 June 2003 but members of the Committee would be briefed about the visit in "informal mode" by the chair (as agreed during the previous Committee meeting held on 16 May 2003).

71 Yung Chul Park, Kee Hong Bea, Financial liberalisation and integration in East Asia, in Financial stability and growth in emerging economies - The role of the financial sector, Ed J.J. Teunissen & M. Teunissen , The Hague, 2003, p. 185: East Asian policy makers regret that there is:
- no reliable global or regional lender of last resort
- no agreement among the global community to establish a global regulatory authority
- not enough effort to expanding and strengthening cross-border financial supervision and regulation by advanced countries with developed financial markets
- an absence of effective cross-border prudential supervision of foreign financial companies operating out of East Asian financial markets.

72 Yung Chul Park, Kee Hong Bea, Financial liberalisation and integration in East Asia, in Financial stability and growth in emerging economies - The role of the financial sector, Ed J.J. Teunissen & M. Teunissen , The Hague, 2003, p. 185-186; see also activities of the Joint Forum on Financial Conglomerates.

73 See chapter 5: only 63% of the items considered important by the Basel Committee of Banking Supervision (the association of major supervisory authorities). While that was an improvement over the previous years, it was still far from sufficient. In particular, information about their techniques for mitigating credit risks (including more speculative credit derivatives) was lacking, which makes it difficult to monitor from the outside their practices and expertise for avoiding bad loans, a major source of (in)stability
The need for more transparency became clear during the financial crisis in South East Asia in 1997-98. There was too little oversight that foreign banks had been giving too much short term foreign currency loans.

Annexes

For the annexes and more information about the financial sector and financial corporations see our website: www.somo.nl, look for <file> financial sector.

Annex I:
UNEP Statement by Financial Institutions on the Environment & Sustainable Development
See http://www.unepfi.org/signatories/statements/fi/

Annex II:
The "Equator Principles"
See http://www.ifc.org/ifcext/equatorprinciples.nsf/Content/ThePrinciples

Annex III:
CEO's and Chairmen statement of companies operating in the financial sector of WBCSD
See http://www.wbcsd.ch/DocRoot/5PV72pFXVXcIqJX88UlC/20020925_finance.pdf

Annex IV:
The Collevecchio Declaration on Financial Institutions and Sustainability
See http://www.foe.org/camps/intl/declaration.html

Annex V: NGO
Collective Analysis of the Equator Principles
See http://www.globalpolicy.org/socecon/ffd/2003/06ngos.htm
For a summary of the main points see http://www.ran.org/news/equator_ngo.html

Annex VI:
UNEP Statement of Environmental - Commitment by the Insurance Industry
See http://www.unepfi.org/signatories/statements/ii/

Annex VII:
Gri financial services sector supplement on social performance (November 2002)
See http://www.globalreporting.org/guidelines/sectors/GRIFinancialServices.pdf