KPMG GLOBAL PERSPECTIVES

G-20 2010

Toronto, the banks and the global economy

"Banks viewed the G-20 with concern and uncertainty. Toronto alleviated their concern yet left them even more uncertain.

The G-20 put reforms for the banking sector into the context of the state of the economy. Immediate application of new rules on liquidity and capital could have increased the cost of credit and reduced the availability of capital. The timescale can now be amended to take into account national circumstances. Banks have more time to adjust their financing and balance sheets.

The universal bank levy has been diluted. Yet the commitment to reform remains. The need for amended Basel III proposals, a leverage ratio and for banks to hold the capital to withstand the stresses associated with the recent financial crisis were all reiterated. Many banks are already thinking through the implications of the reforms for their business.

On the global economy, the G-20 was caught between one priority that was urgent and another that was essential. The bailout of the banks turned the banking crisis into a sovereign debt crisis. And the G-20 reflected the fact that the markets see the need to restore confidence on sovereign debt taking priority over the need for economic growth.

I hope this publication gives you food for thought. I look forward to hearing your views, and discussing how future regulation across the global economy will affect you."

Jeremy Anderson
Global Chairman, Financial Services

AUDIT ▪ TAX ▪ ADVISORY

The key outcomes

1. Advanced economies in the G-20 agreed to halve government deficits by 2013 and to cap or cut public debt/GDP ratios by 2016.
2. The timeline for implementing Basel III bank reform rules was loosened. The 2012 deadline is still an aspiration but countries can delay if they fear it will threaten their recovery.
3. The G-20 opened the door for consultation on Basel III, which banks warn could cost US$6bn (€4.8bn). The proposals will now be finalized in Seoul.
4. There was no consensus on a global bank tax. France, Germany and the UK will press on with a levy, other G-20 members won't.
5. Leaders called on the International Monetary Fund to shift more voting power to emerging economies by the G-20 in Seoul.

Contents

Toronto on banks

What the G-20 had to say on the main issues – and when we might see a resolution

2012 deadline?

Basel III rules for banks to set aside far more capital and hold a minimum level of liquid assets were to come into force by the end of 2012. Keen not to threaten the economic recovery, the G-20 agreed that "the new standards will be phased in over a timeframe that is consistent with sustained recovery and limits market disruption". The 2012 deadline remains a goal, but this decision gives banks and finance ministers wiggle room.

Bank levy

The G-20 communiqué was brutally clear: "Some countries are pursuing a financial levy. Others are pursuing different approaches." Australia, Brazil and Canada object to a global levy, while France, Germany, the UK – and the IMF – favor one.

Tier 1 capital

For regulators, Tier 1 capital is the fundamental measure of a bank's financial strength. Basel III had proposed that Tier 1 capital, consisting of common equity and retained earnings, should form most of a bank's core capital. But the Basel Committee has hinted it would not entirely exclude from Tier 1 deferred tax assets, software and other intangible assets.

Liquidity ratios

Basel III proposed two new liquidity ratios for banks: a coverage ratio to ensure banks have enough quality liquid assets to survive 30 days of severe stress, and a net stable funding ratio to avoid long-term structural mismatches in liquidity. Despite speculation it might, the G-20 did not agree to amend these ratios, though they may yet be tweaked by the Basel Committee.


World leaders in Toronto failed to agree binding rules on the future of banks – but change is coming

Banks tell regulators big isn't always ugly

The regulatory picture remains uncertain, but the industry's greatest fear is downsizing

After Toronto, there are only four things banks don't know about the regulations that will reform their industry: when they will be introduced, what they will be, how much they will cost and whether they will be globally consistent.

Basel III *(see right)* – which analysts say could cost banks US$6bn (€4.8bn) – will not be implemented in its current form by 2012. Countries accordingly have some leeway to protect their recovery and the debate over the impact of Basel III could refine the proposals studied at the next G-20 in November 2010.

John Varley, chief executive of Barclays Bank, says the industry backs many reforms – such as the need for better supervision of firms and the financial system and more transparency in the derivatives markets. Banks must, he says, raise the quality and quantity of their capital, take better account of market and counter-party risk on balance sheets, strengthen their liquidity management and assess leverage more effectively in a way that is comparable across markets.

The short-term debate – as Basel III's detail is finalized – will be about cost, but the reforms will have a structural impact. Some bankers fear that politicians are looking to redesign the industry. Taxpayers' fury over the bill they paid for banks that were "too big to fail" prompted the U.S. Congress to vote to limit the size of banks in the 2010 reform bill.

Yet big banks support large corporations in ways narrow banks can't. The past 100 years have proved, Varley says, that "we will not make the system safer by making big banks smaller. Small banks are more volatile than big banks." In the 1930s and 1980s, two of the worst decades for American bank failures, many banks shut because they were not geographically diverse enough. In their bid to make banks more resilient, regulators must be wary of one risk: creating a banking industry that is unfit for purpose.

Regulating the global economy

From the G-8 to the G-20 and Basel III

1988

Basel I
Minimum capital requirements for banks are set by the Basel Committee on Banking Supervision (BCBS), to reduce credit risk.

1992

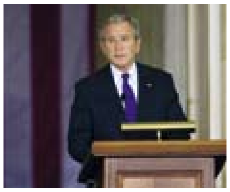
G-8 (Munich)
The world's eight major economies agree to legally enforce Basel I.

2004

Basel II
BCBS's new proposals create an international standard regulators can use when assessing a bank's strength. These are to be implemented globally by 2011.

2008

G-20 (Washington)
As the global economic crisis deepens, the G-8 becomes the G-20 and meets in November, with U.S. President Bush *(right)* in the chair.



2009

Basel III
Recognizing that Basel II didn't help avert the financial crisis, the BCBS publishes fresh proposals to govern the way banks manage risk, liquidity and leverage.

BASEL III

Capital conundrum taxes rulemakers

Bankers fear changes to leverage ratios could irrevocably undermine their business model

In December 2009, the Basel Committee on Banking Supervision (BCBS) launched a consultation paper called Basel III, in an attempt to make the regulatory framework for the banking sector (as set out in Basel II) relevant again after the global financial crash. The most crucial proposals in Basel III are:

- Proposals to raise the quality, consistency and transparency of the capital base
- A new, risk-based, harmonized leverage ratio
- New liquidity standards
- Introducing counter-cyclical capital buffers that would be replenished in good times and drawn down in tough times

The banks' objections to these proposals are driven by three core concerns: timing, content and philosophy.

Many bankers argue that forcing banks to set aside large amounts of capital when they are being asked to lend to support a fragile global recovery is foolish. Even the BCBS recognizes that its proposals could affect global GDP if implemented too soon. Some analysts suggest that Basel III – coupled with one-off levies being introduced in various countries – could reduce a typical bank's return on equity from 20% to 5%. In Toronto, the G-20 loosened the timescale for implementation and left room for consultation with the BCBS.

> "It's not clear that we would have avoided the crash if capital holdings were higher"

The International Banking Federation says: "We welcome the fact that the G-20 has stepped away from imposing an arbitrary timeline for the implementation of new measures and agreed to phase in requirement agreements as and when national economic conditions allow."

The BCBS meets again before the next G-20 summit in Seoul, aiming to agree a road map for implementing Basel III. The banks hope the BCBS will amend the liquidity standards. They would like to see the definition of high quality assets broadened and say a certain level of mismatch between assets and liabilities is necessary so they can, for instance, use retail deposits to fund long-term mortgages.

Some financiers cavil at the philosophy behind Basel III. Andrew Lilico, a principal at consultancy Europe Economics, who has studied the proposals for the City of London, says the G-20's position – that all banks should hold enough capital to survive a 2008-style crash – is wrong: "The crash was a crisis of liquidity, not of capital. It is by no means obvious that capital holdings were too low, or if they had been higher that we would not have had the liquidity crunch," he says.

Lilico says the G-20 is trying to engineer a situation in which no bank could possibly fail. That, he says, is not capitalism, and "no failure" is not an appropriate regulatory goal.

Although the Bank of England talks of a gradualist approach to raising bank capital requirements, Lilico fears banks might race to implement new requirements to attract investors and customers, which could shrink bank balance sheets and lending.

The BCBS's first proposals, Basel I, were issued in 1988. Basel II followed in 2004 but has still not been fully implemented globally. So getting Basel III just right is a serious challenge. Agreeing new rules when we can't measure the impact of the old rules was never going to be easy.

Key Basel questions

1 Can the G-20 juggle coordination and flexibility? G-20 nations agree that a coordinated approach to regulation is essential. Yet there is no global agreement on a levy on banks or transactions. With the Basel Committee weighing the impact of Basel III, nations could have flexibility on such issues as banks' partially owned subsidiaries and pension deficits. One Spanish banker has said too much freedom means "a mess and no level playing field".

2 Will the NSFR remain? The net stable funding ratio (NSFR) is a gauge to make sure a bank has, over a one-year horizon, the stable funds to survive under various stress scenarios. Some analysts suggest most banks would fail to comply with this Basel III proposal. Banks hope the NSFR will be replaced by another form of oversight. But the BCBS has not yet indicated it plans to abandon the NSFR.

3 How will OTC derivatives be regulated? In 2009, the G-20 nations agreed to centrally clear and exchange OTC derivatives. Yet one European Commission official has said: "Jurisdictions will come up with different solutions." The U.S. reform bill envisages central clearing but regulators are yet to specify which instruments should be standardized, listed on exchange and cleared centrally. Up to 10%-15% of OTC derivatives in the U.S. may not be exchanged or cleared centrally.

4 Can the U.S. and Europe agree accounting standards? Without international accounting standards, G-20 cannot hope to enforce international regulatory principles. Yet Bill Rhodes, Citigroup's senior advisor, suggests the U.S.-Europe split over accounting standards is getting wider.

2010

G-20 (Toronto)
The summit gives banks/countries more freedom over the timing of Basel III, opening the door for further consultation.

2011

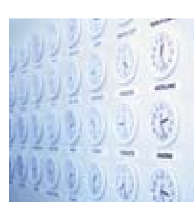
Accounting moves
Global accounting standards are scheduled to converge by the end of 2011.

2011

Risk capital
Trading book rules which could treble market risk capital requirements for large international banks come into force globally.

2012

Basel III
The original Basel III deadline, deferred in 2010 after banks said rules would cut growth in the U.S., Europe and Japan by 3%.



2013

Deficits
Deadline for the advanced economies to halve deficits. Countries with "serious fiscal challenges" may need to act faster.

2016

Debt down?
Government debt-to-GDP ratios in the G-20 nations are due to have been reduced or, at worst, stabilized by the end of this year.

Emerging discontent on cutting deficits

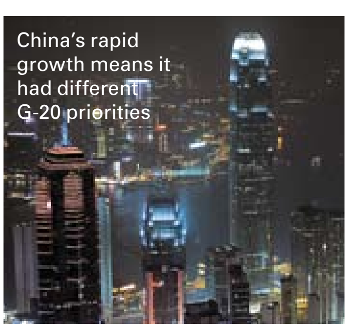
Leaders of emerging economies in the G-20 left Toronto trying to calculate how the advanced economies' pledge to halve deficits by 2013 would hit them.

Brazil, China and India fear such big cuts could stifle their export-fuelled growth. In 2009, for example, Chinese exports to the European Union were worth US$285.2bn (€227.7bn). Cristina Fernández, Argentina president, said Europe's austerity drive was "absolutely wrong". She found an ally in South Korean president Lee Myung-bak, who warned such actions could be counterproductive: "If European countries proceed with fiscal austerity plans, the global turnaround may slow down."

Argentina's president called the European austerity drive "absolutely wrong"

India'sprimeminister,Manmohan Singh, said there was a need for "investment and capital flows, and an open, rule-based trading system that does not succumb to protectionist tendencies," to ensure the recovery was "durable, balanced and sustainable".

China may yet boost domestic consumption by raising the value of its currency (giving workers more buying power) and strengthening the social safety net. But with its massive infrastructure spend winding down by the end of 2010, China will not want to see its major export markets shrink.


China's rapid growth means it had different G-20 priorities

The IMF comes of age

The global regulator has fresh impetus and an invigorated budget – but its biggest task lies ahead

Formed in the ashes of a ruined world in 1944, the International Monetary Fund (IMF) is acting with renewed purpose in current difficult times. At the heart of a globally coordinated effort to avoid a second Great Depression, the IMF had its budget tripled by the G-20 in 2009, giving it access to US$750bn (€522bn) in funds. It has guided policy, leading the calls for stimulus and, more recently, for fiscal responsibility.

Yet the funds come with strings attached. In the 1980s, the IMF was dubbed the 'International Monetarist Fund' by Keynesian critics, who accused it of adopting a "one-size-fits-all" approach to developing economies. The G-20 recognized such charges damage the IMF's credibility and called on the organization to reform its quota system that gives 42% of its votes to emerging economies.

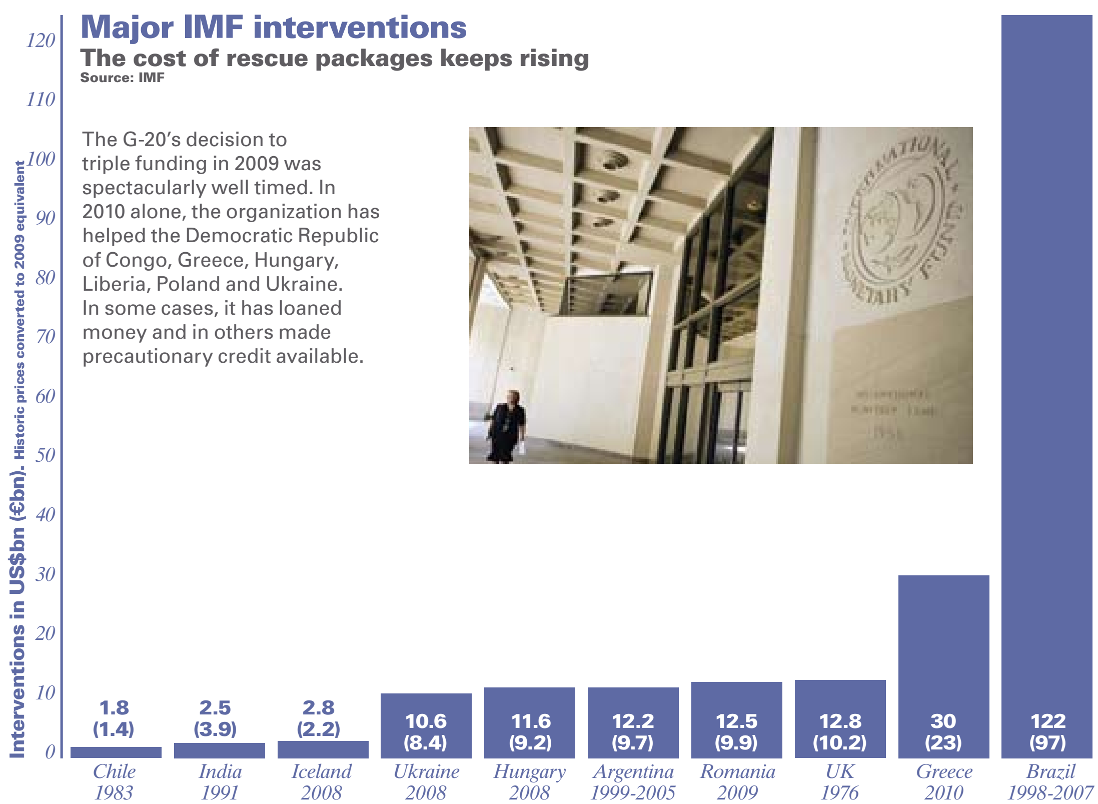
The BRIC countries had called for a 7% shift in voting power in their favor, but the G-20 backed a U.S. proposal for a 5% shift. That reform, due to be ready for the G-20 summit in Seoul, will subtly recalibrate the organization.

The IMF has found it easy to rally the G-20 behind its mission as a lender of last resort, but has been less successful in efforts to persuade countries to collaborate on financial reform. In Toronto, leaders were unable to agree on a global levy on banks, but IMF managing director Dominique Strauss-Kahn *(below)* has said it is "too early to write the obituary" for the financial sector tax.

Since the Toronto summit, the IMF has said a tax on financial transactions would be unworkable but called for a global levy on banks – on the grounds that the financial sector has been undertaxed – and it would support regulations designed to change banks' behavior. The IMF levy would mean the UK, for example, would have to treble its US$3.26bn (€2.27bn) tax on banks.

Mark Carney, governor of the Bank of Canada, has argued against a levy, saying if nations got the "core capital rules right", it would be unnecessary. Australia, Brazil and Canada, whose banks were not heavily exposed in the recent crisis, see no need for such a tax but Strauss-Kahn says every G-20 nation has experienced a bank-inspired crisis in the past 20 years. He says the fact that many countries may emerge from the crisis without spending billions to support banks "is no reason to dismiss the possibility of putting in place strategies to pay for future failures – from which no country can regard itself as immune".

With governments already nervous about the procyclical side effects of new bank regulations, the IMF may lose this argument, but by keeping a levy on the agenda at future G-20 summits, Strauss-Kahn may hope to stiffen resolve over bank reform.



DEFICIT REDUCTION

Big decisions cut to the heart of the matter

The G-20 may take varied approaches to tackling national debts, but fiscal growth is key

The headlines suggested a global consensus. The G-20's advanced economies had agreed to halve their deficits as a percentage of GDP. But the news obscured some serious differences. Brazil's finance minister, Guido Mantega, called the targets "draconian". French president Nicolas Sarkozy called them "a compromise, a point of equilibrium" rather than an "instruction from the G-20".

The G-20 speaks for 85% of the global economy but priorities vary: from growth (China, India) to debt (Italy, UK) to growth and debt (France, Japan).

To reduce their debt/GDP ratio to a sustainable 60% by 2030, the G-20 nations must, the IMF says, improve their structural primary budget balance by 18% of GDP between 2010 and 2030. Australia, Denmark, Ireland, Israel, Finland, Portugal, Sweden and the UK have all achieved that scale of shift in recent turnarounds. But two of the levers that helped Canada and Sweden in the 1990s – low interest rates and a devalued currency – are of little use today.

The dilemma over how to cut deficits is summed up by Murilo Portugal, IMF deputy managing director: "The risk of stifling the economy through premature fiscal tightening must be balanced against the risk of killing it through a fiscal and debt crisis."

The choice is not as stark as 'cut or stimulate'. OECD figures show that governments normally raise 80% of the money they need by cutting spending and 20% by increasing tax. Structural reforms to labor and product markets can generate growth as austerity bites. In the G-20 economies, a 1% increase in growth – assuming a tax ratio of 40% – lowers the debt ratio by 10% in five years.

The timing of reforms is complex. Front-loading cuts may imperil recovery but is politically essential because the crisis gives governments a mandate to act tough. Piecemeal reforms may be diluted or fail to deliver benefits. As turnarounds have taken from four to 11 years, ministers will want to act sooner.

IMF macroeconomist Olivier Blanchard says nations must target a "long-term decline in the public debt-to-GDP ratio, not just its stabilization". Bankers' errors have obscured the fact that in 2007, G-7 average gross debt was 82% of GDP, a level never before reached without a major war (when that hits 90%, economists say it impedes growth.) Finance departments need to sharpen up their risk management too.

G-20 public debt as a percentage of GDP

The differing challenges facing the world's major powers

Source: *CIA World Factbook*. All figures are 2009 estimates.

Russia	6.3%	*U.S.*	52.9%
China	16.9%	*India*	58%
Australia	17.6%	*Brazil*	60%
Saudi Arabia	22.9%	*UK*	68.1%
South Korea	23.5%	*Germany*	72.1%
Indonesia	27.4%	*E.U.*	73.6%
South Africa	29.5%	*Canada*	75.4%
Mexico	37.7%	*France*	77.5%
Turkey	46.3%	*Italy*	115.2%
Argentina	48.6%	*Japan*	189.3%

Roads to 2013

Australia With almost no real government debt, and recovery set to put the budget in surplus by 2013, Australia's austerity plan is to not boost spending by more than 2% a year.

BRICs Brazil, Russia, India and China aren't bound by the G-20 targets – they're not defined as 'advanced economies'. They are relying on growth to cut their deficit, which varies from 3% to 10% of GDP.

France Finance minister Christine Lagarde aims to beat the G-20 target – slashing the public deficit as a percentage of GDP from a projected 8% this year to 3% in 2013. Lagarde will freeze state spending and cut operating costs by 10% by 2013. She hopes to raise US$71bn (€50bn) in new tax revenue as growth returns and loopholes are closed.

Japan With public debt set to top 225% of GDP, Japan is exempt from the G-20's targets. To halve the deficit by 2013, the government would have to save US$239bn (€166bn). A consumption tax may secure some revenue to stimulate an economy that hasn't grown in real terms for two decades.

U.S. The government aims to cut its deficit from 10.1% of GDP to 4.2% by 2013 by focusing on growth. President Barack Obama admits the target will mandate change for social security, Medicaid and Medicare and a "messy, unfair tax system".

UK The new coalition is evaluating spending cuts and tax rises worth US$172bn (€119bn), to cut the deficit from 11% to 1.1% of GDP by 2016. Trade is set to be the single biggest contributor to economic growth in 2011.

In their own words

What they really thought about the G-20 summit

"The U.S. may be concentrated on premature fiscal tightening, but most other countries are looking with a nervous eye to the sovereign debt mess in Europe. Aiming for a gradually improving debt-to-GDP ratio by 2016 is hardly wild-eyed fiscal conservatism."
Kenneth S. Rogoff, Harvard economist and former IMF official

"We must act in a cautious and appropriate way concerning the timing, pace and intensity of an exit from economic stimulus, and consolidate the momentum of recovery of the world economy."
Hu Jintao, president of China

"To be honest, the communiqué was more than I expected, because it is quite specific."
German chancellor Angela Merkel

"Around the world – most recently at the deeply discouraging G-20 – governments are obsessing about inflation when the real threat is deflation, preaching the need for belt-tightening when the real problem is inadequate spending."
Paul Krugman, *New York Times*

"What's left over for Seoul? Everything."
Hyun Song Shin, presidential adviser, South Korea

"I don't see real action to alter the imbalances that brought us to this crisis. The U.S. has been the world's consumer of first resort and because it has been unable to persuade other countries to spend more or reform quickly, it is likely to take up that position once again."
Raghuram G. Rajan, finance professor, University of Chicago

"A casual reader of the document would presume that G-20 members are on the same page, when countries are moving in quite different directions."
Stewart M. Patrick, senior fellow, Council of Foreign Relations

Senate Majority Leader Harry Reid (at microphone) has driven U.S. reforms

Global powers pulling in different directions

Beyond the happy group photos, there are real national discrepancies in approaches to reform

Communiqués from summits such as the G-20 in Toronto are notoriously difficult to gauge. While on paper the nations remain committed to joint action on bank regulation, in practice it's not clear that the summit will truly lead to a single, unified regulatory approach.

As consultation continues over Basel III, the European Union, the UK and the U.S. look set to impose tougher banking regulations on their own turf.

The UK will move primary responsibility for regulating the sector back to the "lender of last resort", the Bank of England. The Financial Services Authority (FSA) is to be abolished and its responsibilities divided between several new agencies and the Bank of England.

In the U.S., a new bill aims to reform the financial services sector, yet Matthew Bishop, New York bureau chief of *The Economist*, says it is implementation that matters: "The bill introduces a systemic risk council, but that looks like window dressing. The regulators had these powers or others much like them before and never used them."

The difficulty for financial institutions is that there are nearly 400 items in the bill which require regulators to fill in the rules so the law can be implemented. While not every financial product demands consistent global regulation – mortgages, for instance, don't – there is a risk

> "If the global flow of capital is disrupted we will need more capital to do the same job"

that U.S. regulators could complicate implementation of Basel III by setting precedents on regulation of a variety of issues – and even the timescale under which banks have to set aside more capital for tough times.

Avinash Persaud, former chair of the UN's Stiglitz Commission on financial reform, says Europe's approach is focused on regulating financial markets to moderate future crises. It is more concerned with macro-prudential regulation, minimum liquidity buffers and oversight of systemic risk. The U.S. is seeking to devise fresh ways to contain bank failure.

One of the problems Europe has is mapping regulation against nations' widely different economic circumstances. Spain's financial crisis, for example, was provoked by the fact that its banks' exposure to the construction industry was around US$560bn (€445bn) by the end of 2009, with doubtful assets in the sector soaring. In this climate, regulation plays second fiddle to stabilization, and the Spanish authorities will worry about Basel III, which the Basel Committee admits could cost 1% of Europe's GDP.

In Asia, where the banks are largely unscathed by recession, Shizuka Kamei, Japan's banking minister, has spoken out against re-regulation, saying governments should let self-regulation work.

Some fragmentation of the global consensus on regulation may suit banks in the short run. But it does pose long-term risks. If countries effectively compete with different regulations, the global flow of capital will be disrupted and ring-fenced into local pools. If that happens, the world economy will need more capital just to do the same job.

Who's making the rules?

Regulators and governments want a say. Who are they – and what might they do?

FSB

Established in April 2009 by the G-20, the Financial Stability Board replaced the Financial Stability Forum. On June 27, the FSB sent a report to the G-20 on reducing the moral hazard of 'systemically important' financial institutions (the 'too big to fail' problem). The G-20 envisages the FSB enforcing new rules on capital requirements, though it is not certain what powers it will have to punish banks that fail to abide by them.
www.financialstabilityboard.org

Basel Committee

The Basel Committee On Banking Supervision (BCBS) is responsible for the redraft of Basel II, known as Basel III, which will define global capital standards. The BCBS has studied the likely impact of Basel III (specifically whether the costs will endanger economic recovery) and will refine its proposals before the next G-20. It has produced a consultative paper on how supervisory colleges of regulators should collaborate, and proposals for strengthening cross-border bank resolution frameworks and corporate governance.
www.bis.org/bcbs

U.S. government

The U.S. tripartite structure of the Federal Reserve, the Treasury and the Securities and Exchange Commission (SEC) is responsible for effective regulation of financial services, with several lesser bodies regulating at state or market level. The U.S. Congress is passing a finance reform bill which sets out to protect consumers, regulate derivatives, hedge funds and private equity firms, introduce new capital requirements for banks, monitor systemic risk and organize orderly liquidations.
www.ustreas.gov

European Union

The European Commission and Parliament are formulating proposals to regulate bonuses (by tying them to profits), hedge funds and private equity firms. The European Central Bank promotes fiscal stability in the EU, including stress-testing EU banks, and has a central role in bank regulation via supervisory colleges, which have a watching brief on systemic risk and individual bank weaknesses.
www.ecb.int

Q&A

Jitendra Sharma

KPMG's Global Financial Risk Management Leader cuts through the fallout from the G-20 summit to focus on Basel III, banking and the future of regulation

In your view, what was the most significant decision taken in Toronto?
The leaders agreed to take a more thoughtful approach to Basel III and its implementation, asking for further study and recommendations.

The immediate implications of Basel III are significant, especially in terms of the extra capital requirements. Asking the banking industry to recapitalize might be a good long-term goal, but by agreeing to defer implementation, the G-20 recognized that the right idea implemented at the wrong time could prove disastrous: Basel III could be procyclical at exactly the wrong time.

How will Basel III affect the banking industry?
The prospect of regulatory reform is already changing the banking industry. In five years' time, banks will look very different to how they do now. The costs will be burdensome – and the new regulations will change the structure of the industry.

Some say Basel III could cost the industry US$6bn (€4.8bn) globally.
It is very hard to talk figures, but the costs could be more expensive than complying with Sarbanes-Oxley a few years ago.

What kind of structural changes could we see?
More mergers and acquisitions so banks can spread the costs over a bigger operation. If the rules aren't applied consistently globally, you could, for example, see fewer foreign banks entering the U.S. market because of the cost of regulation.

How confident are you that the new rules will be applied consistently?
The G-20 needs to tighten up its rule-making on financial reform. We need a mechanism that overcomes the disadvantages of summits, that does all the heavy lifting before the next G-20 starts in Seoul, so that the leaders have the time and the means to tackle the key areas of disagreement, resolve them and agree on content and implementation.

The devil with these new rules really is in the detail and we need another body to help the G-20 to synchronize rule-making. The G-20 needs to play a key role in harmonizing rules.

How will the G-20 and Basel III be affected by the U.S.'s financial reforms?
The U.S. financial reform bill will move into the phase of rule-making with regulators and legislators over the next six to nine months. That process will be surrounded by uncertainty because we're not sure how other countries are going to react

There has been some harmonization on living wills – the UK's Financial Services Authority and the U.S. have explicitly recognized the role crisis contingency plans can play in ensuring taxpayers are not asked to pay the bill if other financial institutions are in trouble. But if you look at the regulation of derivatives, for example, the U.S. regulators have to balance the risk that their rules might prompt derivatives to move offshore. So while the focus turns to Basel III, it will be interesting to see how the rule-making process plays out in the U.S. in the next six months.

What was your overall impression of the G-20?
The leaders went for a lot of easy, low-hanging fruit. They didn't really address some other issues that are important for the global economy – they glossed over the impact of China, for example, and I'm not sure they did anything to change the imbalances in the global economy – but they reiterated the need to converge on accounting standards, warned against protectionism and recognized the greater role the IMF could play.

The IMF had lost its sense of direction before the financial crisis, but the G-20 has recognized the role it can play and given it a lot more money. Reorganizing the IMF, giving emerging and developing economies more votes, may help it to fulfil the expanded role it now has in stabilizing the global economy.

What will be the big issue at the next G-20 in Seoul?
Regulatory reform will still be on the agenda, and the numerous regulatory frameworks will need to be converged in a meaningful way. Banks will also face greater regulation: the nature and scale of this is still up for discussion.

Moving forward: the next steps

For banks

Plan for Basel III
Jeremy Anderson, KPMG's global chairman for financial services, says: "Banks need to work through scenarios and focus on how they would respond. The planning process may be more valuable than the plans but if they address these issues now they can focus on running their business while others are still adjusting."

Run stress tests
Anderson points out that the G-20 communiqué says "banks need to be able to handle stresses of the magnitude we saw in the recent crisis. The onus is on banks to run stress tests." The decision on how much extra capital banks must hold will be taken in Seoul this November. The sums discussed could restrain profit in the long term.

Apply scenario forecasting
Even if Basel III is implemented consistently, and global accounting standards are agreed, regulation will not be cheap. Does the cost and complexity – especially if rules vary across markets – affect the geographic spread of your business?

For regulators

Remember the law of unintended consequences
The 1977 Community Reinvestment Act had a laudable goal: encourage U.S. lenders to try harder to give mortgages to the poor. Yet George Soros says this intervention set the U.S. off on the road to the housing bubble. Benjamin Segal, Insead's assistant professor of accounting, says new rules drive certain people to be more innovative to circumvent them.

For businesses

Appraise your capital
It isn't just banks that need stress tests. If banks must keep more capital in reserve, this will impact cost and availability of credit. Some firms already hoard cash due to regulatory, fiscal or financial uncertainty. CFOs should run stress tests to ensure they have the capital to fulfil their strategies under a variety of scenarios and raise funds now if in doubt – or risk borrowing later at higher cost.

kpmg.com

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