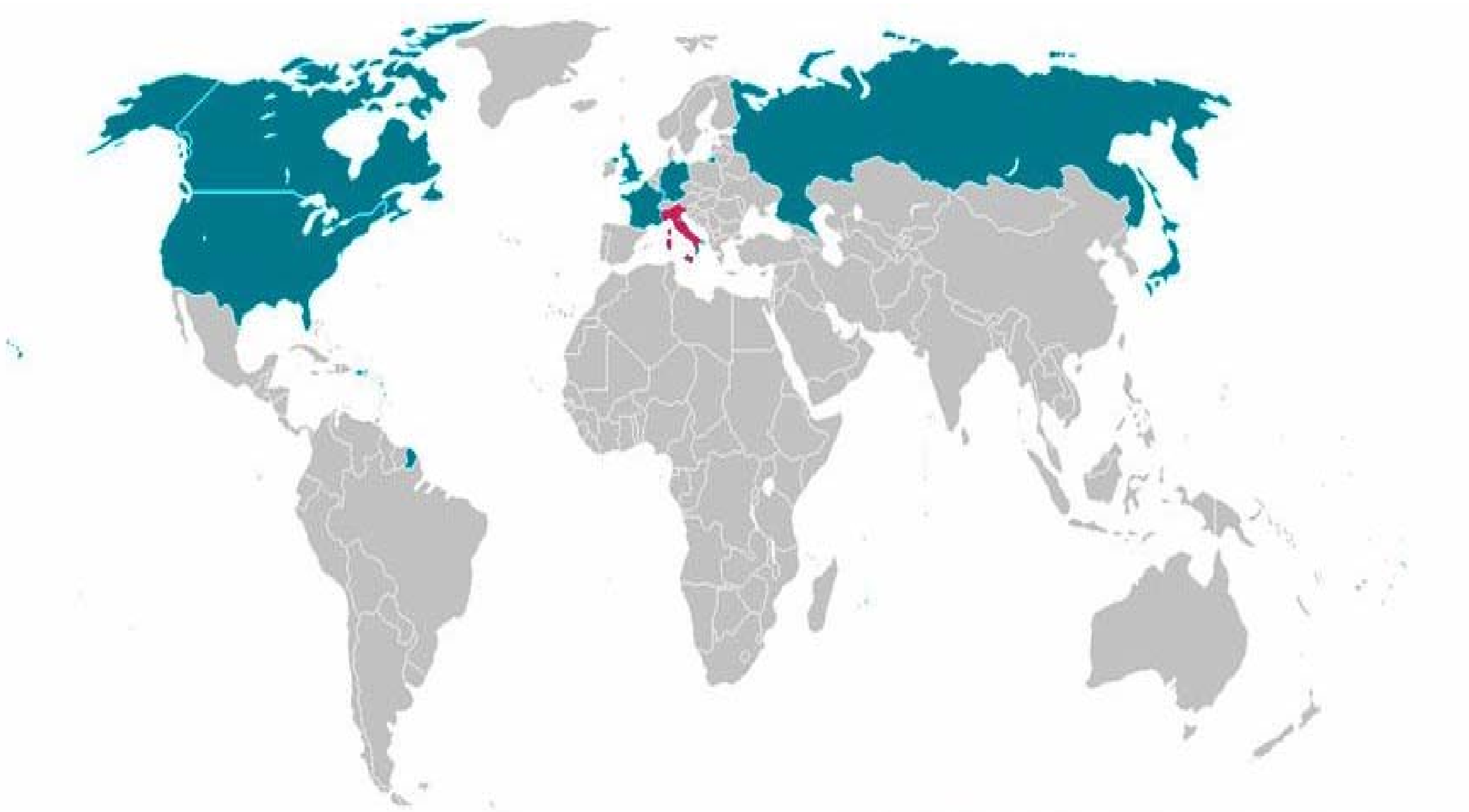

G8 Youth Summit 2009

Technical Experts in Sustainable Finance

Rating Agencies and Basel II

Recent financial market troubles highlight a number of problems with the ratings agencies. Ratings agencies exist to deal with principal-agent problems and asymmetric information. Company managers or sovereign finance ministers may seek to mislead investors. Requiring a minimum rating can limit the risk for asset owners and guarantors if an asset manager would otherwise invest principals' funds in high-risk assets.

One of the problems that the current crisis has highlighted is the difference in practice and transparency of the different rating agencies. This has resulted in inadequate ratings of financial products and a lack of trust in the effectiveness of these ratings. At present, there exists a code of conduct that was created in 2004 by the International Organisation of Securities Commissions

We propose that a new international body be created, along the lines of the International Rating Group, to establish common international standards for Rating Agencies. These standards will reform the 2004 code of conduct to make it more mandatory. The common standards should include the following:

- Replace the existing system of a point estimate rating with a range for the risk of each financial product, with increased attention to structured financial products.
- Greater transparency of the ratings reached by the agencies, through disclosure of methodology.
- Increased information to accompany the given rating, outlining the market volatility for each product and the different risks associated with the products.

Given the oligopolistic nature of the market, there is little competition between rating agencies. We encourage increased competition in this market to remove the advantages gained by the limited number of rating agencies.

We would welcome modifying the existing payment system for rating services. We feel that the current system whereby the company that is being rated pays a fee directly to the rating agency creates a conflict of interest. To elimintate this conflict of interest, we propose that investors who use the ratings pay a subscription to the rating agencies, as was the case before the 1970s.

We advise that new national regulatory requirements are created for the purpose of separating rating services from advisory and consultancy functions within rating agencies to remove any conflicts of interest.

Basel II

Pillar one of the Basel II Accord, which specifies capital adequacy ratios is heavily reliant on credit ratings. The risk weighting, which determines the amount of capital held by financial institutions is determined by the credit risk assessments given by rating agencies. Therefore, there is an urgent need for these risk assessments to be more accurate and more reliable.

There is a need to give banks, bank holding companies, savings associations and other financial institutions that are not subject to the Advanced Approaches of Basel II the option of using the Basel

II Standardized Approach to compute their risk-based capital requirement which are more risk-sensitive to withstand crises.

We propose the following modifications to the existing Basel II Accord:

- Increase the number of the Risk Weights for the general and specific market risk to more levels to make the capital requirements more risk-sensitive
- Revision of Basel II by its founders with participion of representatives from emerging markets, so that the Basel II Accord is not detrimental to Emerging Markets. This revision should include the removal of "sovereign ceilings"
- Introduce incremental capital reserve amounts during periods of financial growth to counter the procyclical nature of Basel II
- Use of additional types of collateral ("financial collateral") for risk mitigation

Financial Inclusion

At this point in time, there is no international structure to facilitate the lending of institutions to individuals in developing countries. Without this structure available, the field of microfinance will remain fractured and limited. We propose to take the idea of microfinance to the global level by creating the International Microfinance Institute, what will become more commonly known as the IMI.

The idea is to provide the framework for institutions across the world to be able to provide loans to those in the developing world. They would receive possible incentives from their respective government to partake in this lending, the IMI would establish the connections in developed countries, and the money would be lent to individual entrepreneurs in those countries. As a result, there is a continued profit incentive for corporations to invest a portion, regardless of how small, of their loan portfolio in the microfinance of developing nations. Also, financial inclusion is addressed because thousands more people across the developing world will now have access to credit.

The organization will be set up essentially as an intermediary organization. If an institution wants to become involved in microfinance, perhaps due to the allure of national incentives in the form of reduced capital gains tax, the IMI would: 1) provide the lender with a list of possible projects (agriculture, construction, etc.) and find out if there is a preference of project and receiving nation, 2) collect the funds, 3) distribute to our microfinance banks in the aforementioned countries, and 4) have them allocate the funds accordingly to those who desire the loan. As loans are paid back, the funds are then collected by our regional MFI's and distributed back to the lending institution, along with all interest received.

Interest rates on loans will be calculated by the IMI based on a number of macro-economic factors including political stability, current financial policy of the nation, the currency, etc. The interest rates actually charged will be determined by the institutions lending the money; the IMI will not interfere with the free market. However, the IMI will give a recommended interest rate based on chance of default, reasonable profit, and other risk factors. The IMI will have a reasonable amount more information because of its' presence in the corresponding developing nation, and the IMI will be in a better position to provide a reasonable rate of interest based on research. For the personal factors concerning ability to acquire IMI loans, the Grameen Bank lending policy will be used as a basic model, but requirements will be adjusted given the current condition of each country and the specific project proposals. With every loan received, the IMI banks that we had established in the country would provide specific business development training to the debtor. By providing financial and business education, we hope to help promote the creation of successful business that will last.

If there is not an existing micro-finance institution, the IMI will establish them with the number of regional MFI's created based on need, land area, population size, etc. In countries that already have strong and well established micro-financing institutions, the IMI will not try and overlap their services provided. If their business model and loan requirements are successful and sustainable, we would aim to create a partnership with them. The influx of capital would yield to a larger loan portfolio for their organization, and as a result more people in that respective nation would have access to the credit markets. In addition to this collaboration, we would seek to help create additional projects of financial education.

The creation of an international non-governmental organization will create a network to bridge the gap between lenders and entrepreneurs in developing nations across the world. The organization would operate independently of the United Nations, IMF and World Bank without any intervention. The structure of the organization would be a nonprofit organization with a Board of Directors consisting of one member from each of the G8 nations. Once every three years, they will vote on an Executive Director. This will lead to increased accountability of leadership in the organization, and operating independently of the UN, IMF, etc. will lead to more efficient operation without the constraints of government bureaucracy and intervention.

A joint funding effort will limit the cost per nation to a completely feasible number. If the organization is funded by G8 or G20 nations, then 100% of the money from institutions would be loaned to those in developing nations as no funds would needed to recover costs. Not having to recover costs would eliminate the need to charge higher interest rates to those who are receiving microfinance loans.

The French expert would like further proposals such as a reflection on currency risk to be considered.

Financial Education

Preamble

Now, more than ever, there has been a world-wide realization that financial education must be a priority. The current economic crisis, which has had dramatic effects on the entire world, has repercussions which cannot yet be fully measured. This issue can, at least partially, be attributed to misinformation about finance and financial products. This, we believe, extends to all levels of the economy: from financial professionals down to the consumers who utilize these products.
The financial crisis has also marked a period of heightened fear. This fear is present with many consumers who simply do not understand how to avoid losing their hard-earning money in the current market conditions. This fear is only amplifying the issue, and needs to be addressed through a comprehensive education campaign.
In a separate issue, we have seen stagnation in the growth within developing countries over the past decade. While the amount of resources has continually increased, this has not realized the desired results. Without the proper understanding how to use this aid effectively, the support has been seen to be highly ineffective. It is important, if the global community is serious about development issues, that there be a concerted effort to educate the developing world.

Financial Education in the Developed World

While traditionally financial illiteracy is seen as a problem restricted to the developing world, the financial crisis has shed considerable light onto the lack of understanding within the developed world about the inner workings of the financial system. An important signal of this financial illiteracy is the amount of citizens who defaulted on their mortgages. In the year between 2007 and 2008, the number of US foreclosures nearly tripled (See Appendix 1). This reached its peak in the third-quarter of 2008, when 765,558 homes in the United States experienced foreclosure activity. This was undoubtedly a direct result of many families not understanding the financial implications of inheriting such a large mortgage. Many of them, approached by banks who were not concerned with the high probability for default, were given houses at rates which were much lower than the risk should have reflected. For the consumer, this provided an opportunity which they didn't properly understand the consequences of, and for many it was only a matter of time before they defaulted.

Another issue, one which was discussed during the Financial Inclusion Panel, is the idea that immigrants to developed countries may arrive with no (or at best incomplete) understanding of how to gain access to the financial sector. This is a result of the fact that their native countries do not have these types or services and therefore they are unfamiliar with them. However, there has been little focus on providing education regarding these services. This stems from a misguided assumption is that a majority of citizens in a developed country have equal access to the financial system.

Our proposed solution to both of these problems involves a comprehensive, dual faceted approach. First, each country should be responsible for establishing a committee which will be responsible for educating its citizens. This could be modeled after President Bush's 2008 introduction of a President's Council on Financial Literacy. However, even that initiative lacks the funding which is required to aptly address this major issue. As with most education, we firmly believe that this needs to start with the youth. Programs need to be created in schools, outlining proper saving techniques. In the United States, personal saving rates prior to the financial crisis had reached nearly 0% (See Appendix 2). This mismanagement of money poses substantial problems as an entire generation moves towards retirement without adequate funds to be able to cope. It will be important to devote substantial effort in educating the youth currently, to avoid a similar problem in the future. However, in addition to this, there will be adult literacy classes, focused at small business owners and new families, who truly require additional information.

The second piece which needs to be addressed is the increasingly complexity of financial products, and the alarming trend of having underemphasized clauses which can have dramatic implications on the consumer. Regulators within countries should work to ensure that financial firms are providing explanations of financial products which are simple and easy to understand – even to those without a financial background. This idea has precedence in other professional sectors. There has been a trend in law to reduce the amount of 'legalese' which exists. A similar principle would apply to the finance sector. While exact measures would need to be further researched to ensure this simplified process is truly beneficial to consumers, it marks a distinct and important step forward to reducing the literacy required to interact with the financial sector.

Financial Education in the Developing World

Over the past decade, a concerted effort has been undertaken to increase the amount of funds available in the developing world. This has been led by an increase in micro-finance firms who are providing entrepreneurs funds to start their businesses. However, a critical piece which has been neglected in this process is a dedicated effort towards ensuring that education is attached to the funds.

We envision this role being taken on by our newly created NGO who will be coordinating micro-finance in the developing world. A free education program will be offered, outlining different financial issues and dramatically increasing the knowledge of how the financial system works. This will have the complementary effect of increasing the amount of funds loaned to developed countries since firms will see this investment as a lower risk.

Financial Professional Education

A major concern within the financial sector is that during the cyclical growth of the economy, firms were neglecting utilizing proper hiring practices. In an attempt to fill vacant positions, many employees were hired who did not have the necessary qualifications required to fulfill the role. As a result, firms were exposed to unnecessary risk.

We propose that international regulation should be instituted which creates a requirement for every financial professional to apply for a trader's licence. In order to receive this, they would be required to take courses which touch on subjects such as risk management and complexities within financial products. This would have three distinct characteristics. First, it would be truly international, whereas currently the CFA designation is limited to a select number of countries. Second, it would need to be renewed periodically throughout their career to ensure their education is dynamic and reflects the current market conditions. Also, a punitive board would be created, having the ability to revoke this trader's licence if proper conduct is not followed. Finally, firms would be required to hire only individuals who hold this designation. This would ensure that the baseline education within the financial sector is consistent across the world.

With regards to the management of this initiative, it will be managed through a two-tier system. The international body would be responsible for creating and maintaining a global education curriculum which outlines financial topics relevant to all countries of the world. The national organization would be involved with the creation of a supplemental country-specific curriculum, as well as the maintenance of the punitive board which will review the revoking of licences.