WORLD ECONOMIC FORUM

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Future of the Global Financial System Challenge

# The Global Financial System
# Policy Recommendations for the Future

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# Introduction

Significant forces are shaping the future of the global financial system:

- **Emerging markets** occupy an increasingly important role in the international financial system. By 2020, total financial assets on a global basis are estimated to approach $900 trillion, a 50% increase from 2010. Developing economies will account for an enlarged portion of this total, approximately 25%, with China's capital footprint alone expected to reach $125 trillion.

- **Technology** is rapidly redrawing the boundaries of the financial system, allowing new entrants that fall outside of the traditional domain of policy-making to emerge and fill gaps left by incumbents. These alternative providers of capital, payment platforms and automated investment solutions, among others, have the potential to transform the financial services landscape with possibly significant implications for risk management and systemic stability.

- **Regulatory and monetary policies** since the financial crisis have been re-geared to better ensure the safety and soundness of the financial system and to support economic growth. Strengthened prudential measures, such as enhanced capital adequacy and liquidity standards, are now in place, while developed-market interest rates remain highly accommodative. It is now incumbent on the industry and policy-makers to assess the impact of these decisions on the delivery of core financial services activities as well as the associated impact on systemic stability.

- **Trust loss** in financial services is another major repercussion of the global financial crisis. Poorly designed incentive systems, insufficient risk disclosure, lax corporate governance, weak internal controls and illegal or unethical activities from some market participants were all root causes. Seemingly endless queues of legal actions and large fines have reinforced negative public sentiment. This loss of trust has been extremely costly to society. A commitment to ensure that the financial system can meet society's needs today and in the future is required.

- **Financial inclusion** is absent for more than 2 billion adults globally. Recognized as critical to poverty reduction and economic growth, financial inclusion has become a strategic priority for national governments and businesses across a number of industries. Having a financial account is a first step towards being financially included but, in many instances, the usage rates of accounts remain low to dormant. The digitization of financial services, including savings, credit, payments, transactions and insurance, has significantly increased the number of financially included individuals over the past few years; but to accelerate progress, extensive cross-sector collaboration, innovation and investment remain essential.

The future of the global financial system needs to be considered in the context of these driving forces. Sustainable growth and financial stability hinge on the collective efforts of financial services actors and policy-makers to effectively manage the system's growth and rising complexity. The financial system's institutional framework must be further integrated to account for the growing significance of emerging market economies, while the financial services sector – consisting of traditional actors and new entrants – must also systematically engage in designing a more fair, sustainable and global system.

With a framework that is properly fit to purpose, the international financial system of the future will be in a stronger position to fulfil its mandate: connecting financial services providers, corporates, public institutions and households with access to a range of quality, affordable financial products and services that protect customers from risks, enable saving and investment, and support the creation of jobs and enterprises through the efficient allocation of credit and capital.

This paper provides additional context for each of the five dimensions identified above, as well as ideas to build a stronger global financial system in light of these forces.

# Emerging markets have reshaped the global financial context

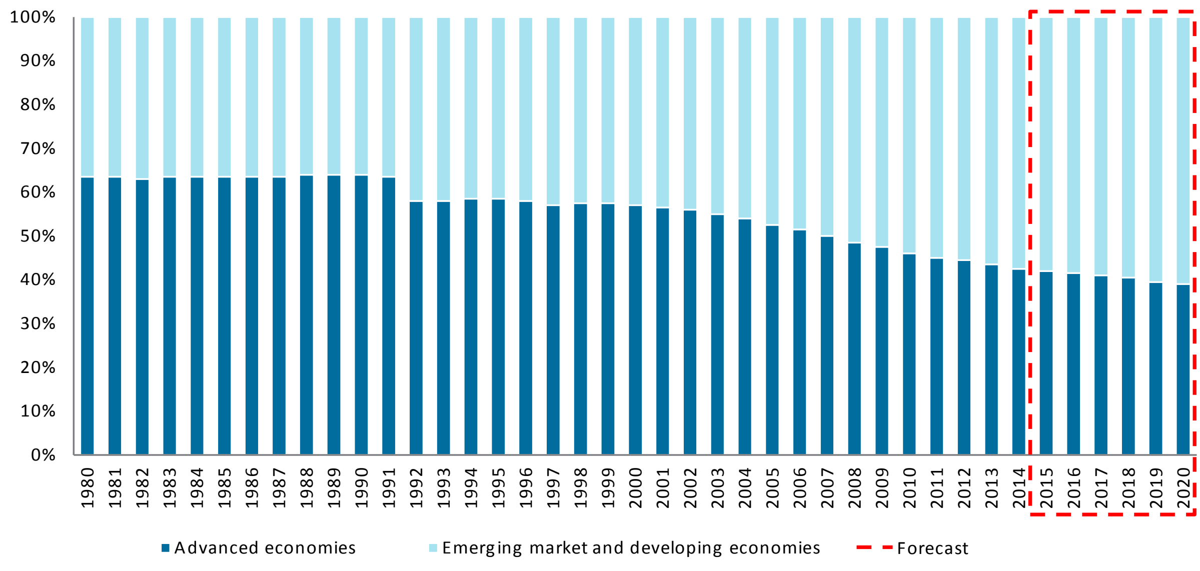
In the aftermath of World War II, the Bretton Woods Agreement established the rules of engagement for the global financial system. The resulting institutional architecture has served as an effective forum for international coordination and cooperation on financial matters during the subsequent decades.

Yet, over the past 30 years, a profound metamorphosis has occurred that has rewritten the economic and financial balance of power on a global scale. More than ever before, emerging markets occupy an important role in the international monetary and financial system. Bolstered by globalization, relative political stability and rapid urbanization, emerging-market countries represent an ever larger piece of the global economic pie.

A set of key statistics quantifies this economic transformation in marked terms. Real annual GDP growth over the past 17 years has averaged 9.5% for China and 7% for India. Latin America and Africa have also seen growth rates accelerate. Large developed economies performed less remarkably during the same time frame: the United States (+2.4%), Japan (+0.6%) and the Euro Area (+1.3%).

Global GDP on a purchasing-power-parity basis provides further evidence of emerging-market economic performance. In 1980, advanced economies[1] accounted for two-thirds of the world's GDP, while emerging and developing economies[2] made up the remainder. By 2014, a noteworthy reversal had occurred: the share of GDP attributable to advanced economies represented slightly more than 40% versus almost 60% for emerging and developing countries. This trend is not forecast to abate (see chart).

### Global GDP (on a PPP basis)




1. Advanced economies (37 countries): Australia, Austria, Belgium, Canada, Chinese Taipei, Cyprus, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hong Kong SAR, Iceland, Ireland, Israel, Italy, Japan, Korea, Latvia, Lithuania, Luxembourg, Malta, Netherlands, New Zealand, Norway, Portugal, San Marino, Singapore, Slovak Republic, Slovenia, Spain, Sweden, Switzerland, United Kingdom and United States.

2. Emerging market and developing economies (152 countries): Afghanistan, Albania, Algeria, Angola, Antigua and Barbuda, Argentina, Armenia, Azerbaijan, The Bahamas, Bahrain, Bangladesh, Barbados, Belarus, Belize, Benin, Bhutan, Bolivia, Bosnia and Herzegovina, Botswana, Brazil, Brunei Darussalam, Bulgaria, Burkina Faso, Burundi, Cabo Verde, Cambodia, Cameroon, Central African Republic, Chad, Chile, China, Colombia, Comoros, Democratic Republic of the Congo, Republic of Congo, Costa Rica, Côte d'Ivoire, Croatia, Djibouti, Dominica, Dominican Republic, Ecuador, Egypt, El Salvador, Equatorial Guinea, Eritrea, Ethiopia, Fiji, Gabon, The Gambia, Georgia, Ghana, Grenada, Guatemala, Guinea, Guinea-Bissau, Guyana, Haiti, Honduras, Hungary, India, Indonesia, Iran, Iraq, Jamaica, Jordan, Kazakhstan, Kenya, Kiribati, Kosovo, Kuwait, Kyrgyz Republic, Lao P.D.R., Lebanon, Lesotho, Liberia, Libya, FYR Macedonia, Madagascar, Malawi, Malaysia, Maldives, Mali, Marshall Islands, Mauritania, Mauritius, Mexico, Micronesia, Moldova, Mongolia, Montenegro, Morocco, Mozambique, Myanmar, Namibia, Nepal, Nicaragua, Niger, Nigeria, Oman, Pakistan, Palau, Panama, Papua New Guinea, Paraguay, Peru, Philippines, Poland, Qatar, Romania, Russia, Rwanda, Samoa, São Tomé and Príncipe, Saudi Arabia, Senegal, Serbia, Seychelles, Sierra Leone, Solomon Islands, South Africa, South Sudan, Sri Lanka, St Kitts and Nevis, St Lucia, St Vincent and the Grenadines, Sudan, Suriname, Swaziland, Syria, Tajikistan, Tanzania, Thailand, Timor-Leste, Togo, Tonga, Trinidad and Tobago, Tunisia, Turkey, Turkmenistan, Tuvalu, Uganda, Ukraine, United Arab Emirates, Uruguay, Uzbekistan, Vanuatu, Venezuela, Vietnam, Yemen, Zambia, and Zimbabwe.

**Ideas to reflect growing economic contribution of emerging markets**

- **Strengthen the governance legitimacy of international institutions that have financial oversight responsibilities** (e.g. IMF, World Bank). The economic contribution of emerging-market economies is increasing and, as a result, it is particularly important to increase their representation in the governance structures of international bodies that help shape economic policy and regulation. More broadly, rules that guide governance should be redesigned to automatically reweight stakeholders to accurately reflect contribution to the global economy. Consolidated representation among European members of the IMF and World Bank boards should be considered. In the future, it may also be necessary to consider creating international institutions that focus on key geographies, such as North America, the Eurozone and Asia.

- **Enable development banks, including the World Bank and the Asian Infrastructure Investment Bank, to build infrastructure and facilitate long-term growth.** The need to increase infrastructure investment and energy is substantial given the rapid growth of the global population. International development banks should facilitate bankable projects and support private sector involvement to mobilize the necessary resources. The investment banks should focus on dealing with market failures and facilitation, while private-sector resources can play a bigger role in making investments possible.

- **The IMF should actively assess the suitability of currencies included in the special drawing rights (SDR) basket.** In the long term, GDP and population growth will shift geographic concentrations in the financial system and the SDR basket should reflect these changes. The IMF decision to include the Chinese Renminbi (RMB) in the SDR basket, effective October 2016, is an example of this change. As such, it is time to assess the SDR framework to make future adaption easier and more rule-based.

Comparisons based on financial assets and consumption tell similar stories. By 2020, total financial assets on a global basis are estimated to approach $900 trillion – a 50% increase from 2010. Developing economies will account for an enlarged portion of this total, approximately 24%, or $215 trillion, with China's capital footprint alone expected to reach $125 trillion.

Furthermore, it is anticipated that an additional 1.8 billion people globally, predominantly from emerging economies, will become part of the consumer class by 2025. Their appetite to spend is expected to grow from $12 trillion annually today to $30 trillion over the next decade.

Given this backdrop, it is not surprising that questions about the relevance and legitimacy of the existing financial architecture have become increasingly pronounced. The financial system's institutional framework must be further integrated to account for the growing significance of emerging-market economies. There is a clear principle of fairness and recognition in granting additional weight to select emerging economies.

Moreover, through greater recognition comes added responsibility in making important structural changes. For example, much of the developing world would benefit from accelerated broadening and deepening of capital markets. In greater Asia, bank lending stands at 47% of total financing. China is very bank-balance-sheet heavy, with traditional lenders providing 70% of total financing and 85% of debt financing in 2013. Conversely, US banks account for 22% of total financing while financial markets act as the primary conduit for capital-raising for much of the rest.

Further integration could also prompt financial supervisors in Asia, in particular, to become more engaged in global regulatory discussions. This would help to support global regulatory coordination while limiting a proliferation of bilateral or unilateral legal, accounting and tax policies that may or may not be consistent with international norms. Regulatory coordination on a global basis continues to be a goal worth striving for, especially given the exceptional fluidity of global financial flows and growing concerns of select financial activities occurring outside of the established regulatory perimeter.

With a framework that is properly fit to purpose, the international financial system of the future will be in a stronger position to fulfil its mandate: connecting financial services providers, corporates, public institutions and households with access to a range of quality, affordable financial products and services that protect customers from risks, enable saving and investment, and support the creation of jobs and enterprises through the efficient allocation of credit and capital.

# Technology-enabled innovation: redrawing traditional boundaries in financial services

The proliferation of internet connectivity and digital technologies has redrawn how individuals, institutions and governments interact with one another, produce and consume products and services, and compete for resources, information and customers. The opportunity set attributable to digitization is enormous, cross-cutting and potentially very disruptive to traditional business models across sectors, let alone financial services providers. Historical cost paradigms, which served as barriers to entry for upstarts at the expense of established institutions with scale, are eroding.

The past several decades have seen tremendous business consolidation across financial services. This trend has led to the genesis of systemically important financial institutions. More recently, technology, regulatory uncertainty and the macroeconomic environment have served as enabling catalysts for new entrants. A potentially seismic change towards incumbent disintermediation may now be underway: traditional financial institutions no longer control the entire value chain, a trend that has created fierce competition for ownership of the end consumer.

The economics underpinning this transformation are significant: some predict a $4.7 trillion revenue opportunity as technology redraws the traditional borrowing, lending, payment and investing paradigm. The volume of new upstarts attempting to capitalize on this trend is expanding: the first Chinese peer-to-peer lender was founded in 2007; by 2014, 1,575 P2P platforms had emerged. Ample money is available in support: $23 billion in venture capital have converged on approximately 200 financial technology (FinTech) companies since 2000.

From virtual currencies to marketplace lending and big data solutions, new technologies come with great promise for a more efficient and accessible financial system. At the same time, by creating new markets and blurring the boundaries between financial services and adjacent industries, technology-enabled innovations bring a new set of risks to the financial system, both conduct and prudential. Managing these risks appropriately is essential to rebuilding society's trust in the financial system and for realizing the full potential of these innovations as they gain scale over the long term.

Technology-enabled innovation has a number of positive impacts on the financial sector and broader society. A democratization of the financial services sector is underway. Historically underserved market segments are benefiting from improving distribution mechanisms, increased competition, decreasing costs and the creation of novel financial products. A key driver of this transformation is expanding global smartphone ownership, which in five years is expected to reach 80% of the population, an increase from 50% today.

Better capture and use of financial and consumer data allows for the private sector and financial supervisors to identify risk concentrations (e.g. stress testing) and develop early warning infrastructure. Technology-enabled innovation helps to better spread risk across a range of actors in the financial system, which can reduce the propagation of financial contagion. Finally, recent innovations are helping to ensure greater transparency and promote information sharing, creating opportunities for members of the public and private sectors to work together in the best interests of both the end customer and the broader system.

Identification and exploitation of benefits from technology-enabled innovation are still in their early stages. As such, both the private sector and financial supervisors should seek to understand how best to maximize societal utility from these opportunities. Nevertheless, along with innumerable opportunities come countervailing risks: some well known, others less understood, and many more that have yet to be identified.

The market size for many new clusters of technology-enabled innovation is small in comparison to activity in the traditional financial services sector; however, unprecedented rates of adoption demonstrate the potential for increased risk. Such rapid growth raises important questions. How sustainable will these new business models and products be during times of economic stress? How do FinTech companies ensure appropriate customer data collection and usage practices? What are the related cyber-risks? Is the regulatory framework of yesteryear prepared to adjust to such rapid changes?

Marketplace lending provides an interesting illustration of technology-led innovation. Although representing only a tiny slice of the unsecured lending market globally – estimated at approximately 1% of total unsecured consumer and SME lending in the US, for example – current forecasts estimate a $150 billion–$490 billion global opportunity by 2020. Marketplace lending platforms have obvious benefits for financial inclusion and serve as a launch pad for new types of assets for investors. Nonetheless, many of the same financial risks associated with traditional credit products (e.g. default and liquidity risks) remain. Many marketplace lending schemes shift risk to the end consumer and are not protected by deposit insurance. Most of these platforms have yet to experience a full economic cycle. Hence, projected default rates have not been time-tested during periods of economic distress.

One US-based marketplace lender founded in 2011 issued 25,000 loans since inception with only two defaults, both due to the death of the obligor. But the past is no harbinger of the future. There is a risk that average investors, who may or may not fully understand the product suite, incur potentially sizable losses in the event of an adverse scenario.

Safeguarding and ensuring appropriate usage of customer data are critical concerns for both the public and private sectors. As businesses increase their reliance on technology and continue to amass larger amounts of data, it becomes increasingly important (and difficult) to certify system resilience. Moreover, uncertainty about the appropriate use of customer information – the line between enhanced risk analysis and use of data to deny service to a particular customer – remains ill-defined. Without proper oversight, there is potential for financial service providers to prioritize profitability and growth over risk management in an attempt to satisfy shareholder demands.

From both a public- and private-sector standpoint, challenges created by the existing regulatory framework are likely the most tangible source of technology-driven risk at present. In many instances, the pathway to compliance when deploying a new type of innovation is unclear from the perspective of both incumbent institutions and new, non-traditional financial services companies.

Furthermore, the regulatory remit is not defined consistently across countries and is often defined based on legal entity vs financial activity, which allows some businesses to fall through the regulatory cracks. This can ultimately reduce the portability of business models and stifle innovation.

Economic growth is driven by innovation and is a key source of business-model transformation. Innovation that has a positive economic impact should be made to thrive, while other, less viable businesses should be allowed to fail. The long-run viability of technology-enabled innovations and their associated business models depends on the financial sector maintaining public trust and mitigating emerging risks. This requires public-private coordination between all actors in the system.

### Ideas to address technology transformation

- **Establish a global forum for public-private sector dialogue aimed at exploring technology-enabled transformation in financial services.** At present, a formalized platform for cross-sector collaboration on the topic of technological transformation does not exist. This emphasizes the need for a global forum with membership that reflects all actors in today's financial system, including traditional financial services companies, non-traditional financial services providers, policy-makers and regulators. Many new clusters of innovation fall within a regulatory grey area that can result in unnecessary compliance costs for the private sector, and can also result in incomplete assessment of systemic risk from a supervisory standpoint. To mitigate this issue, the forum should seek to create a structured framework to assess risk associated with particular clusters of innovation and use this to inform public guidance for policy-makers and practitioners. As an International Organization for Public-Private Cooperation, the World Economic Forum is well positioned to organize this platform and could work in collaboration with the G20's international business community, the B20.

- **The international supervisory community should define a set of standards on internal capabilities required to ensure that national supervisors are well equipped to monitor and mitigate risks arising from technology-enabled innovation.** As financial supervisors move away from implementing new prudential standards out of the recent financial crisis, there will be an opportunity to increase focus on technology-driven transformation and ensure that the approach used to create regulation and define the regulatory perimeter is suitable in the current digital context. The FSB is well positioned to develop these standards, which can be used by national supervisors as an effective tool in identifying and addressing gaps in internal capabilities.

# Business operations and financial stability in a post-crisis world

### Ideas to address changes to the financial system since the Great Recession

- **The IMF needs to assess the economic impact of regulatory reforms implemented over the last decade and to identify opportunities for additional restructuring.** Although it is clear that regulatory reform out of the recent financial crisis has strengthened the resilience of individual financial institutions, the system-wide impact from an economic standpoint is not clear. A more detailed cost-benefit analysis will be the first step in identifying pain points for both the public and private sectors, and to develop recommendations for additional policy changes that will collectively reduce risk and economic burden. The IMF is well positioned to perform this review given the broader surveillance activities it completes as part of the Financial Sector Assessment Program (FSAP) and Article IV consultations.

- **Strengthen communication among policy-makers across the global financial system.** Tensions exist in the global financial system due to diverging monetary policy – these clearly need to be alleviated to ensure stability in light of pending changes in macroeconomic strategy. Institutions charged with policy coordination, such as the G7, G20 and IMF, have difficulty in consistently aligning on communication and outreach. At present, the BIS provides a forum for central bank coordination, while the FSB provides a broader platform for financial stability coordination. It is now more important than ever for these groups to remain in close communication with each other and to ensure that the interests of the broader financial system and its diverse economic regions (e.g. Euro area, US, China, Japan, UK and India) are well balanced. As a first step in ensuring greater coordination, the BIS should assess the current framework for cross-institution communication and make recommendations for improvement.

The global financial crisis laid bare the downside of a highly interconnected and complex global financial system. Declines in US housing prices in 2007 triggered a cascading set of write-downs on real estate assets held by financial institutions. Securitization and real estate-linked derivative exposures aided in spreading risks to non-bank institutions around the globe.

Deficiencies in industry conduct and risk management, poorly aligned incentives across financial actors, inadequate capital and liquidity in the banking sector and lax supervisory oversight, among a host of other ailments, all contributed in varying degrees to the resulting economic malaise.

Since the crisis, the supervisory community and financial services sector have taken meaningful steps to address these issues in an effort to reduce the risk of future financial crises. Balance sheets have been substantially bolstered through the adoption of stress testing, adherence to revised risk-based capital and leverage standards, and establishment of stricter funding and liquidity protocols.

Key transmission mechanisms of systemic risk have also been curtailed. The swap market has moved away from bilateral arrangements between counterparties towards a centrally cleared mechanism. The tri-party repo market has been scrutinized, prompting more proactive monitoring and increased transparency. Legal entity identification methods are being developed in an attempt to more accurately quantify micro and macroprudential risks as well as to facilitate orderly resolution in the event of an institutional failure. Systemically important institutions have been required to codify resolution plans in the event of liquidation.

The industry has also taken a critical look at incentive structures and organizational cultures across multiple dimensions. Before the crisis, senior managers, board members and supervisors relied too heavily on the perceived sophistication of quantitative modelling in providing adequate visibility into enterprise risk. Not enough time was spent certifying adequate separation between risk and business functions or analysing incentive structures that commensurately balanced risk and reward.

Today, senior financial managers are re-emphasizing the importance of culture as key to the strategic success of the institution. Boards are increasingly focusing on making sure the “tone from the top” is consistent and clear, and that it permeates the institution. Compensation models are being revamped to incentivize desired behaviours among managers and staff, while defining the consequences and disciplinary actions to deal with infractions.

Stronger prudential measures applied to the largest banks, such as enhanced capital, liquidity and leverage standards mentioned previously, have been complemented by the use of macroprudential policies, which focus on the detection and mitigation of systemic risk. These policies enable policy-makers to use a more calibrated approach to addressing excesses in specific asset classes or sectors of the economy.

Macroprudential policies have specific applicability during periods of low interest rates. They provide an alternative policy option to a classic rate hike – with its tempering effects on aggregate demand across the entire economy – while affording policy-makers a tool to calibrate the level of credit with potentially greater precision. Examples of macroprudential policies include adjusting loan-to-value and debt-to-income caps on real estate lending or imposing a countercyclical capital buffer in addition to the mandated minimum capital level.

Policy-makers in emerging markets have used such policies frequently since the 1990s (e.g. Mexico, Singapore, South Korea), while macroprudential policies have re-emerged more recently in advanced economies since the financial crisis (in the UK, Sweden and New Zealand) as a way to address potential financial imbalances. With post-crisis regulatory policies largely defined and implementation underway, policy-makers and business leaders are now in a position to assess the impact of regulations on core business activities and profitability, as well as financial stability and economic growth.

As it relates to business activities and the profitability of the financial sector, some initial trends are emerging. Correspondent banking, which has important global implications, has been identified as an activity that is in retreat within private-sector financial services firms. A significant pullback could adversely impact developing economies by cutting off a core channel to the international financial system. This has consequences for international dollar/euro payments, clearing and settlement, cash management services and trade finance.

The primary drivers of this pullback are increased regulations (“know your client” and anti-money laundering, KYC/AML). Monetary reparations associated with a breach in AML regulatory protocol can be sizable; moreover, the added cost of increased compliance has significantly reduced already-meagre profit margins from correspondent banking activities.

Top of the house profitability has also declined from historical levels across financial sector institutions in the US, Eurozone and UK since the financial crisis. According to one analysis, returns across the largest American and European banks have declined by 70% since 2006, and are now hovering between 6% and 7%. This dynamic is partially explained by the post-crisis interest rate environment, which has compressed asset returns on fixed income investments held by financial institutions. Other factors impacting profitability include higher capital, leverage and liquidity requirements.

To meet future shareholder expectations, especially if firms are benchmarked off past return assumptions, management will likely continue to cut costs through headcount reductions, and improve operational efficiencies by relying more heavily on technology. Exiting more capital-intensive business functions, such as fixed-income sales and trading, is another route towards building a less-capital-intensive business model. Yet another is through financial innovation.

The spectre of instability returning to global markets in the coming years despite substantial regulatory reforms is an ongoing concern. The global financial system is growing rapidly; interconnectedness and complexity are on the rise. Global credit volumes are expected to increase faster than GDP over the coming years, increasing leverage in the system. Global financial market correlations are converging, and certain structural reforms have potentially introduced new vulnerabilities: the IMF has warned that liquidity in financial markets has decreased since the financial crisis. If this is a permanent shift, there is a risk that financial turmoil could be amplified. Moreover, the differences in regulatory regimes across jurisdictions are substantial, adding complexity to the system and opportunities for regulatory arbitrage.

Another feature of the current situation in advanced markets is low inflation and expansionary monetary policy. Price inflation is likely to remain subdued as rapid technological innovation, digitization and automation increase competition and reduce the costs associated with meeting consumer demand. Simultaneously, the labour market is going through a structural change towards more flexibility in most OECD countries.

Innovation, digitization and automation will increase labour market turnover. Self-employment, temporary contracts and part-time solutions are anticipated to play an increasing role in labour formation for the foreseeable future. These evolving features of the labour market will continue to pressure wages to the downside even if the global economy is experiencing a recovery.

In this environment, interest rates in developed economies are likely to remain low for an extended period. There is a risk that expansionary monetary policy will result in inflated asset prices and lead to financial instability. In particular, appreciating home prices may cause greater household indebtedness in some advanced economies. The underlying trend towards urbanization puts pressure on the existing housing stock, pushing prices upwards in attractive locations. New housing supply does not move lockstep with demand as construction processes are often hamstrung by cumbersome and complicated planning procedures. As real-estate exposure constitutes a disproportionately large part of bank balance sheets, significant price appreciation must be measured through a systemic risk prism.

Hence, a collaborative effort to assess the impact of post-crisis financial reforms on the sector – and perhaps recalibrate from time to time when unintended consequences are unearthed – will become an increasingly important dialogue between policy-makers and the financial services industry.

# Bridging the trust divide in financial services

Finance plays a critical role for society at large, serving individuals, families, businesses, governments and civic institutions. The financial sector performs indispensable functions such as enabling saving and investment, providing protection from risks and supporting the creation of new jobs and enterprises. It is critical that the sector operates to provide these functions for society in a stable, sustainable way.

Experiences of recent years have revealed a range of vulnerabilities in the financial system. Critiques include the implicit subsidies for firms considered “too big to fail” that can allow financial institutions to enjoy privileged access to low-cost funding but protect creditors in the event of failure; the complex and often opaque interconnections that exist among large financial institutions and industry participants; poorly designed incentive systems; excessive leverage; insufficient liquidity; inadequate or unenforced fiduciary standards; and the illegal or unethical activities of some market participants. These issues have been extremely costly to society and resulted in a significant loss of public trust and confidence in the financial system.

An enormous, multi-year effort by policy-makers and financial institutions is underway to make the financial system more resilient and enable it to sustainably contribute to economic growth and prosperity. The regulatory community has strengthened oversight and prudential requirements as part of a global effort to overhaul and improve financial regulation. The industry has also taken a range of steps to change the way it does business.

These combined efforts have resulted in a significant reduction in leverage, an increase in reserves and improved capital adequacy. Changes have been made to the level and structure of compensation, including implementation of longer deferral periods and introduction of bonus-malus schemes and clawbacks, which are unique to financial services. Improvements have also been made to business practices such as training, whistleblowing, sales and product approvals, with increased penalties for breaching standards.

The enduring challenge, and necessary next step, is to identify how the sector should evolve to fulfil these needs more completely and effectively. Industry participants must focus on redesigning business and operating models, ensuring that they are consistently acting in the best interests of all stakeholders of the financial system and society as a whole. They must continue the reform process in areas such as risk and control, performance management, product design, conduct standards, culture, ethics and values, among others. In doing so, they must ensure that the goals and incentives of financial institutions and individual practitioners are aligned with the needs of society.

### What the financial system should provide to society

- Promote financial and economic resilience
- Safeguard savings and the integrity of financial contracts
- Facilitate efficient allocation of capital to support economic growth
- Provide broad access to financial services products and services
- Enable smoothing of cash flows and consumption over time
- Enable payments
- Provide financial protection, risk transfer and diversification
- Collect, analyze & distribute information for better economic decision-making
- Provide effective markets

### Idea to address loss of trust

– **The financial industry needs to do its utmost to build a culture of trust.** As a means of cultivating this culture, the private sector should emphasize to employees at all levels the importance of non-financial metrics and fair treatment of customers and stakeholders. Culture is not a one-size fits all concept; rather, individual businesses should aim to feel comfortable that their established culture encourages appropriate behaviour of employees across the organization, including consideration of the broader interests of society and of financial stability. Additionally, it is important that the increased focus on trust aims to improve internal and industry-wide standards and does not weaken overall enforcement.

Equally important, the official sector must renew its emphasis on the coordinated global overhaul of financial regulation. This includes developing regulation that is pragmatic, provides clarity and creates a level playing field. Policy-makers should recognize strength in the diversity of business models and ensure that the political discourse takes into account the value of appropriate international competition, which is best served by common approaches to regulation. The regulatory framework should be designed to enable financial institutions to fulfil the societal needs described above.

# The financial inclusion imperative

### Ideas to ensure increased financial inclusion

- **Rapidly implement the G20 principles for financial inclusion to achieve universal financial access by 2020.** To increase access and usage of financial services, basic infrastructure and favourable regulatory conditions must first be in place. Full financial inclusion requires public and private sector cooperation. The public sector should seek ways to enable users to save, send and receive money using non-traditional channels that suit their needs, while the private sector should complement these efforts by designing customer-centric products and services delivered through sustainable partnerships models.

- **Ensure the global financial system supports cross-border banking.** Corresponding banks are crucial for increasing remittances and are vital in supporting poverty reduction, growth and security. Action taken to support cross-border banking should ensure that high standards remain in place to avoid flows / remittances being driven to less opaque, unsafe channels.

Today, approximately 2 billion adults have no account at a financial institution and over 200 million micro, small and medium-sized businesses have unmet financing needs. Commonly recognized as critical to poverty reduction and economic growth, financial inclusion has become a strategic priority for national governments and business across industries, and there have been widespread efforts to improve access and usage of financial services around the world.

Financial accounts are a first step towards full financial inclusion: meaning convenient access to a comprehensive range of quality, affordable financial products and services to all people in ways that are economically sustainable. In addition to acting as a digital repository, where one can send and receive remittances, centralize government subsidies and pension distributions, accept employment payments and buy financial products like insurance or investment funds, a financial account provides a personal identity number that is integral to securing a passport or applying for a mobile phone subscription, among many other things. Yet transaction account penetration rates vary significantly based on geography. For example, 64% of the population of Indonesia do not have an account; in Egypt, the figure is 85%; 94% in Yemen; 87% in Pakistan; and 21% in China.

While the digitization of financial services has significantly increased the number of financially included individuals over the past few years, in many instances, usage rates of accounts and other tools remain low to non-existent. For instance, the Indian government's Aadhaar biometric identification card programme has 85 million issuances, yet only a 25% utilization rate.

To be considered fully financially included, four essential aspects must be achieved. First, the requisite market infrastructure – payment systems, credit bureaux, financial reporting standards and policies – to facilitate digital transactions across the value chain must be in place. The regulatory framework must align investor, retailer and consumer incentives to adopt and promote digital financial services.

Second, a bank account is required. This account would ideally be conjoined with a payment vehicle (debit card or mobile application) and serve as the primary repository for all government social transfers.

Third, merchants – retailers, grocers, dining establishments, etc. – and consumers must be in a position to transact digitally rather than with cash. The entire value chain must be fully socialized and incentivized to operate in a cash-light manner. Substantial financial capacity and trust building are often a necessity to cultivate a sufficient level of comfort to transact digitally.

Fourth, and building on the previous three points, as digital transactions take place, data should be collected, analysed and stored to allow alternative credit profiles to propagate. A credit history accessible to consumers and founded on digital transactions would then serve as a basis for loans, insurance and other product offerings.

For the above mentioned sequence to be realized, governments, financial services providers, technology companies, mobile network operators and consumer goods companies, among others, must collaborate. Although complex, success pays significant dividends in terms of economic growth and development, productivity enhancement and wealth creation.

The SME space in emerging markets can be used as an illustration. Emerging markets account for $2 trillion of the global SME funding gap. Allowing SMEs access to capital would substantially bolster economic output and employment. On the latter, a recent survey of 99 countries indicates that SMEs employing between five and 250 staffers account for 67% of total permanent, full-time employment. In China, SMEs dominate the local economy, accounting for 99% of all enterprises, 70% of employment, 60% of GDP and 50% of tax collections – however, these firms only account for approximately 20% of bank lending. Realizing the full potential of small businesses through enhanced financial access could unleash untold economic capacity.

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