Group of Twenty

Implementing measures to protect financial institutions from failure

MODEL UNITED NATIONS
THE INTERNATIONAL SCHOOL OF THE HAGUE

Thomas Hamaker

Forum: Group of Twenty

Issue: Implementing measures to protect financial institutions from failure

Student Officer: Thomas Hamaker

Position: Deputy President

Introduction

Since the introduction of currencies and the gradual phasing out of bartering-based economies, financial institutions such as banks were formed to protect wealth starting as early as 352 BCE in Rome. Although unrefined, early banks promised protection of wealth in exchange for small fees and some were already state-subsidized. However, many early banks suffered from large insecurities and often were not able to provide the protection of wealth they promised, leading to substantial losses for those who deposited any amount of money.

For more than a millennium, financial institutions had little to no evolution until the emergence of the Medici Bank during the early 15th century. The Medici Bank is widely regarded as the first 'modern' bank, providing services such as lending, credit and money transfer which allowed for rapid economic growth in medieval Europe. Although more modern, these banks faced the same issues as Roman banks had 1500 years prior and faced large insecurities in their banking system. Bank failures happened often, mostly caused by factors such as fraud, mismanagement of funds or large economic downturns in the area. Any bank failure would result in significant financial losses for depositors, highlighting the need for regulation and safeguards in the event of a collapse.

Despite these setbacks, financial institutions evolved as demand for them grew due to advancements in technology and the beginning of global trade. Financial institutions provided a medium for global trade, even when two distant countries had vastly different currencies or measures of value. Slowly, financial institutions evolved more into what we recognize today, such as the emergence of central banks in nations, which played a major role in organizing, regulating, and stabilizing the financial system. For example, the bank of England, established in 1694, was responsible for issuing currency, managing interest rates and even lending funds to the government in the event of a crisis.

With the introduction of electronic banking in the 20th century, demand for financial institutions skyrocketed as they provided easy access to any funds deposited, seemingly without major risks. Consumers were promised banks were very unlikely to fail, and even when they did, all the money they had was insured and would be recovered. Before 2008, when a bank failed it was thought only the primary nation of the bank would be affected, but the global crisis in 2008 proved otherwise; major banks collapsed, causing a large economic downturn as consumers were unable to obtain any money they may have deposited. Despite governments and central banks intervening with large stimulus packages and massive bailouts to prevent a total collapse of the global economy, it was shown to consumers that their faith in banks was perhaps misplaced.

Since then, there have been large global efforts undertaken to regulate and implement measures to protect financial institutions from failure. The Basel III framework, introduced by the Basel Committee on Banking Supervision in November 2010, aimed to address the specific issues that caused the 2008 global financial crisis. It introduced stricter capital requirements, detailed risk management standards and above all a focus on liquidity so banks would always be able to pay consumers.

After the introduction of measures such as the Basel III framework, financial institutions around the globe have made significant progress in risk management and general resilience to period of economic downturn. Since 2008, no global failure of financial institutions has occurred, however, since the start of this year there has been a fear of a crisis occurring again. Over a five-day period in March, three mid-size US banks failed, which many thought was the beginning of another large financial crisis. Swift government intervention paired with large bailouts quickly stabilized the problem, but measures must be taken to ensure no further collapses will occur.

Definition of Key Terms

Financial Institution

A financial institution is a company or business that deals with financial transactions, such as investments, loans, and deposits. Examples include banks, credit unions and insurance companies.

Credit union

A credit union is effectively a non-profit bank, meaning compared to banks, credit unions mostly act out of consumer interest rather than their own.

Intervention

Intervention or government intervention is when the government or an organization steps in to prevent something. An example of government intervention is large subsidies to credit unions so they may stay non-profit and don't fail.

Liquid assets

Liquid assets are assets such as bonds, stocks and shares which can easily be converted into cash when required.

Liquidity

Liquidity refers to the percentage of wealth of a company or individual is in liquid assets, and therefore easily able to be converted into cash.

Bank capital

Bank capital is the total amount of money a bank has obtained from any consumers, shareholders, or investors which it has not paid out and is simply holding onto, most commonly in the form of liquid assets.

Regulation framework

A regulation framework is effectively a set of rules (on both a national and international level) parties must abide by. They are usually mandatory and have penalties such as fines set in the event a regulation is broken.

General Overview

Although the global economy has largely recovered from the 2008 economic crisis, some financial institutes still face consequences of the crisis today. As previously mentioned, consumer trust fell by a large amount and is still not at the level it was at prior to 2008. It has also caused a shift in expectations of consumers; consumers are now more cautious, and demand absolutes from any financial institution in the case of failure. The crisis highlighted the importance of risk management and the lack of vigorous preparation most financial institutions had, and it is now expected any bank, credit union or insurance company has enough liquid funds to pay out any customer when requested. One of the most crucial changes the 2008 crisis brought is not only preparation in the event of a failure, but also analyzing causes for failure and mitigating any potential risks. Focusing on mitigation rather than preparation has allowed for a smooth economic recovery and has mostly caused fears about further failure to subside.

However, recent events including covid-19, the Ukraine conflict and global economic downturns have caused fears to arise yet again. By themselves, none of the events posed major challenges for financial institutions on a global scale, however, a compounding effect was caused due to every event being closely followed by another. After the pandemic, there were only a few months until tensions rose in Ukraine, which proved to be too little time for all financial institutes to regain their footing. Amidst all the chaos, countries have found it hard to intervene and stop any failures, and action must be taken if the world is to recover.

COVID-19

The start of the COVID-19 pandemic in early 2020 has had quite large effects on the global economy as a whole and notably financial institutions. The first key factor which had effects on the economy and financial institutions was the widespread and global disruption of services. Lockdowns and travel restrictions meant a large decrease in volume of global trade, and on both a local and global level, many businesses faced bankruptcy. Sectors such as tourism and retail faced the largest impacts, and tourism-dependent economies had little to no opportunity to grow further and faced recessions. The Maldives for example faced a 34% decrease in GDP during the COVID-19 pandemic and has only now started reaching pre-pandemic levels after numerous stimulus packages and aid from foreign countries. This all lead to financial institutions (mostly banks and credit unions) having problems in managing loan defaults, declining asset value and most importantly increased credit risks as individuals and businesses alike faced large financial problems, meaning little to no loans were given out as the uncertainty was too big for banks and credit unions to justify lending any money.

Furthermore, as emphasis after the 2008 global financial crisis was put on liquidity, financial institutions had almost all their funds in stocks, bonds, or shares. Due to COVID-19, most if not all stocks, bonds and shares devalued significantly, limiting the liquidity of the financial institutions. Luckily, consumer trust had not fallen by a large amount, so large withdrawals were rare thus banks still provided certainty when required, mostly due to regulations made after 2008. This allowed financial institutions and governments to use excess funds (if present) for severance packages and large stimuluses to support failing businesses and individuals, but only slightly reduced the economic problems faced after the pandemic as financial institutions still had to ensure they had enough liquid assets to pay out if needed.

Ukraine conflict

After the COVID-19 pandemic, the invasion of Ukraine by Russia only furthered worsened the financial state of the world. The conflict, which started in February 2022, has seen a rise in global tensions ever since, and has led to numerous sanctions on both Russia and Ukraine. Although at surface level it may seem that there have been no significant consequences for any financial institutions, most global banks and credit unions have had to choose to either remain neutral or take a side in the conflict. Many financial institutions had liquid assets based in Russia, and those who were not quick enough to pull out had their assets frozen, which has severely limited their total liquid assets. Furthermore, if financial institutions do not comply with the sanctions and still attempt to use their assets, they risk their reputation and large penalties.

Governments have also provided aid for Ukraine, in the form of financial support or sending military gear. Although not required, it is heavily recommended they aid Ukraine in some way, even if it is only for increasing their reputation. However, spending on a foreign country means the spending is taken away from potentially being used nationally, which has put a stop to expensive projects and such. This means there is a possibility of more unemployment and less consumption, in turn causing further economic downturn. Financial institutions are less motivated to give out loans, as it is in their best interest to wait for a period of certainty rather than insecurity. Although this would not lead to any major failure, banks and credit unions are still failing to invest, which is crucial for economic growth. Without economic growth in the coming years, it is likely that a total global collapse could occur, similar to the crisis of 2008, which must be avoided.

Future challenges

Aside from current problems, financial institutions are always looking ahead to mitigate any future challenges. The rapid innovation of technology such as artificial intelligence and blockchain technology can provide both solutions and problems to financial institutions. Cybersecurity has also rapidly become an important issue; as most funds in banks are non-liquid, if any vulnerabilities are discovered in banking systems it could lead to large losses of funds for both the banks and consumers. Finally, an increasing focus on the global solving of both environmental and social challenges incentivizes financial institutions to lend money to those who attempt to innovate rather than recreate. It is paramount that appropriate measures are taken and regulations are written to combat any future challenges or create future solutions to create certainty for the future of financial institutions.

Major Parties Involved

International Monetary Fund (IMF)

The IMF is one of the largest international financial organizations, with over 190 member countries. It promotes financial stability, provides financial assistance where necessary and offers advisors to any financial institutions. The IMF works closely with both governments and financial institutions around the globe to implement measures to protect them from failure. If needed, they may offer emergency loans with a low interest rate to developing countries so sustainable economic growth can be maintained worldwide.

Financial Stability Board (FSB)

The FSB is an international organization that monitors, analyzes and makes recommendations about the global financial system. They have a similar mission to the IMF, which is promoting stability whilst protecting against risk. As such, they work closely together and often partner to solve issues when required, such as during the 2008 crisis, where the FSB provided the data and the IMF provided the solutions.

Bureau of International Settlements (BIS)

The BIS is a large organization with many smaller committees dedicated to global monetary and financial stability. They promote international cooperation and provide a medium for this, ensuring all parties are content when a deal is made or a project is created. Both the BCBS and the CPMI are committees under the BIS which are relevant to this issue.

Basel Committee on Banking Supervision (BCBS)

The BCBS is the global regulator of financial institutions, setting the global standard and providing cooperation with financial institutions in the form of supervision and advisory panels. There are 45 members, comprising of central banks and bank supervisors from 28 jurisdictions. Since its creation in 1974, the BCBS has updated regulations when necessary and creating solutions for financial institutions to prevent times of crisis, such as the Basel III international regulatory framework.

The Committee on Payments and Market Infrastructures (CPMI)

The CPMI is an international body under the BIS responsible for regulation and promotion of payment and the safety thereof. They ensure settlements are made between countries and are paid, and thereby support global financial stability. The CPMI also provides cooperation to central banks in the event of oversights or problems in policy or operational manners.

European Union (EU)

The EU is a union comprised of 27 member states that are located in Europe, promoting both political partnership and international trade. The EU has one of the largest banks, the European Central Bank, which regulates and maintains the price of the Euro. As such, when considering the global state of financial institutions and regulations thereof, the EU is considered a major party and has a large say in any occurrences. Furthermore, the large number of member states makes financial failure in the region unlikely and the idea could potentially be adopted in other regions for the same purpose.

Timeline of Key Events

Date	Description of event
352 BCE	Creating of early banking systems, first emerging in ancient Rome.
1397	Creation of the Medici Bank, widely regarded as one of the first ‘modern’ banks.
1609	Bank of Amsterdam formed, considering the first truly modern bank.
1964	Bank of England formed followed by widespread adoptions of central banks.
September 1929	Great Depression; massive global economic recession causing many to live in poverty.
May 1930	Creation of the BIS in response to the Great Depression.
December 1945	Creation of the IMF in response to the end of WWII and the recession caused by it.
July 1997	Asian Financial Crisis; large period of economic downturn in Asia caused by the collapse
September 2008	Global Financial Crisis; largest financial crisis since the Great Depression, collapsing many financial institutions and businesses
April 2009	FSB established as a reaction to the Global Financial Crisis
January 2020	Start of the COVID-19 pandemic
February 2022	Start of the Russian invasion of Ukraine

UN involvement, Relevant Resolutions, Treaties and Events

- G20 Summit on Financial Markets and the World Economy, 15 November 2008
- Transforming our world; the 2030 Agenda for Sustainable Development, 25 December 2015 (A/RES/70/1)
- Countering the financing of terrorism, 28 March 2019 (S/RES/2462(2019))
- G20 Summit on realizing opportunities for all, 21 November 2020
- G20 Summit on cooperative recovery, 15 November 2020

Previous Attempts to solve the Issue

The first 'successful' attempt to stabilize financial institutions and lower the risk of collapse was the series of regulatory frameworks introduced by the BCBS called the Basel Accords, the precursor to Basel III mentioned prior. It was introduced in 1988, attempting to establish international minimum capital requirements for any bank. It was swiftly followed by the creation of Basel II in 2004, further expanding on the minimum requirements as well as introducing standards for risk management. However, the 2008 financial crisis showed the BCBS that neither accord was as effective as previously thought, and caused the creation of Basel III, introducing even stricter capital requirements, risk management standards and put a focus on liquidity in the event of another financial crisis.

The IMF introduced many programs which provided financial assistance and supervision to any country facing economic and financial problems. The IMF has worked closely together with many developing countries to prevent bank failures, strengthen financial security, and promote global trade. Furthermore, since the establishment of the FBS in 2009, they have worked closely together to realize the goal of global financial stability, coordinating wherever possible and allowing close cooperation between every state. For example, the FBS commonly helps introduce policies for financial regulation in developing countries and attempts to help any troubled financial institutions via partnerships with the government.

Finally, since 2008, almost every country has introduced national reforms to their financial system (specifically banking regulations) where applicable. Although not as refined as those outlined in any Basel accord, they proved to be a crucial first step to preventing failures of financial institutions on a national scale. While all the mentioned solutions have been a step in the right direction and undoubtedly prevent many issues from occurring, further steps must be made to bridge the gaps and challenges that are still prevalent. The evolution of financial systems requires the constant revision of regulatory frameworks, and it is of global interest to cooperate as much as possible when revising these frameworks.

Possible Solutions

The recommended solution for the stabilization of financial institutions is yearly revision and analysis of all major global financial institutions and evolution of current regulations depending on the outcome of this analysis. This could include stress tests and simulations in the event of a large economic crisis to ensure the financial institution is ready for a worse-case scenario. Paired with this is the introduction of employed analysts which would monitor global events and predict likely outcomes, as well as close supervision of any actions of financial institutions. Financial institutions should also work to adopt improved risk management, as it is still common that they would be overloaded in times of crisis. For any solution to work, it is likely it would have to be mandatory, as although it is in the best interest of the consumer, from a business point of view they might not want to invest in elaborate risk management or supervisory schemes.

Increased transparency with the consumer would also provide some solutions. Although it will negatively impact the revenue of the financial institutions (again requiring it to be mandatory to have any effect), it may allow the consumer to think before they deposit all their money into one bank. The employment of presentations or detailed explanations of the risks and possible problems that may arise to educate the consumer would decrease the total cost of a failure of a financial institute. Paired with this, national financial education literacy schemes could be created to further educe individuals on the dangers, risks, and problems of financial institutions and what the best option for them is as an individual. Other than the options presented, creative solutions must be thought of as many ideas have already failed in the past. Solutions involving making current regulations stricter would only work on the short-term, as the ever changing financial system of the world evolves on a daily basis, but could be beneficial whilst a long-term solutions is being developed.

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