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Towards the G20 Summit: From Financial Crisis to International Regulatory Reform

Eric Helleiner and Stefano Pagliari

Amid pressures from British Prime Minister Gordon Brown and French President Nicolas Sarkozy, US President George W. Bush has called the leaders of the countries comprising the "Group of 20" to Washington on November 15, 2008, to discuss the current global financial crisis. The gravity of the financial crisis has encouraged some policy makers and commentators to describe the forthcoming G20 summit as a new "Bretton Woods" conference. The invocation of the 1944 Bretton Woods meeting suggests a potentially very wide conference agenda with issues that could range from reform of the International Monetary Fund (IMF) and World Bank to the management of global economic imbalances. But one of the issues sure to be at the centre of the summit agenda is reform of the regulation of international financial markets. This policy brief is designed to provide a backgrounder to recent developments and debates surrounding the international financial regulatory regime.¹

At the Core of the Crisis: Bank Regulation

It is important to recognize that any summit agenda to reform international financial regulation will not begin with a tabula rasa. Already over the past year, an international regulatory response to the crisis has been developed under the umbrella of the Financial Stability Forum (FSF) and backed by the G7 countries. Created in 1999, the FSF comprises financial regulators from the main industrialized countries and international financial institutions. In April 2008, it outlined a comprehensive set of more than 60 regulatory recommendations which drew on an extensive body of work by national and international regulatory authorities as well as private sector-led initiatives (FSF, 2008a).

Initiatives to update the regulation of the banking industry sit at the core of these recommendations. Over the past two decades, the Basel Committee on Banking Supervision (BCBS) has developed rules concerning capital requirements for international banks (the 1988 Basel I and 2004 Basel II agreements), but two developments have left these capital requirements outdated. The first

is the securitization trend wherein loans, such as those for subprime mortgages, have been transformed into securities that are then bundled and sliced up into tradable portfolios with distinct risk profiles. The second development has been the attempts by banks to escape existing capital requirements by moving part of their securities activities to newly created structured investment vehicles (SIVs), which remain off-balance sheet.

The Basel Committee, backed by the FSF, has already committed to widening its regulatory umbrella to bring these developments under its capital requirements. In July 2008, it sought to close the regulatory loophole created by the securitization trend by reforming the procedures used to calculate risk on banks' trading books. The goal is to make more costly the holding of the kind of structured debt products that have ended up generating massive losses for most banks during the current financial crisis (BCBS and IOSCO, 2008). In addition, the Basel Committee will extend the capital requirements to off-balance sheet vehicles, reducing the incentive for banks to avoid existing charges by moving assets off their balance sheet. Because the crisis highlighted the vulnerability of banks to drastic changes in the liquidity available in the markets, the Basel Committee has also required banks to establish a liquidity risk management framework and to maintain cushions as a safeguard against protracted periods of liquidity stress (BCBS, 2008).

Some commentators have called for a more radical reform agenda that would extend capital requirements to a wide range of highly leveraged financial institutions. Recent transformations in financial markets have meant that many institutions – including investment banks and bond insurers – have become more systemically important either because they are “too big to fail” or because they are “too interconnected to fail.” When public money has been used during the crisis to bail out these institutions, the question has naturally been asked whether they should also be covered by the same kinds of prudential risk management rules as commercial banks.

The FSF has also set the stage for a different kind of reform of existing bank regulation. As many critics have pointed out, official support for market price-based assessments of risk and value has generated a pro-cyclical bias within the existing regulatory regime. These provisions encourage, rather than combat, the tendency for financial institutions to engage in excessive risk-taking during booms, while reinforcing constraint during economic downturns. The FSF has opened the door to addressing this issue, expressing the need to better understand the forces that contribute to pro-cyclicality in the system and to revise the capital regime as codified in the Basel II agreement “to strengthen capital buffers in good times and enhance banks' ability to dip into them during adverse conditions” (FSF, 2008b: 8).

The FSF report also calls for efforts to address counter-cyclicality by regulating bankers' compensation schemes. It has been alleged that the pay packages of financial firms' employees have made banks' activities more pro-cyclical, encouraging bankers to take excessive risks, the consequences of which are paid by the wider financial system and by the bank after the bonus has been paid out. Critics have questioned the capacity of governments to effectively align bankers' compensations to shareholders' interests and long-term firm-wide profitability. Various governments, at the time

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that they allocated public funds to support their financial institutions in trouble, recently made commitments to address compensation issues; thus this is likely to remain on the international policy agenda.

Weapons of Mass Destruction: Credit Derivatives

The crisis has also focused attention on the market for credit default swaps (CDS), a derivatives market involving contracts for insurance against bond defaults. These contracts have mainly been traded “over-the-counter” (OTC); that is, they have been negotiated privately between the buyer and the seller of the insurance without a formal clearing house or exchange that could minimize counter-party risk and force margin requirements for all contracts. This market grew at an astonishing speed over the last decade and regulators left it unchecked. In 2000, for example, the US Congress voted to exempt the OTC markets from oversight by the US futures regulator.

While these contracts were seen as beneficial instruments to spread default risk, they now stand accused of having exacerbated the current crisis. Warren Buffett’s famous description of derivatives as “weapons of mass destruction” appears vindicated. The insurance giant American International Group (AIG) had to be rescued by the US Treasury after it had issued US\$440 billion in swaps to cover defaults on debt. The opacity of the market has also contributed to uncertainty. In the aftermath of the default of the US investment bank Lehman Brothers, both the total amount of credit default swaps on its debt and the hands in which these contracts ended were unknown, and these knowledge gaps heightened the panic in the financial markets.

Most regulatory institutions around the world, including the FSF, are now calling for OTC derivatives transactions to be recorded and cleared through a clearing house standing between the parties of the trade. Even the International Swaps and Derivative Association (ISDA), the most important private industry organization in the sector, has shifted its position. After long resisting tighter public controls over OTC derivatives, the ISDA recently welcomed the creation of a centralized clearing house, while developing a series of protocols to facilitate net settlement of credit default swaps on the debt of Lehman Brothers, Washington Mutual, Freddie Mac and Fannie Mae.

Different US-based futures exchanges, hedge funds, and groups of banks are now competing to create the centralized platform requested by regulators and to reap the first-movers’ benefits. At the same time, European policy makers, perceiving the risk of being left behind, are collaborating with market participants, especially in the City of London, to create a European clearing system for credit default swaps (Van Duyn and Chung, 2008).

Reforming the Gatekeepers of Financial Markets: Credit Rating Agencies and Accountants

In addition to the regulation of the banking sector and credit derivatives, the FSF has focused on two actors that have been under the spotlight since



Eric Helleiner

Eric Helleiner is CIGI Chair in International Governance and Professor of Political Science of the University of Waterloo. He received a BA in Economics and Political Science from the University of Toronto, and a M.Sc. and PhD from the Department of International Relations of the London School of Economics. He is author of *States and the Reemergence of Global Finance* (Cornell University Press, 1994), *The Making of National Money* (Cornell University Press, 2003), and *Towards North American Monetary Union?* (McGill-Queen's University Press, 2006). He is also co-editor of *Nation-States and Money* (Routledge, 1999), *Economic Nationalism in a Globalizing World* (Cornell University Press, 2005) and *The Future of the Dollar* (Cornell University Press, forthcoming). He has won the Marvin Gelber Essay Prize in International Relations (Canadian Institute for International Affairs), the Donner Book Prize (Donner Canadian Foundation), and the Trudeau Foundation Fellows Prize. He is presently co-editor of the book series *Cornell Studies in Money*.



Stefano Pagliari

Mr. Pagliari is a PhD Candidate in Global Governance at the University of Waterloo. His academic interests focus on the politics of the international financial system, financial regulation, and international political economy.

His current research thesis analyzes the influence of the financial industry over the politics of international financial regulation in the context of the subprime mortgage crisis.

Mr. Pagliari holds a Balsillie Fellowship at the Centre for International Governance Innovation. Prior to the University of Waterloo, Mr. Pagliari studied in Italy (University of Bologna) and in England (London School of Economics and Political Science, and University of Manchester).

the beginning of the crisis: credit rating agencies (CRAs) and accountants. CRAs occupy a central position in the “originate-to-distribute” securitization model that is at the heart of the current crisis. When subprime mortgages were packaged into complex debt securities, CRAs provided a rating that enabled these securities to be sold and distributed across the global financial markets. When the housing bubble burst, it became clear that CRAs had significantly underestimated the risk attached to structured credit products, assigning top ratings to bonds backed by poor quality US mortgages.

Most critics argue that this failure was caused by three fundamental conflicts of interests at the heart of the CRAs’ business model. First, the agencies are paid by the issuers of the securities they rate rather than by the investors who use the ratings. Second, CRAs base their ratings on information provided by issuers of the securities they are rating. Third, CRAs act as advisers to issuers on how to structure their offering to achieve the best ratings, and then rate the same securities.

The most important international attempt to reform CRAs has been led by the International Organization of Securities Commissions (IOSCO), which is reviewing its *Code of Conduct Fundamentals for Credit Rating Agencies* (IOSCO, 2004). IOSCO does not aim at changing the governance of CRAs, but rather focuses on transparency and disclosure in relation to the methodologies and the use of their ratings. For example, it proposes to differentiate the ratings on structured products from those on corporate bonds through a different set of symbols.

IOSCO’s initiatives have been viewed skeptically by many, particularly European policy makers, who have called for more radical changes. From Brussels, the European Commissioner Charlie McCreevy has described the IOSCO Code of Conduct for CRAs as “toothless” since it does not address the limits of the existing regime of voluntary self-regulation that characterizes the industry (quoted in Tait and Davies, 2008). European finance ministers have agreed to move towards a region-wide set of rules for the industry, requiring CRAs to obtain a European registration, conditional on several requirements (such as avoidance of conflicts of interest, sound rating methodologies and transparency of rating activities), and establishing a European monitoring system. Moreover, the German Chancellor Angela Merkel has proposed a further step, suggesting the creation of a euro zone rating agency that could break the oligopoly of the US firms that currently dominate the sector (Barber, Benoit, Williamson, 2008).

The FSF report has also called for a revision of the existing international accounting standards set by bodies such as the International Accounting Standard Body (IASB), whose standards are followed by many countries around the world. Two weaknesses of the existing accounting regime have been highlighted by the crisis. First, during the credit crunch, buyers completely disappeared in the markets for some of the most exotic financial products, making the pricing of these assets almost impossible. Second, the crisis has demonstrated the need to shed light on the opaque relationship between financial institutions and their off-balance sheet vehicles, in order to understand the respective risks and responsibilities. The IASB is currently revising the existing standards to address these issues.

As was the case with CRA reform, critics – particularly in Europe – have argued that this kind of “fine-tuning” of the existing regulatory architecture does not go far enough. Many commentators have argued that the crisis has been deepened by a key principle in international accounting: “fair-value” or “mark-to-market” accounting. Fair value implies that financial firms are expected to report the value of their holdings according to the current market prices, instead of the historic cost of the asset. This practice is criticized for having increased the kind of pro-cyclicality of the financial regulatory regime discussed above. As institutions have been forced to report current depressed prices that do not necessarily reflect long-term expectations, they have had to curtail their lending or sell off more assets, further depressing the prices, and generating a vicious cycle. More generally, when prices have been extremely volatile and erratic in the middle of the panic market, it has been difficult to justify the delegation to the market of the role of independent arbiter over the value of banks’ assets.

Dissatisfaction with the use of fair-value accounting has been particularly prevalent in the banking industry. While banks widely supported this approach when the value of many of their financial assets was rising, they abandoned this position with the worsening of the financial crisis. The Institute of International Finance, representing the world’s major international banks, called in May 2008 for a relaxation of fair-value accounting. In the aftermath of the bailouts of several European banks in September and October 2008, European policy makers have increasingly created a common front with the banking industry in order to give their financial institutions breathing space in the middle of the panic and reduce their competitive disadvantage vis-à-vis American financial institutions (Hall and Tait, 2008). On October 13, the IASB responded to these pressures by suspending fair-value accounting in a higher number of banks’ holdings. The IASB and its US counterpart, the Financial Accounting Standards Board, have also recently agreed to establish a joint global advisory group to examine the implications of the crisis for accounting issues.

Renewing the Push to Regulate Hedge Funds and the Offshore Sector

The recent initiatives on accounting standards and credit rating agencies signal a more forceful stance and a renewed activism on the international scene by some European leaders. On September 23, in a highly emphatic speech before the UN General Assembly in New York, President Sarkozy called for the rebuilding of a “regulated capitalism in which whole swathes of financial activity won’t be left to the sole judgment of market dealers [...] a capitalism in which banks do their job, and the job of the banks is to finance economic development, it isn’t speculation” (Sarkozy, 2008a). Under the banner of “no financial institution should escape regulation and supervision” (Sarkozy, 2008b), Sarkozy has subsequently tried to bring back into international debate the regulation of offshore financial centres and the hedge fund industry.

Their regulation has represented an important priority of France and other continental European countries in the last decade. For instance, in 2004, as the French Minister of the Economy, Mr. Sarkozy had argued in front of the IMF International Monetary and Financial Committee that offshore centres were “sources of vulnerabilities for the international financial system” (Sarkozy, 2004). The current financial crisis has allowed him to raise this issue again on the international agenda and to call for the elimination of “the grey areas that undermine our efforts at coordination, in this case the offshore centres” (Sarkozy, 2008b).

Hedge Funds – the second target of Mr. Sarkozy – are mostly private pools of capital subject to a light regulatory status and transparency requirement, and with only loose constraints on the kind of trading strategies and level of leverage they can adopt. In the current market turmoil, hedge funds are accused of having contributed to the crisis by accelerating the falls in equity prices. At the apex of the panic in the financial markets, the US and several European countries decided to place a ban on short-selling, the attempt to profit from the decline in the price of a share, which is one of the typical investment strategies of hedge funds.

In the last two years, several IOSCO initiatives have sought to increase the transparency of the hedge fund industry, but the approach falls short of the more prescriptive regulation advocated by some European officials since the American hedge fund Long-Term Capital Management (LTCM) collapsed in 1998. The German government tried twice in the last decade to press for regulation of hedge funds within the FSF, in 1999-2000 and in 2007-2008, drawing support from France and most Asian countries. But US and British government opposition, and the actions of the financial industry effectively thwarted these initiatives. In both instances, the hedge fund industry and its bank counterparts proposed voluntary self-regulating initiatives to deflect the pressure for more stringent public regulation.

The current crisis, however, has given new impetus to European regulatory initiatives. At the end of September 2008, the European Parliament approved by a vote of 562 to 86 a report demanding that the European Commission propose measures to ensure improved supervision and transparency of hedge funds. The Internal Market Commissioner Charlie McCreevy rejected the call on the ground that hedge funds “were not the cause of the turmoil,” which, he asserted, lay with regulated financial institutions such as banks and credit rating agencies (quoted in EurActiv, 2008). Pressure to extend regulation is likely to grow, however, because not only has the crisis weakened the usual defense that hedge funds boost the efficiency of financial markets but it has eroded the power of the industry itself. Hedge Funds are currently facing high withdrawals from their clients and posting their worst monthly returns in at least a decade. George Soros, the most famous hedge fund manager in the world, has projected that the financial crisis will reduce the size of the industry “by anywhere between half and two-thirds” (quoted in Reuters, 2008). More importantly, the credit crunch has raised doubts about the viability of the hedge funds’ business model, which is often dependent on high levels of leverage.

Coalitions for Change?

Whether the hedge fund industry will be brought under more stringent regulation will serve as a good marker of the actual influence that European policy makers will have in reforming the international financial architecture, compared with their resurgent ambitions. In the late 1990s, it was US policy makers who acted as the main “agenda-setter” in the reform of the financial architecture, while European countries acted more like “junior partners” absorbed with their own regional issues and creation of the euro. A decade later, the European Commissioner for Economic and Monetary Affairs, Joaquín Almunia, has declared that “the economic situation must make the US acknowledge that Washington can’t dictate unilaterally the rules,” while asserting that Europe “has a great opportunity to demonstrate that our ideas and our economic and social model are capable of forging the path into the future” (quoted in Medina, 2008). The German finance minister, Peer Steinbrück, has argued that a more “multipolar” global financial system will emerge from the crisis and that “America will not be the only power to define which standards and which financial products will be traded all over the world” (quoted in Mangasarian, 2008). The Europeans have admonished the US for their past opposition to European calls for tighter regulation and for having excessive faith in the financial markets’ ability to regulate itself.

Despite their bolder stance, the German and French ability to influence the international regulatory debate will depend to a large extent on the attitude of the new US administration. Also crucial will be whether these leaders can win the support of other G20 countries. The UK’s position will be particularly important because of London’s centrality within the international financial markets. In the last decade, London has sided more often with Washington than it has with Paris and Berlin on financial regulatory issues, and British policy makers have strenuously defended the City of London’s autonomy from an extension of European financial regulation. While Gordon Brown would like the upcoming summit to address such issues as IMF reform, executive remuneration, and the strengthening of cross-border supervision and global standards for accounting and regulation (Brown, 2008), the degree of his support for many of the initiatives launched by President Sarkozy is not yet clear.

The emerging powers in the developing world such as China, India and Brazil will also now play a more important role. As noted earlier, the international regulatory response to the crisis was driven by the FSF, which is dominated by industrial countries.² Now that the financial crisis has become truly global, such “Western clubs” as the G7 and FSF are seen as too narrow and lacking in the legitimacy to effectively direct the international regulatory response. Hence, President Bush’s convening of the G20 summit. But what perspectives do the G20 developing countries bring to these debates? Will they, for example, seek to broaden the regulatory agenda to include items that might be of particular concern to poorer countries, such as debt restructuring, capital flight or commodity futures trading?

Leaders at the third annual India-Brazil-South Africa summit in mid-October left no doubt that they support strengthened and expanded regulation, stating that the “the explosion of new financial instruments unaccompanied

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by credible systemic regulation has resulted in a major crisis of confidence for which those responsible should be held accountable.” (Agence France Presse, 2008). Brazilian President Luiz Inacio Lula da Silva openly chastised “the irresponsibility of speculators who have transformed the world into a gigantic casino” (Agence France Presse, 2008). Expressing his support for wide reforms, Indian Prime Minister Manmohan Singh has more recently urged better supervision of CRAs and expressed a desire for a “global monitoring authority” to facilitate “supervision and cooperation” in the global financial system (Bagchi and Dasgupta, 2008). At the Asia-Europe Meeting (ASEM) summit on October 24-25, other Asian leaders also seemed quite receptive to President Sarkozy’s pleas for tighter international financial regulation (Freedman and Stearns, 2008).

Given its growing financial power, the position of China is particularly important. In his opening speech to the ASEM meeting, Chinese premier Wen Jiabao called for an expansion of “the scope of the regulation of the international financial system” and argued that “we should coordinate virtual economy with real economy and enable the former to better serve the latter” (Wen, 2008). Chinese financial regulators expressed similar sentiments as the crisis unfolded earlier in the year. One official, Liao Min, told the *Financial Times* in May: “I feel the western consensus on the relation between the market and the government should be reviewed. In practice, they tend to overestimate the power of the market and overlook the regulatory role of the government and this warped conception is at the root of the sub-prime crisis” (Anderlini, 2008).

One of the most important agenda items for the emerging powers and other developing countries is their role in the governance of international financial issues. These countries seek increased voice and representation in the bodies where international financial regulatory debates are conducted. The reform of the IMF’s governance structure is of course part of this agenda.

But equally important is the desire for a greater say in other fora that are often more significant in the politics of international financial standard-setting and regulation, such as the FSF and the Basel Committee. This goal is particularly important to many officials in these countries who have resented the imposition by G7 countries of various international standards and codes established with little or no input from developing countries and that are often inappropriate to their particular contexts.

If changes are not made in governance structures to reflect views wider than the Anglo-American ones that have dominated international financial regulatory policymaking, then a growing fragmentation of regulatory politics will become more likely. Some signs are already pointing in this direction. China and South Korea have recently backed a Japanese proposal to establish an Asian FSF, and members of the Association of Southeast Asian Nations (ASEAN) are being urged to join this initiative (Daily Yomiuri, 2008). Looking to Europe as financial integration there progresses, officials in that region may also be increasingly tempted to push for unilateral EU-wide regulatory initiatives if reforms at the broader international level fall short of their expectations.

The global spread of the financial crisis already has had the repercussion of weakening the credibility of the Anglo-American financial model and, as discussed above, fuelling centrifugal pressures in the international financial system. If the upcoming G20 summit fails to meet the expectations it has generated, the strengthening of the regulation of financial markets could easily be accompanied by a growing decentralization of international regulatory politics. This prospect only reinforces the significance of the outcomes of the November 15 G20 meeting.

Endnotes

¹ For a discussion of some issues relating to the governance of global economic imbalances, see Eric Helleiner, "International Payments Imbalances and Global Governance," CIGI Policy Brief No. 7. Available at: <http://www.cigionline.org/cigi/Publications/policybr>.

² Its members are the G7 countries, Australia, Hong Kong, the Netherlands, Singapore, Switzerland as well as various international organizations (BIS, OECD, IMF, WB, European Central Bank, IOSCO, IASB, International Association of Insurance Supervisors, and the BCBS along with two other BIS-centred committees).

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CIGI was founded in 2002 by Jim Balsillie, co-CEO of RIM (Research In Motion), and collaborates with and gratefully acknowledges support from a number of strategic partners, in particular the Government of Canada and the Government of Ontario. CIGI gratefully acknowledges the contribution of the Government of Canada to its endowment fund.

Le CIGI a été fondé en 2002 par Jim Balsillie, co-chef de la direction de RIM (Research In Motion). Il collabore avec de nombreux partenaires stratégiques et exprime sa reconnaissance du soutien reçu de ceux-ci, notamment de l'appui reçu du gouvernement du Canada et de celui du gouvernement de l'Ontario. Le CIGI exprime sa reconnaissance envers le gouvernement du Canada pour sa contribution à son Fonds de dotation.



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57 Erb Street West
Waterloo, Ontario, Canada N2L 6C2
tel +1.519.885.2444 fax +1.519.885.5450
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