

THE GLOBAL FINANCIAL CRISIS AND THE FINANCIAL STABILITY BOARD: HARDENING THE SOFT LAW OF INTERNATIONAL FINANCIAL REGULATION?

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I INTRODUCTION

Although the lack of international coordination in regulation was by no means at the heart of the current global financial crisis, there have been repeated calls for the intensification of cooperation between national regulators as part of the policy response.¹ Thus, for example, the final communiqué of the Group of 20 ('G20')² London Summit issued on 2 April 2009 contained a commitment 'to establish the much greater consistency and systematic cooperation between countries, and the framework of internationally agreed high standards, that a global financial system requires'.³ In this the G20 was merely echoing a series of official sector and quasi-official sector reports published during the early months of 2009, all of which had contained recommendations concerning enhancements

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1 See Douglas Arner, 'The Global Credit Crisis of 2008: Causes and Consequences' (2009) 43 *International Lawyer* 91.

2 The G20, formed in 1999 in the wake of the Asian financial crisis, comprises Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, Mexico, Russia, Saudi Arabia, South Africa, South Korea, Turkey, the United Kingdom and the United States, as well as the European Union and the European Central Bank. In addition, the United Nations, World Bank, International Monetary Fund ('IMF') and Financial Stability Board ('FSB'), among others, are also invited to attend.

3 G20, *Global Plan for Recovery and Reform*, (2009) [14] <<http://www.g20.org/Documents/final-communicue.pdf>> at 8 August 2009.

to the existing policy networks that are responsible for international regulatory standard-setting.⁴

Policy networks⁵ have been at the centre of the new forms of cooperation and coordination that nationally based regulatory agencies have used to adapt to the realities of the global financial system in the past thirty years, with international standard-setting bodies being at the core of their response.⁶ These bodies include the Basel Committee on Banking Supervision ('Basel Committee'), the International Organisation of Securities Commissions ('IOSCO'), the International Accounting Standards Board ('IASB'), the International Association of Insurance Supervisors ('IAIS') and the Joint Forum on Financial Conglomerates. Regulators have sought to achieve convergence on minimum standards in the form of 'soft' law,⁷ with compliance being achieved through force of example and other forms of moral suasion, including the positive impact on sovereign credit ratings of adherence to these international standards.⁸ One of the greatest policy questions of our time, brought to prominence by the global financial crisis, is whether these arrangements are capable of delivering effective regulation of financial institutions which operate beyond the borders of their home countries.

The G20 response has placed the Financial Stability Board ('FSB') at the centre of intensified regulatory cooperation. The FSB was originally established as the Financial Stability Forum ('FSF') by the G7 Finance Ministers and Central Bank Governors in 1999 to promote international financial stability through enhanced information exchange and international cooperation in financial market

4 See, eg. Group of Thirty, *Financial Reform: A Framework for Financial Stability* (2009) <<http://www.group30.org/pubs/reformreport.pdf>> at 12 August 2009; Jacques de Larosière et al, The High-Level Group on Financial Supervision in the EU: Report (2009) European Commission ('Larosière Report') <http://ec.europa.eu/internal_market/finances/docs/de_larosiere_report_en.pdf> at 12 August 2009; Lord Adair Turner, *The Turner Review: A Regulatory Response to the Global Banking Crisis* (2009) Financial Services Authority <http://www.fsa.gov.uk/pubs/other/turner_review.pdf> at 12 August 2009.

5 For the concept of policy networks, see generally Anne-Marie Slaughter, *A New Global Order* (2004).

6 See Joseph Norton, 'Comment on the Developing Transnational Network(s) in the Area of International Financial Regulation: The Underpinnings of a New Bretton Woods II Global Financial System Framework' (2009) 43 *International Lawyer* 175.

7 For discussions of soft law and its role, see Giulia Bertezolo, 'The European Union Facing the Global Arena: Standard-Setting Bodies and Financial Regulation' (2009) 34 *European Law Review* 257, 265–8; Timothy Meyer, 'Soft Law as Delegation' (2009) 32 *Fordham International Law Journal* 888; Pierre-Hugues Verdier, 'Transnational Regulatory Networks and Their Limits' (2009) 34 *Yale Journal of International Law* 113; Andrea Hamann and Hélène Ruiz Fabri, 'Transnational Networks and Constitutionalism' (2008) 6 *International Journal of Constitutional Law* 481, 504–6; Sol Piccioto, 'Constitutionalizing Multilevel Governance?' (2008) 6 *International Journal of Constitutional Law* 457.

8 See Joseph Norton, *Devising International Bank Supervisory Standards* (1995).

supervision and surveillance.⁹ A response to deficiencies in the mechanisms for international coordination that had been identified during the Asian financial crises of 1997–98,¹⁰ it aimed to bring together national authorities responsible for financial stability in significant international financial centres, international financial institutions, sector-specific international groupings of regulators and supervisors, and committees of central bank experts. Now reconstituted as the FSB, its membership has been expanded to encompass, in addition to its original members, all G20 nations, Spain and the European Commission, among others.¹¹ As we will discuss in this article, the renamed Financial Stability Board has also been granted a significantly enhanced mandate.

This article considers the likely effectiveness of the expansion of the FSB's mandate and the extent to which this extension of the current 'soft law' regime can be a substitute for a 'hard law' regime with greater enforcement powers. Following this introduction, Part II presents an overview of the current framework of international financial regulation, based primarily on soft law international standards and organisations. From this basis, Part III discusses the shortcomings of the current soft law regime to which the expanded mandate of the FSB has been presented as a (partial) response. Two main issues are identified: improved coordination of the supervision of cross-border financial institutions, including enhanced cooperation on enforcement actions; and the coordination of crisis management arrangements and agreements for sharing the costs of the failure of cross-border financial institutions. Part IV discusses possible treaty-based or 'hard law' structures, focusing on the examples of the World Trade Organisation ('WTO') and the International Monetary Fund ('IMF'), concluding that such structures are probably inappropriate for international financial regulation at this time. However, the WTO's dispute settlement arrangements could provide a possible model for disputes over international burden sharing in the event of cross-border financial institution failures. The European Union ('EU') offers an alternative 'hard law' structure, but the difficulties this structure has encountered in responding to similar

9 As originally constituted, the FSF comprised financial authorities from developed financial systems (Australia, Canada, France, Germany, Hong Kong, Italy, Japan, the Netherlands, Singapore, the United Kingdom, the United States, plus the European Central Bank), and the major international financial institutions (the Bank for International Settlements ('BIS'), IMF and World Bank), international regulatory and supervisory bodies (the Basel Committee, IOSCO, IAIS, IASB) and committees of central bank experts (the Committee on the Global Financial System ('CGFS') and the Committee on Payment and Settlement Systems ('CPSS')). Switzerland joined in 2007.

10 For discussion, see Douglas Arner, *Financial Stability, Economic Growth and the Role of Law* (2007); Rolf Weber and Douglas Arner, 'Toward a New Design for International Financial Regulation' (2007) 29 *University of Pennsylvania Journal of International Law* 391, 402–5.

11 Thus, as reconstituted, the FSB comprises: financial authorities (usually the central bank and/or ministry of finance plus in some cases one or more regulatory agencies) from Argentina, Australia (represented by the Reserve Bank of Australia and the Treasury), Brazil, Canada, China, France, Germany, Hong Kong, India, Indonesia, Italy, Japan, the Netherlands, Russia, Saudi Arabia, Singapore, South Africa, South Korea, Switzerland, Turkey, the United Kingdom and the United States; international organisations (the BIS, ECB, European Commission, IMF, OECD and World Bank); and international standard-setting and policy bodies (the Basel Committee, CGFS, CPSS, IAIS, IASB and IOSCO).

problems to those encountered by the international ‘soft law’ regime suggests that it is of doubtful applicability as a possible model. Part V concludes, arguing that greater institutional backing for the FSB is achievable without moving to a fully treaty-based, hard law solution. However, while these arrangements are likely to enhance the ongoing supervision of cross-border financial groups and will lead to generally higher supervisory standards throughout the world, it is unlikely that they will be able to deliver improvements to the second major issue on which enhanced coordination is being sought, namely improved crisis management arrangements and agreements on burden sharing. In the latter case, only a hard law solution, perhaps imposing binding arbitration on the relevant parties, is likely to be effective, but the political will to develop such an approach was not evident at the 2009 G20 London Summit.

II INTERNATIONAL FINANCIAL REGULATION: THE PRE-CRISIS SOFT LAW FRAMEWORK

Since the establishment in 1974 of the Basel Committee on Banking Supervision (or the ‘Basel Committee on Bank Regulation and Supervisory Practices’ as it was originally known),¹² a consistent international strategy for promoting financial stability has gradually emerged that can be described as a system of international financial standards.¹³ The system has the following primary characteristics:¹⁴ (1) the development of an international consensus on the key elements of a sound financial and regulatory system by representatives of the relevant economies; (2) the formulation of sound principles and practices by international groupings of technocratic authorities with relevant expertise and experience, known to international relations theorists as ‘policy networks’;¹⁵ (3) the use of market discipline and market access channels to provide incentives for

12 As originally constituted, the Basel Committee comprised the central bank governors of the Group of Ten (‘G10’) countries plus Switzerland (which along with Luxembourg subsequently joined the G10), thus overall comprising Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Sweden, Switzerland, the United Kingdom and the United States, with its secretariat at the BIS. See Norton, above n 8. In 2009, the Basel Committee’s membership was expanded to comprise the central banks and banking supervisor of Argentina, Australia (which is thus represented by the Reserve Bank of Australia and the Australian Prudential Regulatory Authority), Belgium, Brazil, Canada, China, France, Germany, Hong Kong, India, Indonesia, Italy, Japan, Luxembourg, Mexico, the Netherlands, Russia, Saudi Arabia, Singapore, South Africa, South Korea, Spain, Sweden, Switzerland, Turkey, the United Kingdom and the United States.

13 The prototypical international financial standard is the Basel Committee’s 1988 Capital Accord setting minimum international standards for bank capital and its replacement, Basel II, which have been implemented very widely into domestic legal systems: see Basel Committee on Banking Supervision, *International Convergence of Capital Measurement and Capital Standards* (1998) Bank for Institutional Settlements <<http://www.bis.org/publ/bcbasel111.pdf>> at 12 August 2009; Basel Committee on Banking Supervision, *International Convergence of Capital Measurement and Capital Standards: A Revised Framework – Comprehensive Version* (2006) Bank for Institutional Settlements <<http://www.bis.org/publ/bcbs128.pdf>> at 12 August 2009.

14 For detailed discussion, see Arner, above n 10; Weber and Arner, above n 10, 410–11.

15 See Slaughter, above n 5.

the adoption of sound supervisory systems, better corporate governance and other key elements of a robust financial system; and (4) the promotion by multilateral institutions such as the IMF and the multilateral development banks (MDBs, that is, the World Bank and regional development banks) of the adoption and implementation of sound principles and practices.

Most generally, this system can be described as having four levels, incorporating a range of international institutions and organisations.¹⁶ At the first level, there is a structure which has mainly been established through political processes. The second level is international standard-setting, largely of a technocratic nature. At the third level is implementation of standards – in principle a domestic process but with technical assistance through a variety of international, regional and bilateral sources. The fourth level focuses on monitoring implementation of standards. Importantly, however, under the current structure, the ultimate responsibility for policies to strengthen financial systems lies with the governments and financial authorities in the economies concerned. As a result of the current global financial crisis, the appropriateness of reliance on this basic assumption of individual responsibility in the context of global financial markets and global financial institutions is now under serious question.

A International Financial Standards and Standard-Setting Organisations

Although international standards have a long history, with the Basel Concordat,¹⁷ dating back to the 1970s, in the 1990s a major change in their status took place. Standards that had been previously a matter of mutual agreement among a relatively narrow group of countries now became the basis for a new framework of international regulation, intended to be of universal application, including to countries that were not directly involved in formulating the standards. At their Lyon Summit in 1996 the G7 directed the international financial institutions and international financial organisations – especially the IMF, World Bank and Basel Committee – to set standards for financial regulation to be implemented in developed, developing, emerging and transition economies, as well as to seek solutions for domestic crises with international implications. As a result, a wide range of institutions and organisations have been producing standards in an increasing range of areas.

At the end of the same decade, discussions of the international financial architecture resulted in the formation of a new body, the FSF. The FSF was established to serve the role of the coordinator in the system of international standards and to promote the adoption of these standards. In addition to coordination and standard-setting through the FSF, the established international financial institutions such as the IMF, World Bank and Bank for International

16 This essential structure was affirmed by the G7 Finance Ministers in the Communiqué from their Köln summit in 1999: G7 Finance Ministers, *Report of the G-7 Finance Ministers to the Köln Economic Summit* (1999).

17 Basel Committee on Banking Supervision, *Report to the Governors on the Supervision of Banks' Foreign Establishments* (1975) Bank for International Settlements <<http://www.bis.org/publ/bcbis00a.pdf>> at 12 August 2009.

Settlements ('BIS'), also engage in standard-setting, as well as implementation and monitoring. Other formal international organisations such as the Organisation for Economic Cooperation and Development ('OECD') are of importance in the standard-setting process. However, the WTO is not formally included – a potential weakness in the existing framework. Finally, much standard-setting takes place through various international financial organisations of varying levels of formality.¹⁸

At the political level, prior to the current global financial crisis, the G7 industrialised countries have taken the lead in establishing an operating framework for the process, supported by the Group of Ten ('G10') elaborating details. Prior to the current global financial crisis, the process appeared to be largely formalised. Since the onset of the systemic phase of the financial crisis in late 2008,¹⁹ however, coordination and direction has increasingly shifted to the G20.

1 Coordination

The FSB and the BIS currently serve the primary role in coordination of the process of standard-setting. As noted, the FSF was established under the auspices of a G7 mandate in February 1999, with a threefold purpose: (1) promote international financial stability; (2) improve the functioning of markets; and (3) reduce systemic risk through enhanced information exchange and international cooperation in financial market supervision and surveillance.

The FSF, as originally constituted, included five different types of members: national authorities, international financial institutions, other international organisations, international financial organisations and committees of central bank experts. In addition, the FSF created a number of ad hoc working groups to develop recommendations on specific issues. These included: highly leveraged institutions; capital flows; offshore financial centres; implementation of standards; incentives to foster implementation of standards; deposit insurance; and e-finance.

In addition to the FSB, the BIS plays an important role in coordination. It provides the secretariat for the FSB, as well as the Basel Committee, Committee on Payment and Settlement Systems, Committee on the Global Financial System, G10 and IAIS.

2 Key Standards for Sound Financial Systems

The FSF agreed upon 12 key standards areas, including a total of 15 standards, as the basis of internationally agreed minimum standards of financial regulation.²⁰ They are grouped into the three main categories of macroeconomic

18 David Zaring, 'International Law by Other Means: The Twilight Existence of International Financial Regulatory Organizations' (1998) 33 *Texas International Law Journal* 281, 282.

19 For discussion of the crisis and the role of the G20, see Arner, above n 10; Weber and Arner, above n 10.

20 See Financial Stability Board, *12 Key Standards for Sound Financial Systems* <http://www.financialstabilityboard.org/cos/key_standards.htm> at 12 August 2009. For detailed discussion, see Arner, above n 10; Weber and Arner, above n 10.

policy and data transparency, institutional and market infrastructure, and financial regulation and supervision, each encompassing several different aspects (for example, banking, securities and insurance in the context of financial regulation). The intention is that each set of key standards will be supported by a methodology for assessment and implementation and a variety of related principles, practices and guidelines.

3 *Process of Standard-Setting*

As noted, standard-setting takes place through a range of different bodies. These can largely be grouped into international financial institutions,²¹ other formal international organisations²² and international financial organisations. The international financial organisations include a range of different forms, including regulators,²³ central banks,²⁴ professional groups,²⁵ market associations,²⁶ expert groups,²⁷ and legal groups.²⁸

Despite the emphasis given to transparency in many international standards, the standard-setting process itself suffers from a lack of transparency. No criteria have ever been published for determining priorities in selecting issues on which to develop standards, for designating standard areas and standards as 'key', or for selecting appropriate standard-setting organisations. Nonetheless, in pre-crisis practice standard-setting processes appeared to follow a pattern, with the basic elements (for both initial development and revision) as follows: (1) networking and lobbying by potential standard setters for mandates to develop standards in various areas; (2) support through the G7, the FSF and/or other bodies for a standard development process to proceed; (3) an international process of awareness building and discussion of issues; (4) multilateral technocratic cooperation in drafting; (5) support from the governing body of the standard-setting organisation; (6) testing the use of standards in monitoring and implementation; (7) finalisation of guidance and supporting materials; and (8) approval by the governing body of the standard-setting organisation(s) and referral to other bodies such as the G7 and/or FSF. Revisions (recently completed in some areas and ongoing in others) appear to follow a similar path.

21 The international financial institutions include the IMF, World Bank and BIS.

22 At present, the OECD. The WTO is not officially represented.

23 Basel Committee, IAIS and IOSCO. The Financial Action Taskforce ('FATF') can also be included in this category.

24 The CPSS and CGFS.

25 These include the IASB and the International Federation of Accountants.

26 Market associations include the International Swaps and Derivatives Association, the International Capital Markets Association and the Loan Market Association.

27 Expert groups include the Institute of International Finance, the Group of Thirty, the Institute for International Economics and a plethora of domestic and academic research and policy institutes.

28 Legal groups include the International Law Association, International Bar Association, the UN Commission on International Trade Law, the International Institute for the Unification of Private Law, the Hague Conference on Private International Law, and the Council of Europe.

B Implementation and Monitoring

An important element of the pre-crisis system of international standards involved monitoring their implementation. While primarily a domestic process, pre-crisis implementation was supported by a range of assistance mechanisms. Monitoring was mainly to take place at the international level through the international financial institutions, especially the IMF and World Bank. Specifically, the IMF worked through its annual Article IV consultations,²⁹ and through Reports on the Observance of Standards and Codes ('ROSCs') and Financial Sector Assessment Programmes ('FSAPs') (the latter are conducted jointly with the World Bank where they relate to countries outside the OECD). The OECD and the Financial Action Task Force on Money Laundering ('FATF') also engaged in monitoring, with the FATF playing quite an influential role in the context of money laundering and terrorism financing. At a regional level, the regional development banks³⁰ encourage implementation through their respective projects and reviews. In addition, regional economic associations³¹ may have a role – in some cases (for example, the EU) a very important one. At the bilateral level, some countries (especially the United States) are keen to support the implementation of certain standards – for example, those of the FATF. Finally, at the market level, the rating agencies have shown some interest in monitoring standards, though not to the extent of policy makers' hopes.

While this system appeared a reasonable approach following the Asian financial crisis (focusing on improving regulation in emerging market financial systems and enhancing harmonisation in support of globalisation),³² for a range of reasons, it has proven insufficient to prevent the current global financial crisis. As a result, attention is now turning towards reform.

III DEFICIENCIES IN THE 'SOFT LAW' APPROACH AND THE FSB'S NEW MANDATE

The global financial crisis was as much the result of deficiencies in national regulatory systems as it was due to any shortcomings in the current soft law framework of international standard-setting. National deficiencies were particularly pronounced in the United States where they included inadequate (or non-existent) regulation of the mortgage brokers that were responsible for the origination of many sub-prime assets (the Federal Reserve delayed implementation of its regulatory authority over this market until 2008); inadequate surveillance of the credit default swaps market due to the deficiencies

29 See Section IV B of this article, 'The IMF Model', below.

30 Chiefly, the African Development Bank, the Asian Development Bank, the European Bank for Reconstruction and Development, and the Inter-American Development Bank.

31 Chiefly, the EU, Association of Southeast Asian Nations, Mercosur, North American Free Trade Agreement, and Southern African Development Community.

32 See Arner, above n 10; Weber and Arner, above n 10.

of the Commodities Futures Modernization Act 2000;³³ and the inadequate regulation of systemically important firms, especially insurance companies, owing to the lack of a Federal Charter for such companies. Within this catalogue of deficiencies, the problems of international coordination were of lesser significance.

A Coordinated Regulation and Crisis Management

Nonetheless, policy makers have placed considerable emphasis on the need for greater post-crisis coordination of regulation and further steps to harmonise regulatory standards. In his report on behalf of the United Kingdom's Financial Services Authority, Lord Adair Turner provides the following recommendations:

International coordination of bank supervision should be enhanced by

- The establishment and effective operation of colleges of supervisors for the largest complex and cross-border financial institutions.
- The pre-emptive development of crisis coordination mechanisms and contingency plans between supervisors, central banks and finance ministries.³⁴

In other words, the current framework for the coordinated supervision of cross-border financial groups needs to be enhanced both in respect of their ongoing supervision – through colleges of supervisors – and, in the event that banks or other financial institutions fail, more detailed crisis management arrangements together with, potentially, advance agreement on sharing the burden of rescuing or resolving a cross-border banking or financial group.

A recent report from the Group of Thirty is more expansive in setting out four specific issues for enhanced cooperation:

National regulatory authorities and finance ministers are strongly encouraged to adapt and enhance existing mechanisms for international regulatory and supervisory coordination. The focus of needed enhancements should be to: (i) better coordinate oversight of the largest international banking organizations, with more timely and open information sharing, and greater clarity on home and host responsibilities, including in crisis management; (ii) move beyond coordinated rule making and standard setting to the identification and modification of material national differences in the application and enforcement of such standards; (iii) close regulatory gaps and raise standards, where needed, with respect to offshore banking centers; and (iv) develop the means for joint consideration of systemic risk concerns and the cyclical implications of regulatory and supervisory policies. The appropriate agencies should strengthen their actions in member countries to promote implementation and enforcement of international standards.³⁵

The first three of the issues identified by the Group of Thirty – coordinated oversight, the elimination of enforcement differences, and the closing of regulatory gaps – relate to the first of Lord Turner's recommendations. The fourth recommendation goes beyond Turner, although he does recognise the need

33 For an account of the lobbying effort that resulted in this Act see Gillian Tett, *Fool's Gold: How Unrestrained Greed Corrupted a Dream, Shattered Global Markets and Unleashed a Catastrophe* (2009) 75.

34 Turner, above n 4, 9, Recommendation 25.

35 Group of Thirty, above n 4, 62, Recommendation 8.

for greater coordination of systemic risk assessments at the EU level. Although a later recommendation in the Group of Thirty report recognises the importance of effective bank resolution methods at the national level, it does not discuss the importance of better international coordination of crisis management other than as a subsidiary issue in coordinated oversight.

This difference in emphasis may reflect that the impact of major institutional failures has tended to flow from the United States to other countries, rather than the other way round.³⁶ Commenting on the collapse of Lehman Brothers, Turner remarks:

The failure of Lehman Brothers demonstrated ... that decisions about fiscal and central bank support for the rescue of a major bank are ultimately made by home country national authorities focusing on national rather than global considerations. It also illustrated that separate legal entities and nationally specific bankruptcy procedures have major implications for creditors.³⁷

In other words, although banks and other financial institutions are international in life they are national in death.³⁸ Developing agreements in advance on how to handle the failure of a major bank or other financial institution might go some way to alleviate this problem. Ground rules on who to tell, and when, concerning an imminent closure would certainly help. At the same time, however, purely voluntary agreements on burden sharing are unlikely to be effective. There are good reasons for expecting that a *saive qui peut* strategy will dominate when handling the failure of a cross-border institution; as Charles Goodhart has remarked, '[w]hether on purpose, or not, in a globalized financial system losses occurring in a bank in one country could be effectively passed through to the depositors or to the fiscal authorities in another country'.³⁹

B The Financial Stability Board's New Mandate

The enhanced mandate awarded to the Financial Stability Forum (Board) at the G20 London Summit reflected these demands for greater international coordination.⁴⁰ It reflects both the objective of improving the ongoing supervision of cross-border banking groups and the desire to improve crisis management arrangements. Specifically, the FSB's new mandate is to:

- assess vulnerabilities affecting the financial system and identify and oversee action needed to address them;

36 Although the Group of Thirty has an international membership, this particular report was authored by a group chaired by Paul Volcker and betrays a mainly United States-centric approach to the crisis.

37 Turner, above n 4, 37.

38 Although at least one of the authors has included this explicitly in teaching since the early part of the century, the first quotation of the idea is difficult to find. While Mervyn King and Charles Goodhart are both frequently cited as the source, the earliest quotation appears from *The Economist*: 'banks may be global in life but are national in death.' *The Economist*, *Homeward Bound* <http://www.economist.com/displaystory.cfm?story_id=13057265> at 12 August 2009.

39 Charles Goodhart, 'Multiple Regulators and Resolutions' in Douglas Evanoff and George Kaufman (eds), *Systemic Financial Crises: Resolving Large Bank Insolvencies* (2005) 253, 266.

40 Financial Stability Forum, 'Financial Stability Forum Re-established as the Financial Stability Board' (Press Release, 2 April 2009) <http://www.financialstabilityboard.org/press/pr_090402b.pdf> at 12 August 2009.

- promoting co-ordination and information exchange among authorities responsible for financial stability;
- monitor and advise on market developments and their implications for regulatory policy;
- advise on and monitor best practice in meeting regulatory standards;
- undertake joint strategic reviews of the policy development work of the international standard setting bodies to ensure their work is timely, coordinated, focused on priorities, and addressing gaps;
- set guidelines for and support the establishment of supervisory colleges;
- manage contingency planning for cross-border crisis management, particularly with respect to systemically important firms; and
- collaborate with the IMF to conduct Early Warning Exercises.⁴¹

As obligations of membership, FSB members commit to:

pursue the maintenance of financial stability, maintain the openness and transparency of the financial sector, implement international financial standards (including the 12 key International Standards and Codes), and agree to undergo period peer reviews, using among other evidence IMF/World Bank public Financial Sector Assessment Program reports.⁴²

The latter represents a departure from existing practice as participation in the IMF/World Bank FSAP process has remained a purely voluntary exercise and the United States, for one, has not so far undergone such an assessment.

In support of its new objectives, the FSB will establish Standing Committees for Vulnerabilities Assessment, Supervisory and Regulatory Cooperation (including for supervisory colleges and cross-border crisis management), and Standards Implementation. The intention underlying these reforms is clearly to enhance the existing framework of soft law and to create something akin to an enforcement mechanism beyond the current largely voluntary system.

In considering how such a soft law, peer review system might operate in practice, the experience of several of the international standard setters is instructive. Both IOSCO, through its multilateral memorandum of understanding ('MMoU') and the FATF are based on a combination of soft law and strong membership obligations that are nonetheless imposed through a peer review process. Both of these bodies provide possible pointers to how the FSB might work in practice.

1 *The Financial Action Taskforce (FATF)*

Established in 1989 to coordinate international efforts in respect of money laundering, the FATF today is the primary standard setter for anti-money laundering and countering financing of terrorism standards. In addition to standard-setting, the FATF also undertakes multilateral monitoring and peer review, primarily through its Mutual Evaluation Programme. Under this

41 Financial Stability Board, *Mandate* (2009) <<http://www.financialstabilityboard.org/about/mandate.htm>> at 12 August 2009. See also Financial Stability Forum, above n 40; Financial Stability Board, 'Financial Stability Board Holds Inaugural Meeting in Basel' (Press Release, 27 June 2009) <http://www.financialstabilityboard.org/press/pr_090627.pdf> at 12 August 2009.

42 Financial Stability Board, *Mandate*, above n 41.

system, each member country is examined by the FATF on the basis of an on-site visit conducted by a team of legal, financial and law enforcement experts drawn from other member governments. The FATF enforces implementation through a series of graduated measures.

2 *IOSCO Multilateral Memorandum of Understanding (MMoU)*

Unlike the FATF mutual evaluation programme, while IOSCO is responsible for standard-setting in the area of securities regulation, it does not undertake a general process of evaluation, monitoring of implementation or enforcement, with these roles generally left to the FSAP under the general system of international financial standards.

However, in one area, IOSCO has developed a particularly innovative approach to implementation, monitoring and enforcement on the basis of soft law mechanisms modelled on self-regulatory systems: the IOSCO MMoU.⁴³ As a self-regulatory system, the IOSCO MMoU contains three main levels: implementation of pre-established standards via pre-commitment; monitoring via peer review; and enforcement. At the first level, the MMoU contains a range of specific obligations to which signatories both agree and commit to, having the authority and legal backing necessary for compliance and performance of obligations. Signature is open to securities regulators but only on the basis of an evaluation by IOSCO and the existing signatories that the potential signatory meets the necessary requirements.⁴⁴ Potential signatories thus have to apply for permission to join (as in a traditional self-regulatory organisation (SRO)) and must be vetted by the organisation and its existing membership for suitability and compliance.⁴⁵ As a second level, peer review is undertaken in the context of actual implementation, with failure to perform according to obligations being subject to investigation and potential enforcement (up to and including expulsion – once again, similar to an SRO) by the organisation.

While certain problems have emerged with jurisdictions and non-compliance, the IOSCO MMoU nonetheless provides an interesting example of a possible soft law self-regulatory model for the FSB.

Although these examples suggest ways in which the present oversight of the implementation of international standards might be strengthened through the FSB's processes, nonetheless, the system remains fundamentally a soft law system: the FSB is not the creation of treaty and although substantial moral

43 See International Organisation of Securities Commissions, *Multilateral Memorandum of Understanding: Concerning Consultation and Cooperation and the Exchange of Information* (2002) <<http://www.iosco.org/library/pubdocs/pdf/IOSCOPD126.pdf>> at 12 August 2009.

44 The current signatories are the securities regulators of Australia, Bahrain, Belgium, Bermuda, the British Virgin Islands, Canada (Alberta, British Columbia, Quebec, Ontario), China, the Czech Republic, Denmark, Dubai, Finland, France, Germany, Greece, Hong Kong, Hungary, India, the Isle of Man, Israel, Italy, Japan, Jersey, Jordan, Lithuania, Luxembourg, Malaysia, Malta, Mexico, Morocco, the Netherlands, New Zealand, Nigeria, Norway, Poland, Portugal, Romania, Singapore, the Slovak Republic, South Africa, Spain, Sri Lanka, Thailand, Turkey, the United Kingdom, and the United States.

45 Pending signatories currently include Austria, Bulgaria, Chile, Costa Rica, Cyprus, El Salvador, Ghana, Indonesia, Panama, Peru, Philippines, Russia, South Korea, Switzerland, Taiwan, and Tunisia.

suasion and peer pressure might be brought to bear on individual members, they are under no binding commitments to either abide by international standards or to subject themselves to external assessments. Moreover, the FSB lacks the powers to impose binding agreements on its members concerning such matters as the resolution of large cross-border financial firms. The latter is perhaps the most important lesson of the global financial crisis. As Turner observed in the quotation from his report cited earlier, when crises occur, it is national central banks that have to provide lender-of-last-resort support and national governments that provide fiscal support. If a failure does occur, bankruptcy procedures are national and it will matter against which specific jurisdictional legal entity a creditor has its claim.⁴⁶ This problem, which is fundamental to a globalised financial system, is not addressed by the change in the FSB's mandate as it will have only the ability to advise, encourage and to warn that Walter Bagehot attributed to the sovereign under the British parliamentary system.⁴⁷

IV HARDENING THE SOFT LAW OF INTERNATIONAL FINANCIAL REGULATION?

In looking at possible reforms, there is a natural tendency to first consider possible hard law treaty-based solutions based on formal international organisations, as was done at the end of the Second World War. In this respect, the first option would be a treaty establishing an international organisation responsible for developing and for monitoring the implementation of regulatory requirements. This would involve the harmonisation of the rulebooks of national regulators, as the majority of domestic financial regulation takes place not through legislation but through rules promulgated and enforced by regulatory agencies. It is, therefore, a highly problematic solution as, even in the context of the EU, such an approach was abandoned in the mid-1980s. After the EU's initial experiments in regulatory harmonisation it had become apparent that complete harmonisation of financial regulation on the basis of hard law directives was impossible. Instead, following the European Court of Justice's ruling in *Rewe-Zentral AG v Bundesmonopolverwaltung für Branntwein*⁴⁸ ('*Cassis de Dijon*') an alternative approach was adopted that involved agreement only on minimum standards, with substantial discretion left to national authorities in the implementation of those standards and the imposition of higher standards than the minimum.

In this section we thus consider the various options for hardening the soft law of international regulation. The most obvious options are to look to existing

46 For discussion, see Douglas Arner and Joseph Norton, 'Building a Framework to Address Failure of Complex Global Financial Institutions' (2009) 39 *Hong Kong Law Journal* 95.

47 Walter Bagehot, *The English Constitution* (1863, 2nd ed, 1993) 113. (Bagehot's actual formulation was that 'the sovereign has, under a constitutional monarchy such as ours, three rights – the right to be consulted, the right to encourage, the right to warn'.)

48 (C-120/78) [1979] ECR 649.

international institutions, such as the WTO or the IMF, to provide the basis for a treaty-based, hard law regime for international standard-setting. These options are also, we argue, unsuitable for the purpose of setting international financial regulatory standards – both because their existing mandates are not well adapted to international financial regulation and because of other institutional limitations that we discuss. We next turn to consider the lessons that could be learned from the experience of the EU, which is perhaps the leading example of an attempt at regulatory harmonisation based on minimum standards with a treaty-based hard law basis. However, as we argue, the EU's institutions are difficult to universalise in a way that would fit them for the setting of international financial standards. Finally, we consider whether a new international treaty, establishing a global financial regulator, would be a viable option. We conclude that it would not be.

A The WTO Model

The starting point in regard to hard law institutions in the economy today is usually the WTO. Established in 1995, the WTO is in some ways the heir to the idea of the International Trade Organisation ('ITO') agreed at the end of the Second World War but never established. However, in reality, the WTO is far more the heir to the approach which was adopted in place of the ITO, the General Agreement on Tariffs and Trade ('GATT'). As the GATT was essentially an agreement to negotiate multilateral liberalisation of domestic trade restrictions, the WTO is based on an umbrella agreement establishing the institution and general principles and incorporating separate agreements on goods (the GATT), services (the General Agreement on Trade in Services ('GATS')), intellectual property (Trade-Related Aspects of Intellectual Property Rights) and a number of other specific aspects such as government procurement. Most importantly, the framework also includes a dispute resolution mechanism, as well as a trade policy review mechanism.

Overall, the WTO structure is based on three main aspects: (1) provision of an institutional framework for negotiated trade liberalisation, with (2) hard law commitments from members subject to (3) a formal dispute resolution mechanism. The WTO itself has very limited authority and direct monitoring power, with responsibility for monitoring placed on individual members' use of the WTO Dispute Resolution Mechanism to police commitments.

In addition to the various elements summarised above, foreign participation in domestic financial services is dealt with largely through bilateral, regional and international negotiations, with the latter centred on the WTO. Specifically, on 1 January 1995, the Marrakesh Agreement Establishing the WTO entered into force, with its annexes, including, inter alia, the GATT and the GATS. The main legal components affecting international trade in financial services include (1) the

GATS,⁴⁹ (2) the Annex on Financial Services, (3) the Second Annex on Financial Services, (4) the Understanding on Commitments in Financial Services, (5) the Second Protocol to the GATS, (5) the Fifth Protocol to the GATS, (6) the Decisions, and (7) the Understanding on Rules and Procedures Governing the Settlement of Disputes ('DSU').

These components contain a number of general obligations respecting trade and financial services contained in the various agreements, including most-favoured nation ('MFN') treatment,⁵⁰ transparency, and the effect of domestic regulation, discussed further in the following section. The GATS covers all sectors of services,⁵¹ including financial services. In addition, the Annex on Financial Services and the Second Annex on Financial Services, as part of the GATS, directly relate to financial services.⁵² The Understanding on Commitments in Financial Services, as part of the Final Act, stipulates higher requirements for financial liberalisation for those members that have adopted it. The so-called Financial Services Agreement and its scheduled commitments, in contrast to the financial services commitments undertaken in the Uruguay Round and in the 1995 interim agreement, are not temporary, but permanent, until the WTO members conclude a new agreement through negotiations. The Fifth Protocol to the GATS entered into force on 1 March 1999, and at the same time, those schedules of specific commitments and lists of MFN exemptions annexed to the Fifth Protocol replaced those undertaken in the 1995 interim agreement and in the Uruguay Round. These commitments form the basis for future financial services negotiations.

The WTO provides the international framework for foreign participation in financial services. However, unlike areas such as trade in goods, in the area of financial services, commitments made by members are exclusive rather than inclusive. Therefore liberalisation is at the discretion of individual WTO members and remains quite limited in most cases. The framework is an important starting point in supporting foreign competition in financial services, but because of its essential focus on liberalisation combined with bilateral dispute resolution, it is probably not an ideal framework to address financial stability and financial regulation issues.

49 According to the Results of the Uruguay Round of Multilateral Trade Negotiation, the General Agreement on Trade in Services ('GATS') is composed of four parts: (1) the main text of the Agreement (The General Agreement on Trade in Services); (2) eight Annexes; (3) Schedules of specific commitments; and (4) List of Art II Exemptions. The GATS Text refers to only the first part.

50 The GATS Article II (Most-Favoured-Nation Treatment) is composed of three paragraphs, applicable to all services sectors. Paragraph 1 is the core rule identifying the MFN obligation with respect to trade in services. It requires that each member accord to services and service suppliers of any other member treatment no less favourable than that it accords to like services and service suppliers of any other country.

51 *General Agreement on Trade in Services*, opened for signature 15 April 1994, 1869 UNTS 183, art I(3)(b) (entered into force 1 January 1995): "services" includes any service in any sector except services supplied in the exercise of governmental authority'.

52 For a general overview, see Wendy Dobson and Pierre Jacquet, *Financial Services Liberalization in the WTO* (1998) 72-5.

B The IMF Model

The second major international institutional structure is that of the IMF. Established at the end of the Second World War, the IMF is a very different institution operating on the basis of a very different legal framework from the WTO. Essentially, the role of the IMF was to focus on monetary stability and related fiscal and balance of payments concerns, and its purposes (even after a major amendment in the 1970s) continue to reflect this.

Under Article 1 of the IMF Articles of Agreement, the purposes of the IMF are to: (1) promote international monetary cooperation through a permanent institution which provides for consultation and collaboration on international monetary problems; (2) facilitate international trade, thereby contributing to high levels of employment, real income and development of productive resources of members as primary objectives of economic policy; (3) promote exchange stability, maintain orderly exchange arrangements and avoid competitive exchange depreciation; (4) assist in the establishment of a multilateral system of payments in respect of current transactions between members and the elimination of foreign exchange restrictions which hamper the growth of world trade; (5) give confidence to members by making the IMF's resources available to them under adequate safeguards, thus providing them opportunity to correct maladjustments in balance of payments without resort to destructive measures; and (6) shorten the duration and lessen the degree of disequilibrium in international balances of payments of members. Significantly, these purposes were not amended in any way in 1977. However, an additional preamble was added to Article 4, section 1:

Recognizing that the essential purpose of the international monetary system is to provide a framework that facilitates the exchange of goods, services, and capital among countries, and that sustains sound economic growth, and that a principal objective is the continuing development of the orderly underlying conditions that are necessary for financial and economic stability, each member undertakes to collaborate with the Fund and other members to assure orderly exchange arrangements and to promote a stable system of exchange rates.⁵³

As such, the purpose of the IMF centres upon monetary stability and related macroeconomic policy. Unlike the WTO system, the IMF is primarily an organisation charged with monitoring and therefore is supported neither by a hard law framework of liberalisation nor a bilateral dispute resolution mechanism.

Generally speaking, IMF member commitments fall into two categories: Article IV commitments and Article VIII commitments, with members having the choice of which level of commitment and constituent monitoring to accept.

Under Article IV, section 1, each member commits to: (1) endeavouring to direct its economic and financial policies toward the objective of fostering orderly economic growth with reasonable price stability, with due regard to its circumstances; (2) seeking to promote stability by fostering orderly underlying

53 International Monetary Fund, *Articles of Agreement of the International Monetary Fund* (1990) art IV s 1 <<http://www.imf.org/external/pubs/ft/aa/aa.pdf>> at 12 August 2009.

economic and financial conditions and a monetary system that does not tend to produce erratic disruptions; (3) avoiding manipulating exchange rates or the international monetary system in order to prevent effective balance of payments adjustments or to gain unfair competitive advantage; and (4) following exchange policies compatible with the undertakings under this section.

Under Article VIII, members commit to: (1) the avoidance of restrictions on current payments: no member shall without the approval of the Fund impose such restrictions; exchange contracts contrary are unenforceable; (2) the avoidance of discriminatory practices: no discriminatory or multiple currency practices except as authorised or approved; (3) current account convertibility; (4) the furnishing of information; and (5) consultation regarding existing international agreements.

These commitments are monitored through the IMF's surveillance powers. Specifically, under Article IV, the IMF shall: (1) oversee the international monetary system in order to ensure its effective operation and shall oversee the compliance of each member with its obligations under Article IV, section 1; and (2) exercise firm surveillance over the exchange rate policies of members and shall adopt specific principles for the guidance of all members with respect to those policies. These principles shall respect the domestic social and political policies of members and in applying these principles the IMF shall pay due regard to the circumstances of members.

In supporting surveillance, under Article IV, each member shall provide the IMF with the information necessary for such surveillance and when requested by the IMF shall consult with it on the member's exchange rate policies. In addition, under Article VIII, the IMF may require members to furnish it with such information as it deems necessary for its activities, including a range of specified national data. Further, the IMF shall act as a centre for the collection and exchange of information on monetary and financial problems, thus facilitating the preparation of studies designed to assist members in developing policies which further the purposes of the IMF.

In terms of operations, this system is implemented through regular Article IV consultations, normally once per year with each member.

While the IMF's (almost) universal membership means that it could provide an institutional home for international financial regulation, to date it has shown little desire to take on this role. In part, its reluctance to become an effective institutional basis for international financial regulation reflects the fact that the IMF Articles of Agreement would need to be refocused and its mandate would need to be changed from its current concern with monetary stability and balance of payments issues.⁵⁴ To the extent that the IMF has become involved in financial stability issues in the past decade, this is largely the product of its coming to regard these issues as ancillary to its monetary stability and balance of payments mandate, rather than due to any direct concern with financial stability as such.

54 For more detailed discussion of the role of the IMF in a redesigned international financial architecture, see Douglas Arner and Ross Buckley, 'Redesigning the Architecture of the International Economic System' (Working Paper 7, Asian Institute of International Financial Law, 2009).

The Asian financial crises were significant for the IMF's work because they showed the large contingent liabilities on government budgets resulting from poorly regulated banking systems; financial stability was therefore important for fiscal discipline and thus in turn for the monetary and balance of payments mandate. However, this essentially secondary concern with financial stability contrasts with the mandate of most central banks where financial stability is, in the words of Tommaso Padoa-Schioppa, part of their 'genetic code'.⁵⁵

C EU Approaches

In the past five decades, the EU has developed an approach alternative to that of either the WTO or IMF that might provide a possible model for developing a hard law framework for international regulatory coordination. Financial integration among EU states is the most developed of any region, the result of objectives set over a long period since the 1950s that related particularly to the creation of a single internal market in financial services. Advances in integration have transformed major markets among professional intermediaries but Europe's trade in retail financial services remains fragmented and not yet subject to regional competition.⁵⁶ This is the result of strong national socio-economic norms that reform and regulation find difficult to overturn, although the introduction of the euro may have induced greater similarities in national retail financial markets.⁵⁷

EU founding treaties provide for free movement of goods, services, persons (both natural and legal) and capital. In theory, investments may be made without restriction across national borders. However, these initial ideals did not begin to have real meaning until the mid-1980s, the second stage of EU financial integration, which focused on harmonisation to minimum standards. Today's level of integration has been achieved in these dimensions partly due to

55 Tommaso Padoa-Schioppa, *Central Banks and Financial Stability: Exploring a Land in Between* (2002) European Central Bank [7] <www.ecb.int/events/pdf/conferences/tps.pdf> at 12 August 2009.

56 The EU's official view in 2005 was that:

A long-anticipated surge in EU cross-border banking integration and consolidation has failed to materialise. This failure is striking in view of several apparently catalytic developments – notably the liberalisation of capital movements and efforts to create an internal market in financial services. ... However, cross-border integration have [sic] not been major features of developments in EU retail banking in recent years and this latest disappointment suggests that obstacles – other than exchange-rate risk – have yet to be addressed.

European Commission Directorate-General for Economic and Financial Affairs, *The EU Economy: 2005 Review* (2005) European Commission 365

<http://ec.europa.eu/economy_finance/publications/publication433_en.pdf> at 12 August 2009. One leading banker argues that:

a unified European financial market is still far from reality. One reason is that even where the [Financial Services Action Plan] has created a common legal basis, there are differences in actual implementation of the rules by the member states. ... Another reason is that in some segments, Europe still lacks the necessary legal and institutional framework for truly integrated markets. ... Even worse is the situation in retail markets.

Josef Ackermann, 'Europe Has to Storm Its Cross-Border Financial Barriers', *Financial Times* (London), 26 January 2007, 17.

57 See Christoffer Kok Sørensen and Josep Maria Puigvert Gutiérrez, 'Euro Area Banking Sector Integration: Using Hierarchical Cluster Analysis Techniques' (Working Paper No 627, European Central Bank, 2006) 7–8.

supportive rulings of the European Court of Justice. Hence, markets have become considerably harmonised,⁵⁸ so that national legislation over most market segments now reflects regionally initiated developments. Member states must adhere to certain precepts so that decisions and legislation at the EU level will directly affect those in individual states, while national governments may be liable in damages for failing to implement EU legislation to the detriment of their citizens. No similar obligations exist elsewhere in a regional setting. In a more technical sense, the EU experience shows how collaboration and political integration may encourage the adoption of sound principles and practices. The concept of mutual recognition and a system providing a single regulatory license for financial intermediaries now allow EU directives to set minimum norms without hindering competition.

The EU legislative framework for financial markets seeks equivalence among disparate regulatory and legal systems, so that regional initiatives recognise national legal and regulatory regimes.⁵⁹ Full rule harmonisation proved impossible for many activities and the European Commission adopted principles first outlined in a 1985 White Paper (the basis of the second stage of development),⁶⁰ that led to the *Single European Act*.⁶¹ This stipulated a common internal market based upon mutual recognition and common minimum standards, made applicable by EU directives and brought into effect through domestic law.⁶² Member states would recognise each other's law, regulations and authorities structured along common minimum standards, enabling the freeing of the trade in goods and services without need for prior harmonisation.⁶³ The system also uses minimum regional requirements to limit competitive deregulation by state actors and regulatory arbitrage by commercial parties.

National financial regulation in Europe has intensified in recent years due to a combination of the needs of government and pressure from harmonisation, access deregulation and prudential re-regulation inherent in the process of market opening developed under the Maastricht Treaty for unhindered capital mobility. The EU framework for financial services provides minimum standards for financial intermediaries, securities regulation, accounting, company law, and regulation of institutional investors, based on intermediation being unfettered by national borders or restrictions on activity, and an open internal market. However, harmonisation leaves the framework incomplete since it augments rather than replaces existing national laws.

58 Elemer Tertak, 'Address' (Speech delivered at The Euro: Lessons for European and Asian Financial Markets, Hong Kong, 24 February 2006).

59 See Benn Steil, *The European Equity Markets: The State of the Union and an Agenda for the Millennium* (1996) 113.

60 Commission of the European Communities, *Completing the Internal Market: White Paper from the European Commission to the European Council* (1985) European Commission <http://europa.eu/documents/comm/white_papers/pdf/com1985_0310_f_en.pdf> at 13 August 2009.

61 *Single European Act*, opened for signature 17 February 1986, OJ L 169/1 (entered into force 1 July 1987).

62 *Ibid.*

63 See Steil, above n 59.

Today's single market is manifested in 'passport directives',⁶⁴ by which an authorised intermediary may generally be able to supply services overseas directly or through a foreign branch without maintaining a permanent presence in its target market.⁶⁵ The passport's aim is to promote competition and allow intermediaries to choose how they deliver products or services into any part of the internal market.⁶⁶ Passport directives in financial services define the intermediary to which they apply, its activities or market segment, the conditions for initial and continuing authorisation, the division of regulatory responsibility between the home (domicile) state and the host (target) state,⁶⁷ and aspects of dealings with non-EU member states.⁶⁸ Further, free movement of capital to facilitate European monetary union became effective through the Maastricht Treaty in 1994. This provided an impetus for states to implement prior financial services directives and led to members other than Ireland and the United Kingdom adopting legislation that was foreign to their traditional market practices. The introduction of the euro in 1999 had a further catalytic effect on the nature of market flows and activity. Following the introduction of the single currency, EU members were forced to turn once again to increasing levels of regulatory convergence, a process which is ongoing and represents the third stage of development.

1 *Lamfalussy Process*

The third stage of European financial integration is based on the work of a committee of 'wise men', chaired by Alexandre de Lamfalussy. Based on their analysis of financial regulation in Europe, the committee recommended the adoption of a new system, now known generally as the 'Lamfalussy process'. As adopted, the process establishes a four level structure. At the first level is primary legislation based on European directives and regulations, implemented at national level. Primary legislation however is at a relatively general level, establishing principles and standards. Detail is left to the second level of implementing measures, with such measures adopted at the level of a new system of financial regulatory committees: in banking, the European Banking Committee and the Committee of European Banking Supervisors ('CEBS'), based in London; in securities, the European Securities Committee and the Committee of European Securities Regulators ('CESR'), based in Paris; and in insurance, the European Insurance and Occupational Pensions Committee, and the Committee of European Insurance and Occupational Pensions Supervisors ('CEIOPS'), based

64 Passport directives in financial services address banking, investment services, collective investment schemes, life and non-life insurance, and pension funds.

65 See Innes Fraser and Paul Mortimer-Lee, 'The EC Single Market in Financial Services' (1993) 33(1) Bank of England, *Quarterly Bulletin* (2009) 92, 92.

66 Ibid.

67 The home state will generally be responsible for the supervision of intermediaries, their branches and the fitness and propriety of managers and major shareholders. The host state will be responsible for conduct within its jurisdiction: *ibid* 93.

68 Ibid.

in Frankfurt. In each case, the first committee is a high level committee, chaired by the European Commission and comprising senior finance ministry representatives from each member state, while the second committee is comprised of heads of relevant regulatory agencies from each member state.

In addition to primary legislation and implementing measures, the Lamfalussy process also includes transposition and implementation (level 3) and monitoring and enforcement (level 4). Primary responsibility for levels 3 and 4 lie with the respective regulatory committee, which also drafts level 2 implementing measures for approval by the respective policy committee. Monitoring is done on the basis of peer review, with enforcement through the committee process, albeit backstopped by the potential for actual enforcement actions taken either by the Commission or by aggrieved parties through the European court system.

2 *Larosière proposals*

In response to the current global financial crisis, the EU established a working group chaired by Jacques de Larosière to review existing supervisory arrangements and recommend reforms. The report,⁶⁹ released in February 2009, made two major recommendations, which as they are implemented, will signal the fourth stage of legal development in European financial integration.

Under the first, the group recommended the establishment of a new European Systemic Risk Council ('ESRC') under the auspices of the European Central Bank ('ECB') and comprising the members of the ECB General Council, the Commission and the chairs of CEBS, CEIOPS and CESR. The mandate of the ESRC will be focused on macroprudential supervision in the EU and will work closely with the IMF, FSB and G20.

Under the second, the group recommended the establishment of a new European System of Financial Supervision and transforming the Lamfalussy level 3 committees (CEBS, CEIOPS, CESR) into three new European Authorities: the European Banking Authority, the European Securities Authority and the European Insurance Authority. The main tasks of these authorities, in addition, to existing level 3 responsibilities, will include: (1) the legally binding mediation between national supervisors; (2) the adoption of binding supervisory standards; (3) the adoption of binding technical decisions applicable to individual institutions; (4) the oversight and coordination of colleges of supervisors; (5) the licencing and supervision of specific EU-wide institutions (for example, credit rating agencies and post-trading infrastructures); (6) the binding cooperation with the ESRC to ensure adequate prudential supervision; and (7) a strong coordinating role in crisis situations.

The difficulty of securing agreement within the EU on even these limited institutional reforms shows how difficult it would be to attempt to generalise from the attempt to harmonise regulatory standards among 27 member states to create an arrangement which could have a near universal membership. Despite

⁶⁹ Larosière et al, above n 4.

the significant achievements of the EU in setting out new financial regulatory standards over the past three decades, most of these reforms are likely to prove *sui generis*.

D Hard Law, Formal International Institutional Approach: The Global Financial Regulator

A final possible approach would be for states to agree to a new international treaty establishing a new institution with powers to regulate the largest, most systemically important banks and financial institutions.⁷⁰ The main justification that has been advanced for such an agency is the need for better mechanisms for coordinating regulation to reduce regulatory arbitrage in a world of global capital markets. In addition, as some of its advocates claim, it would have a better chance of being independent of political pressures than nationally-based regulators.⁷¹

A global financial regulator would, however, appear to be beyond the realm of practical politics. It is unrealistic to imagine that the United States, or any other country for that matter, will turn over the conduct of national financial regulation to an international body at this time. Regulation of financial markets is a valued national prerogative. Not even EU member states have been willing to agree to a single regulator. In any case there is the particularity of national financial structures, which places effective oversight beyond the grasp of any global body. There is also the problem of the deep differences in legal systems which would affect the enforcement powers of a hypothetical world regulator.

Moreover, as critics of the idea have pointed out, the only resources for bank rescues come from nation-states (and ultimately the taxpayers of each country).⁷² As long as this remains the case, politicians will not pass responsibility for regulating banks to a supranational body while they remain liable for the costs if regulation fails. Given that resources for bank rescues are likely to remain a closely guarded national prerogative, a global financial regulator would not be able to address the second fundamental problem in international coordination we have identified – crisis management and burden sharing – since it would possess no resources of its own that could be committed to bank rescues.

V CONCLUSION

During the previous period of global finance prior to the First World War, not only was there no international financial regulation, but in fact there was very little domestic financial regulation as well. At the end of the Second World War,

70 See John Eatwell and Lance Taylor, *Global Finance at Risk: The Case for International Regulation* (2000).

71 Carmen Reinhart and Kenneth Rogoff, 'Regulation Should Be International', *Financial Times* (London), 18 November 2008, 13.

72 See Goodhart, above n 39.

reflecting the view that while global trade was desirable, global finance was not, the Bretton Woods structure did not provide a specific hard law, international institution-based structure for finance because the design was based on the premise that finance would be domestic and subject therefore only to domestic regulation.⁷³ This system functioned rather well until the 1970s, by which time finance was once again internationalising. In response to the risks raised by the increasing internationalisation of finance, domestic central banks and regulators established informal committees hosted by the BIS. As finance continued to internationalise across the 1970s and 1980s, these initial efforts expanded beyond banking to a range of other areas, including securities and accounting. As a result of the 1980s debt crisis and other cross-border financial problems, these informal committees began to agree common approaches to common problems, with such approaches implemented via domestic legal and regulatory systems – a network-based, soft law approach of which the 1988 Basel Capital Accord is the leading and most widely implemented example.

During the 1990s, as finance became increasingly global, so did financial crises, especially in emerging market economies. Following the Mexican and Asian financial crises, much was said and written about the need for a ‘new international financial architecture’ to meet the needs of global finance.⁷⁴ In the event, the system adopted was the organisation of the disparate soft law networks through a new informal organisation, the FSF. However, for the first time, the international standards being developed were to be supported by a rudimentary level of monitoring at the international level, primarily through the IMF/World Bank FSAP/ROSC process, hence moving standards and standard-setting organisations from a purely agreement-based system, to one with a limited level of international review.

As a result of the current global financial crisis, this system, while not fundamentally a cause of the crisis, has been exposed as insufficient to meet the realities of global finance and its attendant risks. In looking at this issue, this article has sought to highlight a variety of approaches.

At the most fundamental level is the question which was addressed at Bretton Woods: whether, on balance, finance should be global. While the decision taken at Bretton Woods was in the negative, in the context of the global financial crisis, despite some misgivings, the consensus appears to be settling in favour of continued globalisation of finance, albeit with enhanced mechanisms for prevention and resolution of problems arising.

73 For discussion, see Arner, above n 10; Weber and Arner, above n 10.

74 For discussion, see Arner, above n 10.

In this context, the discussion in many ways has followed the forms of global administrative law,⁷⁵ with a range of approaches ranging from a traditional hard law treaty-based approach centred on a formal international organisation down to uncoordinated domestic responses. While the latter have been found to be ineffective in the context of global finance (albeit not domestic finance under the Bretton Woods design), despite periodic proposals for a global financial regulator, a traditional international law/institution approach does not seem feasible at this time, even in the context of the EU: issues of domestic sovereignty continue to make a global regulator for global finance unlikely for the foreseeable future. In looking forward, on balance, it appears to make little sense to incorporate financial regulation into the WTO framework, both because the WTO system is already overburdened and also due to its focus on negotiated liberalisation combined with dispute resolution which is not overly useful in the context of financial regulation. At the same time, however, if amendments are to be undertaken to the IMF Articles of Agreement, then this would also present an opportunity to provide the IMF with a specific mandate and related tools in relation to financial regulatory surveillance. However, it is uncertain at this time whether actual amendment will be the path chosen – though for a variety of reasons beyond the scope of this article, this is probably in fact necessary though not politically simple, even in the present crisis environment.⁷⁶

At the other end of the spectrum, purely soft law cooperative arrangements (such as the Basel Committee and the 1988 Basel Capital Accord) as existed until 1999 have proven ineffective in preventing and resolving international crises such as the Asian financial crisis. Following financial crises in the 1990s, to some extent, the cooperative mechanisms were given a greater level of coordination through the FSF and a higher level of formality through the FSAP/ROSC monitoring mechanisms. Once again, however, a hardened soft law approach of coordinated networks with limited external monitoring of compliance proved insufficient to address either the prevention or the resolution of a truly global financial crisis.

Discussion has thus turned towards intermediate arrangements. At the next level down from a hard law or international organisation approach are

75 For discussion of global administrative law ('GAL'), see Benedict Kingsbury, 'The Concept of "Law" in Global Administrative Law' (2009) 20 *European Journal of International Law* 23; Sabino Cassese, 'Administrative Law without the State? The Challenge of Global Regulation' (2005) 37 *New York University Journal of International Law and Politics* 663; Benedict Kingsbury, Nico Krisch and Richard B Stewart, 'The Emergence of Global Administrative Law' (2005) 68(3–4) *Law and Contemporary Problems* 15; see generally Institute for International Law and Justice, 'Global Administrative Law Project' <<http://www.iilj.org/GAL>> at 13 August 2009. For the application of the GAL approach to international financial regulation, see David Zaring, 'Rulemaking and Adjudication in International Law' (2008) 46 *Columbia Journal of Transnational Law* 563; Michael Barr and Geoffrey Miller, 'Global Administrative Law: The View from Basel' (2006) 17 *European Journal of International Law* 15; David Zaring, 'Informal Procedure, Hard and Soft, in International Administration' (2005) 5 *Chicago Journal of International Law* 547.

76 See Arner and Buckley, above n 53.

discussions of creating a hard law underpinning for the existing network model.⁷⁷ While this is the approach which is largely being pursued in the EU following the Larosière Report, with European authorities composed of domestic agencies responsible for setting regional regulation but with domestic enforcement, this approach has to date not been followed at the international level and may still prove impossible even in the EU context.

Instead, the approach which has been adopted at the international level by the G20 is a further hardening of the pre-crisis system, through the strengthening of the FSF into the FSB, with a wider range of member commitments and strengthened peer review and external monitoring mechanisms. While the details of its operation are yet to materialise, it appears initially to be following the experiences of the FATF and its peer review and external monitoring systems. Most explicitly, this methodology has been adopted in relation to banking secrecy, tax disclosure, information sharing and cooperation in enforcement. Unfortunately, while this may be the most effective compromise possible under present circumstances, it must also be said that this is largely the model adopted by the EU in the Lamfulussy Process – and which is now being viewed as less than satisfactory in the context of the operations of a truly single European financial market, even at the wholesale level only, as largely existed prior to the current crisis. At the same time, the experiences of the IOSCO MMoU provide potentially a very useful model for the development of the FSB as a truly international self-regulatory organisation, of the sort familiar to financial regulators around the world. In this way, standard-setting would continue to rest with individual standard-setting organisations such as the Basel Committee, IOSCO and the like, with coordination through the FSB. Under this framework, the FSB would be a membership organisation, with requirements for initial and continuing membership and monitoring of those requirements through peer review (similar to the IOSCO MMoU and FATF mutual evaluation systems). Under this structure, membership would be open at varying levels, with differing requirements and monitoring.

Overall, the FSB might work reasonably well when it comes to coordination and prevention functions without it being a hard law institution, but the issue which remains is how to handle cross-border financial institution failures. Although the FSB will play a role in facilitating discussion among its members, what is lacking from the system is the ability to put its members under binding obligations that will lead to a greater willingness to burden share the costs of cross-border bank failures. Some form of binding arbitration mechanism might

77 One approach would be a new treaty: Barry Eichengreen, 'Not a New Bretton Woods but a New Bretton Woods Process,' in Barry Eichengreen and Richard Baldwin (eds), *What G20 Leaders Must Do to Stabilise Our Economy and Fix the Financial System* (2008) 25 <http://www.voxeu.org/reports/G20_Summit.pdf> at 12 August 2009. Another possible approach would be an amendment to the BIS Charter, to provide the BIS with an explicit mandate in the area of financial regulation and formally bringing the FSB under its umbrella. Under this approach, the FSB would become part of an existing international institution without the necessity of establishing a new institutional framework.

be the best way to achieve this (and this in fact is the approach being pursued in the EU), but without a more formal and binding arrangement for burden sharing and dispute resolution arrangement, probably through a formal treaty and/or international organisation, the problems raised by the failure of global financial institutions will not be adequately addressed by the current approach to international financial regulation.⁷⁸ As in many ways these were amongst the major causes of the systemic phase of the global financial crisis, failing to properly address these issues must be seen as either indicating that significant risks will continue to exist in the context of global finance or a tacit conclusion that finance and financial institutions will no longer in fact be global. Unfortunately, based on the unsuccessful experience of the IMF's proposals for a sovereign debt restructuring mechanism,⁷⁹ the outlook in the context of the perhaps even more complicated arena of failure resolution mechanisms for cross-border financial institutions is not overly bright.

78 For discussion of possible domestic responses, see Turner, above n 4; Arner and Norton, above n 46 (arguing that, in the absence of effective international arrangements, individual jurisdictions should adopt an approach based on requirements for separately capitalised and regulated subsidiaries for foreign financial institutions).

79 See International Monetary Fund, *Factsheet – Proposals for a Sovereign Debt Restructuring Mechanism (SDRM) – Includes Questions and Answers on SDRM* (2003) <<http://www.imf.org/external/np/exr/facts/sdrm.htm>> at 12 August 2009. See also Ross Buckley, *International Financial System: Policy and Regulation* (2008) 145–50.