The global financial crisis of 2007-2008 demonstrated serious weaknesses in global financial governance and has led to comprehensive reforms of international financial regulation. The G20 and the Financial Stability Board have taken the lead post-crisis with efforts to make international financial standard setting more accountable and legitimate by involving more countries in the standard setting process and by making deliberations more transparent and reflecting the views of a broader number of stakeholders. Moreover, the G20 initiated at the Pittsburgh Heads of State Summit in September 2009 an extensive reform of international financial regulation with the overall aim ‘to generate strong, sustainable and balanced global growth.’ An important feature of the international regulatory reforms has been the G20’s stated objective to make financial regulation more ‘macro-prudential’, that is, to address risks and vulnerabilities across the financial system and broader economy that might threaten the stability of the financial system – and hence imperil the stability and sustainability of the economy.

Since the 1970s, increasing liberalisation of financial markets and cross-border capital flows have brought more liquidity to financial markets during periods of market confidence, but have proved to be a channel for contagion during periods of fragility and crisis. These cross-border linkages between national financial systems have led to the emergence of a globalised financial market in banking, wholesale securities, and asset management. Indeed, the move from segmented national financial systems to a liberalised and globalised financial system has posed immense challenges to financial regulators and supervisors, including the need to adopt more effective regulation and supervision across financial systems and to
enhance coordination between states in supervising on a cross-border basis and internationally.

The crisis demonstrates the need to adopt a more holistic approach to financial regulation and supervision that involves linking micro-prudential supervision of individual institutions with broader oversight of the financial system and to macroeconomic policy. This paper argues that the ‘macro-prudential’ dimension of financial regulation will have important implications for global financial governance and will require more accountability and legitimacy in the international financial standard setting process. First, the paper traces the development of international financial standard setting from the 1960s to the reforms following the 2007-08 crisis. Second, the paper defines the concept of ‘legitimacy’ in public international law and suggests that any reform of global financial governance should include a wider definition of ‘legitimacy’ that reflects a broader view of stakeholder interests that must be taken into account. Third, the paper considers the post-crisis international regulatory reforms and whether they adequately address regulatory weaknesses and represent relevant stakeholder interests. Fourth, the paper suggests that although international reforms have addressed the interests of wider stakeholder groups through macro-prudential regulation, more should be done to address stakeholder concerns regarding the impact of environmental and social risks on financial stability.

1. RELEVANT GLOBAL ORGANISATIONS/INSTITUTIONS


In international finance, the globalization of financial services has necessitated that regulators develop cooperative relations to facilitate their oversight and regulation of banking and financial services. Beginning in 1962, the central banks of the ten leading industrialized nations began to meet regularly at the Bank for International Settlements1 and other venues to coordinate central bank policy and to organize lending to each other through the General

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1 The Bank for International Settlement (BIS) is an international organization created under the Hague Agreements of 1930 and the Constituent Charter of the Bank for International Settlements of 1930. It was established in the context of the Young Plan, which dealt with the issue of the reparation payments imposed on Germany by the Treaty of Versailles following the First World War. The BIS served as the payment agent for the European Payments Union (EPU, 1950-58), which facilitated the restoration of currency convertibility for the western European countries following the Second World War. See Daniel Gros & Niels Thygesen (1998) *European Monetary Integration* (2nd ed.) pp. 4-8.
Arrangements to Borrow. These ten countries (plus the Swiss National Bank) became known as the Group of Ten or G10.

It is important to emphasise that the central bank governors of the world’s advanced industrialised countries were responsible for setting the agenda of the G10 committees and that in the G10’s early years much of their activity – central bank operations and lending to one another - concerned the maintenance of each country’s currency exchange rate parity within the IMF’s fixed exchange rate regime. In the 1960s, the G10 central bank governors established two committees whose secretariats were based at the BIS. The first of these committees was the Eurocurrency Standing Committee (also, known as the Markets Committee, 1962). Founded in 1962, it was formed to monitor and assess the operations of the then newly established Euro-currency markets. This Committee later became the Committee on the Global Financial System in 1971. It now deals with broader issues of systemic risk and financial stability. And the Committee on Payment and Settlement Systems was formed in 1990 to negotiate and set standards to support the continued functioning of payment and settlement systems.

In the early 1970s, after the IMF exchange rate regime collapsed, the G10 was confronted with extreme volatility in the foreign exchange markets and imbalances caused by ‘petro dollar’ flows from oil producing countries following the Arab oil embargo. These market developments led the G10 to establish the Basel Committee on Banking Regulation and Supervisory Practices in December 1974, which is today known as the Basel Committee on Banking Supervision, to address cross-border coordination issues between central banks and bank supervisors in overseeing cross-border banking activity. The Basel Committee was

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4 Indeed, Goodhart described the relationship of the G10 with one of its standard-setting committees—the Basel Committee—as one of delegated authority to engage in regulatory standard setting: ‘Having established a standing committee of specialists in this field, the G-10 Governors would find it difficult to reject a proposal from them, especially on a technical matter. The relationships between the G-10 Governors and the BCBS emerge from the analysis of what the BCBS actually did and were quite complex. The G-10 Governors set priorities for work, and frequently required papers to be revised and reconsidered. But at the same time they often gave the BCBS considerable freedom to decide its own agenda, and frequently rubber-stamped the papers emerging; basically the Governors did not have the time or the desire for textual criticism. They had a general oversight role; the detail was to be hammered out in the BCBS’. Charles A. E. Goodhart (2011) A History of the Basel Committee on Banking Supervision (Cambridge: Cambridge University Press), chapter 14.
formed in response to a serious threat to banking stability caused by collapse of the German bank Herstatt, which had created significant problems in the foreign exchange settlement markets between U.S. and European banks. In the same year, the U.S. Franklin National Bank became insolvent and posed a risk to counterparty banks because of its miscalculations of foreign exchange risk in the wholesale loan market. These bouts of financial instability exposed substantial gaps in the ability of central bankers and national regulators to control and manage banking sector instability with cross-border effects.

Since the 1970s, the three main G10 committees – the Basel Committee on Banking Regulation, the Committee on Payment and Settlement Systems, and the Committee on the Global Financial System – have become the most influential international standard setting bodies by exercising either direct or indirect influence over the development of banking, currency and market operations, and payment system law and regulation for all developed countries and most developing countries. Specifically, the Basel Committee has produced a number of important international agreements that regulate the amount of capital that banks must set aside against their risk-based assets and the allocation of jurisdictional responsibility for bank regulators in overseeing the international operations of banks. Its activities have usually been kept away from the fanfare of high politics, but its efforts in the early 2000s to adopt Basel II and to extend its application to all countries where international banks operate attracted significant critical comment and brought its work under close scrutiny by leading policymakers and regulators.

The Committee on Payment and Settlement Systems has produced important agreements setting forth principles and recommendations for the regulation of bank payment systems and have worked with the International Organisation of Securities Commissions (IOSCO) to adopt principles and standards for the regulation of clearing and settlement of financial instruments.

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5 Walker (2000) observes that:
‘International standards have become of particular importance in recent years due to the need to develop some common or, at least, minimum level of rules and regulations in various core areas of modern financial and economic practice. In light of the difficulties that naturally arise in attempting to agree any formal treaty, convention or similar formal prescriptive solution at the international level, a more informal consensus based approach has to be attempted, at least, during the early stages until some basic common agreement (and supporting sense of self-interest and commitment) may be achieved. This will certainly be the case in many such sensitive and complex areas as international bank and financial market control. A standards based approach also has the obvious advantage of flexibility and informality although this necessarily means that it suffers from the associated operational limitations of weak adoption and compliance. The key issues that then arise with international standards are not with regard to legal classification and formal enforcement but with national adoption and implementation and implementation review’. (Preface, p. xxiii).
securities and derivatives trading. The Committee on Global Financial Systems, though it has not adopted regulatory principles or recommendations, has produced a number of influential reports that have influenced the debate over macro-prudential financial reforms post-crisis to control systemic risk across financial systems and the interrelationship with monetary policy.

These Committees have examined many important central banking and financial regulatory issues, as well as attempted to elaborate and promulgate best practices in supervision and regulation, the functioning of payment and settlement systems, and the overall operation of financial markets. The Committees are usually chaired by senior officials of member central banks and are composed of experts from central banks, regulatory authorities, and finance ministries. In the case of the Basel Committee on Banking Supervision, members also include non-central bank supervisory authorities and other regulatory and economic policy experts. Members of the Committees have voting power and decision-making authority, while non-G10 country representatives were often consulted for their views on a variety of regulatory and economic issues. Frequently, special initiatives are undertaken to share experience with, and invite the opinions of, those not directly involved in the work of the Committees. In promoting cooperation in their respective areas, the Committees determine their own agenda and, within their mandate, operate independently from their host organization, the BIS, which only provides its good offices for meetings as well as administrative and research support. Significantly, these Committees have resolved not to adopt legally binding international standards in a public international law sense, but rather to influence domestic regulatory practices and standards by adopting what has become known as “international soft law.”

The Basel Committee has been the most influential of the G10 committees with respect to its impact on developing legally nonbinding international financial norms of banking regulation standards, especially through the adoption of the Capital Accord, the Concordat, and the Core Principles for Effective Banking Supervision and their impact on domestic regulatory and supervisory practices. For instance, the Basel Committee’s Concordat – adopted in February 1975 - established principles of information exchange and cross-border coordination for the oversight of the international banking operations. The 1983

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6 See Kern Alexander, Rahul Dhumale and John Eatwell (2006, OUP) Global Governance of Financial Systems: The International Regulation of Systemic Risk (chap. 3, discussing international soft law). As an international legal matter, the Basel Capital Accord and its amended version, Basel II, are not legally binding in any way for G10 countries or other countries that adhere to it. The Capital Accord has been analyzed and classified as a form of “soft” law. See Alexander et al., supra note, at 135-37.
Revised Concordat contained the principle of consolidated supervision; this principle provides that home country regulators shall have responsibility for ensuring that the transnational operations of their home country banks are sound regarding credit risk exposure, quality of assets, and the capital adequacy of the banking group’s global operations, while the host country authority will mainly be responsible for the provision of local liquidity to foreign banks.

Following the Latin American debt crisis of the early 1980s and the near collapse of several major U.S. banks, the Basel Committee adopted the 1988 Capital Accord, which established a minimum eight percent capital adequacy requirement on internationally active banks within G10 country jurisdictions. The Capital Accord was originally calculated based on a bank’s credit risk exposure, but was later amended in 1996 to include a bank’s market risk exposure (i.e., trading book exposure), thereby extending the eight percent capital adequacy requirement to a bank’s trading book activities. Between 1999 and 2004, the Committee engaged in a lengthy and radical revision of the Accord known as “Basel II.” The revision was concluded in 2004, and the Committee published a final text of the revised Capital Accord in June 2004.

Basel II aimed to make regulatory capital more sensitive to the risks which banks face in the marketplace. In doing so, it allowed banks, under most conditions, to hold less regulatory capital for their credit, market and operational risk exposures than what was required under Basel I. The global credit crisis of 2007-08, however, revealed that banks are also exposed to significant liquidity risks, especially in their off-balance sheet exposures, and

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7 The 1975 Concordat was amended in 1983 in response to the collapse and insolvency of the Italian bank Banco Ambrosiano. The 1983 Revised Concordat was entitled Principles for the Supervision of Banks’ Foreign Establishments.

8 See Alexander et al., Global Governance, supra note, pp. 47-48.

9 The 1988 Capital Accord’s original purpose was to prevent the erosion of bank capital ratios resulting from aggressive competition for market share by the leading banks during the 1980s. The Accord also hoped to harmonize the different levels and approaches to capital among the G-10 countries. In adopting the 1988 Accord, banking regulators wanted to establish an international minimum standard that would create a level playing field for banks operating in the G10 countries and that banking regulators wanted capital requirements to reflect accurately the true risks facing banks in a deregulated and internationally-competitive market. The 1988 Capital Accord required banks actively engaged in international transactions to hold capital equal to at least 8 per cent of their risk weighted assets. This capital adequacy standard was intended to prevent banks from increasing their exposure to credit risk by imprudently incurring greater leverage. The 1988 Capital Accord was entitled ‘International Convergence of Capital Measurement and Capital Standards’ and it applied based on the principle of home country control to banks based in G10 countries with international operations (Basel 1988).

10 This was known as the Market Risk Amendment 1996. See Alexander et al (2006, pp. 38-39)
that banks should hold more loss-absorbent capital. Basel II failed to address the liquidity risks to which banks are exposed and also did not require banks to hold adequate levels of loss-absorbent capital. Moreover, Basel II’s excessive reliance on risk-weighting of assets to calculate regulatory capital resulted in procyclicality – that is, banks holding too little capital during market upturns and too much capital during downturns.\(^\text{11}\) It also favoured large banks with sophisticated data bases over small banks with less data in that it allowed larger banks to hold less capital as a percentage of risk-weighted assets compared to medium-sized and smaller banks. It also advantaged the banking systems of advanced economies at the expense of less-developed and emerging market economies, as banks in advanced economies had access to large amounts of default data on borrowers and counterparties, therefore were in a better position to devise risk models based on this data that would qualify the bank for a lower capital requirement. Moreover, the procyclicality of Basel II had pernicious effects on economies that were more prone to volatility and booms and busts – specifically, developing and emerging market economies.

The Basel Committee responded to the 2007-2008 financial crisis by adopting further amendments to Basel II, which became known as Basel III. Basel III requires an increased level of Tier One regulatory capital to 4.5% from 2% plus a 2.5% capital conservation buffer, a tighter definition of tier one capital to include mainly ordinary common shares and retained earnings, and up to an additional 2.5% countercyclical capital ratio that will be adjusted across the economic cycle.\(^\text{12}\) Basel III also contains liquidity requirements that include a ratio for stable wholesale funding, liquidity coverage ratios, and an overall leverage ratio. Also, an additional capital charge of up to 2.5% regulatory capital will be required for large and interconnected systemically important financial institutions (SIFIs).

Despite significant increases in capital and liquidity requirements, Basel III essentially builds on the edifice of Basel II by leaving in place the Basel II risk-weighting regime. However, Basel III requires regulators to challenge banks more in the construction of their models and broadens regulatory authority to require banks to undergo more frequent and demanding stress tests. The Pillar 2 review also consists of a supervisory review enhancement


process (SREP) that includes separate assessments of bank capital and governance. The SREP can be utilised to forecast the bank’s exposure to systemic risks and related macro-prudential risks. The SREP is also designed to address bank corporate governance and risk management. The corporate governance dimension of Pillar 2 is important for assessing the effect of Basel III on broader stakeholders who are affected by the regulation and supervision of banks. Enhanced bank corporate governance is designed not only to promote bank shareholder value but also to control and limit the potential social costs of weak bank management and the deleterious effect on the broader economy. In other words, pillar 2 of Basel III – especially through the SREP process – is concerned the effect of bank governance and risk management on stakeholders – those in the economy who are directly and indirectly affected by banks. As discussed below, a significant of Basel III (and of Basel II) can be utilised to address environmental and social governance issues.

The Committee on Payment and Settlement Systems and the Committee on the Global Financial System

The other G10 committees that serve as international financial standard setting bodies—the Committee on Payment and Settlement Systems and the Committee on Global Financial System—have adopted standards, principles, codes, guidelines, frameworks, and reports that have had a significant impact on the development of domestic public law standards, national regulations, and supervisory practices. The CPSS consists of the G10 central bank officials who examine issues of payment system regulation as well as clearing and settlement of securities and foreign exchange transactions. The Committee undertakes specific studies in the field of payment and settlement systems at its own discretion or at the request of the G10 Governors. It has published several important sets of principles and recommendations in the areas of payment system regulation and clearing and settlement of securities. The Committee operates through a network of working groups. To address concerns that it is merely an exclusive committee of G10 central bankers, the Committee has in recent years developed relationships with other central banks, particularly those of emerging market economies, so that its work can have more influence with, and be influenced by, central banks outside the G10. The CPSS has also published a number of reports that have

13 The CPSS’s publication of the Core principles for systemically important payment systems, the CPSS/IOSCO Recommendations for securities settlement systems and the CPSS/IOSCO Recommendations for central counterparties, has contributed to the set of standards, codes and best practices that are deemed essential for strengthening the international financial system. See <http://www.bis.org/cpss/index.htm>.
influenced the regulation of payment infrastructure and settlement systems. As with the Basel Committee, the principles and recommendations issued by the CPSS are not legally binding, as regulators seek to agree on standards that different jurisdictions can flexibly implement into their regulatory regimes. Although these international standards are without legal effect, they provide an important set of international norms that influence regulatory and supervisory practices and the standards for controls and oversight of financial infrastructure.

Similarly, the Committee on Global Financial Systems monitors developments in global financial markets for the G10 central bank Governors. The G10 Governors have provided a mandate to the Committee to identify and assess potential sources of stress in global financial markets. The Committee engages in research to identify issues and threats to systemic stability in global financial markets, examine the structural underpinnings of financial markets, and promote improvements to the functioning and stability of these markets. Representatives of the G10 monitor on a quarterly basis the discussions and reports issued by the Committee. As mentioned above, they also work with the Committee to identify long-term research projects involving working groups consisting of central bank and regulatory staff and the drafting of various reports.

Other international supervisory bodies have also played a key role in developing international standards and rules for the regulation of financial markets. The International Association of Deposit Insurers meets at the BIS and discusses and adopts international principles and standards that govern deposit insurance regulation. In the area of money laundering and terrorist financing, the OECD’s Financial Action Task Force (“FATF”) has attained a high profile role in setting international standards (so-called recommendations) of disclosure and transparency for the regulation of banks, financial service providers, and other businesses in order to combat the global problem of financial crime. The FATF and the Basel Committee have each played a much more prominent role in their respective

14 The Committee has published various reports examining large-value funds transfer systems, securities settlement systems, settlement mechanisms for foreign exchange transactions, clearing arrangements for exchange-traded derivatives and retail payment instruments, including electronic money. Its 'Red Book' on payment systems provides extensive information on the most important systems in the CPSS countries.

15 G10 Committee of Central Bank Governors, Mandate As approved by the Governors of the G10 central banks (8 February 1999), see <http://www.bis.org/cgfs/mandate.htm>.

16 See also the International Accounting Standards Board (IASB) and the International Federation of Accountants (IFAC) are bodies composed of professional accountants and academics who devise international accounting standards for the accounting industry. Similarly, the International Auditing and Assurance Standards Board (IAASB) sets standards for international financial reporting. See <http://www.ifac.org/Committees/>, last visited 27 October 2007.
international regulatory standard-setting functions as compared to the International Organization of Securities Commissions (“IOSCO”) and the International Association of Insurance Supervisors (“IAIS”). In recent years, however, IOSCO and the IAIS have attracted much more policy attention since their standards and recommendations have been recognized by the IMF and World Bank as international benchmarks against which IMF and World Bank member countries are assessed for compliance in their financial sector assessment programs.

As discussed above, these international standard-setting bodies have been characterized as “networks” of international technical experts, which are not concerned with broader public policy or international political economy issues. Rather, they are at the “coal face” of technical and regulatory standard setting. The goal of these regulatory technicians in international bodies is to coordinate regulatory and supervisory oversight of international banks and financial conglomerates with operations across financial sectors. These networks are composed of national regulators and supervisors—mainly from developed countries—who have established several international bodies to coordinate communication and the exchange of ideas among regulators on common issues of concern. These regulatory networks play an important role in disseminating information among regulators across financial sectors in different jurisdictions.

The Joint Forum on Financial Conglomerates (“Joint Forum”) and the Financial Stability Forum have both been characterized as intergovernmental standard-setting bodies. They are composed of regulators and supervisors from the G10 and G20 countries and some large emerging market countries, and of representatives from other G10 standard-setting bodies. Established in 1996 under the aegis of the BCBS, IAIS, and IOSCO,17 the Joint Forum issues legally nonbinding documents and principles. In contrast to its constituent international bodies, the Joint Forum has established a set of principles designed to assist regulated entities in determining the minimum steps they should take when considering outsourcing activities. These include creating a coherent policy and specific management plan for programs as well as deciding the types of issues that should be considered in contracts. The Joint Forum also issues reports that contain broad principles to help supervisors.18 It develops its principles in conjunction with the IOSCO, which produces principles designed for the securities industry.19 The Joint Forum’s principles are in its own words “high-level and

17 See Alexander et al., Global Governance, supra note 17, p. 50.
18 Ibid.
19 Ibid.
cross-sectoral, designed to provide a minimum benchmark” for all financial institutions.20

Before the 2007-8 crisis, the Financial Stability Forum coordinated activities relating to issues common to the banking, securities, and insurance sectors. As the common body of three international financial standard setters, the BCBS, the IAIS, and the IOSCO, the Forum set soft law in the form of guidance21 and reports22 in the form of broad principles, which serve to establish a minimal standard.23 Crucially, it involved representatives of the banking and financial services industry in its deliberations and they played an important role on FSF working groups that published papers on regulatory reform that had significant influence on the work of the BCBS, the IAIS, and the IOSCO.

2. External stakeholders and legitimacy challenges

The legitimacy of global financial governance under international law

In contrast to international economic organizations such as the WTO or IMF, most international financial standard-setting bodies are not entities with separate legal personality created by States, but rather informal associations of state representatives and/or professionals that address specific problems or to identify issues of concern that have cross-border or international effect.24 As discussed above, the substantive content of international financial standards are expressly non-binding in a legal sense, but nevertheless these standards have considerable impact on the financial policies and regulations of most states because of a number of official sector incentives and constraints and private market pressures. The wide

20 Ibid. In contrast to the IOSCO principles, the Joint Forum minimal benchmarks are complementary and “more focused and designed specifically for securities firms.”

21 See Alexander, et al., Global Governance, supra note , pp. 74-76.
22 Ibid. For a list of FATF reports, see http://www.fsforum.org/
23 The Financial Stability Forum (FSF) was established in 1999 in response to the Asian financial crisis and is composed of regulatory officials from leading developing countries and some large developing countries. It relies on the work of the other international financial standard setting bodies and the central banks and the various departments of the OECD. See <http://www.fsforum.org/about/who_we_are.html>, last visited 17 September 2004. The FSF has compiled a Compendium of Standards (CoS) with a summary and classification of the most significant rules, best practices, principles and guidelines of international financial regulation. They are categorized according to the sector they pertain to, such as government and central bank, banking, securities, and insurance industries, and the corporate sector, and functionally, such as to governance, accounting, disclosure and transparency, capital adequacy, regulation, and supervision, information sharing, risk management, payment and settlement, business ethics etc., and according to their specificity in principles, practices and guidelines. See <http://www.fsforum.org/compendium/what_are_standards.html>, last visited 17 September 2007
24 On an institutional level, the BCBS has no authority to take a decision of its own and has no formal legal mandate. It merely serves as a forum for discussion amongst central bankers and bank supervisors. It voluntarily adopts common regulatory standards and suggested financial policies, but leaves it to the discretion of national authorities to implement them into their national systems.
impact and application of international financial standards to almost all countries suggests that the decision-making processes that generate these norms could be subject to applicable international legal norms. This section argues that the principle of legitimacy, as it relates to state decision-making in international economic norm development, is set forth in variety of international legal instruments as discussed below and governs most areas of inter-state relations, especially those regarding international economic and financial norm development.

1. The Requirement of a democratic and equitable international economic order

The UN General Assembly has stressed the importance of a democratic and equitable international order in a number of resolutions.25 Most recently, General Assembly Resolution 63/189 notably applies this principle to the international economic order by stating:

“(t)he right to an international economic order based on equal participation in the decision-making process, interdependence, mutual interest, solidarity and cooperation among all States.”26

Moreover, General Assembly Resolution 3201 requests states to adhere to the following principles regarding the organization of the international economic system:

“b. The broadest co-operation of all the States members of the international community, based on equity, whereby the prevailing disparities in the world may be banished and prosperity secured for all;

c. Full and effective participation on the basis of equality of all countries in the solving of world economic problems in the common interest of all countries, bearing in mind the necessity to ensure the accelerated development of all the developing countries, while devoting particular attention to the adoption of special measures in favour of the least developed land-locked and island developing countries as well as those developing countries most seriously affected by economic crises and natural calamities, without losing sight of the interests of other developing countries; […]

e. […] No State may be subjected to economic, political or any other type of coercion to prevent the free and full exercise of this inalienable right; […]”27

Even though these provisions are legally non-binding and primarily intended to address the economic inequalities between western developed and former colonial countries,28


27 UNGA Res. S-6/3201 (N 34) cipher 4 (emphasis by author).
they reveal two things: First, regarding substantive content they suggest a growing understanding that prosperity and development are universally desirable aims. Second, they clarify that the fate of the global economy, and the questions inevitably connected to it, should not be determined by a handful of economically advanced nations, but by a broader range of countries, including developing and least-developed countries (LDCs). In fact, Resolution 3201 strongly encourages effective co-operation of all members of the international community based on the principle of equality. If the authority to determine the content of international financial norms and to issue regulations lies in the hands of a few countries, this may result in a greater imbalance of economic and political power and create (another) oligarchy in international relations. Indeed, this would be contrary to an equitable economic order and may endanger economic and political stability.

2. Universalized institutions and legitimacy principles in international law
   
a) Development of institutions and procedural principles

Since the founding of the United Nations, the international community has developed rules and procedures to address and resolve problems arising from the challenges of globalisation. For instance, decolonisation and the subsequent acceptance of newly decolonized states into the international community as sovereign members are important achievements in the history of international law. The UN has achieved a near universal membership of 192 states, all of which have voting rights in the General Assembly as well as in various UN committees. Indeed, the influence of developing and emerging market countries in the decision-making structures of most international organisations has grown despite persistent economic and social inequalities between developed and developing countries that are still partly reflected in the institutional structures of these organisations.

Although the Bretton Woods institutions - the World Bank and the International Monetary

29 UNGA Res. S-6/3201 (N 34) cipher 3 “Thus the political, economic and social well-being of present and future generations depends more than ever on co-operation between all the members of the international community on the basis of sovereign equality and the removal of the disequilibrium that exists between them.”
30 See however C P Kindleberger, The World in Depression 1929-1939 (University of California Press 1986) (espousing hegemonic stability theory arguing for the need of a hegemonic power (or few powers) who are able and willing to serve as an international lender of last resort for other countries experiencing temporary funding problems in order to maintain a stable global financial system).
31 UNGA Res. S-6/3201 (N 34).
32 This is according to economic value of quotas of their members which are determined in part by members economic output, see: IMF, IMF Members’ Quotas and Voting Power, and IMF Board of Governors <www.imf.org/external/np/sec/memdir/members.aspx> accessed 1 April 2014.
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Fund - and the World Trade Organisation have established near universal regimes to coordinate and regulate the economic, monetary and trade policies of their member countries, respectively, decision-making and agenda setting in these organisations remains largely in the domain of developed countries and a few large developing countries. At the same time, regional organisations and associations have been established (outside the European Union), such as the African Union (AU), the Organization of American States (OAS), and the Association of Southeast Asian Nations (ASEAN), to promote regional cooperation in economic, financial and trade matters, and have made progress in integrating developing and emerging market countries into their decision-making structures.

The development of international law in the post-war era, however, has not been limited to the institutional dimension. Indeed, international law has established fundamental norms and principles of law and procedure that serve as reference points to assess the legitimacy (or legitimation) of international institutions and the effectiveness of the rules and norms they create. In this regard, international law consists of both important substantive norms and principles (so-called material legitimacy) as well as fair decision-making processes and ways of reaching conclusions and opinions on contentious issues (so-called procedural legitimacy). Although material legitimacy is necessary and desirable for a functioning legal

33 The WTO has 153 and the IMF has 187 member states. The OECD has a limited circle of members because it is generally only open for democratic countries with liberal economic systems. Also, discussing the role of law in monetary and trade policy, see E Baltensperger and T Cottier, ‘The Role of International Law in Monetary Affairs’, in International Law in Financial Regulation and Monetary Affairs (Oxford: OUP) 357-381, pp 371-74.


37 This paper does not distinguish between the two terms legitimation and legitimacy even though legitimacy is sometimes used with a different meaning. Legitimation generally means the justification of political power under normative and sociological (factual) aspects. See R Wolfrum, ‘Legitimacy of International Law from a Legal Perspective: Some Introductory Considerations’ Legitimacy in International Law (Beiträge zum ausländischen öffentlichen Recht und Völkerrecht, 1994) 1 et seqq., 6; N Petersen, ‘Demokratie als teleologisches Prinzip, Zur Legitimität von Staatsgewalt im Völkerrecht’ (Beiträge zum ausländischen öffentlichen Recht und Völkerrecht, Band 204) 2009 5.

38 See D Thürer, ‘Von der komplexen Gestalt des Völkerrechts’ 2005-present (Internationale Gemeinschaft und Menschenrechte, 2005) 307ff, 313: The realization that legitimation of international rules, regime and international order as a whole emerges from processes of open and fair forming of opinion is important; see also T Franck, Fairness in International Law and Institutions (Clarendon Press 1995).
and political system, it cannot guarantee its full acceptance by states over time unless there is procedural legitimacy. To this end, Franck (1990) has defined legitimacy as:

“[…] a property of a rule or rule making institution which itself exerts a pull toward compliance on those addressed normatively because those addressed believe that the rule or institution has come into being and operates in accordance with generally accepted principles of right process.”

In light of Franck’s definition, it seems questionable whether and to what extent there is a trade-off between legitimacy and efficiency in decision-making as is often suggested. Especially with respect to international law, which largely lacks centralised decision-making authorities and enforcement procedures, but rather relies on universal adherence by states and decentralised compliance structures, material and procedural aspects of legitimacy, as defined by Franck, seem to have merged in a conceptual sense.

Although the international financial bodies mentioned above accomplished a great deal in developing international regulatory standards, their decision-making frameworks have been largely controlled by the advanced developed countries and more recently by a few large emerging market economies (so-call ‘BRIC’ nations). Based on Franck’s theory of legitimacy, it is submitted that the many developed and developing countries that have neither been adequately consulted, nor meaningfully involved in developing the content of international financial norms. Nevertheless, they are subjected to these norms and therefore have reason to question their effectiveness and legitimacy on the grounds that these norms have not been formed in accordance with generally accepted principles of right process. On the other hand, however, the decision-making of these institutions represents established values and time-tested, approved procedures of multilateral collaboration. Nevertheless, a more universalised approach in international economic and monetary rulemaking has evolved in international organisations such as the IMF, World Bank and WTO and some of the UN economic agencies. In particular, some consider that the United Nations is the only global institutional forum with universal membership whereby states can negotiate and decide

economic, monetary and trade matters with an acceptable degree of legitimacy. These accomplishments should not be jeopardised through new forms of international governance that fail to incorporate generally accepted principles of legitimacy as applied by international law to the decision-making of international institutions.

b) Rule of law, principle of democracy and good governance

In connection with Franck’s “generally accepted principles of right process”, three widely recognised systems of legal rules stand out whose meaning shall be investigated more closely: First, the growing recognition and importance of the principle of the rule of law, which demands that all authoritative acts are to be governed by a pre-existing system of substantive and procedural rules, can be observed. For instance, some common lawyers assert the basic principles of the rule of law to be Fuller’s classic eight principles. Under international law, the rule of law can be applied to international institutions as well. Indeed, Harlow (2006) has observed that:

“[i]n classical administrative law systems, then, the rule of law normally requires that the government acts always within its powers; follows the proper procedures; and provides equality of access to courts and other machinery for adjudication. […] At global level, the key requirement of the rule of law is a legal order with fixed and stable general principles, together with formal rights of access to courts for the resolution of disputes. The rule of law doctrine may also operate to lock the machinery in place through a process of constitutionalization.”

Second, the principles of democracy have practically been universalized during the last few decades. Democracy has become an obligation of international law defining how states should organize themselves and from which a right to democracy can be derived. It

has become a general principle of law that legitimises the exercise of power and the maintenance of political order that applies across national borders as well as to international organisations and institutions of all kinds.\textsuperscript{46} Democracy, rightfully called the “organizational consequence of human dignity”,\textsuperscript{47} is based on the principle of being affected, or otherwise known as the “all-affected principle”.\textsuperscript{48} The all-affected principle is an important principle of democracy that involves identifying those people who exercise decision-making or governance powers and those people who are governed by such powers, and demands the participation of all addressees in the decision-making process. Another criterion is the accountability of all governmental or institutional actors who are entrusted with executing delegated public tasks.\textsuperscript{49}

The good governance standard is the third system of rules closely connected to and overlapping with the first two.\textsuperscript{50} These standards are not only expected to be implemented on a national level by state and administrative departments but also on an international level. In this regard, the EU has played a pioneering role by adopting a system of rules and standards to fulfil the principles of transparency and openness, democratic accountability and participation and responsiveness.\textsuperscript{51} Even though the EU has a strongly integrated institutional and legal structure, its governance framework could become a model for other international institutions with less integrated structures.\textsuperscript{52} In practice, good governance requires the alignment of state interests with the interests of the identified group of people over whom the


\textsuperscript{52} Ibid (N 57). However, for a critique in light of EU Democratic Deficit Debate see Charlemagne, ‘A democratic debate’ (The Economist, 26 October 2013).
state exercises governance authority. These governance principles also apply at the supranational and international levels with the exercise of decision-making power being subject to the aforementioned principles of transparency and openness, accountability, participation and responsiveness.\textsuperscript{53}

These three systems of legal rules have become widely recognized criteria for any form of exercise of power.\textsuperscript{54} For these reasons, adherence to all mentioned criteria has become indispensable for determining the legitimacy of multilateral cooperation and decision-making.

**The legitimacy of international financial standard setting and external stakeholders**

The international financial bodies lack the requisite attributes of an international organization, namely, they are not subject to international law, and do not have international personality, the capacity to conclude treaties, or international legal immunities. Insofar as these organizations are neither composed of States nor founded upon an international treaty, they also do not meet the traditional legal definition of an international organization and therefore are not subject to minimum rules of transparency regarding, for example, the keeping of meeting minutes and other records concerning decision-making and deliberations. It is argued in some quarters that this lack of accountability in decision-making and operational processes can potentially undermine the effectiveness and legitimacy of the IFIs. On the other hand, other commentators suggest that precisely because these international standard-setting bodies are devoid of legal personality and excluded from the potential discipline of international law, they gain in flexibility and enhanced coordination benefits, by not being subject to formalistic rules of decision-making process and consultation, and therefore are in a position to devise international norms that turn out to be more effective in influencing state practice than traditional methods and procedures of public international law-making.\textsuperscript{55} The worldwide credit crisis, however, has called the efficacy of this flexible and unstructured decision-making framework into question and in particular has raised concerns regarding the accountability and legitimacy of the IFI standard setting processes.

\textsuperscript{53} Good governance is not always defined the same and with such the principles assigned to them vary. The ones mentioned however are the ones most commonly named: see S Seppänen (N 58) 100ff.
\textsuperscript{54} See Harlow (N 52) 211, expressing a sceptical view.
\textsuperscript{55} See Alexander et al. (2006) pp. 136-139.
In assessing whether the Basel Committee’s standard setting process complies with the principle of legitimacy as discussed above, a closer look at the Basel Committee’s deliberation and decision-making process is necessary. The Basel Committee addresses issues that are of global concern to regulators and supervisors through a set of committees established to address particular issues of concern to bank regulators. After committees deliberate they issue recommendations to the Basel Committee Secretary General and Deputy Secretary General who are in position to table recommendations or issues of concern (including reports by external bodies) to Committee. The Basel Committee’s decision-making operates on a consensus basis. Although the Committee’s decision-making has traditionally been secretive and substantially relied on personal contacts, it has become more formalized in recent years because of the considerable attention given to the deliberations over Basel II.56

As discussed above, the Committee’s decisions are legally nonbinding in a traditional public international law sense and place a great deal of emphasis on decentralized implementation and informal monitoring of member compliance.57 The Committee has sought to extend its informal network with banking regulators outside the G10 through various consultation groups.58 Most recently, it has conducted seminars and consultations with banking regulators from over 100 countries as part of the deliberations over adopting the Basel II agreement.

Although some have viewed the informality of the Committee’s decision-making process as effective for developing international banking regulatory standards,59 others have considered it a constraint on effective implementation.60 As Goodhart has observed, “The way that the BCBS, under its various Chairmen, interpreted this constraint was that all proposals for forward transmission to the G-10 Governors, and thence to the wider community of

56 For instance, during the Basel II negotiations, the Committee put a number of issues for consultation on its website and engaged in a public dialogue on its website through the publication of its quantitative impact studies which measured the impact of Basel II on a hypothetical basis based on the reports of a number of banks in both G10 and non-G10 countries.

57 Indeed, the Basel Committee states on the BIS website http://www.bis.org/bcbs/aboutbcbs.htm the following:
“The Committee does not possess any formal supranational supervisory authority, and its conclusions do not, and were never intended to, have legal force. Rather, it formulates broad supervisory standards and guidelines and recommends statements of best practice in the expectation that individual authorities will take steps ‘to implement them through detailed arrangements – statutory or otherwise – which are best suited to their own national systems. In this way, the Committee encourages convergence towards common approaches and common standards without attempting detailed harmonisation of member countries’ supervisory techniques.’

58 The Core Principles Liaison Group remains the most important forum for dialogue between the Committee and systemically-relevant non-G10 countries. Moreover, the BIS established the Financial Stability Institute to conduct outreach to non-G10 banking regulators by holding seminars and conferences on implementing international banking and financial standards.

59 Jackson, 2000

60 Goodhart, supra note
regulators/supervisors around the world, had to be accepted consensually by all country members of the Committee.”61 As a consensus of all Committee members was required to adopt any standards or agreement, each country had a veto. According to Goodhart, however, this was in practice “somewhat less of a constraint than it might seem at first sight.”62 The smaller countries, for example, Benelux, Canada, Italy, Sweden, and Switzerland, were reluctant to object to proposals by the United States and United Kingdom and rarely took a minority position, “except on a matter of extreme national importance, an example of [which is] . . . banking secrecy for Switzerland.”63 Despite Japan’s substantial economic and financial influence, Goodhart notes that Japanese representatives on the Committee “usually remained quiet and withdrawn . . . partly due to their rapid turn-over of personnel, so they had little opportunity to build up expertise.”64

Monitoring noncompliance has generally been a decentralized task that is the responsibility of Member States themselves, not international organizations, such as the BIS, or other international bodies.65 Nonetheless, the Committee monitors and reviews the Basel framework with a view to achieving greater uniformity in its implementation and convergence in substantive standards. Moreover, the Committee claims that the legitimacy of the international standards it adopts derives from a communique issued by the G7 Heads of State in 1998 that encouraged emerging economies to adopt “strong prudential standards” and “effective supervisory structures.”66 To ensure that its standards are adopted, the Committee expects the IMF and World Bank to play a surveillance role in overseeing Member State adherence through its various conditionality and economic restructuring programs. In addition, because most G10 countries are members of the European Union, they are required by EU law to implement the Capital Accord into domestic law.67 In fact, the only G10 countries not required by local law to implement the Capital Accord are Canada, Japan, and the United States.68 This extended application of the Basel Committee’s standards to non-G10

61 Ibid.
62 Ibid.
63 Ibid.
64 Ibid.
66 Ibid.
67 See the European Union’s Capital Requirements Directive, supra note 36.
68 In fact, a major obstacle in negotiations over Basel II had been the initial reluctance of US Congress and refusal of some US bank regulators to apply Basel II to most US banks. The Federal Reserve, which has been an important supporter of Basel II and has authority to apply it to US Financial Holding Companies, has begun applying it to the largest US financial holding companies, while all
countries has raised questions regarding the accountability of its decision-making structure and its suitability for application in developing and emerging market economies.

In addition, the Basel Committee’s capital adequacy standards and rules on consolidated supervision were originally intended to apply only to credit institutions based in G10 countries that had cross-border operations. But this changed in 1998 during the Asian financial crisis when, at the urging of the G7 finance ministers and the world’s largest financial institutions, which were lobbying for more market sensitive capital standards, the Basel Committee stated its intent to amend the Capital Accord and to begin working on Basel II with a view to making it applicable to all countries where banks operate on a cross-border basis. Many non-G10 countries have incorporated the Basel standards into their regulatory frameworks for a variety of reasons, including strengthening the soundness of their commercial banks, raising their credit rating in international financial markets, and achieving a universally recognized international standard. The IMF and World Bank have also required many countries to demonstrate adherence or a realistic effort to implement the Basel Accord in order to qualify for financial assistance as part of IMF Financial Sector Assessment Programs and World Bank Financial Sector Adjustment Programs. Moreover, as a condition for obtaining a bank license, all G10 countries require foreign banks to demonstrate that their home country regulators have adopted the Capital Accord and other international agreements. International reputation and market signals are also important in creating incentives for non-G10 countries to adopt the Capital Accord. Many non-G10 countries (including developing countries) have found it necessary to require their banks to adopt similar capital adequacy standards in order to attract foreign investment as well as to stand on equal footing with international banks in global financial markets.

**Regulatory capture in Global Financial Governance**

Although the flexible and secretive manner in which the G10 international financial standard setting bodies conducted their deliberations and standard setting was generally considered a strength in the effectiveness of their governance structures and decision-making other US credit institutions will follow a different implementation schedule that will result in Basel II being fully adopted by US banks around 2013-2015. See ‘Risk-based Capital Guidelines; Capital Adequacy Guidelines; Capital Maintenance; Domestic Capital Modifications’, Advanced Notice of Proposed Rule-making’ 12 CFR part 3 (Oct 6, 2005).
processes, it also had the unfortunate result of exposing them to special interest group pressure from major banks and international finance associations. For example, most of the major international banks and their advocates pressured the Basel Committee to incorporate weaker capital adequacy measurement processes into Basel II; allowing banks to use more market-sensitive risk-measurement models, these processes resulted in lower levels of regulatory capital being held by banks. This left the banking system seriously exposed to liquidity risk and subsequently deteriorated the credit risk exposure of bank balance sheets, a development that began in the summer of 2007 and later intensified with the worldwide credit crisis of 2008–2009. Consequently, Basel II permitted regulators to approve more market-risk sensitive capital models, which led to lower levels of regulatory capital and created an incentive for banks to increase their leverage levels in the structured finance and securitization markets. The Basel Committee’s failure to adopt regulatory capital standards that would protect the global financial system from systemic risk contributed significantly to the regulatory failings that caused the worst financial crisis since the Great Depression of the 1930s. In other words, the lack of transparency, accountability and legitimacy in the Committee’s decision-making structure and the bank’s excessive influence on the regulators who were members of the Committee resulted in the leading G10 countries adopting weak bank capital standards, thereby significantly contributing to the largest global financial crisis since the 1930s that resulted in a worldwide economic recession, from which the global economy has not fully recovered.

The implications for global financial governance of the international financial standards produced by the international bodies discussed above have raised important questions regarding the accountability, and legitimacy of global financial governance. The

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69 The unstructured and secretive deliberations process has been praised because it allows regulators to respond quickly to rapidly-changing developments in financial markets. See Jackson (2002).
70 For example, the Institute for International Finance in Washington DC.
71 Indeed, a major impetus for Basel II was the lobbying of major multinational banks and their trade associations who wanted the eight percent capital adequacy standard of the 1988 Capital Accord lowered significantly to reflect more approximately the economic capital levels which bank risk models suggested that they hold to protect the investment capital of bank shareholders.
72 As the financial crisis of 2007-2009 has unfolded, it has been demonstrated that the market sensitive regulatory capital measurement processes approved by the Basel Committee in 2004 have undermined financial stability and put the global financial system at serious risk. See Kern Alexander, John Eatwell, Avinash Persaud and Robert Reoch (Dec. 2007) ‘Financial Supervision and Crisis Management in the EU’ Commissioned Report by the EU Parliament Committee on Economic and Monetary Affairs, 2-7 (Brussels: EU Parliament).
73 Ibid.
growing importance of international financial standards, such as the Basel Capital Accord, and their acceptance by most countries for their domestic regulatory systems demonstrated the importance of international financial soft law in influencing state regulatory practice. Nevertheless international financial soft law and its development through global financial governance structures failed to produce effective regulations and supervisory standards because the countries and the banking industry that developed the standards did not consult countries that were not members of the Basel Committee (mainly developing and emerging market economies), including their banking industries, and did not consider the interests of broader stakeholders in society who were affected by the operations of the banking and financial system. As a result, Basel II was inadequate for the needs of most countries’ economies and their banking sectors and broader financial systems. In particular, it demonstrated a lack of accountability and legitimacy for the non-members of the Basel Committee and their banking sectors who were subject to these international financial norms. Also, because the standard setting process was opaque and subject to excessive influence by some stakeholder groups (e.g., the large banking groups) it failed to adopt efficient regulatory standards that would promote regulatory objectives for the countries that were members of the Basel Committee.

3. **International institutional reforms**

The global financial crisis that began in 2007 and intensified in 2008 with the collapse of Lehman Brothers bank and which resulted in the largest global economic slowdown since the 1930s has demonstrated serious weaknesses in global financial governance. Financial markets in the United States and many developed countries had moved away from a bank-based model of finance to a wholesale capital market model of finance which had brought diversification and increased liquidity to financial markets, but also had introduced systemic risks to the financial system which regulators had failed to identify and control. Specific types of financial innovation – such as securitization and credit default swaps – that began in the early 1990s partially in response to regulatory requirements such as Basel I had changed the nature of financial risk-taking and systemic risk.

The financial crisis has triggered intense efforts internationally, regionally and nationally to enhance the monitoring of systemic stability and to strengthen the links between macro- and micro-prudential oversight, supervision and regulation. One such response is the widening of the international forum in which world-wide economic and financial policy
issues are discussed from G8, the group of eight leading industrialized countries, to G20 in 2008. The transition from G8 to G20/FSB is of great importance because at all G20 meetings of 2008 to 2010, notably those in London (2009), Pittsburgh (2009) and Seoul (2010), the financial crisis and the international response to it were the dominant topics. And it were indeed decisions taken by the assembled 20 heads of state which kick-started many of the national and regional responses to the crisis that are discussed in this section of the paper. For instance, in motivating the steps it has taken to avoid a repetition of the crisis or at least to mitigate the negative effects that a new financial crisis might have, the EU authorities regularly referred to commitments made at G20 meetings. Through this stimulating function of the G20 meetings alone the mid-term reactions have an international dimension.

Since the crisis, the philosophy of prudential financial regulation has shifted away from a sole focus on micro-prudential regulation and supervision - the regulation of individual banks and financial firms - to a broader focus on the whole financial system and how it relates with the broader economy. This is called macro-prudential regulation. The redesign of international financial regulation – and the main objective of global financial governance – is regulatory challenge posed by the financial crisis will be how regulators and central bankers can strike the right balance between micro-prudential regulation and supervision with macro-prudential controls on the broader financial system and economy. The overriding theme of the international financial reform initiatives (eg., the G20, the Financial Stability Board and Basel Committee) that began with the G20 Summits in Washington DC in November 2008 and London in April 2009 has been how to devise effective regulatory frameworks that durably link micro-prudential supervision with broader macro-prudential systemic risk concerns. Indeed, a major reform of global financial governance has been the shift in regulatory and supervisory focus from micro-prudential to macro-prudential regulation.

The focus on macro-prudential regulation has involved, for instance, devising regulatory standards to measure and limit leverage levels in the financial system and to require financial institutions to have enhanced liquidity reserves against short-term wholesale funding exposures. Macro-prudential regulation will also involve capital regulation that is counter-cyclical – requiring banks to hold more regulatory capital during good times and

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74 See the G20 Washington Action Plan and the London & Pittsburgh Summit Statements on strengthening the financial system reaffirm the policy recommendations of the Financial Stability Forum’s (FSF) April 2008 and 2009 Reports that provided a roadmap on financial supervision and regulation, and set forth principles for a more robust supervisory and regulatory framework based on new rules not only for financial institutions but also other actors, markets and supervisors.
permitting them to hold less than what would be usually required during bad times. Counter-cyclical capital requirements would link capital charges to points in the macro-economic and business cycle. For example, this would involve dividend restriction policies during a crisis or recession so that banks will lend more. This will necessarily involve banks using more forward-looking provisions based on expected losses. Moreover, a more effective macro-prudential capital regime requires enhanced quality and transparency of tier one capital that allow shareholders to absorb losses more readily and to impose losses on certain creditors and bondholders before a bank becomes insolvent.

The Financial Stability Board

The Financial Stability Board is the international body that has been given the responsibility by the G20 to develop international financial standards that control systemic risk and provide more effective oversight of the global financial system. The FSB was created at the G20 London Summit in 2009 and was later established with legal personality by the G20 in the Cannes 2010 Summit Communique that stated that the Financial Stability Board will have ‘legal personality’, which could dramatically change the present system of legally non-binding international financial soft law standards. The Cannes Communique also provided for enhanced G20’s/FSB’s coordination with the International Monetary Fund on macro-prudential financial regulation and oversight of the global financial system. This raises important issues regarding the binding nature of G20/IMF macro-economic policy regulatory objectives and their decision-making and standard setting processes.

The FSB has adopted twelve key standards for sound financial systems, all of which are legally non-binding soft law but nevertheless are expected to be incorporated into the

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75 The Basel Committee has introduced a framework for national authorities to consider how to implement counter-cyclical capital buffers. The Committee is reviewing the appropriate set of macro-economic indicators (e.g., credit variables) and micro-indicators (banks’ earnings) to determine how and when counter-cyclical regulatory charges and buffers should be imposed.

76 The Financial Stability Board is an institutional continuation of the FSF and has continued more or less to follow similar financial policies and regulatory approaches that are market-based and sensitive to the needs of the major international banks.

77 The FSB was formally created in April 2009 by the G20 Heads of State. See G20, ‘London Statement’ (2 April 2009) para. 15. The G20 Washington Action Plan and the London & Pittsburgh Summit Statements on strengthening the financial system reaffirm the policy recommendations of the Financial Stability Forum’s (FSF) April 2008 and 2009 Reports that provided a roadmap on financial supervision and regulation, and set forth principles for a more robust supervisory and regulatory framework based on new rules not only for financial institutions but also other actors, markets and supervisors.
national regulatory regimes of all countries.\textsuperscript{78} Since its establishment, the FSB has been addressing a diverse range of regulatory issues.\textsuperscript{79} For example, it has taken some of the work of the Financial Stability Forum forward by overseeing reviews of the system of supervisory colleges to monitor each of the largest international financial services firms.\textsuperscript{80} It has developed guidance notes and draft bank recovery and resolution plans to assist with its advice to national authorities for implementing the FSB Principles for Cross-Border Cooperation on Crisis Management.\textsuperscript{81} It has established Principles for Sound Compensation Practices,\textsuperscript{82} and has coordinated with other international financial bodies such as IOSCO to develop a consistent regulatory framework for the oversight of hedge funds.\textsuperscript{83} It is also overseeing the emergence of national and regional frameworks for the registration, regulation and oversight of credit rating agencies and encouraging countries to engage in bilateral dialogues to resolve home-host country issues, involving inconsistencies and disagreements that may arise because of different regulatory approaches.

To enhance the legitimacy of the FSB standard setting, the G20 and FSB increased their membership to include 12 additional member countries compared to the previous membership of the Financial Stability Forum and the G10 standard setting committees. The additional membership includes large developing and emerging market countries, such as China, South Africa, India and Brazil.

Regarding the Basel Committee, when the crisis hit, it started almost immediately to work on Basel III, a fundamental overhaul of its former capital requirement rules by adopting Basel III. The G20 London Summit communiqué put the work of the Basel Committee under the oversight of the Financial Stability Board, a post-crisis version of the former Financial Stability Forum.

\textsuperscript{78} The list is published at http://www.financialstabilityboard.org/cos/key_standards.htm
\textsuperscript{79} Initially, the FSB addressed the significant regulatory gaps in overseeing the failure of banks with cross-border establishments and operations by introducing resolution principles in late 2009 that aimed primarily at controlling systemic risk when a bank fails. Also, banks were required to under Basel III to “move expeditiously” to raise the level and quality of capital, but in a manner that “promotes stability of national banking systems”.
\textsuperscript{80} See G-20/FSB protocol to establish colleges of supervisors for all major cross-border financial institutions.; Reports of the Financial Stability Board to G20 Finance Ministers and Governors, Overview of Progress in Implementing the London Summit Recommendations for Strengthening Financial Stability (FSB September Report 2009) 2-3 and (FSB November Report 2009), 13. Other FSB initiatives include its principles for cross-border cooperation on crisis management (2009). The Basel Committee and FSB have also established a task force to review the practices of colleges.
\textsuperscript{81} FSB November Report, 14.
\textsuperscript{82} FSB Principles for Sound Compensation Practices: Implementation Standards (September 2009).
\textsuperscript{83} FSB November 2009 Report, 11-12.
The EU response to the crisis: changes in substantive regulatory reform to implement revised international standards (e.g., Basel III) and a fundamental change in the institutional structure of EU regulation and supervision with the creation of three European Supervisory Authorities, prompted by the experience of the crisis, along with further institutional reforms related to the European Banking Union and the European Central Bank’s new power to supervise banks in the euro area. At the national level, most countries reacted unilaterally to the crisis by adjusting their financial regulatory rules and supervisory practices and in the case of the United Kingdom changing the institutional structure of financial regulation.

The design and implementation of macro-prudential oversight and regulation at the international level concerns practical policy and legal issues involving the operation of the newly created Financial Stability Board and the need for it to adopt effective standards of macro-prudential regulation. The creation of the Financial Stability Board has not yet demonstrated that it is a meaningful institution for enhancing the macro-prudential focus of international financial regulation. Although the FSB has been engaged with micro-prudential reform issues, its efforts so far do not inspire confidence that more adequate macro-prudential measures are being adopted at the international level.

**Financial Stability Board and International Monetary Fund coordination**

The FSB is part of a new drive to devise more effective international regulatory frameworks that durably link micro-prudential supervision with broader macro-prudential systemic concerns. Indeed, a major shift in regulatory focus is occurring from micro-prudential to macro-prudential regulation. The focus on macro-prudential regulation involves,

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84 The most recent embodiment of an international financial soft law institution is the Financial Stability Board (FSB). The FSB consists of twenty six member countries, the European Central bank and the International Monetary Fund. The representatives of FSB member countries are the same as that of the Basel Committee. [http://www.financialstabilityboard.org/about/overview.htm](http://www.financialstabilityboard.org/about/overview.htm) (last accessed 15 Jan 2012).

85 The FSB consists of representatives from the central banks and national supervisory authorities of the following countries: Argentina, Australia, Brazil, Canada, China, France, Germany, Hong Kong SAR, India, Indonesia, Italy, Japan, Korea, Mexico, Netherlands, Russia, Saudi Arabia, Singapore, South Africa, Spain, Switzerland, Turkey, United Kingdom, United States, and non-state representatives including the European Central Bank, International Financial Institutions, International Standard-setting bodies, and Committees of Central Bank Experts. See Financial Stability Board, Press Release, Annex (9 Jan 2010).

among other things, devising regulatory standards to measure and limit leverage levels in the financial system as a whole, requiring financial institutions to have enhanced liquidity reserves against short-term wholesale funding exposures, and, more generally, counter-cyclical capital regulation whereby capital requirements are linked to points in the macro-economic and business cycle. This move to a more macro-prudential regulatory regime has led the FSB to work more closely with the International Monetary Fund. The FSB-IMF have undertaken collaborative early warning exercises to strengthen assessments of systemic risks and to identify possible regulatory controls and supervisory practices as a response to the changing face of systemic risk in financial markets.\textsuperscript{87} These exercises are aimed at providing policymakers with policy options and, as such, they add to the data-gathering, analysis and evaluation work and information-sharing activity that the IMF already conducts with a view to preventing crises by identifying policies to control macro-economic and systemic risks.\textsuperscript{88} It is argued that the combination of the IMF’s macro financial expertise with the FSB’s regulatory perspective will provide an important link between the micro-prudential regulatory perspective and the macro-prudential supervisory perspective.\textsuperscript{89} These exercises are expected to be incorporated into the IMF’s surveillance activities and this could serve as a way by which findings and policy recommendations may acquire more concrete effect.

The success of the FSB/IMF collaboration in macro-prudential regulation raises concerns about the effectiveness, accountability and legitimacy of its standards and recommendations. For instance, Lord King of Lothbury, former Governor of the Bank of England, has raised important questions regarding the accountability and legitimacy of FSB standards for countries not represented in the G20. He observed that “the legitimacy and leadership of the G20 would be enhanced if it were seen as representing views of others countries too”.\textsuperscript{90} Close collaboration between the FSB and the IMF is a step towards addressing this concern. However, the involvement of the IMF does not address fully the existing weaknesses in the international financial architecture because the IMF itself has been subject to extensive criticism on legitimacy grounds, most recently because of its allocation of Special Drawing Rights and the related allocation of weighted voting rights. Also, the recent appointment of Christine Lagarde as Managing Director perpetuates the image that the IMF is governed by and for the interests of the G10 advanced economies. The IMF’s Executive

\textsuperscript{87} IMF-FSB Early Warning Exercise (IMF Factsheet, 2009).
\textsuperscript{88} The IMF’s Global Financial Stability Reports and World Economic Outlook Reports are its “flagship” global surveillance publications.
\textsuperscript{90} Mervyn King, Text of Speech at the University of Exeter (19 Jan 2010), p. 8.
Board should therefore develop a new multilateral mandate that recognizes the importance of it adopting internal governance reforms to enhance its accountability and legitimacy and to re-orient its financial policy advice towards a more holistic approach to financial regulation that takes account of macro-prudential risks and the differential impact of regulatory structures on different financial systems and economies.

Reforming and Restructuring Financial Supervision

In addition, to enhance prudential oversight of cross-border financial groups, the Financial Stability Board has encouraged host state supervisors to participate in supervisory colleges to oversee the cross-border operations of financial groups. The main function of colleges will be to exchange information between supervisors, coordinate communication between supervisors of the financial group, voluntary sharing and/or delegation of tasks, joint decision on model validation (eg., Basel II/III). The colleges will also be involved in joint risk assessment and joint decision on the adequacy of risk-based capital requirements. The planning and coordination of supervisory activities for the financial group and in preparation of and during emergency situations (ie., crisis management).

The use of supervisory colleges is expected to modify the existing principle of home country control with limited host country intervention of a bank’s cross-border operations by recognising that host state authorities should play a greater role in approving the risk models and engaging in other supervisory practices of cross-border banking groups. This is a departure from existing principles of home–host coordination under the Basel Concordat which places most of the responsibility for supervising the cross-border operations of a banking group with the group’s home country supervisory authority. For example, the global banking group’s risk models are ordinarily assessed and approved by the home country supervisory authority and applied on a global basis without much adjustment by host country authorities in whose jurisdiction the bank operates. By contrast, international and European

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91 Essentially, Basel II and Basel III are based on a home country regulatory control model that encourages cross-border banks to adopt centralised risk models based on data calculated and assessed by risk managers at the level of the banking group to be applied (without much adjustment) on a global basis for measuring and managing the banking group’s risk-taking. See discussion in K. Alexander, R. Dhumale and J. Eatwell (2006) Global Governance of Financial Systems: the International Regulation of Systemic Risk (OUP) pp. 27-38.
regulatory regimes should focus on equipping host country regulatory authorities with greater powers to implement macro-prudential tools to control excessive risk-taking by global banking groups. For instance, national regulatory authorities should require cross-border banking groups to maintain subsidiaries in every jurisdiction where they have significant operations and to hold minimum capital in these subsidiaries. This would have the effect of subjecting the global bank’s risk management practice to a local assessment by the host supervisor that would require the bank to show how its local operations are holding adequate capital and liquidity that are appropriate for the host country’s macro-prudential objectives. This would result in global banking groups moving away from a centralised approach to risk management at the global level to a decentralised approach for measuring and managing risks at the national or host state levels. This would have important implications for Basel III’s present approach to cross-border supervision that encourages and rewards global banking groups with more favourable capital and liquidity requirements for centralising and consolidating risk management and measurement in the jurisdiction (or few jurisdictions) where the banking group is based. Moreover, increased host country authority in supervising cross-border banking militates against the principle of home country supervisory oversight contained in the Basel Concordat and the Basel III principles of home-host country control. Although not legally binding, these principles support limiting a host country supervisory authority’s discretion to apply prudential regulatory controls to a foreign bank’s operations in the host country.

In contrast, macro-prudential regulation will necessarily involve host countries in playing a more proactive role in prudential supervision because the design of macro-prudential regulation must fit the particular attributes of the local economy where the banking group operates. There is no one size fits all macro-prudential regulatory approach. Moreover, macro-prudential regulation is not well defined in practice and there needs to be a period of experimentation by national authorities before tested approaches are adopted by international standard setters. Countries must be given discretion to experiment with different macro-prudential tools whose effectiveness will vary from country to country based on differences in economic and financial systems. This means that bank capital management should be decentralised from the group level and based on diverse approaches across countries and different economies. This would give host country authorities a wider array of regulatory tools to address the particular risks that different banking groups and conglomerates pose to their financial system. This would be an important step in creating incentives for bank management to take more efficient financial risks that promote more sustainable economic
growth for the country or region in question. Effective macro-prudential regulation therefore will require that host countries intervene and challenge risk management and measurement models that global banks use and which have been approved by their home regulatory authorities, but which may be inappropriate in a macro-prudential regulatory sense for some host countries. Moreover, regulators working through IOSCO and the FSB will have agreed a consistent regulatory framework for hedge funds oversight; and there will be adopted consistent frameworks for registration, regulation and oversight of credit rating agencies for consideration by national legislatures.

4. Consequences

A. International reforms

The crisis has led to significant changes in regulatory standards, stricter supervisory practices, and institutional restructuring of financial regulation. Nevertheless, weaknesses remain. Basel III continues to allow global banking groups to use risk-weighted internal models to calculate credit, market, and liquidity risks that rely on historic data and risk parameters that are based on individual bank risk exposures and not to systemic risk across the financial system. Although Basel III contains higher core tier one and tier one capital requirements, liquidity requirements and a leverage ratio, it remains essentially dependent on risk-weighted models that were proven to be unreliable prior to the crisis because of their disproportionate focus on risk management at the level of the individual firm. As discussed above, the G20 and the Financial Stability Board have adopted the overall objective of reconstructing financial regulation along macro-prudential lines. This requires not only stricter capital and liquidity requirements for individual institutions, but also monitoring risk exposures across the financial system, including the transfer of credit risk to off-balance sheet entities and the general level of risk across the financial system. For example, the G20/FSB objective of requiring systemically significant financial instruments (ie., OTC derivatives) to be traded on exchanges and centrally cleared with central counterparties is an important regulatory innovation to control systemic risk in wholesale securities markets. Also, systemically important financial institutions will be subjected to more intensive prudential regulatory requirements, including higher capital requirements and more scrutiny of their cross-border operations.
In addition, the wide scope of macro-prudential regulation will require a broader definition of prudential supervision to include both *ex ante* supervisory powers, such as licensing, authorisation and compliance with regulatory standards, and *ex post* crisis management measures, such as recovery and resolution plans, deposit insurance and lender of last resort. Indeed, the objectives of macro-prudential regulation – to monitor and control systemic risks and related risks across the financial system – will require greater regulatory and supervisory intensity that will necessitate increased intervention in the operations of cross-border banking and financial groups and a wider assessment of the risks they pose. The broad area of recovery and resolution will necessarily involve authorities in restructuring and disposing of banking assets and using taxpayer funds to bailout and provide temporary support for ailing financial institutions.\(^92\)

The exercise of macro-supervision and regulation along with overseeing recovery and resolution programmes will require a greater role for host country authorities to ensure that the risk-taking of cross-border financial groups complies with the host country’s macro-prudential objectives. Most host countries will be able to achieve macro-prudential objectives in part by utilising traditional tools of macro-economic policy – exchange rates, interest rates and fiscal policy – and by applying traditional tools of micro-prudential supervision. However, under the FSB/G20 proposals, countries will be expected to intervene in a bank’s or financial firm’s business practices at an early stage to require prompt corrective action to comply with regulatory requirements and if necessary to alter the organisational structure of the institution by requiring, for instance, that the local operations of a cross-border bank be placed in a separately capitalised subsidiary or independent legal entity so that the local operations of a large systemically important institution could be compelled to undergo a restructuring and/or recapitalisation by local authorities. Indeed, a key element of any bank resolution regime is that the local authority can have tools at its disposal to intervene in bank management (ie., restrict dividends), restructure creditor claims or use taxpayer funds to recapitalise a systemically important institution or facilitate the transfer of assets to a private purchaser in a bank insolvency.

\(^92\) Indeed, the Financial Stability Board has stated in its *Key Attributes of Effective Resolution Regimes* that: “[t]o improve a firm’s resolvability, supervisory authorities or resolution authorities should have powers to require, where necessary, the adoption of appropriate measures, such as changes to a firm’s business practices, structure or organisation […] To enable the continued operations of systemically important functions, authorities should evaluate whether to require that these functions be segregated in legally and operationally independent entities that are shielded from group problems.” FSB Key Attribute 10.5.
B Environmental and Social Risks

An important question arises whether international financial regulation adequately addresses systemic environmental risks – for example, the macro-prudential economic risks associated with the banking sector’s exposure to high carbon assets. As discussed above, Basel III has already taken important steps to address both micro-prudential and macro-prudential systemic risks in the banking sector by increasing capital and liquidity requirements and requiring regulators to challenge banks more in the construction of their risk models and for banks to undergo more frequent and demanding stress tests. Moreover, under pillar 2, banks must undergo a supervisory review of their corporate governance and risk management practices that aims, among other things, to diversify risk exposures across asset classes and to detect macro-prudential risks across the financial sector. Regarding environmental risks, Basel III already requires banks to assess the impact of specific environmental risks on the bank’s credit and operational risks exposures, but these are mainly transaction-specific risks that affect the borrower’s ability to repay a loan or address the ‘deep pockets’ doctrine of lender liability for damages and the cost of property clean-up. These transaction specific risks are narrowly defined and do not constitute broader macro-prudential or portfolio-wide risks for the bank that could arise from its exposure to systemic environmental risks.

Recent research suggests that Basel III is not being used to its full capacity to address systemic environmental risks and that such risks are in the ‘collective blind spot of bank supervisors’.93 Despite the fact that history demonstrates direct and indirect links between systemic environmental risks and banking sector stability and that evidence suggests this trend will continue become more pronounced and complex as environmental sustainability risks grow for the global economy, Basel III has yet to take explicit account of, and therefore only marginally addresses, the environmental risks that could threaten banking sector stability.

Nevertheless, some international standard setting groups are taking the lead in addressing environmental and social risks in the banking and other financial sectors. The Sustainability Banking Network (SBN) of the International Finance Corporation – consisting of bank regulators of developing and emerging market countries, China, Brasil and Peru, and a number of large banking groups and financial institutions – have adopted standards of bank

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corporate governance that incorporate environmental and social risk controls into the institution’s risk governance strategy. Under the SBN guidelines, bank supervisors in participating jurisdictions (no participation from Europe and US regulators) have engaged in a variety of innovative regulatory and market practices to control environmental systemic risks and to adopt practices that mitigate the banking sector’s exposure to environmentally unsustainable activity and related social risks.

These initiatives have been based on existing regulatory mandates to promote financial stability by acting through the existing Basel III framework to identify and manage banking risks both at the transaction specific level and at the broader portfolio level. What is significant about these various country and market practices is that the regulatory approaches used to enhance the bank’s risk assessment fall into two areas: 1) Greater interaction between the regulator and the bank in assessing wider portfolio level financial, social and political risks, and 2) banks’ enhanced disclosure to the market regarding their exposures to systemic environmental risks. These innovative regulatory approaches and market practices are the result of pro-active policymakers and regulators adjusting to a changing world. Other international bodies, such as the United Nations Finance Initiative, have sought to promote further dialogue between practitioners and regulators on environmental sustainability issues and to encourage a better understanding of these issues by financial regulators.

Although the Basel Committee has formed a committee to address certain areas of social risks, such as financial inclusion, it (and other international financial bodies) have not addressed larger environmental and social risk governance concerns. China, Brazil and Peru, among others, are example of countries, acting under the guidance of the SBN, that have embarked on innovative risk assessment programmes to assess systemic environmental risks from a macro-prudential perspective as they recognise the materiality of systemic environmental risks to banking stability. These state practices should be coordinated more through traditional international financial standard setting bodies.

**Conclusion**

The global financial crisis of 2007-08 has called into question the efficacy of the traditional global financial governance model’s flexible and unstructured decision-making framework
and in particular has raised concerns regarding the accountability and legitimacy of the IFI standard setting processes. The discussion of the international financial standard setting bodies’ efforts in this area and the need for them to be more inclusive in their membership suggests that international financial regulation should be more legitimate in how it is developed and that the failed economic policies and regulatory practices of the US and other G10 countries do not provide sustainable models for economic and financial development. This means that the development of global financial regulation should be influenced more by countries outside of the traditional G10 power structure and the regulatory standards should address broader risk factors – environmental and social – that can have an effect on financial stability. The overall message – welcomed in many reform circles - is that economic policymakers should consider building institutional mechanisms that transcend national borders which establish solidarity between the financial sector and all parts of society that are affected by financial risk-taking.