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The Limits of Incrementalism: The G20, the FSB, and the International Regulatory Agenda

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At their very first summit in Washington in November 2008, the G20 leaders placed the reform of international financial regulation at the core of their agenda. The issue has retained a central place in discussions and communiqués at every subsequent meeting. It has been remarkable to see heads of state commit such detailed attention in their communiqués to a topic which has historically been the more obscure preserve of technocratic officials. Equally striking has been the fact that policymakers have looked beyond the immediate task of managing the crisis to focus on this more forward-looking agenda to prevent future crises. It took more than a decade after the crisis of the early 1930s for political leaders to agree at the 1944 Bretton Woods conference on international financial reforms designed to prevent a repetition of that economic calamity. This time around, the crisis has been used as an immediate catalyst for reform.

But what have the G20 leaders actually accomplished so far in this field? There is no question that they have successfully negotiated more initiatives in this area than in any other, initiatives that are aimed at reforming both the content and the governance of international financial regulation. While the breadth of these reforms has been impressive, they also suffer from some important limitations. Despite the scale of the crisis, the reforms have been much more incremental than radical. Their implementation has also been slow and uneven, and some important issues have been neglected entirely. As we have entered a new phase of financial instability unleashed by the eurozone's difficulties, these limitations have become increasingly evident, with political consequences that are very difficult to predict.

Reforming the Content of International Financial Regulation

During the several decades leading up to the global financial crisis, cooperation to develop international standards for prudential financial regulation grew in a piecemeal fashion alongside the globalization of financial markets. Standards were developed at different speeds in a number of distinct international standard setting bodies (SSBs), such as the Basel Committee on Banking Supervision (BCBS, created in 1974), the International Organization of Securities Commissions (IOSCO, created in 1983), the International Association of Insurance Supervisors (IAIS, created in 1994), the Committee on Payments and Settlements Systems (CPSS, created in 1990), and the International Accounting Standards Board (IASB, created in 2001). From 1999 onwards, the G7 leaders also attempted to create greater coherence in the emerging international financial standards regime by creating a new body, the Financial Stability Forum (reborn as the Financial Stability Board in 2009, as noted below), to identify the most important standards and promote them worldwide.[1]

[1] Andrew Walter, *Governing Finance* (Ithaca: Cornell University Press, 2008); Eric Helleiner, Stefano Pagliari and Hubert Zimmermann, eds., *Global Finance in Crisis: The Politics of*

The G20 leaders' initiatives have been designed to address a number of key limitations in the international standards regime that were revealed by the global financial crisis that began in 2007. Some reforms have had the goal of strengthening existing "micro-prudential" regulations aimed at promoting the stability of individual financial institutions, markets and instruments. But the G20 has also encouraged regulators and supervisors to give more attention to the "**macro-prudential" objective of addressing wider systemic risks**. Indeed, one of the most significant accomplishments of the G20 summits has been to build a new international consensus around the need to incorporate macro-prudential concerns into the international financial regulatory regime. The case for giving greater priority to macroprudential regulation was well laid out by the G20's Working Group 1 in advance of the London summit in April 2009:

> "while each financial crisis is different, the crises over history generally share some key common elements including excessive risk taking, rapid credit growth and rising leverage. This points to the need for regulators, supervisors, and central bankers to supplement strong microprudential regulation with a macroprudential overlay to more effectively monitor and address the build-up of risks arising from excess liquidity, leverage, risk-taking and systemic concentrations that have the potential to cause financial instability."[2]

The most prominent international regulatory reform has been the endorsement at the November 2010 Seoul summit of a new set of **international bank capital and liquidity standards** developed by the BCBS. These standards updated two earlier international banking standards that had been endorsed by the BCBS in 1988 and 2004. This "Basel III" agreement was negotiated much more quickly than its two predecessors, and it signals a tightening of standards with respect to the quantity and quality of capital and liquidity required of banks. It also breaks new ground in integrating macroprudential principles into bank regulation through an endorsement of leverage ratios and the use of counter-cyclical buffers that encourage banks to build up extra capital in boom times that can be drawn down in times of economic stress.

The rapid negotiation of Basel III was impressive and it will improve banks' resilience to financial and economic shocks. But there remain questions about whether the agreement will be implemented in full, particularly given high

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International Regulatory Change (London: Routledge 2010), Tony Porter, *Globalization and Finance* (Cambridge: Polity, 2005).

[2] G20 Working Group 1 (2009). *Enhancing Sound Regulation and Strengthening Transparency: Final Report,* March 25.

profile opposition in key jurisdictions such as the US and EU.[3] Even if it is implemented, the agreement has some important limitations. In order to appease various interests, the regulators agreed that the new standards would not need to be fully in place until 2019. Many have also questioned whether the levels of required capital have been set high enough; indeed, according to Peter Boone and Simon Johnson, "Basel III will end up with capital requirements for systemically important institutions no higher than that reported by Lehman the day before it failed"[4]. In addition, the agreement continues the rely on banks' use of internal risk models as well as the existing practice of classifying sovereign debt that is rated above double-A minus as risk free. This latter provision provides incentives for firms to load up on sovereign debt, thus potentially compounding the contagion effects of sovereign debt crises such as that which began unfolding in the eurozone in 2010.

The implementation of counter-cyclical buffers has also been left voluntary under Basel III. Many analysts wonder whether authorities will be willing to take the unpopular move of raising capital requirements during boom times in ways that curtail lending and also may hurt the international competitiveness of national banks. As an interim report commissioned by the G20 leaders noted in February 2011, "since macroprudential policy involves managing tail risk (the incidence of a financial crisis), the benefit of taking an action becomes apparent only in the long run, while the costs will often be highly visible and felt immediately. This may lead to a strong bias in favour of inaction. This bias can be further exacerbated by lobbying on the part of financial institutions and by other political pressures."[5] Even when authorities have decided to use counter-cyclical buffers, their implementation may be hindered by complicated voluntary reciprocity agreements that have been established for international banks. Under these agreements, host regulators will be reliant on home authorities to impose buffers on international banks calculated on the basis of a weighted average of a bank's domestic and international exposures.

A second important regulatory initiative with implications for banks has involved the G20's efforts to regulate **systemically-important financial institutions (SIFIs)** more effectively**.** In the words of the Financial Stability Board (FSB), "SIFIs are financial institutions whose distress or disorderly failure, because of their size, complexity and systemic interconnectedness, would cause

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[3] Brooke Masters and Tom Braithwaite, "Bankers versus Basel" *Financial Times*, October 3, 2011.

[4] Peter Boone and Simon Johnson, "The future of banking: is more regulation needed?" *Financial Times*, April 1, 2011.

[5] FSB, IMF, BIS, *Macroprudential Policy Tools and Frameworks*, Update to G20 Finance Ministers and Central Bank Governors, February 14, 2011, p.11.

significant disruption to the wider financial system and economic activity."[6] As part of their new macroprudential regulatory agenda, the G20 leaders have set out to subject these institutions to tighter supervision and regulation than other institutions. Before the crisis, the world's largest banks experienced the opposite treatment; under Basel II, they had laxer standards because of policymakers' trust in the sophistication of internal risk management practices. The massive economic costs associated both with the collapse and/or bailouts of large institutions and with the broader crisis have prompted policymakers to correct this misplaced trust. As the G20 leaders put it at their September 2009 summit, "our prudential standards for systemically important institutions should be commensurate with the costs of their failure".[7]

This goal has been driven not just by the experience of the crisis but also by developments since the crisis. The bailouts, mergers and acquisitions associated with the crisis have created even larger and more interconnected financial institutions than existed before the crisis. These institutions are also more aware than ever that they can be backed by state support because of their systemically significant status. That awareness creates moral hazard problems, encouraging these institutions to engage in excessively risky activities.

The G20 leaders have developed a number of initiatives vis-à-vis SIFIs. At their most recent summit in Cannes in November 2011, the G20 leaders endorsed the release of a list of 29 banks that have been designated as "global SIFIs" and that will be subject to "more intensive and effective supervision" as well as additional capital requirements from 2016 onwards. All G-SIFIs must also develop "recovery and resolution planning" (which includes drafting living wills explaining how they will be wound down in the event of trouble) and they will be subject to institution-specific cooperation agreements between home and host countries.[8] The leaders also supported the creation of a new international standard for national resolution regimes to ensure that failing financial firms are resolved effectively and without costs to taxpayers.

Although these initiatives are aimed at banks, the G20 leaders stated clearly that they are "prepared to identify systemically important non-bank financial entities".[9] They have ordered a methodology to be prepared for identifying systemically important non-bank entities by the end of 2012 and have asked insurance regulators to continue their work on a framework for supervising

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[6] FSB, *Policy Measures to Address Systemically Important Financial Institutions* (Basel: Financial Stability Board, November 4, 2011), p.1.
[7] G20 Leaders, *Leaders Statement, The Pittsburgh Summit*, September 24-5, p.9.
[8] G20 Leaders, *Cannes Summit final declaration: Building our common future: Renewed collective action for the benefit of all*, November 4, 2011, p.6.
[9] G20 Leaders, *Communiqué: G20 Leaders Summit Cannes, 3-4 November 2011*, p.3.

internationally active insurance groups. At the same time, they are also exploring how to extend these initiatives taken vis-à-vis G-SIFIs to domestic SIFIs.

The goal of these initiatives is, in the words of the G20 leaders, "to make sure that no financial firm is 'too big to fail' and that taxpayers should not bear the costs of resolution".[10] Whether they succeed in meeting these ambitious goals remains to be seen.

Key aspects of these initiatives cannot be implemented without significant legislative initiatives whose passage is far from guaranteed. As the memories of the crisis fade, the determination of legislators to take decisive action is waning, particularly when faced with increasingly bold and concerted private sector opposition. The historical record of international cooperation vis-à-vis international burden-sharing and cross-border resolution for failing international firms – even in a tightly integrated community such as European Union – also raises questions about the credibility and effectiveness of non-binding international agreements in this area.

Many analysts also lament the fact that the G20 leaders did not go much further to endorse initiatives such as the forced breaking up of large, interconnected firms, or restrictions on large banks from engaging in high-risk, casino-like activities. At the Toronto summit in June 2010, the G20 leaders chose not to endorse proposals for internationally coordinated levies/taxes on the financial sector that were outlined in an IMF report they had commissioned to explore how to help pay for "any burdens associated with government interventions to repair the banking system".[11] Endorsing those proposals would have signaled a more serious commitment by G20 leaders to address the distributional consequences of bailouts and their social costs. It might also have helped address the expansion of public debt in the US and European countries, a phenomenon that subsequently contributed to the reemergence of global financial instability. At Cannes, the G20 leaders considered proposals for a financial transactions tax once again, but agreement remained elusive despite some high profile advocacy of the issue by Bill Gates and others.

A third set of international regulatory initiatives have been driven by the macroprudential goal of extending regulation and oversight to cover "all systemically important financial institutions, instruments and markets".[12] This goal has provided the justification for the G20 leaders to extend regulation and supervision to cover institutions, such as **credit rating agencies and hedge funds**, that had previously been subject to little or very weak official oversight. Since poor ratings practices were widely blamed for contributing to the crisis, the G20 leaders committed to subject all credit rating agencies whose ratings are used

[10] Quotes from G20 Leaders, *Cannes Summit final declaration*, p.6.
[11] Quote from G20 Leaders, *Leaders Statement, The Pittsburgh Summit*, September 24-5, p.10.
[12] G20 Leaders, *Declaration on Strengthening the Financial System*, London, April 2, 2009, p.3.

for regulatory purposes to an oversight regime – including registration of the agencies – consistent with IOSCO's (previously voluntary) code of conduct. They have also committed more generally to reduce the reliance on credit ratings in prudential rules and regulations. The G20 leaders also agreed to new requirements that hedge funds or their managers register and disclose information to financial authorities. While these initiatives signaled a departure from past practice, critics have noted their weak nature as well as the slow pace of their implementation in some areas (e.g. reducing the reliance on credit ratings).

More extensive initiatives have been launched to bring the massive **over-the-counter (OTC) derivatives markets** under the official international regulatory umbrella for the first time. The financial crisis revealed starkly the vulnerability of the global financial system to a failure of a major counterparty in these opaque, poorly regulated markets. OTC commodity derivatives markets have also been widely blamed for contributing the volatility of global energy and food prices during 2008 and since. To address these issues, the G20 leaders have committed that, by the end of 2012, all "standardized" OTC derivatives contracts will be traded on exchanges or electronic trading platforms, and cleared through regulated central counterparties (CCPs) (which reduce counterparty risks by serving as an intermediary between the seller and buyer). They have also insisted that all contracts should be reported to trade repositories and that those contracts not centrally cleared should be subject to higher capital requirements. In addition, they committed to develop global standards for CCPs and trade depositories.[13] As part of their efforts to address commodity price volatility, the G20 leaders also committed at their Cannes summit to stricter regulation (including position limits) and supervision of commodity derivatives.[14]

These various initiatives represent significant departures from past international regulatory and supervisory practices, and they have the potential to usher in what one market analyst called a new "ecosystem" for OTC derivatives.[15] But they also have some limitations. To begin with, their significance will be diluted if large loopholes are created through wide interpretations of key terms such as "standardized" contracts or "electronic trading platforms" (the latter are called "swap execution facilities" in US legislation). The G20 leaders have also refrained from restricting the use of market instruments that are widely blamed for contributing to destabilizing speculation, namely "naked" credit default swaps (CDS) which allow investors to speculate on the likelihood of default on the

[13] Eric Helleiner, "Reining in the Market: Global Governance and the Regulation of OTC Derivatives", in Dag Harald Claes and Carl Henrik Knutsen, eds., *Governing the Global Economy* (Routledge, 2011).
[14] G20 Leaders, *Cannes Summit final declaration*, p.7.
[15] Brian Daly quoted in Jeremy Grant, "Market structures face test of trust", *Financial Times*. November 3, 2010.

underlying bond without actually owning that security. Citing the collapse of Lehman Brothers and AIG, George Soros and others have argued forcefully that these "toxic" instruments encourage self-reinforcing bear raids and should be banned (similar to prohibitions on the purchase of insurance where there is no underlying interest).[16] Greater efforts could also be made to constrain the market power of large dealer banks in the markets (including via rules about the ownership of CCPs, organized trading platforms, trade depositories, and data service providers).[17]

A further limitation of derivatives reforms is that it appears quite unlikely that G20 countries will meet the deadlines they have committed to in this field. Moreover, we are already witnessing – often in response to lobbying from financial interests – the emergence of different priorities across jurisdictions vis-à-vis issues such as definitions of the terms noted above, the imposition of collateral requirements on uncleared contracts, and the granting of exemptions from clearing requirements for specific products (e.g. currency derivatives) and institutions (e.g. end-users). Inconsistent rules between countries risk opening the door to competitive deregulation pressures because of the sensitivity of these globally integrated markets to regulatory differentials. The complex interconnectivity and systemic significance of OTC derivatives means that lax regulation in one jurisdiction could well generate financial upheavals that affect everyone.

At the recent Cannes summit, the G20 leaders also endorsed tighter regulation and oversight of the "**shadow banking system**" which has reemerged, three years after the 2008 crisis, larger than it was before the crisis in the world's largest economies.[18] As they noted, "the shadow banking system can create opportunities for regulatory arbitrage and cause the build-up of systemic risk outside the scope of the regulated banking sector."[19] This initiative is important, but it raises questions about how precautionary authorities will be in determining which financial activities should be considered "systematically important". For example, the BIS has recommended an ambitious approach in which all new financial products would be registered and evaluated on an ongoing basis by a

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16 George Soros, "The Game Changer", *Financial Times*, January 29, 2009. At the Cannes summit, the G20 leaders have called on IOSCO to "to assess the functioning of credit default swap (CDS) markets and the role of those markets in price formation of underlying assets". G20 leaders, *Cannes Summit final declaration*, p.7.

17 Robert Litan, *The Derivatives Dealers' Club and Derivatives Market Reform*. Initiative on Business and Public Policy at Brookings (Washington: Brookings, April 7, 2010); Louise Story, "A secretive banking elite rules trading in derivatives", *New York Times*, December 12, 2010.

18 Brooke Masters, "Shadow banking hits new peak" *Financial Times*, October 27, 2011.

19 G20 Leaders, *Cannes Summit final declaration*, p.6

consumer financial products regulator for the systemic risks they might pose.[20] Like pharmaceutical drugs, some products could be endorsed for everyone's use, others could be restricted to authorized users (or be available only in limited amounts to pre-screened users), while still others might be banned. The G20 leaders show few signs of willingness to endorse or even consider this kind of comprehensive precautionary approach to regulation.

Another initiative of the G20 leaders has been to develop a new set of international principles and standards on **compensation practices** for significant financial institutions. This initiative has clear populist appeal, but the official rationale for it has been a macroprudential one of restricting excessive risk taking. Although the new principles and standards are meant to be enforced by national supervisors (who could, for example, apply higher capital requirements on non-complying institutions), the G20 leaders have been forced to recognize that implementation so far has been inconsistent.[21] Consequently, at the Cannes summit, they called on the FSB to "undertake an ongoing monitoring and public reporting on compensation practices" and to "carry out an on-going bilateral complaint handling process to address level playing field concerns of individual firms".[22]

Two other issues on the G20 regulatory agenda deserve a brief mention: accounting and cross-border capital flows. At their April 2009 summit, the G20 leaders told **accounting** standard setters that they should improve standards for the valuation of financial instruments, including in ways that might help mitigate the pro-cyclicality of fair value accounting. They have repeated this message at subsequent summits and have also called for the convergence on a single set of global accounting standards by the IASB and its US counterpart. Progress on many of these issues has been very slow.

Although almost entirely absent from the first several G20 summits, the issue of regulating **cross-border capital flows** appeared on the Seoul summit agenda when the G20 leaders called for "further work on macro-prudential policy frameworks, including tools to mitigate the impact of excessive capital flows".[23] A decade earlier, during the East Asian crisis of 1997-98, the IMF and many top G7 policymakers had been quite hostile to any efforts aiming at regulating capital flows. The Seoul summit's statement signaled a greater open-mindedness to discuss this issue, perhaps encouraged by the broader commitment of G20 leaders at this time to "better reflect the perspective of emerging market economies in

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[20] Bank for International Settlements, *79th Annual Report* (Basel: Bank for International Settlements, June 29, 2009).

[21] Megan Murphy, "Banks fail to trim bonuses in pay packages", *Financial Times*, October 12, 2011.

[22] G20 Leaders, *Cannes Summit final declaration*, p.5.

[23] The G20 Leaders, *The G20 Seoul Summit, Leaders' Declaration, November 11-12, 2010*, p.13.

financial regulatory reforms".[24] From the standpoint of many developing countries (including many G20 members), restrictions on capital flows have an important role to play in macroprudential policy because financial crises in their countries have often been preceded by excessive capital inflows (as was also the case for the US in the years leading up to the subprime crisis) and/or exacerbated by large-scale capital flight.[25]

Further evidence of the shifting international consensus on this issue came at the Cannes summit when G20 finance officials backed a set of non-binding "conclusions for the management of capital flows". While highlighting the benefits of free capital movements, this statement endorsed the macroprudential rationale for "capital flow management measures" (including capital controls). But this statement was not accompanied by any significant policy initiative to help countries strengthen their counter-cyclical capital account regulations (e.g. international cooperation to encourage and strengthen national initiatives).[26] Perhaps reflecting the ongoing disagreements on the issue, the G20 leaders chose instead to support a quite different initiative to develop and deepen local currency bond markets in developing countries as a way to bolster resilience against shocks induced by capital flows.

Reviewing these various initiatives as a whole, the G20 leaders certainly deserve applause for tackling a wide range of issues in their efforts to reform international financial regulation. Particularly noteworthy are their efforts to give greater attention to macroprudential goals. But the content of many of the reforms they have endorsed has been quite cautious in the context of the scale of the global financial crisis that began in 2007. In addition, important issues that were discussed in the wake of the last global financial crisis of 1997-98, such as the need for an international sovereign debt restructuring mechanism, have been entirely absent from the current G20 reform agenda – a weakness that the European sovereign debt crisis has exposed particularly starkly.

Equally important, many questions remain about whether the reforms endorsed by the G20 will actually be fully implemented. As the outgoing FSB Chair Mario Draghi acknowledged just before the Cannes summit: "we have a long way to go to fully and consistently implement the reforms we have committed to and the policy measures already agreed."[27] Efforts to strengthen regulation within key jurisdictions such as the US and Europe are being

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[24] *Ibid*, p.3.

[25] See for example Kevin Gallagher, Stephany Griffith-Jones and José Antonio Ocampo, *Capital Account Regulations for Stability and Development*. (Boston: Frederick S.Pardee Center for the Study of the Longer-Range Future, November, 2011).

[26] *Ibid.*

[27] Mario Draghi, "The Progress of Financial Regulatory Reforms", October 31, 2011, p.1, http://www.financialstabilityboard.org/publications/r_111104ff.pdf

challenged by opposition from increasingly assertive private financial interests as well as by resurgent competitive rivalries between different national financial systems. If national jurisdictions begin to move in different directions, international competitive pressures will only grow, creating opportunities for market actors to engage in regulatory arbitrage that will undermine the G20's goals. The fact that the content of G20 communiques is often ambiguous only compounds the risks of significant divergences at the implementation phase.

Reforming the Governance of International Financial Regulation

The difficulties involved in implementing G20 commitments highlight a core weakness in the governance of international financial regulation. Unlike in the realm of international trade, there is no supranational institution to enforce international financial regulatory standards. The key international regulatory institutions have no formal power; their main roles are that of fostering networks of informal cooperation, information sharing and the development of international "soft law" whose implementation is left to the discretion of national authorities.[28]

Some efforts were made by the G7 in the wake of the 1997-98 financial crisis to encourage greater compliance with international financial standards through the creation of the FSF. The body brought together in one place for the first time representatives of most of the key SSBs (BCBS, IAIS, IOSCO, IASB, and the CPSS), relevant international financial institutions (the IMF, WB, BIS, OECD, and the Committee on the Global Financial System), and central bank, finance ministry, and regulatory and supervisory authorities from each G7 country (along with the European Central Bank).[29] As one of its first tasks, the FSF compiled a compendium of existing international prudential standards, from which it identified twelve as priority to be promoted worldwide. The IMF and World Bank were then assigned the role of promoting compliance with these twelve standards through their Financial Sector Assessment Program (FSAP) and Reports on the Observance of Standards and Codes (ROSCs).

But participation in the FSAP and ROSCs was entirely voluntary and there were no consequences for non-compliance with international standards aside from possible market discipline (and evidence is mixed about whether investors penalized countries that did not comply with - or refused to publish results of - their FSAPs/ROSCs). At the time of the outbreak of the recent financial crisis, a number of countries – including G20 countries such as the US, China, Indonesia

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[28]Eric Helleiner and Stefano Pagliari, "The End of an Era in International Financial Regulation?" *International Organization* 6(2011): 169-200.

[29] The FSF's membership was subsequently widened to include Australia, Hong Kong, Netherlands, Singapore and Switzerland. For history of the FSF, see Eric Helleiner, *The Financial Stability Board and International Standards*, CIGI G20 Papers, no.1, June 2010.

and Argentina – had still not undergone a FSAP. And among those who had, compliance levels were uneven. Indeed, the fact that national financial systems remained regulated in quite distinct ways, despite the growth of various international financial standards, was brought home clearly by the crisis experience itself. Although the crisis was global in scope, the financial systems of a number of countries—including Canada, right next door to the epicenter of the crisis—remained relatively stable through the crisis, and this outcome was widely attributed to distinct national regulatory choices made before the crisis.

Alongside their initiatives to reform international financial standards, the G20 leaders have set about **strengthening compliance mechanisms** by transforming the FSF into the FSB. Membership in this body has been extended to all G20 countries, along with selected others[30], and - unlike the FSF - it comes with certain obligations. One is to participate in a FSAP every five years and to publicize the detailed IMF/WB assessments used as a basis for the ROSCs[31]. A second is to "implement international financial standards", including new standards created by the FSB itself. The consequences of non-compliance, however, are left unspecified. Indeed, Article 16 of the FSB's Charter acknowledges that the charter "is not intended to create any legal rights or obligations".

A third obligation is to participate in FSB-led peer review processes. The effectiveness of these processes is limited, however, by the fact that the reviews and their recommendations must be approved by a consensus in the Plenary (allowing the country being reviewed a chance to veto unwanted criticism). At the Cannes summit, the FSB reinforced the peer review process with the introduction of a new "Coordination Framework" for monitoring and public reporting of implementation, with special emphasis on the Basel capital and liquidity frameworks, OTC derivatives reforms, compensation practices, G-SIFI policies, resolution frameworks, and shadow banking. Again, however, this process works through the Plenary and its consensus decision-making rule. At this time, the FSB Secretariat also produced a new "status report" on the progress of implementation involving four grades (or "traffic lights").[32]

How effective these compliance mechanisms will be remains to be seen. It is striking, however, that they continue to refrain from imposing "hard law" obligations on countries to implement specific standards. Countries that have not

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[30] The FSB's membership includes the G20 along with other jurisdictions that had already become members of the FSF after its creation - Hong Kong, Netherlands, Singapore and Switzerland - as well as Spain and the European Commission.

[31] These commitments are not in the Charter. They are contained in the January 2010 "FSB Framework for Strengthening Adherence to International Standards". The Charter says only that members agree to "undergo periodic peer reviews, using among other evidence IMF/World Bank public Financial Sector Assessment Program reports."

[32] http://www.financialstabilityboard.org/publications/r_111104hh.pdf.

yet fully implemented even the Basel II bank standards – which includes six members of the BCBS, including the US and China[33] – face no formal consequences beyond exhortations in G20 summit communiqués that they do so. A number of analysts have been calling for some time for a stronger treaty-based international body that could act as an equivalent to the WTO in the financial regulatory sphere, with the power to sanction members whose regulatory policies did not meet minimum international standards.[34] This financial crisis has not acted as a catalyst for this reform; instead, compliance mechanisms have been strengthened in a much more limited manner, building on the FSF experience.

One partial exception to this pattern has been the FSB's recent campaign – strongly backed by the G20 leaders – to encouraging worldwide compliance with some basic international cooperation and information exchange standards embodied in BCBS, IAIS and IOSCO principles. After evaluating compliance in 61 jurisdictions, the FSB published a list of "non-cooperative jurisdictions" (NCJs) right before the Cannes summit, which included just Libya (the former regime) and Venezuela, both of which were described as "not engaged in dialogue with the FSB". In addition to being named-and-shamed in this way, these and other future non-cooperative jurisdictions have been warned by the G20 leaders with the following: "We stand ready, if needed, to use our existing countermeasures to deal with jurisdictions which fail to meet these standards."[35] Past statements suggest that these countermeasures could include denying market access to FSB members' financial markets.

Initiatives of this kind by the FSB raise questions about the legitimacy and accountability of the organization. The FSB's membership is wider than that of the FSF but it is still very restrictive in comparison with the WTO or IMF. The same is true of key SSBs such as BCBS whose standards are being promoted.[36] The more that the FSB takes on a mission of promoting worldwide compliance with international financial standards, the more likely it is that non-members will

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[33] Brooke Masters, "Countries fail to enact Basel bank reforms", *Financial Times*, October 19, 2011.

[34] See for example Barry Eichengreen, *Out of the Box Thoughts about the International Financial Architecture*. IMF Working Paper. No. 09/116. (Washington, DC: International Monetary Fund, 2009), and John Eatwell and Lance Taylor, *Global Finance at Risk* (New York: New Press, 2001).

[35] G20 Leaders, *Cannes Summit final declaration,* p.8.

[36] Before the first G20 leaders summit, the BCBS membership included the G7 countries plus Benelux, Spain, Sweden, and Switzerland. It then expanded its membership in 2009 to include all G20 countries, Hong Kong SAR and Singapore. IOSCO and IAIS have long had much wider memberships, but IOSCO's Technical Committee, which plays the key role in developing standards, is much narrower. In 2009, it added Brazil, India and China to its existing membership of the G7 countries, Australia, Hong Kong, Mexico, the Netherlands, Spain, and Switzerland. The CPSS's membership also expanded at this time from including just the G7 countries, Belgium, the Netherlands, Singapore, Hong Kong, Sweden and Switzerland, to welcome Australia, Brazil, China, India, Mexico, Russia, Saudi Arabia, South Africa and South Korea.

challenge its legitimacy to do so. Compliance with international standards among the many non-members of the FSB (and other international standard setting bodies) would be strengthened by providing them with more voice.

To try to address this issue, the FSB has created six **regional consultative groups** covering the Americas, Asia, the Commonwealth of Independent States, Europe, the Middle East and North Africa, and Sub-Saharan Africa. Invitations to approximately 70 non-members of the FSB have been extended to join these groups. Each group is comprised of both members and non-members of the FSB, and is designed to encourage a sharing of views between non-members and the FSB. But the usefulness of this initiative is limited by the fact that non-members remain as "rule-takers" without a formal say in FSB proceedings, while they are asked to take on many of the obligations of FSB membership (such as implementing international financial standards and undergoing FSAPs).[37] These measures are very unlikely to address the concerns about the legitimacy of narrowly-constituted FSB to set worldwide rules and endorse countermeasures against those who do not comply. A more ambitious strategy would be to widen the membership of the FSB and use the regional groups to provide a formal voice into the FSB's decision making, perhaps through a constituency system like that used in the IMF.

The FSB's capacity to encourage compliance also depends in part on its **legitimacy and accountability to the member countries**. The effectiveness of its peer review mechanisms, in particular, will be influenced by the degree of commitment that member countries have to the FSB and its goals. One key task is to strengthen the "buy-in" of developing countries that were not previously members of the FSF (and some of the key international standard setting bodies). Many of these countries have distinct perspectives on international regulatory issues because of development goals and/or the nature of their financial structures, but the focus of post-crisis international regulatory discussions has initially been focused mainly on the problems of developed countries (where the crisis began). It is encouraging that the November 2010 G20 summit mandated the IMF, World Bank and FSB to report on financial stability issues of particular interest to emerging market and developing economies. At the Cannes summit a year later, the G20 leaders followed this with a call for "international bodies to take into account emerging market and developing economies' specific considerations and concerns in designing new international financial standards and policies where appropriate."[38] Greater efforts should also be made to strengthen the voice of these countries within the FSB's various working groups and committees,

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[37] Domenico Lombardi, *The Governance of the Financial Stability Board: Issues Paper*. (Washington, Brookings, 2011), p.22.
[38] G20 Leaders, *Cannes Summit final declaration*, p.7.

particularly the all-important Steering Committee (which provides operational guidance between biannual plenary meetings of the entire membership).

The composition of the Steering Committee is also relevant to securing greater "buy-in" of many developed country governments. In its initial two years, the FSB's Steering Committee has been dominated by central bankers. Representatives of finance ministries have been much less prominent despite the fact that they have a critical role to play in steering the kinds of national legislative initiatives that are required to implement reforms endorsed by the FSB. At the Cannes summit, the G20 leaders acknowledged this limitation and backed reforms to address this and the need for greater geographical diversity: "as we move into a phase of policy development and implementation that in many cases will require significant legislative changes, we agree that the upcoming changes to the FSB steering committee should include the executive branch of governments of the G20 Chair and the larger financial systems as well as the geographic regions and financial centers not currently represented, in a balanced manner consistent with the FSB Charter".[39]

For the FSB to play a significant role in the governance of international financial regulation, the G20 leaders also agreed at Cannes to **strengthen its institutional standing**. Despite being assigned a more ambitious mandate than the FSF, the FSB has been severely constrained by having less than two dozen staff members (the IMF has approximately 2400), all of whom have been seconded from other organizations for relatively short durations of time because the FSB lacks formal legal status. The FSB needs a stronger and more permanent secretariat not just to fulfill the various tasks that the G20 leaders have given it but also to enable the institution to develop independent analytical capacity and to help integrate the insights and activities of the many organizations that comprise the body. At the Cannes summit, the G20 leaders have moved a step in the right direction by asking the FSB Chair to explore how to provide the organization "with legal personality and greater financial autonomy".[40]

At this time, the G20 leaders also called for "the strengthening of its [the FSB's] **coordination role vis-à-vis other standard setting bodies** (SSB) on policy development and implementation monitoring, avoiding any functional overlaps and recognizing the independence of the SSBs."[41] This recommendation highlights the important role that the FSB can play in encouraging a more integrated view of prudential issues among the patchwork of international SSBs that have emerged since the 1970s. The sector-specific nature of each SSBs (i.e. separate organizations for banking, securities, insurance etc.) inhibits each from

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[39] *Ibid*, p.9.
[40] *Ibid*, p.9.
[41] *Ibid*, p.9.

recognizing the interconnections between sectors and identifying broader macroprudential issues relating to systemic risks.

The goal of creating greater coherence in international regulatory governance had been one of the purposes behind the 1999 decision to create the FSF and to include the key SSBs as members.[42] Ten years later, when designing the FSB, the G20 leaders gave the new body a more explicit mandate in this area. The FSB's charter empowers it to conduct "joint strategic reviews of the policy development work of the international standard setting bodies" and "promote and help coordinate the alignment of the activities of the SSBs". The standard setting bodies are also now required to report to the FSB on their work in order to provide "a broader accountability framework" for their activities (although the FSB Charter also notes that "this process should not undermine the independence of the standard setting process").[43] Unlike the FSF, the FSB has also been given the ability to create its own standards rather than relying entirely on the SSBs.

These new mandates have created a much closer working relationship between the FSB and SSBs, and one in which the FSB (and the G20 leaders forum behind it) has assumed much more of a leadership role than the FSF ever did. The SSBs have also recognized the FSB's usefulness in encouraging the dissemination and implementation of their standards (and they are participating directly in its efforts to encourage compliance vis-à-vis NCJs). But there remain questions about the FSB's capacity to provide leadership because the SSBs' independence is explicitly defended in the FSB's Charter. This issue has been particularly salient vis-à-vis the IASB which has been slow to implement some aspects of the G20-led post-crisis reform agenda.[44]

Summing up, there is no question that the creation of the FSB has strengthened the governance of international financial regulation. But like the specific content of regulatory reforms discussed in the first half of this article, this institutional innovation has been an incremental change rather than a radical one. The FSB builds on the FSF experience in some significant ways, but it remains a network-based organization with little formal power and limited staff and capacity. Its establishment is very far from representing the kind of dramatic

[42] Hans Tietmeyer "Report by the President of the Deutsche Bundesbank, Prof Hans Tietmeyer, on 11/02/99," *BIS Review*. 21(1999) 1-6.

[43] Quotes from FSB Charter: http://www.financialstabilityboard.org/publications/r_090925d.pdf

[44] At their first summit meeting, the G20 leaders asked the IASB – which was then a strictly private body – to review its membership "in particular in order to ensure transparency, accountability, and an appropriate relationship between this independent body and the relevant authorities." In January 2009, the IASB created an international monitoring board to appoint the trustees who oversee its operations and whose members include the US SEC, Japan's FSA, the European Commission, and IOSCO's Emerging Markets and Technical Committees (as well as the BCBS as an observer). Since then, the G20 has continued to welcome further reforms to its governance.

change that the 1995 creation of the WTO represented in the trade realm. Instead, as Louis Pauly has argued, it looks more like a kind of "historical reversion" from the Bretton Woods model of global financial governance involving legal commitments and significant supranational institutions to the weaker and less effective informal model of the League of Nations' core economic and financial machinery.[45] Even if the FSB is granted formal legal standing, this is very unlikely to be via an international treaty. Instead, FSB members are discussing the much more limited step of simply making it a corporate entity registered in a specific country's domestic law.

It is possible that the FSB might evolve over time into a more powerful supranational body helping to enforce detailed international financial standards. But the crisis has presented a number of new challenges in the way of this goal.[46] By politicizing financial regulatory issues at the domestic level, the crisis has eroded the considerable autonomy that regulators had before the crisis to negotiate international standards and has heightened concerns in some domestic quarters about delegating regulatory decision-making to international bodies. Consensus building around new detailed standards has also been complicated by the widening of the membership of various international standard setting bodies and the blow to the reputation of Anglo-American regulatory models (which had acted as a focal point for many pre-crisis international standards). In addition, the failure of many international financial standards to address causes of the crisis has generated more jaded perspectives on the value of international regulatory harmonization. The new post-crisis consensus in favour of macroprudential regulation has also reinforced the case against detailed regulatory harmonization by endorsing greater use of judgment and discretion by national authorities to contain systemic risks.

We live in an historical moment, in other words, when the delegation of power to a supranational authority tasked with harmonizing financial regulation worldwide faces heightened political obstacles. Indeed, if there is a radical change to the governance of international financial regulation, it could well be in the opposite direction towards a more decentralized order. If the incremental nature of international regulatory reform failed to prevent another major global financial crisis, national policymakers might well be prompted to introduce more restrictions on cross-border financial activity and shift towards greater reliance on host country regulation in which international banks were required to established separately capitalized local subsidiaries in each country (particularly if national taxpayers are revealed to be once again the ultimate backstop of institutions

[45] Louis Pauly, "The Financial Stability Board in Context". In S. Griffith-Jones, Eric Helleiner and Ngaire Woods, eds., *The Financial Stability Board* (Waterloo: Centre for International Governance Innovation), p.15.
[46] For more detailed discussion of this theme, see Helleiner and Pagliari, "The end of an era?"

operating in the territory). In a context of global financial turmoil, the attraction of these policies might be that they offer greater protection against unstable global markets and poor regulation abroad as well as enabling national autonomy to be boosted in ways that allow the pursuit of more ambitious regulatory initiatives at home.[47]

The move towards a more segmented, decentralized international regulatory order of this kind could unfold in either a cooperative or non-cooperative manner. The FSB could play an important role in encouraging the former. Under this scenario, national authorities would turn away from the negotiation of detailed harmonized international standards, but they would still benefit from collective commitments to some kinds of international broad minimum standards vis-a-vis sectors and market infrastructure where financial upheavals abroad are more likely to spill over into domestic financial systems. In a more decentralized order, international cooperation could also strengthen national authorities' ability to regulate domestically through information sharing, research collaboration, early warning systems, and capacity building. By fostering these kinds of cooperation, the FSB would be focused on the goal of strengthening the capacity of states to regulate finance within their borders rather than serving as some kind of stepping stone to the construction of supranational body enforcing globally harmonized regulations that superseded national ones.[48]

Conclusion

What have the G20 leaders accomplished in the international financial regulatory sphere to date? There is a strange dichotomy of views on this question. Some - particularly insiders - highlight the successes, arguing that the G20 leaders should be applauded for agreeing to more extensive initiatives in this area than in any other. It is certainly true that they have negotiated a striking number of reforms that address weaknesses in the content of pre-crisis regulation both at the micro and macroprudential level, and across a wide range of issues (banking, SIFIs, credit rating agencies, hedge funds, derivatives, shadow banking, compensation, accounting, and cross-border capital flows). They have also brought a new international organization – the FSB – into existence that is helping to strengthen

[47] For the benefits of host country regulation, see Markus Brunnermeier, Andrew Crockett, Charles Goodhart, Avinash Persaud, and Hyun Shin. *The Fundamental Principles of Financial Regulation* (Geneva: ICMB-CEPR, 2009), Avinash Persaud, "The Locus of Financial Regulation: Home vs Host" *International Affairs* 86(3)(2010): 637-46. See also Dani Rodrik, "A Plan B for Global Finance," *The Economist.* March 12, 2009; The Warwick Commission on International Financial Reform*: In Praise of Unlevel Playing Fields*. (Coventry: University of Warwick, 2009).

[48] Helleiner and Pagliari, "The end of an era"; Eric Helleiner"What Role for the New Financial Stability Board? The Politics of International Standards After the Crisis" Global *Policy* 1(3)(2010): 282-90.

the governance of international financial regulation. The consistent focus that the G20 leaders have given to these often obscure and highly technical regulatory issues has been impressive and the speed with which reforms have been negotiated has often been unprecedented.

Despite these achievements, there is an increasingly widespread sense of disappointment among outside analysts and general public with the results of the international regulatory reform process. The incremental nature of many of the reforms has struck many observers as an inadequate response to the problems revealed by the severity of the global financial crisis. Growing questions have also been asked about the extent to which the commitments made at the G20 summits will actually be implemented at the national and regional levels, questions that have been reinforced by the FSB's lack of teeth. As private financial actors resume pre-crisis patterns of risky behaviour, it is not surprising that questions are being asked about how much the world has actually changed. As the new head of the FSB, Mark Carney, acknowledged, "There's a frustration with policy and a frustration that, 'are things going back to business as usual,'". He added: "If I may say, that is not going to happen, but I can understand the frustrations." [49]

Doubts about the G20's accomplishments in this field have been only reinforced by the renewed global financial turmoil that has been generated by the eurozone troubles. It is far from clear that the thousands of hours of work that have gone into post-crisis G20-led regulatory reforms have made the global financial system much safer from the kind of instability we are now facing. The eurozone crisis has also highlighted starkly the costs of the G20's neglect of important issues, such as the need for a sovereign debt restructuring mechanism that was described a decade ago by Anne Krueger, then-IMF's Deputy Managing Director, as a "gaping hole" in the governance of international finance.[50]

If the current instability spills over into a major global crisis of the kind experienced in the fall of 2008, what will be the consequences for international regulatory reform process? On the one hand, it could generate new political momentum for a more ambitious, and less incremental, approach to international regulatory reform than G20 policymakers have yet been willing to embrace. The Mexican Presidency of the G20 in 2012 could play an important role in mobilizing support around a vision of this kind. That vision could address many,

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[49] Quoted in Jeremy Torobin, "Bank of Canada head calls Occupy protests 'entirely constructive'", *The Globe and Mail*, October 14, 2011. The G20 leaders also felt compelled to declare somewhat defensively at Cannes: "We will not allow a return to pre-crisis behaviours in the financial sector".
[50] Quoted in Eric Helleiner, "Filling a Hole in Global Financial Governance? The Politics of Regulating Sovereign Bond Restructuring" in W.Mattli and N.Woods, eds., *The Politics of Global Regulation* (Princeton: Princeton University Press, 2009).

if not all, of the weaknesses in the post-2008 reform initiatives noted above relating both to the content and governance of international financial regulation.

On the other hand, another major financial crisis could well discredit the goal of international regulatory harmonization and encourage the emergence of a more decentralized pattern of distinct and somewhat segmented regional and national regulatory regimes. Once again, the Mexican G20 Presidency would have an opportunity to play a key leadership role in this scenario. In this case, its task would be to steer centrifugal political pressures in a cooperative direction. If this decentralizing scenario did unfold in a cooperative manner (with the help of the FSB as noted above), it could well generate a more stable global financial system than what we have experienced over the past few decades.[51]

[51] Rodrik, "A Plan B".