

# *Form And Principles In Global Financial Regulation*

David Zaring

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# After The Crisis, Whither Regulation?



"Forgive me, I must start by pointing out that three years after our horrific financial crisis caused by financial fraud, not a single financial executive has gone to jail, and that's wrong." Charles Ferguson, on accepting the Best Documentary Feature Award at the 2011 Oscars.

# Old American Post-Crisis Regulation

- The Traditional Approach
  - Jail for the Principals of Failing Financial Institutions
    - E.g., the S&L Crisis of the 1980s
    - The Government Accountability Office (GAO) concluded that, of the 26 largest thrift failures, 60% had been marred by “serious criminal activity.”
    - The Resolution Trust Corporation (RTC) said criminal fraud was a significant contributor to the failure of 33% of its institutions.
    - The Federal Home Loan Bank Board referred 11,000 cases to the Department of Justice (DOJ) in 1987 and 1988.
    - By 1992, there had been 1,000 convictions, and a reported conviction rate of 91%.
  - Crisis-Driven Governance Reform
    - 1907 Panic – Federal Reserve Act of 1913
    - 1929 Stock Market Crash – The “33 Act” and “34 Act” establishing the Securities and Exchange Commission
    - 1989: FIRREA and 1992 FDICIA – resolution authority enhancements for RTC and FDIC
    - 2001 Enron and WorldCom failures – Sarbanes-Oxley Act
    - 2007-present financial crisis – 2010 Dodd–Frank Wall Street Reform and Consumer Protection Act
      - Created consumer protection regulator
      - New rules for derivatives trading
      - Financial Stability Oversight Council

# New American Post-Crisis Regulation?

- Away From Criminal Sanctions?
- Towards a Global Approach?
- Two New Kinds of International Financial Regulation: Securities and Banking Regulation
- Network Phenomenon
  - The SEC's Increasingly International Focus
- Trade: The Model
- How Does International Banking Regulation Differ From International Trade?
- Is There An Emerging Doctrine For International Banking Regulation?
- Implications And Institutions
  - Will European and American converge?

# The Network Phenomenon

- International work now “comprises over half of my time and responsibilities.” SEC Chair Christopher Cox, January 10 2008
- The European Union is a “Network State,” Manuel Castells, *The Information Age: End of Millennium* 70-165 (1998).
- “The emergence of global rulemaking, with direct consequences for individuals and firms as well as states of course puts pressure on existing national arrangements, unsettles the delicate compromises of decades past, and requires national actors to justify what were once sovereign choices to a world of foreigners.” Joshua Cohen and Charles Sabel, *Global Democracy?* 37 N.Y.U. J. Int'l L. & Pol. 763, 795 (2005)

# Why Networks?

- Global Problems, Local Regulators
- Regulatory Competition: The Race to the Top/Bottom
- Local Regulation, Extraterritorial Effects
- Treaties and Transaction Costs

# The Institutional Solution So Far

“Networks of government officials – police investigators, financial regulators, even judges and legislators – increasingly exchange information and coordinate activity to combat global crime and address common problems on a global scale.” Anne-Marie Slaughter, *A New World Order* 1 (2004)



BANK FOR INTERNATIONAL SETTLEMENTS



FSF

Basel Committee on Banking Supervision

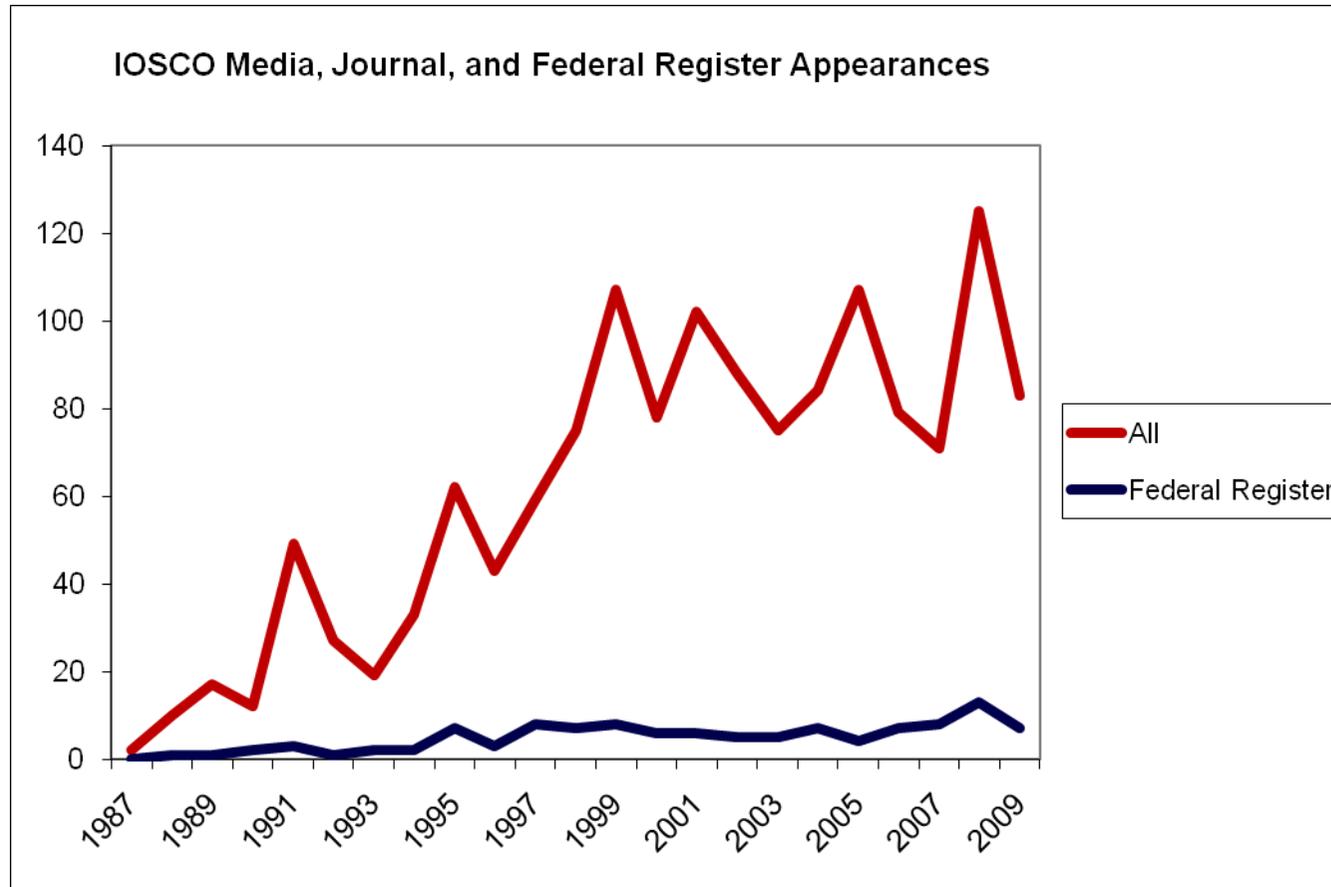
# Harmonization Methods

- Rules - Basel
- Principles - IOSCO
- Best Practices – Every Network
- Enforcement Cooperation – IOSCO MOU

# IOSCO

- Founded 1974 (private bill creating Quebec corporation)
- Inclusive: 100+ members 2009, Technical Committee
- Core Principles
- MOU on enforcement cooperation
  - “the first global multilateral information-sharing arrangement among securities regulators,” that “sets a new international benchmark for cooperation critical to combating violations of securities and derivatives laws.” IOSCO (2008)
- Growth in interest after MOU, rather than Principles, in US

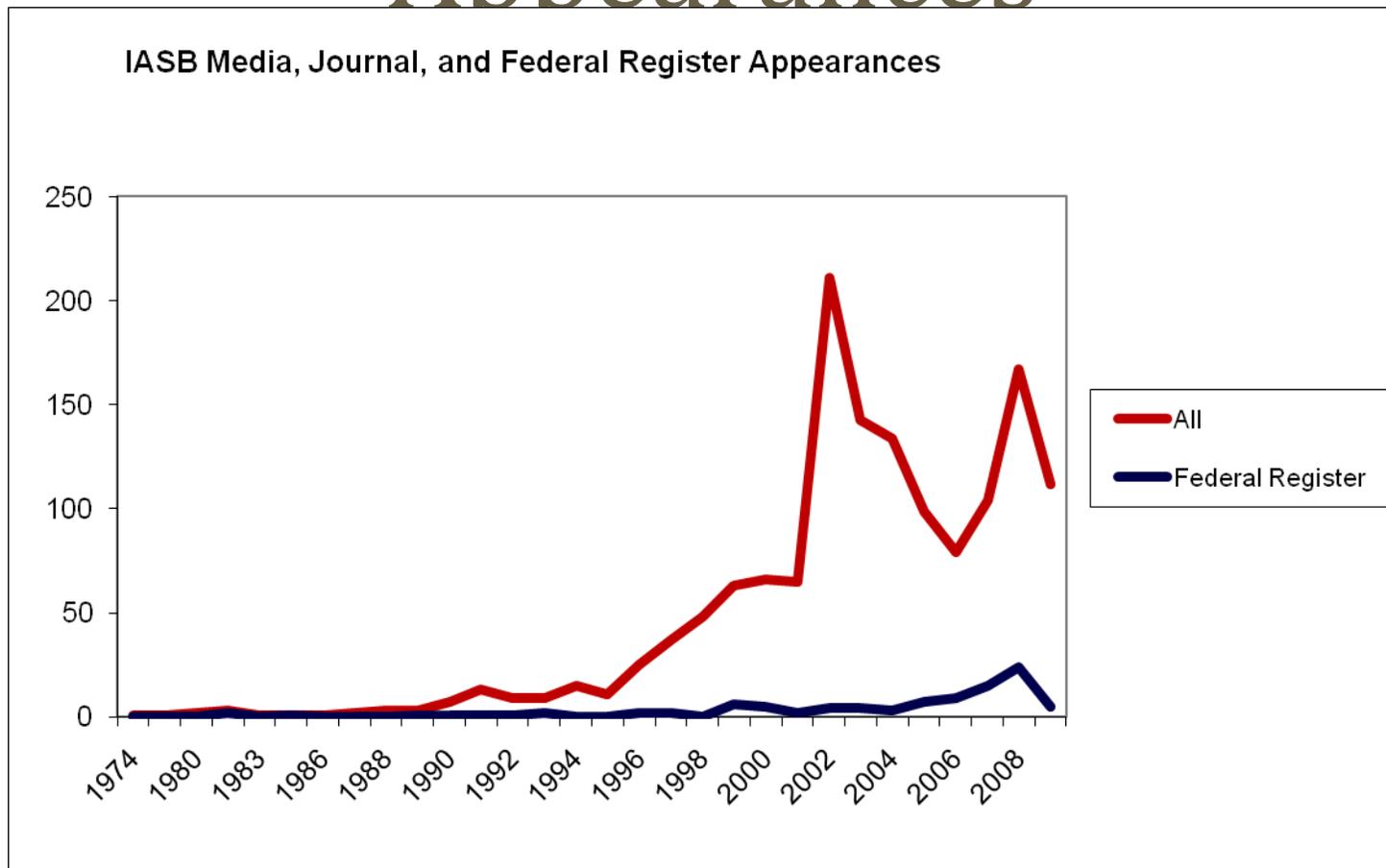
# IOSCO Media, Journal, and Federal Register Appearances



# IASB

- London-based, Delaware corporation
- Exclusive private organization
- International Financial Reporting Standards (IFRS)
  - 59 countries' accounting standard-setters surveyed in 2002; 90% converged to IFRS
  - SEC/FASB exceptionalism – until 2014, at least until the financial crisis

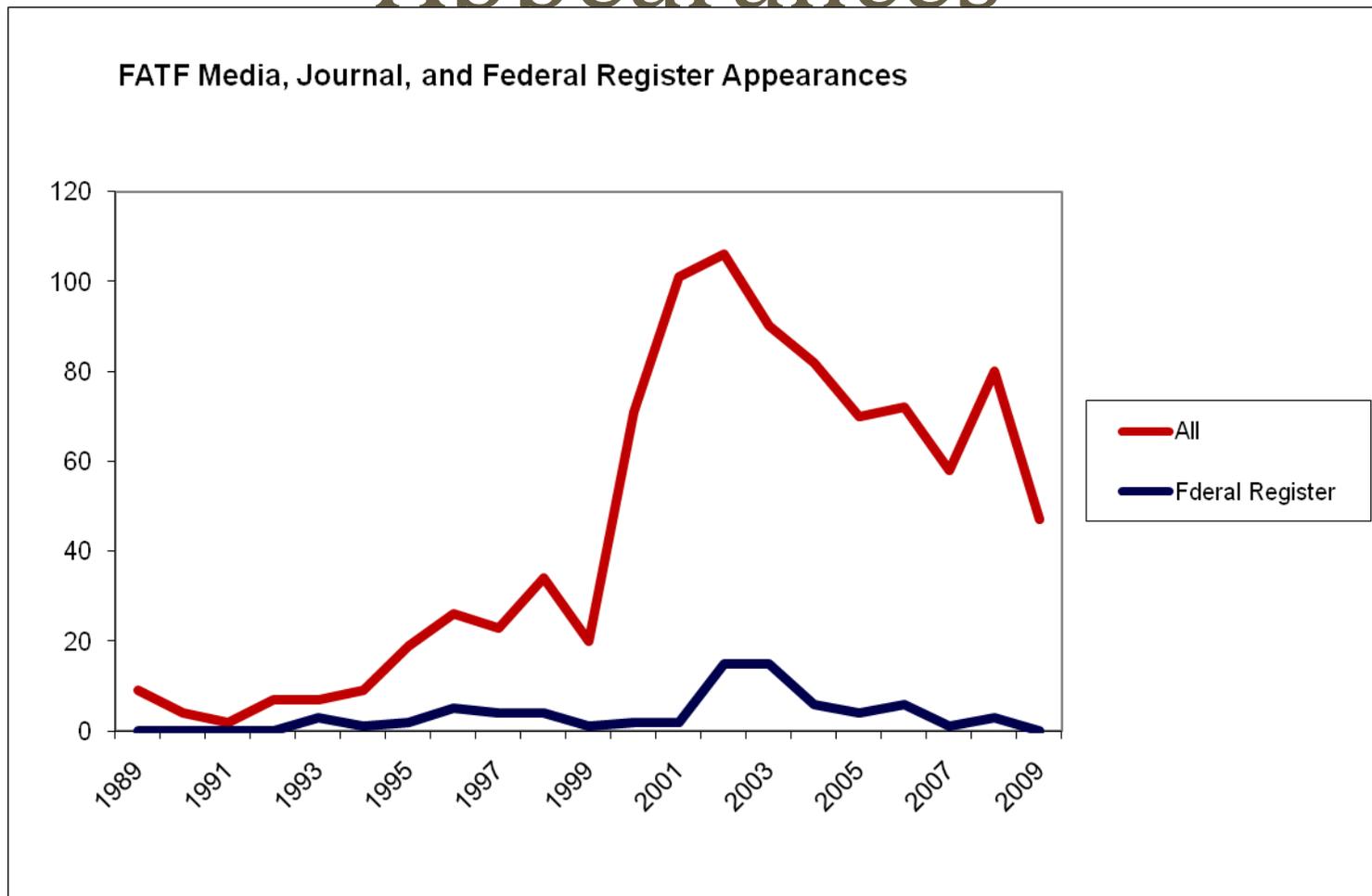
# IASB Media, Journal, and Federal Register Appearances



# FATF

- G7 Announcement 1989
- Exclusive: 34 members 2007
- 40 Recommendations 1990 + 9 2002
  - “set out the basic framework for anti-money laundering efforts and are intended to be of universal application.” FATF 1990
- War on Terror

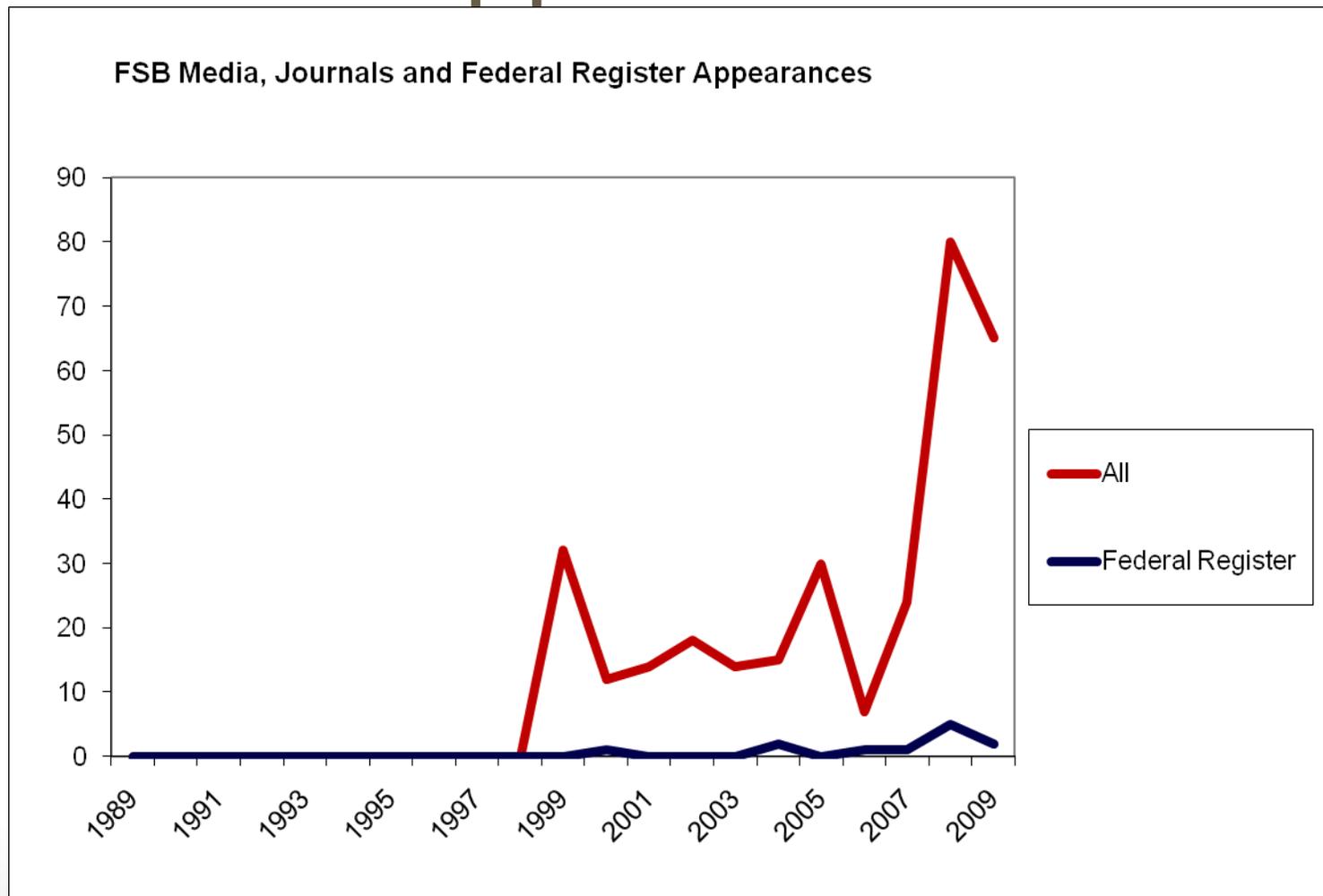
# FATF Media, Journal, and Federal Register Appearances



# FSB

- G8 Announcement 1998
- Exclusive?
- Network of Networks + IMF & World Bank
- “to ensure that national and international authorities and relevant international supervisory bodies and expert groupings can more effectively foster and coordinate their respective responsibilities to promote international financial stability, improve the functioning of the markets and reduce systemic risk.” G20 2009
- Network as talking shop – until, perhaps, 2009

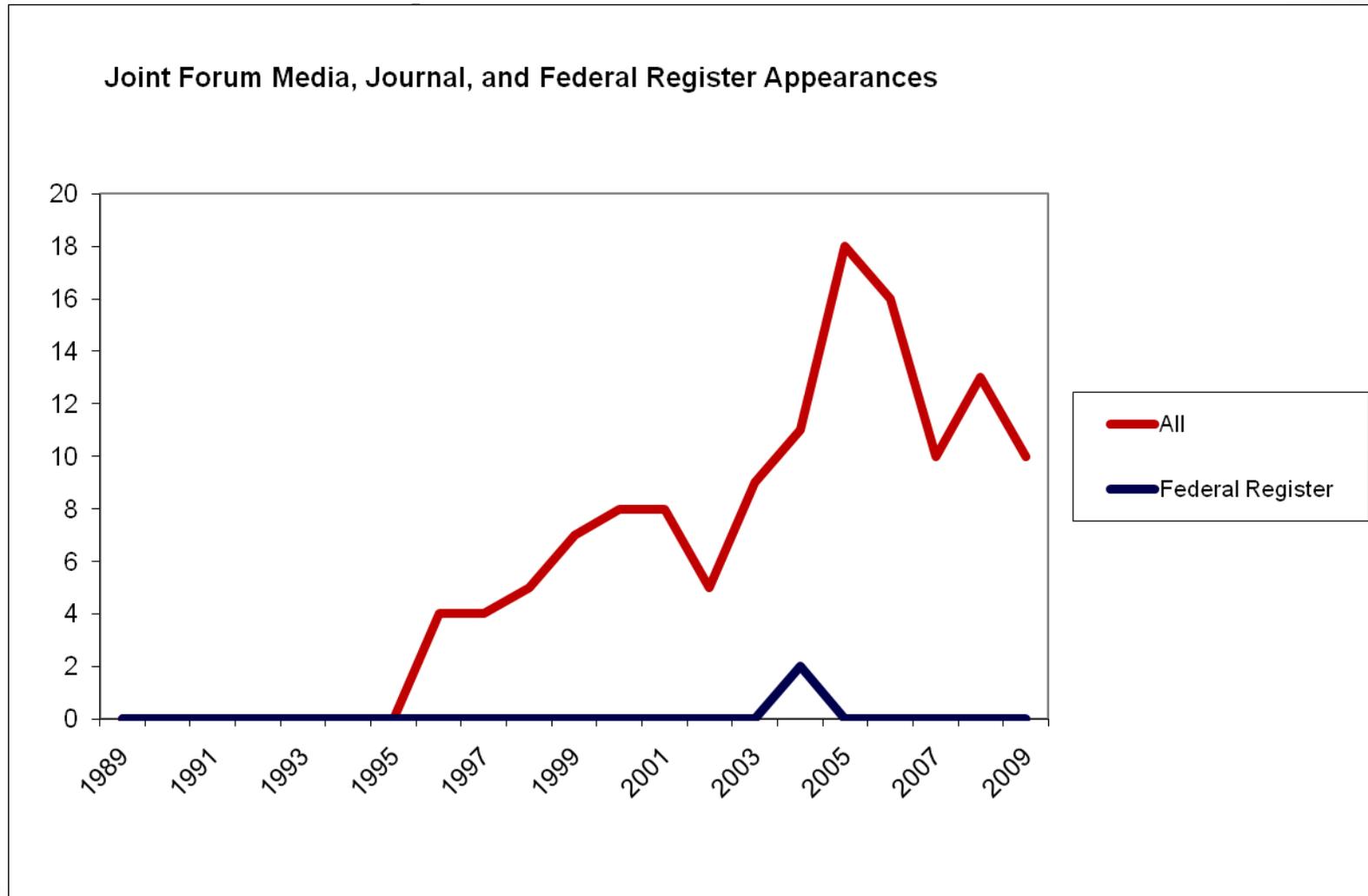
# FSB Media, Journals and Federal Register Appearances



# Joint Forum

- 1996 Basel Committee on Banking Supervision Announcement
- IOSCO, Basel Committee, International Organization of Insurance Supervisors
- Financial Conglomerates
- “[H]elp assessors improve their understanding of the principles and thereby make the implementation and assessment process more effective.” JF Mandate 2009

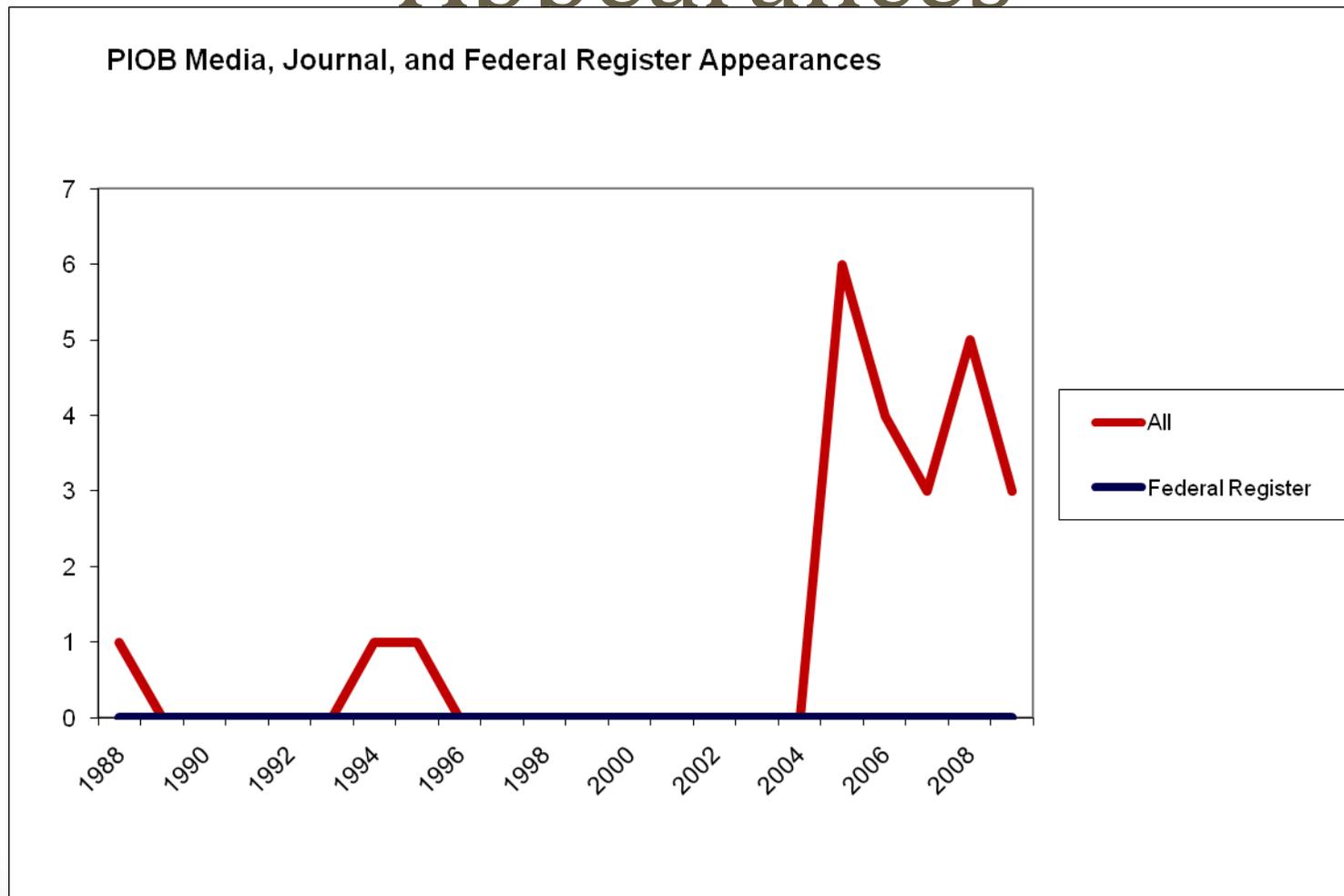
# Joint Forum Media, Journal, and Federal Register



# PIOB

- Announced IOSCO 2004
- “conceived as a response to the crisis of confidence created by numerous corporate and audit failures in the early years of this decade,” PIOB 2009
- Sarbanes-Oxley for IFRS?
- Developing Core Principles, overseeing IFRS implementation by accountants

# PIOB Media, Journal, and Federal Register Appearances



# Two Theories of Network Effectiveness

- Social Networks v. Economic Networks
  - Club goods
  - Cost of exit
    - Brummer 2008
- (Whiggish) Evolution?
  - Enforcement Cooperation (FATF?)
  - Core Principles (IOSCO)
  - Hard Rules (IASB, BCBS)

# Mitrany & Haas

- “No attempt was made to relate [New Deal reforms] to a general theory or system of government. . . . Yet the new functions and the new organs, taken together, have revolutionized the American political system. The federal government has become a national government.”
  - Mitrany 1943
- “the pluralistic thesis that a larger political community can be developed if the crucial expectations, ideologies, and behaviour patterns of certain key groups can be successfully refocused [sic] on a new set of central symbols and institutions,”
  - Haas 1958

# Rulemaking Through Networks

- Basel Capital Accord II
- Cost to lenders: \$50-\$100 million to devise compliance mechanisms
- The proposed regulations run 130 pages in the Fed Reg, many times the size of the first accord.
- The “feel”: akin to domestic regulation, rather than international treaty.
- opened to serial waves of comment, 250 of which were received on the first public draft, including comments from banks, self-regulatory organizations, and other regulators and 200 on a consultative paper about the accord in 2003.

# What Is the International Law of the Basel Committee?

- Is Basel like the WTO and Europe?
  - Subsidiarity - like
  - Enforcement through peer review, not adjudication - unlike
  - Notice and comment rulemaking, not adjudication - unlike
  - Networks, instead of treaty - unlike
  - Non-tariff barriers are the only barriers – unlike?
  - Consensus, but not sovereign equality- unlike?
  - Substantive law – like?:
    - National treatment
    - Vague MFN
    - Division of responsibility: home and host
    - Other principles that mimic banking regulation or other international legal enterprises?
  - Why this project?
    - Do legal principles guide this process?
      - If so, another form of international law with the characteristics of law, predictable, enforceable, procedural
    - Should we broaden our definition of law?

# Summary of Quantitative Disclosure Requirements, Basel II, sec. 825

- “For exposure amounts after risk mitigation subject to the standardised approach, amount of a bank’s outstandings (rated and unrated) in each risk bucket as well as those that are deducted; and
- For exposures subject to the supervisory risk weights in IRB (HVCRE, any SL products subject to supervisory slotting criteria and equities under the simple risk weight method) the aggregate amount of a bank’s outstandings in each risk bucket.”

# What Does This Mean For International Law?

- Basel is not formal international law
  - Made by agencies, not states
  - Avowedly nonbinding
  - No formalities
  - Scholars
    - Slaughter – a transformative new form of cooperation
    - Raustiala – treaties and networks could coexist
    - Posner – as unimportant as any international arrangement
- International economic law success stories
  - European Union
  - WTO/GATT
    - Can we evaluate Basel as an institution by looking at these institutions?

# What Does This Mean For International Law II?

- International relations scholarship:
  - Networks are simply places where states attempt to exercise powers (Newman, Singer)
    - Basel Accord as US/UK collaboration
    - Power politics in informal institutions if anything, could be less legitimate than other forms of international governance.
  - Legitimacy and democratic deficits
    - Networks are the sort of second best governance we often must live with in international relations (Keohane)
- While international law scholarship (esp. Zaring, Slaughter) celebrates networks as a transformative sort of international organization, realist international law scholars are substantially more skeptical.

# Weiler/Pauwelyn

- Weiler: Transformation of Europe
  - Voice, exit – and missing loyalty: Hirschman
  - 1951-1970: juridical foreclosure of exit, political insistence on voice – stasis, and the sidelining of the commission
  - 1970-1992: quiet integration
  - 1992-today: voice guaranteed through parliament, re-energization of commission – the evolution of loyalty?
- Pauwelyn: Transformation of Trade
  - Voice, exit, and missing loyalty
  - 1948-1970: GATT: panels and rounds: foreclosure of exit, political insistence on voice – stasis
  - 1970-1994: quiet integration
  - 1994: the deal: US gives up 301 enforcement, Europe gives up blocking
  - 1992-today: exit eliminated, voice not assured

# The Paradigm Applied To Basel?

- 1974-1988: Basel as vague coordination
- 1988: Basel I: self enforcement, on sophisticated market terms
  - Japan, developing world
- 1989-2002: Quiet integration
  - Basel I evolves from 8% to more elaboration
- 2002-2009: Basel II
  - Capital adequacy through internal models: three pillars
  - Voice, and yet Exit
    - US: yes for investment banks (perhaps to their regret), no for sophisticated banks
  - But also real law: notice, comment, participation, administration
- Basel III
  - Legal accoutrements retained
  - Voice: G20?
  - Exit: self enforced, no ADR

# What Does Basel Do?

- GATT/WTO: Four pillars (Bhala)
  - Most favored nation
  - Bindings
  - National treatment
  - Non-tariff barriers
- Basel
  - Most favored nation? Members agree
  - Bindings – don't really apply
  - National treatment
    - Like the WTO
    - But while one enterprise means to reduce barriers, the other seeks to implement them
  - Non-tariff barriers:
    - TRIPS
    - Basel is an NTB enterprise

# Can We Articulate A Law Of The Basel Committee?

- Rulemaking, not adjudication
  - Voice always, exit in the Weiler sense never?
- Subsidiarity
- Enforcement through peer review, not adjudication
- Notice and comment rulemaking, not adjudication
- Networks, instead of treaty
- Non-tariff barriers are the only barriers
- Consensus, but not sovereign equality
- Substantive law:
  - National treatment
  - Vague MFN
  - Division of responsibility: home and host
  - Goals:
    - Avoidance of arbitrage
    - Minimum standards – safety and soundness
    - Get out of the race

Thank You