The Challenges Facing International Financial Regulation

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The financial crisis in the Fall of 1998 was the first post-World War II crisis in which events in emerging market economies seriously threatened the financial stability of the West, and where the origins of the crisis was clearly to be found in the workings of liberalised markets and private sector institutions. The spark was the financial crisis that overwhelmed many of the Asian economies in 1997, and spread to Russia in 1998, but the centre of the conflagration was the near failure of the hedge fund Long Term Capital Management. More than any of the other problems in the Fall of 1998, the threats that LTCM's difficulties posed to financial stability throughout the world illustrated beyond all reasonable doubt that the international financial system had entered a new era[1]. This was not a problem of sovereign debt, or macroeconomic imbalance, or a foreign exchange crisis. Instead it was the manifestation of the systemic risk created by the market driven decisions of a private firm, and of the behaviour of free financial markets. The potential economy-wide inefficiency of liberalised financial markets was indisputable.

In August 1998, in one of those remarkable coincidences that in retrospect look like good judgement, Lance Taylor and I had delivered a Report to the Ford Foundation that dealt directly with the problem of systemic risk in liberal international financial markets. We had been drawn to this particular topic because of a shared irritation with the overblown claims for the efficiency of financial liberalisation – claims that do not stand up to empirical scrutiny. For example, liberalisation of international financial markets has coincided not only with increased financial instability, but also with a worldwide slowdown in the rate of growth. Whether there is a causal link between liberalisation and that slowdown is, of course, a complex question. But the argument that liberalisation has resulted in a higher growth rate than might otherwise be the case is very difficult to sustain (see Eatwell, 1996).

In our 1998 Report we recommended the establishment of a World Financial Authority (Eatwell and Taylor, 1998). We argued that for efficient regulation the domain of the regulator should be the same as the domain of the market that is regulated. None of the standard tasks of a financial regulator – authorisation, the provision of information, surveillance, enforcement, and the development of policy – are currently performed in a coherent manner in international markets. Indeed, in many cases they are not performed at all. In the absence of a World Financial Authority (WFA) the liberalisation of international markets has resulted in a significant increase in systemic risk, i.e. it has been inefficient.

1. Alan Greenspan commented that he had never seen anything in his lifetime that compared with the panic of August-September 1998.

Our prime objective in proposing the creation of a WFA was to test the regulatory needs of today's liberal financial markets. Whether a single regulator is created or not, the tasks that the model WFA should perform must be performed by someone if international financial markets are to operate efficiently.

The goal of this paper is to take the argument further by identifying the challenges facing international financial regulation today, using the template of a model WFA to identify exactly what the key regulatory tasks might be and thereby to develop proposals as to how they might best be performed. In moving from our initial proposal to this more concrete analysis, consideration must be given not only to the practical developments that have taken place up to now, but also to the international legal and institutional implications of our initial proposals. It is particularly striking that much of the criticism of the idea of a WFA has suggested that the required international cooperation will be impossible to achieve – even when a number of the necessary cooperative mechanisms are already in place! In fact there already exists a body of international legal practice, and a cohort of institutions that would support the further development of the régime of international financial regulation[2]. But that body of legal and institutional practice needs to be assembled and codified in a manner appropriate to today's regulatory needs.

Whilst the emphasis in this paper will be on the development of policy, a not insubstantial part of the argument will be devoted to analysis. This because the theoretical framework within which a new structure of international financial regulation might be formulated is lacking. Without such a framework, policy has inevitably been ad hoc, essentially responsive to pressing need, and deprived of overall coherence. In *Global Finance at Risk* Lance Taylor and I set out the skeleton of the requisite theoretical framework. In what follows I hope to put more flesh on the bones.

A common theoretical framework

Over the past three decades the most difficult task of the financial regulator has been to keep up with the changing marketplace that he or she is supposed to be regulating. The speed of change has, if anything, accelerated, with the continuous development of new trading strategies and new "products", linking assets, markets and currencies in new ways, and creating new risks. In this febrile environment the regulator needs the guidance of a coherent theoretical understanding of the propagation and management of systemic risk, as well as the pragmatic understanding of market institutions and the concrete tools to manage the risk.

2. For example, Will Hutton (1999) in a preview of Eatwell and Taylor (2000) argued that the authors' "… logic is impeccable, but it faces one insuperable obstacle. The United States at present has no intention of ceding any regulatory sovereignty to such an authority". Hutton does not take into account the degree of authority already vested in the consensual decision-making processes of the Basel G10 committees. The capital adequacy requirements of banks in Iowa are determined by a committee sitting in Basel that is not accountable to the US Congress. This approach has not so much involved "ceding regulatory authority" as the recognition of the advantages of collaborative decision-making. However, Will Hutton's point may become more important as the demands for accountability in international regulation become more strident (particularly from developing countries who have, up to now, had only minor roles in development of regulatory rules and practices).

Unfortunately, there is no commonly accepted set of theoretical principles defining what financial regulators are supposed to do, and guiding their actions. It is agreed that systemic risk is an externality, but externalities are peculiarly difficult to define in other than the most abstract terms: Where exactly to external costs and benefits fall? What is their scale relative to the economy as a whole? What is the relationship between particular policies to manage the externality and the performance of the economy as a whole? In the world of finance these difficulties are compounded by the fact that the externality of systemic risk is in large part manifest through a beauty contest – through market participants' belief about what average opinion believes average opinion believes (Keynes, 1936, chpt.12; Eatwell and Taylor, 2000, chpts.1 and 3) – and through the impact of changes in beliefs on macro-economic variables. Assessing the impact of regulation on average opinion is bound to be an art rather than a science, and an imperfect guide to policy.

A further problem in building a coherent theory of regulatory practice is the potential scale of the losses associated with extreme events. Average opinion is typically stable for long periods, dominated by convention. In these circumstances it may be comparatively easy to identify the behavioural relationships that characterise such periods of tranquillity, to believe that they are stable and enduring, and use them to assess values at risk. Yet these seemingly "true models" of the marketplace can be completely overwhelmed by a sharp shift in average opinion, driving markets in previously unimaginable directions, and producing potentially catastrophic disruption in the operation of the real economy[3]. These factors pose enormous problems for the policy-maker. Are regulations to be constructed on the basis of the models of tranquillity, or are they to take account of potentially catastrophic "rare" events when the logic of those models is overthrown? How often do "rare" events actually occur, and what is the relationship between their frequency and the regulation of systemic risk in more tranquil circumstances? Does the cost of defensive regulation against rare events exceed the benefits? Are financial crises simply transitory events, oscillations around the long-run equilibrium of the real economy? Or do crises, and their reverberating impacts on average opinion and on expectations of asset price movements, play a role in determining the long-run performance of the economy, with consequent huge welfare implications?

These questions have both theoretical and empirical dimensions. Lacking generally agreed answers international financial regulation has proceeded by trial and error, regulatory innovations typically following financial shocks. The device of an hypothetical World Financial Authority is designed, in part, to overcome this piecemeal approach. Starting from the perspective of a single regulator of international markets given the objective of maintaining financial stability by limiting systemic risk, the WFA should assess the costs and benefits of particular measures against that goal. It will obviously encounter the problem of evaluating the distribution of costs and benefits. For example, measures to limit short-term capital flows to emerging markets may enhance the stability of financial markets at little cost

3. John Meriwether, former CEO of Long Term Capital Management, commented two years after the activities of his hedge fund had led the financial system of the West to the edge of catastrophe, that "I am not so sure we would have said this earlier - there are times when markets can be much more chaotic than one would ever predict" (quoted in *The Financial Times*, 21st August 2000). But it was not chaos that was the problem, but the design of LTCM's trading strategy. A fundamental error stemmed from the belief that all markets would not move in the same direction at the same time.

to recipient economies, but at significant loss of income to banks in the G10. In these circumstances the WFA (or whatever institution performs its functions) must have the means to develop a coherent analysis of the overall impact on systemic risk, to persuade the participants of the values of the analysis and policies, and to mediate disputes.

Macroeconomic and microeconomic aspects of international regulation

The fact that the externality associated with the risks taken by individual firms is, in many cases, transmitted macroeconomically, requires that regulation be conceived in conjunction with macroeconomic policy. Too often today, regulation is seen as an activity that involves the behaviour and interaction of firms, with little or no macroeconomic dimension. By the very nature of financial risk this is a serious error, and is likely to lead to serious policy mistakes. This is particularly true in an international setting, where a major focus of systemic risk is the exchange rate, a macroeconomic variable changes in which can lead to rapid redistributions of the values of assets and liabilities.

Financial markets are markets for stocks of assets, the value of which today is dependent on the expectation of their future value. Any factor that leads to a shift in expected future values will have an immediate impact on financial markets, and on the major macro-financial variables, the interest rate and the exchange rate. So the failure of a single firm can, by influencing expectations, have an influence not only on its immediate counterparties, or even firms dealing in similar products, but also, through its impact on expectations, on financial markets as a whole, and, via macro variables, on the real economy at home and abroad.

As noted above a peculiarity of market expectations is that they seem to be remarkably stable (or tranquil) for substantial periods of time, even when underlying real circumstances might be decidedly unpropitious. In consequence, the financial markets can resemble the cartoon character who, having run of the edge of the cliff remains suspended for some time in the mid-air, with no visible (or rational) means of support, before suddenly plunging into the abyss. Periods of tranquillity defined by stable expectations and stable market confidence produce the illusion that financial markets are truly reflecting the real economy. The shattering of the illusion can be catastrophic. Keynes referred to this stability of expectations as “the state of long-term expectations” which is determined by “convention” (Keynes, 1936, chpts.5 and 15; Eatwell, 1983). Stable expectations are not necessarily a good thing, since stable pessimism can result in prolonged recession, as, following the burst of the “bubble economy”, the performance of the Japanese economy over the past decade has amply confirmed.

The analytical link between microeconomic risk-taking and the associated macroeconomic externalities has its counterpart in regulatory practice. Microeconomic regulation may be a means of reducing systemic risk, but macroeconomic action may be more efficient. An excellent example of the role of macro-linkages in the formation of regulatory policy has followed the Asian financial crisis of 1997-98. It is clear that an important component of the crisis was the excess foreign-exchange exposure of financial and other institutions in emerging markets. In consequence, the international financial institutions have been urging the authorities in those economies to tighten regulation of short-term forex exposure. The tightening is supposed to take place microeconomically by means of regulations that impact on the actions of individual firms. This is a complex task, and requires a significant input of a scarce resource - trained regulators. Moreover, the quantitative measures proposed are likely to have an uneven effect, limiting the exposure of financial institutions, but missing many holdings outside the financial sector.

The same goal could be attained macroeconomically. Measures that raise the cost of short-term borrowing abroad, such as "Chilean-style" short-term capital controls, would encourage a reduction in the exposure of all firms, financial and otherwise (Agosin, 1998). The higher cost of short-term foreign borrowing "prices in" the risk externality and hence increases economic efficiency. This macro approach would also have the advantage of economising on scarce talent. Yet although capital controls do not today suffer the same level of opprobrium as they did before the Asian crisis, the link between micro and macro means of attaining the same objective is not often made. The neglect of macro-measures is particularly puzzling given that micro-regulation tends to be quantitative and to some degree discriminatory, whilst Chilean-style macro controls are price based and non-discriminatory – characteristics which might be expected to appeal to economic policy-makers.

The difficulty of analysing the macroeconomic transmission of the systemic risk generated by the actions of individual firms, is illustrated by a proposal emanating from within the IMF to construct "macroprudential indicators" (MPIs) to assess the "health and stability of the financial system". As currently constructed MPIs "comprise both aggregated microprudential indicators of the health of individual financial institutions and macroeconomic variables associated with financial system soundness" (Hilbers, Krueger and Moretti, 2000; see also Evans, Leone, Gill and Hilbers, 2000).

The attempt to link micro risk to the performance of the macro economy is laudable, and is exactly where the debate on effective international regulation should be conducted. However, there are two flaws in MPIs as currently conceived. *First*, the *aggregation* of the characteristics of individual firms will not result in an indicator that accurately represents the risk to which the economy is exposed. For example, the *aggregate* capital adequacy ratio of the financial sector, one of the indicators collected, could easily conceal major risks – a few prudent institutions with high ratios disguising the presence of the less prudent. Including data on the frequency distribution of such variables does not fully confront this problem, as the distribution do not capture the nature of the risks taken by individual institutions[4]. *Second*, as yet there has been no attempt to link macroeconomic performance and policy to the incentives surrounding microeconomic risk-taking. Not only is the value of capital, and hence the capital adequacy ratio, directly effected by the revaluation of assets consequent upon a change in the interest rate, but also declines in the level of activity can readily transform prudent investments into bad loans. Taking these two points

4. A further difficulty with the use of capital adequacy ratios as MPIs arises from the ambiguity surrounding the regulatory role of the ratio: is it a buffer, or is it a charge "pricing in" the externality of systemic risk? If ratios must be maintained in all circumstances, capital cannot be a buffer to cover losses; it is needed to fulfil regulatory needs. So the size of the capital ratio merely indicates the size of the charge levied on risk-taking. If the ratio is fixed the charge will not vary significantly as between booms and depressions, yet the risk may undergo large variations.

together, it becomes clear that in the analysis of systemic risk micro and macro factors should not be treated separately. The whole is not just greater, but behaves very differently from the sum of the parts.

Effective international regulation requires a new approach to the theory of financial regulation. This new approach must confront the macro-manifestation of systemic risk within the analysis of the impact of firm behaviour. Building on this theoretical approach it must be recognised that the regulator may be able to operate more efficiently in macroeconomic terms than by means of more traditional initiatives at the level of the firm.

Pro-cyclical and pro-contagion risk management

A further manifestation of the relationship between microeconomic risk and macroeconomic performance derives from the apparently paradoxical links between risk management, the trade cycle and financial contagion. Strict regulatory requirements will result in firms reducing lending as a result of a downturn in the economy, so exacerbating the downturn. In an up-turn, the perceived diminution of risk and the availability of regulatory capital will tend to increase the ability to lend, stoking up the boom (see Jackson, 1999).

This pro-cyclicality of regulation is further amplified by the contagion-inducing techniques of risk management. During the Asian crisis, financial institutions reduced their exposure to emerging markets throughout the world. These cutbacks helped spread the crisis, as reduced lending and reduced confidence fed the financial downturn. The key to the problem is, once again, the link between micro-economic actions and macro-economic consequences. Rational risk-management by individual firms precipitates a macro-economic reaction that, in a downturn, can place those firms and other firms in jeopardy, indeed could overwhelm the firms' defences entirely. Yet because the links between regulation and macroeconomic policy are so little understood, there is no coherent policy response to this perverse consequence. Under pressure, regulators have adopted pragmatic solutions. At the onset of the Latin American debt crisis in the early 1980s many major US banks were technically bankrupt, since Latin American assets held on their books had lost their entire market value. Nonetheless, US regulators allowed those worthless assets to be evaluated in the banks' balance sheets at their value at maturity, hence boosting the banks' notional capital and preventing a sudden collapse in lending and liquidity[5]. In the autumn of 1998, many assets held on the balance sheets of financial institutions in London and New York were, if marked to market, worth nothing. Again, the regulators did not insist on an immediate (potentially catastrophic) write down.

Philip Turner (2000) has argued for a "microeconomic solution" to the procyclicality of regulation:

> "The ideal response to procyclicality is for provisions to be made for possible loan losses (i.e. subtracted from equity capital in the books of the bank) to

5. This does not mean that regulatory standards were abandoned entirely: "… money centre banks whose loans to heavily indebted countries exceeded their capital in the early 1980s were allowed several years to adjust – but there was no doubt that they would have to adjust" (Turner, 2000).

> cover normal cyclical risks. If done correctly, provisions built up in good times can be used in bad times without necessarily affecting reported capital."

But he notes that even this sensible provision for "normal cyclical risks" can run foul of current regulatory procedures:

> "The first stumbling block is that tax laws often severely limit the tax deductibility of precautionary provisioning and may insist on evidence that losses have actually occurred. This is important because loan loss provisions increase internal funding for the bank only to the extent that they reduce taxes.
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> A second possible stumbling block may be the securities laws. For example the SEC in the United States has argued that precautionary provisioning distorts financial reports and may mislead investors. There may then be a trade-off between very transparent, well-documented accounting practices, on the one hand, and the need for banks to build up reserves during good times, on the other.
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> A third possible stumbling block is that the management of banks may be too eager to report strong improvements in earnings during booms (and so too reluctant during good times to make adequate provision for losses). The present wave of takeovers in the banking industry may accentuate this eagerness: good reported earnings and high share prices serve to fend off takeovers."

But even if these stumbling blocks were overcome, as surely they could be, Turner's proposal of extra provisioning would only serve to alleviate the problems created by the procyclicality of regulation in "normal" circumstances. It does not address the issue of the tendency of regulatory standards to deepen and widen major downturns, and to fuel booms. This tendency will become increasingly severe in developing countries as they are further integrated into international capital markets, and adopt the required risk management regulatory procedures. For all countries, there is the further difficulty that even if some sort macroeconomic response were available to offset the procyclicality of regulation, macroeconomic policy is essentially national, whilst the problem may well be international in origin and scope. The very least that a WFA could do is assist in the coordination of macroeconomic responses. At a more general level the presence of a WFA would facilitate the international development of policies that link regulatory risk-management procedures and the needs of macroeconomic balance.

The challenges facing international financial regulation

If the challenges facing international financial regulation today may be best identified through the device of an hypothetical WFA, then: What tasks should be performed by such an Authority? What should be the legal foundation of WFA action? How are the tasks to be performed?

What tasks should be performed by a WFA?

A national financial regulator performs five main tasks: authorisation of market participants; the provision of information to enhance market transparency; surveillance to ensure that the regulatory code is obeyed; enforcement of the code and disciplining of transgressors; and the development of policy that keeps the regulatory code up to date (or at least not more than 10 metres behind the market in a 100 metre race). These are the tasks that now need to be performed at international level, ideally *as if* performed by a unitary WFA.

For example, it is clear that criteria for authorisation should be at the same high level throughout the international market: ensuring that a business is financially viable, that it has suitable regulatory compliance procedures in place, and that the staff of the firm are fit and proper persons to conduct a financial services business. If, in a liberal international financial environment, high standards are not uniformly maintained then firms authorised in a less demanding jurisdiction can impose unwarranted risks on others, undermining high standards of authorisation elsewhere.

Similarly, as far as the information function is concerned, the failure to attain not only transparency but also common standards of information undermines the efficient operation of international financial markets, and creates risk. The persistent inability to agree international accounting standards is a prime example of just such a failure.

Surveillance and enforcement are the operational heart of any effective regulatory system. Without effective, thorough policing of regulatory codes, and uniform enforcement of standards by appropriate disciplinary measures (including exclusion from the market place) the international financial system is persistently exposed to unwarranted risks.

Finally, the policy function is the essential driving force of effective regulation. Regulatory codes must be adapted to a continuously changing marketplace. An important component of that change is international. As national financial boundaries dissolve, and as new products are developed that transcend international boundaries by firms with a worldwide perspective, the policy function must ensure that the regulator is alert to the new structure of the marketplace, the new systemic risks created, and to the new possibilities of contagion[6]. This requires a unified policy function, capable of taking a view as to the risks encountered by particular markets and by the international market place as a whole.

What should be the legal foundation of WFA action?

All these activities are necessary for the efficient operation of the new international financial order. All point to the need for a single authority determining common rules and exercising common procedures. But there are clear, in some cases overwhelming difficulties to attaining that goal, of which the problem of achieving common accounting standards are but a foretaste. All five core activities involve the exercise of authority, and hence trespass into very sensitive political areas. Nation states are naturally reluctant to cede powers to an international body, even if this might mean the acquisition of (collective) sovereignty over activities otherwise beyond their

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6. An important recent example was the use of credit derivatives in Indonesia that ultimately spread financial losses to South Korea.

control. When powers are ceded, this is done typically by treaty, confirming collective rights and responsibilities, and, at least in principle, accountability. But it can also be done by the consensus and by the mutual recognition of self-interest that produces "soft law".

Article IV of the Articles of Association of the IMF empowers the organisation to "oversee the international monetary system in order to ensure its effective operation". To this end the provision that "the Fund shall exercise firm surveillance over the exchange rate policies of members" has been interpreted as covering general macroeconomic surveillance, and, in the new Financial Sector Appraisal Program, *microeconomic* surveillance of the operations of the financial sectors of member states[7]. This new microeconomic, private sector role was made explicit on 1st March 2001, when IMF announced the creation of a new International Capital Markets Department, the task of which is "to enhance … surveillance, crisis prevention and crisis management activities". It is proposed the new Department's responsibilities will include "the systematic liaison with the institutions which supply the bulk of private capital worldwide" (IMF, 2001).

The new FSAP surveillance concentrates on the adherence of national regulation and practices to core principles developed by the Basel committees of the G10, the International Organisation of Securities Commissions (IOSCO) and the International Association of Insurance Supervisors (IAIS)[8]. It is an activity of considerable sensitivity. Not only will comprehensive surveillance require large resources, but also the IMF could easily be drawn into the position of "grading" national financial systems, with any downward revision of grades having the potential to produce dramatic financial consequences (IMF, 2000B). Nonetheless, the IMF, as an accountable body the powers of which are defined by treaty, can legitimately perform a surveillance function. Moreover, in due course the IMF will require countries seeking its assistance to conform to international regulatory codes and standards. In other words, it will be able to *enforce* conformity to those standards, with severe financial penalties (withdrawal of offers of assistance) for those who do not comply. It is to be doubted, however, whether it could, other than by persuasion, effectively enforce regulatory codes when they are infringed by the more powerful countries that do not requires the Fund's assistance (Eatwell and Taylor, 2000, chpt. 7).

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7. Many characteristics of domestic financial systems may be only indirectly connected to "the exchange rate" as such. Nonetheless, it is not unreasonable to link *domestic* regulation to *international* financial stability.
8. For example, the June 2000 IMF "experimental" *Report on the Observation of Standards and Codes* (ROSC) for Canada, prepared by a staff team from the International Monetary Fund in the context of a Financial Sector Assessment Program (FSAP), on the basis of information provided by the Canadian authorities, produced "an assessment of Canada's observance of and consistency with relevant international standards and core principles in the financial sector, as part of a broader assessment of the stability of the financial system. ….. The assessment covered (i) the Basel Core Principles for Effective Banking Supervision; (ii) the International Organization of Securities Commissions' (IOSCO) Objectives and Principles of Securities Regulation; (iii) the International Association of Insurance Supervisors' (IAIS) Supervisory Principles; (iv) the Committee on Payment and Settlement Systems (CPSS) Core Principles for Systemically Important Payment Systems; and (v) the IMF's Code of Good Practices on Transparency in Monetary and Financial Policies. Such a comprehensive coverage of standards was needed as part of the financial system stability assessment for Canada in view of the increasing convergence in the activities of banking, insurance, and securities firms, and the integrated nature of the markets in which they operate." (IMF, 2000A).

But the IMF is using a treaty-sanctioned surveillance function to examine adherence to codes and principles that are not themselves developed by accountable treaty bodies. The rules that the IMF is seeking (experimentally) to embody in its surveillance programme are predominantly formulated within non-treaty, “soft-law” environments.

As Alexander (2000A) explains:

> “Soft law may be defined as an international rule created by a group of specially affected states which had a common intent to voluntarily observe the content of such rule with a view of potentially adopting it into the national law or administrative code.”
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> “International soft law refers to legal norms, principles, codes of conduct and transactional rules of state practice that are recognised in either formal or informal multilateral agreements. Soft law generally presumes consent to basic standards and norms of state practice, but without the *opinio juris* necessary to form binding obligations under customary international law.”

Soft law evades some of the political difficulty of the assignment of sovereignty implicit in international regulation because it does not impose an obligation, even though there is an expectation that states will take agreed codes seriously. In financial matters the most powerful means of enforcing soft law has been the competitive market. A major example of this process was the rapidity with which OECD and other economies subscribed to the 1987 bilateral agreement between the UK and the US to adopt capital adequacy standards for banks. A failure to subscribe would undermine market confidence in a country’s financial sector – too high a price to pay. In 1993 the US reinforced the powers of the marketplace by legislation to exclude from US markets banks that failed to attain the capital adequacy standards,

The adoption by the IMF of soft law as a criterion of surveillance suggests a process of transition from soft law to mandatory regulation, at least for those countries that are beholden to the IMF. Observation of Basel and other codes will become an IMF imposed obligation. If this happens, new questions will be raised about the accountability of the Basel rule-makers and their counterparts at IOSCO and the IAIS.

Even with this potential “legalisation” of international policy-making and of surveillance (which includes some standardisation of the information function in the drive for “transparency”), authorisation and, for the richer countries, enforcement remain national activities – though even here agreements on home-host division of responsibilities inject an international dimension.

There is, in effect, a creeping internationalisation of the regulatory function in international financial markets. That internationalisation is essentially *confederalist* in character, with national jurisdictions being the predominant legal actors guided by international soft law. So some of the functions of a WFA are being performed. But they are being performed imperfectly. Authorisation is still essentially national, the information function is highly imperfect, surveillance (by the IMF) is as yet “experimental”, enforcement is national, and the policy function is predominantly driven by an exclusively G10 consensus. As measured against the template of a proper WFA there is a long way to go.

However, the difficulty of creating an effective framework of international regulation does not derive solely from international legal practice and from politics. An important element of disjuncture derives from history – from differences in national legal systems, in financial custom and practice and in structures of corporate governance. Even within the European Union, for example, there are major differences in national legal systems and in corporate governance that make the introduction of a common regulatory code not only difficult, but potentially damaging (see ECOFIN 2000 for an analysis of these difficulties within the European Union). Regulatory codes that enhance efficiency in one jurisdiction may have exactly the opposite effect in another.

A central theme of Eatwell and Taylor (2000) is that efficient regulation requires that the domain of the regulator should be the same as the domain of the market that is regulated. However, whilst financial markets are "seamless", they are not homogeneous. In consequence uniform financial regulations often have quite different practical effects. The result is that uniform codes will expose the financial system to different systemic risks in the light of their differential impact in different jurisdictions (Alexander and Dhumale, 2000).

This is the central weakness of the fixed regulatory requirements and ratios emanating from the Basel committees, and, the strength of the Basel system of codes. What is ideally required is that there should be an assessment of the relationship between the financial structure of national jurisdictions and the systemic risk emanating from each jurisdiction. That ideal is probably unattainable, since it would require detailed consideration and negotiation of each hypothetical national case – an overwhelming task. A more pragmatic approach would involve:

(a) the construction of specific rules in those cases which refer to basic institutional tenets that are universal, and are necessary for the success of any regulatory environment;

(b) in those circumstances where national legal and governance structures predominate the development of national codes derived from common internationally agreed general principles.

In case (b) regulation is developed at two levels: *first*, a set of general principles, *second*, from these principles should be derived codes that are both flexible as circumstances change and reflect the peculiar legal and governance structures of individual countries. This is, of course, the defining characteristic of the current soft law regime. But at present many of the principles are "ideal types", to be desired rather than enforced. If principles are to be the foundation of an effective regulatory system they must be expressed through clearly articulated codes, which are regularly tested against the principles they are supposed to embody, and against the systemic risks they are supposed to manage. There will undoubtedly be differences of opinion as to whether a particular set of national codes accurately reflects shared principles, and it will be necessary to put in place powerful procedures for adjudicating disputes (another role for a WFA).

The cause of uniform adherence to principles will be reinforced by market competition, in rather the same manner as competition has led to the widespread adoption of Basel capital adequacy standards. Moreover increasingly open markets are likely to produce competitive convergence in standards and procedures of corporate governance that will in turn permit a movement toward uniform regulatory codes, i.e. an increasing role for the universal rules referred to in (a) above.

How are these tasks to be performed?

Whilst the template of a WFA clarifies the tasks that must be performed if international financial markets are to be regulated efficiently, it does not provide much guidance as to how the tasks are actually to be performed in the more likely absence of a unitary authority. In practical terms many tasks can and must be delegated to national authorities. But it is important that national authorities should operate within common guidelines. That is the importance of the WFA – not to tell national authorities what to do, but to ensure that in a single world financial market they behave in a coherent and complementary manner to manage the systemic risk to which, in a seamless market, they are all exposed. Effective international regulation will necessarily be confederal, with different responsibilities at appropriate levels of the system. But there must be a coherent confederation with common principles and common values, resulting in (converging) national codes enforced by national authorities to attain common goals.

Devising an institutional structure: the legacy of post-war international financial regulation

The development of international financial regulation since 1974 has been essentially reactive.

The first major reaction was to the fact of liberalisation itself. The three decades following the end of World War II had seen the refinement of the tools for managing systemic risk in *domestic* monetary and financial systems. Allied with the international commitment to the management of financial flows that was a key component of the Bretton Woods system, these domestic arrangements had resulted in 25 years of reasonable financial stability in most OECD countries. This is not to say that there were not financial crises, there were. But they were predominantly of macro-economic origin, disrupting the micro-economy: high inflation rates undermining confidence in monetary policy, or persistent current account deficits undermining confidence in the exchange rate. The bad old days of micro-economic instability spreading as contagion through the financial sector and destabilising the macro-economy belonged to the pre-war era of economic disaster, from which important lessons had been learned[9]. Those lessons were now embodied in

9. The distinction between crises emanating from the micro-economy and those that are macroeconomically induced is worth further consideration. Though the second phase of the Great Depression was marked by failure at the micro level, that of the Austrian bank, Credit Anstalt, much of the responsibility for the depression rests at the door of inappropriate macroeconomic policy – particularly adherence to the Gold Standard and domestic monetary policies associated with the Gold Standard (Temin, 1989). Similarly, the recent Korean crisis derived substantially from the decision of the Korean government to join the OECD, and to accept the required liberalisation of financial markets.

appropriate policies and institutions. Important amongst these institutions were powerful regulatory structures and interventionist central banks dedicated to the management of (indeed the minimisation of) systemic risk.

There had, of course, been a partial relaxation of wartime and immediate post-war regulation through the 1950s and 1960s. But even at the end of the 1960s the regulatory régime was powerful and national. In the United States domestic money markets were particularly tightly regulated, and President Johnson's interest equalisation tax was used to manage international capital flows. Throughout the OECD the public authorities' international role was dedicated to the maintenance of the fixed exchange rate system. The collapse of the Bretton Woods system of fixed exchange rates in 1971 resulted in the privatisation of foreign exchange risk. If the private sector was to carry this risk it needed to be able to diversify its financial assets amongst a variety of monetary instruments and currencies. So it was necessary to dismantle much of the post-War international and domestic financial regulation that would have prevented that diversification. But dismantling controls threatened to recreate the unstable pre-War environment (see Eatwell and Taylor, 2000, chapter 1).

As international barriers to financial flows disappeared national regulators and national central banks were trapped in increasingly irrelevant national boundaries. The domain of banks, investment houses, insurance companies and pension funds became international. In a rapid return to the pre-War norm, it was a micro-economic failure (of the Herstatt Bank in 1974) that threatened severe disruption of the US clearing system and hence of the US macro-economy. In recent years the Asian crisis also stemmed primarily from failures in the private sector reverberating through the macro-economy.

An important response to the new environment was the establishment in 1975 of Basel committees at the BIS. These committees reported to the grouping of central bankers of the major economies, the Group of Ten (G10). The task of the committees amounted to an attempt, via consensual decision making, to formulate on an international scale some of the powers that had earlier been deemed necessary to stabilise national financial systems. The scope of those committees has steadily increased since 1975, usually in response to crises (Eatwell and Taylor, 2000, chpt. 6). A crucial development came in 1988, with the adoption of capital adequacy criteria. International financial regulation was not just about cooperation, but about the coordination of standards – standards agreed in Basel.

A further important development came in response to the Mexican bond crisis of 1994. The G7 governments, responding to what was perceived to be the excessive instability of financial markets, agreed at their Halifax summit in 1995 that the regulation of international financial markets should not be left to the G10, but should be on the agenda of intergovernmental discussions. At first not much was achieved in concrete terms. Then the Russian bond crisis of 1998, coming as it did at the end of a period of extreme instability emanating from Asia, brought home to G7 governments

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This led to private sector firms increasing their foreign exchange exposure to excessive levels (Chang, Park and Yoo, 1998). In both the 1930s and the 1990s, an inappropriate macroeconomic environment resulted in excessive risk taking by firms. In the 1950s and 1960s macroeconomic crises were not associated with excessive private sector risk taking (which was constrained by strict regulation) but with major macroeconomic imbalances.

that their economies are not immune from the contagion of third world financial turbulence. The response was the creation of the Financial Stability Forum, and establishment of the World Bank-IMF Financial Sector Assessment Program (FSAP) under the direction of the joint Bank-Fund Financial Sector Liaison Committee (FSLC).

The FSF has brought together, on the one hand, the political and the supervisory authorities, and, on the other hand, the regulatory authorities and the macro-economic policy-makers. So, on the operational side, the supervisors are meeting with the politicians and treasury staff who can get things done. On the economic side it brings together regulation and macroeconomic policy, a vital, and up to now missing, component of effective international regulation. At the moment, whilst it has produced some excellent reports, the FSF is a think tank with nowhere to go. It is not at all clear what action will follow the reports, or, indeed, who will act. Having suffered a fright in 1998, the policymakers in national treasuries are retreating from the sort of collaborative view of the world that the establishment of the FSF seemed to foreshadow.

The FSAP involves the Bank and IMF in detailed micro-economic appraisal of the financial markets and regulatory institutions of selected nations. This level of detailed appraisal of private sector structures is a significant change in the involvement of the IMF in a nation's economic affairs, and probably marks a turning point in the surveillance activities of the Fund. The pressure for a new international regulatory regime is leading to a significant reinvention of the IMF.

It is not as yet clear what will prove to be the respective roles of the Basel committees, the Financial Stability Forum (FSF) and the new Bank-Fund structures in the future management of international regulation. What is clear is that the issues identified in the WFA project have proved to be the fundamental issues that must be addressed if that future management is to be accountable, legitimate, and successful.

Devising an institutional structure: the role of the template WFA.

In a liberal international financial system each nation faces risks that may emanate from behaviour entirely outside its jurisdiction. As was demonstrated in the Fall of 1998, even very strong states face risks that may derive from financial crises in poor countries. The desire to manage risks may lead to two polar reactions: *first* the attempt by the rich and strong to manage the poor and weak, to protect the rich from external threat; *second*, cooperation between all countries to manage risk internationally. All procedures for international regulation will fall somewhere on a scale between these two extremes. Other than in the polar first case, international regulation will involve some pooling of sovereignty, even if only at the level of initiating proposals.

Treaties designed to establish international authority and procedures, such as the treaty agreeing the Articles of Association of the IMF, are a pooling of sovereignty in the pursuit of negotiated ends. They also typically contain procedures to ensure some accountability by the international institutions to the national signatories. As Alexander (2000A) has pointed out, the pursuit of international goals by means of treaties has high transactions costs, and may be restrained by uncertainty:

> "One set of problems falls under the heading of *transaction costs*. Complexity of the issues, difficulties in negotiating and drafting, the number of participants and similar factors make it difficult for governments to agree on precise, binding and highly institutionalised commitments. …..
>
> Another set of contracting problems concerns the pervasive uncertainty in which states and other international actors must operate. Many international agreements can affect national wealth, power and autonomy. Yet governments can never foresee all the contingencies that may arise under any agreement. They are never certain that they will be able to detect cheating or other threats. They cannot even be sure how they will react to particular contingencies, let alone how others will. These problems are exacerbated by the relative weakness of the international legal system that cannot fill gaps and respond to new situations as easily as domestic legal systems can.
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> One way to deal with uncertainty is through soft delegation: not to courts, but to political institutions, subject to continuing oversight and control, that can produce information, monitor behaviour, assist in further negotiations, mediate disputes and produce interstitial or technical rules. Another is through imprecise norms that provide general guidelines for expected behaviour while allowing states to work out more detailed rules over time. A third way involves crafting relatively precise, but nonbinding, rules that allow actors to experiment by applying the rules under different conditions while limiting unpleasant surprises. All these approaches have costs, including their limited ability to regularise behaviour. Yet on balance they are frequently seen as beneficial, permitting states to achieve some immediate gains from cooperation while structuring ongoing learning: this is a political process that can take states further along the path of the institutionalisation of obligations."

Because treaties must overcome these difficulties they are typically a compromise, and inevitably inflexible. Moreover, because they necessarily embody some degree of accountability to their signatories, they tend to be slow moving. These are rather unattractive characteristics in the field of international financial regulation. It is therefore not surprising that developments have taken a different route, with the major role being played by the non-treaty committees housed at the BIS, together with IOSCO and the IAIS:

> "The process of devising international norms and rules to regulate international banking activity involves a form of international soft law that has precise, non-binding norms that are generated through consultations and negotiations amongst the major state regulators. This particular form of international soft law provides the necessary political flexibility for states to adopt international rules and standards into their national legal systems in a manner that accommodates the sovereign authority of the nation state. States could then move forward through the process of legalisation by building on the collective intent of the major economic powers to develop binding international rules for banking supervision. States could potentially delegate the adjudication of violations to an international financial authority, but states would retain ultimate enforcement authority, including sanctions" (Alexander, 2000A).

The problem here is, of course, the predominant role of the major states. An effective soft-law regime works by consensus, and a grudging consensus imposed by the major states upon others is likely to be less effective than a consensus in which all participate. Whilst the existence of a legal structure does offer some protection to weaker countries, whose sovereignty is compromised by the very fact of being economically (and perhaps politically) dominated by the developed countries[10], the fact that that structure is determined by the G10 raises the obvious question of whose interests are being protected.

The "obvious" solution of increasing the representation on the Basel committees runs the risk of overloading the decision-making mechanisms, and losing their flexibility. The partial solution adopted at the FSF, of involving a wider range of countries on policy making committees is attractive, but it may not prove to be widely acceptable if the proposals contained in the reports produced by the FSF harden into concrete policy measures.

Ultimately the choice between a soft law and a formal treaty régime may come to the conclusion: "both". The treaty will lay down a method for developing general principles that should guide the regulators, and a mechanism for developing codes derived from those principles. The task of developing the codes can then be entrusted to a less formal body, akin to the current Basel committees.

Today an institutional structure of international financial supervision is emerging which embodies, albeit imperfectly, a few of the features of an idealised WFA. The authorisation function is the responsibility of national regulators, with access to markets being determined by the presence or absence of agreements specifying the terms of mutual recognition. The information function is performed partly by the international financial institutions, particularly the BIS, partly by the International Accounting Standards Committee, and partly by national regulators, stock market rules, and so on. The surveillance function is performed by the World Bank-IMF financial sector programme, and by national regulators[11]. The enforcement function is being developed as an implicit outcome of the World Bank-IMF financial sector programme, and is otherwise the responsibility of national authorities. The policy function is in the hands of the BIS committees, IOSCO and the IAIS, the Financial Stability Forum, the IMF, and national authorities.

This list of international regulatory activities has four major features:

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10. "Small states … may have negative sovereignty costs, since legal arrangements offer them protection from powerful neighbours. Large states, by contrast, would appear to be in less need of legalisation, though in fact they might seek it as an efficient way to structure governance where they can dictate the rules and exert political control over their implementation. Soft legalisation can bridge the gap between weak and strong states. This is especially true of the type of legalisation … where norms and rules are binding and relatively precise but authority for compliance is delegated to national political institutions. In this situation weak states are protected by legal rules that fix expectations of behaviour, while strong states maintain influence in political bodies where they can shape future developments" (Alexander, 2000A).

11. In addition the international surveillance of financial crime, particularly money laundering, is conducted by the Financial Action Task Force (see Alexander, 2000B).

1. If the same list were compiled 10 years ago most of the regulatory functions, with the exception of the policy function, would lack any international dimension. Today in all areas other than authorisation, international bodies are taking up some of the regulatory tasks.

2. There is an eclectic mix of national institutions, international agreements (soft and hard) and international institutions (with varying degrees of legitimacy). Some powers are developing almost accidentally, such as the emergence of an enforcement power at the IMF via the FSAP programme. Others are developing by design, such as the work of the International Accounting Standards Committee. All are developing under the pressures for effective policy exerted by the process of financial market liberalisation, particularly at times of crisis.

3. The list deals only with major international regulatory developments, and omits the growth of *regional* regulation, notably in the European Union. The case of the European Union is particularly interesting since it involves the attempt to develop a fully liberalised, single financial market, characterised by a wide range of different legal practices and structures of corporate governance amongst member states.

4. Measured against the template of a WFA the list displays an international regulatory structure that is limited, even incoherent. It portrays a patchwork response to crises rather rational response to the international development of systemic risk.

This patchy, often incoherent structure embodies significant threats to financial stability. On the one hand the growth of international institutions, such as the FSF, induces the feeling that "something has been done" to tackle systemic risk. On the other hand, the very limited powers of any of the international structures listed above suggest that such complacency is a delusion.

The developments of the past thirty years, and more especially, the innovations of the last three years point to the recognition by states and by market participants of the need for coherent international regulation. But the present conjuncture, in which the predominant rule making bodies are the Basel committees, IOSCO and the IAIS, whilst the predominant international surveillance body (in so far as there is any international surveillance at all) is the IMF, is an awkward hybrid. Moreover, it embodies the unfortunate impression that rules are made by the rich nations and enforced on the rest.

What is needed is recognition of the power of the WFA template, and the design of international institutions that can meet the demands identified by the template in an accountable, coherent and flexible manner. A number of challenges must be met if this goal is to be attained: (1) the development and acceptance of a common theoretical framework within which to confront the tasks of international regulation; (2) the integration of macroeconomic and microeconomic aspects of international regulation; (3) the development of procedures that (at least) alleviate the tendency for risk management to be pro-cyclical and pro-contagion; (4) the harmonisation of risk management in differing corporate governance structures to obtain a common international regulatory outcome: (5) solving the political challenge of accountability in a soft law régime; (6) devising an institutional structure that performs the tasks of the template WFA.

As practical politics, these are rather grandiose objectives. But in pragmatic terms this framework can be used to generate practical proposals for dealing with specific problems (the use of short-term capital controls as the macro component of a regulatory régime was discussed above). These specific proposals are more likely to be agreed upon internationally- it at all - than "common theoretical frameworks". But if they derive from the coherent framework of a WFA they are likely to be more effective and ultimately more acceptable, even within a neo-liberal political and economic environment

Summing-up.

Two themes dominate this appraisal of the challenges facing the development of an efficient system of international financial regulation: *First*, the need for theory and policy that link microeconomic risk-taking to the macroeconomic propagation of systemic risk. *Second*, the need to develop a coherent and accountable set of institutions through which international policy may be developed and implemented. These two needs were met by the authorities in the immediate post-war era. They reacted to the instability of inadequately regulated markets in the 1930s by producing new procedures and institutions based on what were then new models of macroeconomic management. Internationally, the response at Bretton Woods was to put in place a set of international arrangements that permitted the pursuit of national macroeconomic policies, free from the fear of international financial disruption. The problem of accountability did not arise. Tackling the same problems in the context of today's liberal financial markets requires a reinterpretation of what both macroeconomic policy and market regulation mean, and a reassessment of the institutions required to conduct such a policies. The device of a World Financial Authority provides the means of exposing both analytical and institutional questions.

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