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The Specter of Sisyphus: Re-Making International Financial Regulation After the Global Financial Crisis

Yesha Yadav

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THE SPECTER OF SISYPHUS: RE-MAKING INTERNATIONAL FINANCIAL REGULATION AFTER THE GLOBAL FINANCIAL CRISIS

Yesha Yadav^{*†}

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† The author is solely responsible for the content of this paper and, in particular, for all errors and omissions. *The views expressed in this paper are solely those of the author and do not represent the views and opinions of the World Bank or any of the author's present or past employers.*

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INTRODUCTION

The spread of the global financial crisis from its beginnings in the United States to economies around the world has necessitated extraordinary and concerted action by regulators to contain the fallout.¹ As the dust settles, the crisis provides a unique opportunity to more accurately understand the operation of the international financial marketplace and the regulatory mechanisms that have been put in place to oversee its workings.² While the actions of domestic regulators have given much cause for examination, the globally contagious spread of crisis has turned the analytical spotlight on the international regulatory framework and its ability to act to exert control over an increasingly consolidated financial market in products and services.³

Domestic regulators have undergone a period of institutional soul-searching to critically evaluate their performance in predicting the market turmoil and reacting to it once the seriousness of the disruptions became apparent. Reform agendas have been developed and remain works in progress, as the causes of the crisis come into sharper focus and expose the vulnerabilities within national regulatory frameworks.⁴ While this work continues within domestic fora, the globalized aspects of recent events necessitate an examination of the international dimension of financial regulation.⁵ As evidenced by recent events, the presence of international financial firms, combined with a dispersal of complex financial products across jurisdictions, has resulted in an international interweave of risk—both economic and legal—that cannot be fully understood from a domestic perspective alone.⁶ Further, in addition to better grasping the patterns of risk developing across borders, international oversight mechanisms become especially salient where multi-jurisdictional firms fail outright (e.g. Lehman Brothers),⁷ or otherwise, where emergency regulator assistance is deemed necessary to avert cross-border systemic

¹ BASEL COMM. ON BANKING SUPERVISION, REPORT AND RECOMMENDATIONS OF THE CROSS-BORDER BANK RESOLUTION GROUP 9 (2009) [hereinafter BASEL COMM.].

² David A. Skeel, Jr., *Governance in the Ruins*, 122 HARV. L. REV. 696, 741–43 (2008) (reviewing CURTIS J. MILHAUT & KATHARINA PISTOR, *LAW AND CAPITALISM: WHAT CORPORATE CRISES REVEAL ABOUT LEGAL SYSTEMS AND ECONOMIC DEVELOPMENT AROUND THE WORLD* (2008)).

³ See *id.* at 742–43.

⁴ See, e.g., U.S. DEP'T OF THE TREASURY, FINANCIAL REGULATORY REFORM, BUILDING A NEW FOUNDATION: RE-BUILDING FINANCIAL SUPERVISION AND REGULATION 2–9 (2009) [hereinafter NEW FOUNDATION]; U.K. FIN. SERVS. AUTH., THE TURNER REVIEW: A REGULATORY RESPONSE TO THE GLOBAL BANKING CRISIS 5–21 (2009) [hereinafter TURNER REVIEW].

⁵ NEW FOUNDATION, *supra* note 4, at 5–6.

⁶ *Id.* at 29–60.

⁷ *Id.*

spillover (e.g. the failure of Fortis or ING).⁸ Finally, effective international oversight and the application of common rules to comparable practices are desirable to act as a counter-weight to the incidence of regulatory arbitrage by firms seeking to exploit differences between country laws to turn handsome but potentially risky profits.

This Article examines the legal workings of international financial regulatory mechanisms from the perspective of how these have performed in the lead up to and during the global financial crisis. In particular, the Article analyzes normative rationales for regulation and applies these to the specific context and challenges posed by the international regulatory framework. It then discusses how this framework can be reformed to better reflect these rationales within the constraints imposed by a supranational legal system and to mend the cracks exposed in the course of the crisis.

This Article argues that the crisis has shown the present international regulatory architecture to be poorly adapted for tackling the risks arising from the increasingly dynamic and complex international financial marketplace. While international regulators are necessarily constrained by their dependence on domestic legal systems for application and enforcement of international rules and standards, their role is nevertheless significant in light of the emerging distinctness of the international financial market and its own unique patterns of risk. Therefore, oversight of this market can be based on, and justified by, the important rationales for regulation generally advanced in support of domestic regulatory mechanisms. This Article seeks to propose a new design for reform that better reflects these rationales as well as the increasing interconnectedness of the international marketplace.

Part I of this Article sets out some key rationales for regulation together with a discussion of the specific challenges faced by international regulators versus their domestic counterparts. Part II examines the outlines of the current system. Part III critically analyzes the operation of international regulatory mechanisms during the crisis, while Part IV proposes a design for reform.

⁸ BASEL COMM., *supra* note 1, § 2.

I. RATIONALES FOR REGULATION⁹A. *The International Marketplace in Financial Services and Products*

The provision of financial services has undergone a transformative expansion in the last two decades, moving away from a largely domestic market to an increasingly internationalized space.¹⁰ This has been accompanied, and arguably facilitated, by innovations in the types of products offered to the market, which have shown little respect for traditional divisions between banking, securities, and insurance businesses.¹¹ The growth and establishment across jurisdictions of large investment firms, together with the development of technology, has enabled trades in financial products and services to become global.¹² By way of illustration, in 2007, three prominent U.S. investment banks were deriving almost 50% of their net revenue from business undertaken offshore.¹³ Domestically, within the United States, the value of foreign securities holdings by U.S. investors doubled from \$3.1 trillion to \$6.0 trillion between 2003 and 2006, evidencing increasingly rapid traffic in the supply and demand of cross-border financial services.¹⁴ It has been reported that almost two-thirds of all Americans have investments in non-U.S. companies.¹⁵ While cross-border financial activity has tended to gravitate towards certain financial centers, notably London and New York,¹⁶ the overall development of cross-border business to encompass the emerging markets has

⁹ This section relies on a discussion of this topic advanced in my article, *Looking for the Silver Lining: Regulatory Reform after the "Credit Crunch,"* in the context of reforming the framework of the U.S. regulatory architecture. Yesha Yadav, *Looking for the Silver Lining: Regulatory Reform after the "Credit Crunch,"* 15 STAN. J.L. BUS. & FIN. (forthcoming June 2010). See also COMM. ON CAPITAL MARKETS REGULATION, THE GLOBAL FINANCIAL CRISIS: A PLAN FOR REGULATORY REFORM, at i–vi (2009).

¹⁰ For a definition of what may be regarded as "international," see HAL S. SCOTT, INTERNATIONAL FINANCE: TRANSACTIONS, POLICY AND REGULATION 1–30 (15th ed. 2008).

¹¹ For example, the credit default swap may be said to operate functionally as both an insurance device as well as a securities or futures product.

¹² See, e.g., *Russia, Country Forecast*, ECONOMIST, July 22, 2006, at 94.

¹³ See The Goldman Sachs Group, Inc., Annual Report (Form 10-K) (Jan. 28, 2008); Lehman Brothers Holdings, Inc., Annual Report (Form 10-K) (Jan. 29, 2008); Morgan Stanley, Annual Report (Form 10-K) (Jan. 29, 2008).

¹⁴ U.S. DEP'T OF THE TREASURY ET AL., REPORT ON U.S. PORTFOLIO HOLDINGS OF FOREIGN SECURITIES AS OF DECEMBER 31, 2006, at 3 (2007), available at <http://www.ustreas.gov/tic/shc2006r.pdf>.

¹⁵ INV. CO. INST., SEC. INDUS. ASS'N, EQUITY OWNERSHIP IN AMERICA 23 (2005). For a review of the various supervisory and regulatory approaches, see GROUP OF 30, THE STRUCTURE OF FINANCIAL SUPERVISION: APPROACHES AND CHALLENGES IN A GLOBAL MARKETPLACE (2008), available at http://www.group30.org/pubs/GRP30_FRS_ExecSumm.pdf.

¹⁶ Martin Dickson, *Capital Gain: How London Is Thriving as It Takes on the Global Competition*, FIN. TIMES (London), Mar. 27, 2006, at 11.

cemented and extended this trend to include a broader weave of country players within the financial marketplace.¹⁷ While this trend has enabled firms to generate considerable wealth through investment,¹⁸ it has also created increasingly stark financial and economic vulnerabilities between countries, such that risks affecting one jurisdiction have the ability to spread quickly to others, taxing the regulatory resources of several country regulators simultaneously (e.g. the failure of Dexia, Fortis, ING, Kaupthing, or Lehman Brothers).¹⁹

In light of the very active market in cross-border financial services, and the risks it creates that cannot be controlled by any one domestic regulator, the international market can be seen as distinct from the sum of its various domestic parts. In this context, its regulation ought to seek to institutionalize the normative policy rationales traditionally advanced to support the better function of market regulation.

B. Key Reasons to Regulate the Financial Markets

Certain economists, notably Kevin Dowd,²⁰ George Benston, and George Kaufmann,²¹ have suggested that regulation itself can lead to market crisis by muffling the incentives at work for market players to regulate their own behavior. Criticism has also focused on the costs of regulation that may not be sufficient to cover the multiplicity of market risks.²² However, a large body of academic and theoretical consensus has coalesced around some key rationales justifying the development of rules or standards to govern the markets and the deployment of state resources to see to their application.²³ An important assertion in support of regulation cites the collective action dilemma whereby individual firms, while appreciating the desirability of attaining a common good, are either unwilling or institutionally unable to act to appropriately regulate the risks arising from their own behavior and that of their peers.²⁴

¹⁷ *Russia: Country Forecast*, *supra* note 12, at 94.

¹⁸ *Id.*

¹⁹ See BASEL COMM., *supra* note 1, § 2.

²⁰ Kevin Dowd, *The Case for Financial Laissez-Faire*, 106 *ECON. J.* 679, 683 (1996).

²¹ George Benston & George Kaufman, *The Appropriate Role of Bank Regulation*, 106 *ECON. J.* 688, 693 (1996).

²² See David Llewellyn, *The Economic Rationale for Financial Regulation* 7 (Apr. 1999) (Fin. Servs. Auth., Occasional Paper Series No. 1).

²³ See CHARLES GOODHART ET AL., *FINANCIAL REGULATION: WHY, HOW, AND WHERE NOW?* 2 (1998); Llewellyn, *supra* note 22, at 9–12.

²⁴ MARKUS BRUNNERMEIER ET AL., *THE FUNDAMENTAL PRINCIPLES OF FINANCIAL REGULATION*, at xii (2009). In this study, the economists have noted that this may be exemplified in cases where one bank sells an

Broadly, the key rationales for regulation can be summarized as follows:

1. the management of externalities, notably systemic risks;²⁵
2. consumer protection and the correction of information asymmetries;²⁶
3. limitation of moral hazard.²⁷

C. *Managing Externalities*

Regulation for managing systemic risk is necessary where one player or another is unable or otherwise insufficiently equipped to act to prevent the spread of risk through the financial markets as a whole.²⁸ This can occur, for example, where a shock disruption affecting one firm leads the market to believe that other similarly situated firms may also be impacted, prompting contagion and investor runs on the firms implicated; or where a sudden event affects the market as a whole, leading to widespread loss of confidence and panicked runs on financial institutions.²⁹ In these scenarios, in order to meet their obligations, firms can find themselves becoming tightly wound into a spiral of losses, where they must rapidly fire-sell their assets to satisfy creditor and depositor demand during a run, depressing asset values and prompting further runs as balance sheets weaken across the market.³⁰ As a result, firms are rapidly drained of liquidity and unable to access affordable credit in the absence of assets that may be used as collateral.³¹ In such cases, systemic risk can take on a multitude of concurrent guises.³² Specifically, where firms evidence a high degree of inter-connectedness, the spread of systemic risk through the market is easier and can affect a number of its key components at once,³³ further fueling the cycle of losses and rapid sell-offs. Accordingly, regulatory intervention becomes necessary to stop the negative spiral, which

asset when the price of its risk increases. Other banks can act similarly, eventually leading to the price of that asset falling. *See id.*

²⁵ *Id.* at 20.

²⁶ *See id.* at 29–43.

²⁷ *See id.* at 1–10, 23–27.

²⁸ SCOTT, *supra* note 10, at 903; BRUNNERMEIER ET AL., *supra* note 24, at 3.

²⁹ SCOTT, *supra* note 10, at 110–14.

³⁰ BRUNNERMEIER ET AL., *supra* note 24, at 2–4.

³¹ *Id.* at 14–20.

³² *Id.*; SCOTT, *supra* note 10, at 110–14.

³³ For example, firms can be connected through the payments system, clearing and settlement mechanisms, the inter-bank lending market, and through risk-management devices such as chains of credit default swaps. For further discussion, see generally SCOTT, *supra* note 10, at 95–160.

can be done, for example, through the provision of emergency liquidity support³⁴ or the purchase *en masse* of distressed and toxic assets weighing down the balance sheets of financial institutions, possibly through asset management companies like the Resolution Trust Corporation deployed during the Savings and Loans Crisis of the late 1980s and early 1990s.³⁵

In addition to acting to avert the spread of systemic crises, regulation is seen as necessary for the maintenance of financial stability and the safety and soundness of market participants.³⁶ As set out above, the role of regulation is underscored by the perceived inability of firms to act in the common interest where it might adversely affect their own.³⁷ Accordingly, regulators are expected to set benchmarks for controlling the risks posed by market entrants as well as the risks of their continued participation (e.g. by setting qualification criteria for their entry, such as minimum capital cushions or liquidity buffers, to ensure that they can absorb the risks of their activities once in the market).³⁸ Such considerations and calculations are likely to be beyond the capacity of any one firm without a bird's eye view over market operations, and they may not be in their (at least short-term) interests, in view of the expensive compliance costs involved.

D. Consumer Protection and the Correction of Information Asymmetries

Regulation may be imposed to ensure the dissemination of high-quality information to the market and supervisory bodies to enable sound assessments

³⁴ See, e.g., Edmund Andrews, *Federal Reserve Offers No Cash but Loosens Standards on Emergency Loans*, N.Y. TIMES, Sept. 15, 2008, at A19. Actions were taken by the U.S. Federal Reserve to expand the eligibility criteria for accessing its Primary Dealer Credit Facility to include investment banks in the aftermath of the collapse of Lehman Brothers. *Id.*; see also Bank of England, Markets: Asset Purchase Facility, <http://www.bankofengland.co.uk/markets/apf/index.htm> (last visited Feb. 10, 2010) (describing the Asset Purchase Facility and Special Liquidity Scheme established by the Bank of England to purchase or swap securities, such as mortgage backed securities, from firms). These measures are designed to increase liquidity in the market, as seen, for example, where the Bank of England swaps mortgage-backed securities in return for U.K. Treasury Bills that may readily serve as collateral for participating firms. *Id.*

³⁵ See Nicholas F. Brady, Eugene A. Ludwig & Paul A. Volcker, *Resurrect the Resolution Trust Corp.*, WALL ST. J., Sept. 17, 2008, at A27; see also G.N. OLSON, *BANKS IN DISTRESS: LESSONS FROM THE AMERICAN EXPERIENCE OF THE 1980S 201–04* (2000). Following the collapse of Lehman Brothers, there were calls for an asset management vehicle akin to the Resolution Trust Corporation to purchase the toxic securities responsible for weakening the balance sheets of firms during the current crisis. This was seen as a means to stabilize the market and restart normal banking and trading operations and as a medium to prevent a deeper slide into depression. See Brady et al., *supra*.

³⁶ Llewellyn, *supra* note 23, at 9.

³⁷ *Id.* at 27.

³⁸ *Id.* at 26, 28, 47.

of the risks to be undertaken by regulators and investors, bringing into the public domain information disparately held by the various constituents within the market.³⁹

In light of the foregoing, regulation is justified on the basis that regulators and investors cannot be expected to forage for the data necessary to evaluate the health of firms in light of the time and costs involved.⁴⁰ Such disclosure assists regulators in determining the allocation of regulatory resources to target those firms that may be especially in need of oversight.⁴¹ In addition, it helps investors to make better judgments about market risks and, therefore, to more accurately tailor their investments to risk appetite.⁴²

Control of information further assures that insiders do not unfairly benefit from their privileged access to information and manipulate market movement in their favor.⁴³ Accordingly, laws to correct information asymmetries can be seen as warranted because different pockets of the market (e.g. insiders of a firm, auditors, credit rating agencies, or market-wide infrastructure providers like exchanges) may each possess different sets of information on a firm, which, if not properly disclosed, could potentially distort its risk profile and result in a misallocation of regulatory and investor resources.⁴⁴ Finally, disclosure of information can act as a check on excessive and opportunistic risk taking by firms, especially in light of the agency risks arising from firms trading with funds that are not their own.⁴⁵ Accordingly, mandatory disclosure rules can enhance conscientiousness to curb bad behavior and undue risk taking, incentivizing agents to self-police risks, thereby giving consumers greater confidence in the system as a whole, while assisting regulators in the maintenance of financial stability.⁴⁶

³⁹ See Larry Ribstein, *Private Ordering and the Securities Laws: The Case of General Partnerships*, 42 CASE W. RES. L. REV. 1, 8–11 (1992) (discussing why firms should disclose information); see also Llewellyn, *supra* note 22, at 8–9 (discussing the benefits of information disclosure).

⁴⁰ Ribstein, *supra* note 39, at 10.

⁴¹ *Id.* at 11.

⁴² *Id.*

⁴³ *Id.*

⁴⁴ *Id.*

⁴⁵ Frank B. Cross & Robert A. Prentice, *The Economic Value of Securities Regulation*, 28 CARDOZO L. REV. 333, 339–40 (2006).

⁴⁶ *Id.* at 363–64.

E. Moral Hazard

The state can provide safety nets to protect investors and firms from the risks associated with their activities. Examples of these safety nets include deposit insurance or lender-of-last-resort facilities deployed to minimize the spread of systemic risks.⁴⁷ These arrangements may be seen as creating a moral hazard, encouraging risk taking and ill-informed decision making.⁴⁸ Llewellyn has identified four key types of moral hazard that may arise in this context: (i) protection for failing banks as well as deposit insurance may mean that consumers use banks that may be risky and unsafe but offer higher rates of return; (ii) knowing that it and its investors are protected, a firm may be incentivized to engage in risky behavior; (iii) because of insurance, depositors may not demand an appropriate risk premium in their deposit interest rates; and (iv) the existence of deposit insurance may lead banks to hold lower levels of capital.⁴⁹ Accordingly, regulation may be justified to limit the influence of moral hazard and, in particular, to provide that firms and consumers are not permitted to take advantage of taxpayer generosity and engage in undue risk taking and opportunistic investment practices.⁵⁰

Notwithstanding the above, international financial markets cannot simply be assumed to possess the characteristics and processes of domestic ones. For one, most firms (with the exception, perhaps, of hedge funds or private equity houses) are usually quite comprehensively regulated by home-state regulators, such that they already operate under one layer of oversight when undertaking cross-border activities.⁵¹ Following from this, the international financial marketplace is catholic in its legal composition, bringing into its fold a variety of country regulatory regimes, cultures, and governance traditions, without seeking to accord primacy to one or the other, such that standard setting and norms building are required to be sufficiently flexible to fit with the variety of country frameworks involved.⁵² Accordingly, international financial-governance mechanisms do not have recourse to the coercive authority of a single state for implementation of standards but, rather, are required to have

⁴⁷ Dowd, *supra* note 20, at 683.

⁴⁸ *Id.*

⁴⁹ Llewellyn, *supra* note 22, at 29.

⁵⁰ *Id.* at 30.

⁵¹ See, e.g., SCOTT, *supra* note 10, at 111 (stating that within the international system, it is the host country that primarily deals with the systemic risk).

⁵² *Id.* at 3–4.

recourse to national-enforcement processes (which in turn differ across jurisdictions) or reputational pressure for their application.⁵³

Nevertheless, the international financial marketplace may be regarded as evidencing many of the same risks that have prompted domestic regulatory action under the rationales examined above. As set out in greater detail below, the crisis has exposed the international financial market as having a distinct set of risks due to the cross-border nature of financial services, which cannot easily be contained through actions taken by individual, domestic regulators acting alone.

First, domestic regulators face a different set of incentives when dealing with home-state firms that offer cross-border services to clients and counterparties based abroad.⁵⁴ For example, domestic regulators may wish to rely on the regulatory mechanisms of the host countries where their firms are offering services, thus allowing them to devote resources to policing market behavior within their own jurisdictions. Nevertheless, with the possible exception of the European Union, where the Internal Market has brought about considerable harmonization in financial services standards,⁵⁵ regulatory regimes across borders are not always of comparable standard, permitting firms to engage in regulatory arbitrage where it is possible to do so. Accordingly, there is a danger that firms may engage in risky behavior, taking on high-risk clients and investing in volatile but high-yield investment products on a cross-border basis, without the home-state regulator having sufficient resources or motivation to include a risk assessment of these practices in its evaluation of a firm (especially when cross-border business is undertaken by a firm's subsidiaries, which are separate legal entities established under the rules of a host state, rather than branches, which remain part of the firm).

⁵³ See, e.g., Douglas Arner & Joseph Norton, *Building a Framework to Address Failure of Complex Global Financial Institutions*, 39 H.K. L.J. 95, 105 (2009) (arguing that policy makers and implementers of regulations will be at the domestic level).

⁵⁴ See Richard J. Herring, *Conflicts Between Home and Host Country Prudential Supervisors*, in *INTERNATIONAL FINANCIAL INSTABILITY: GLOBAL BANKING AND NATIONAL REGULATION 201*, 201–20 (Douglas D. Evanoff, George G. Kaufman & John R. LaBrosse eds., 2007).

⁵⁵ Arner & Norton, *supra* note 53, at 106. However, it should be noted that, even within the highly harmonized environment of the European Union's internal market for financial services, differences between countries with respect to conduct of business rules are common. For example, the Market in Financial Instruments Directive, while generally seeking to create a maximum-harmonization regime for investment services in the European Economic Area, gives home-state supervisors the power to impose their own set of conduct-of-business requirements, beyond the minimum rules provided for in the Directive. Council Directive 2004/39, Market in Financial Instruments Directive, art. 61, 2004 O.J. (L145) 1 (EC).

Secondly, home-state regulators are arguably faced with high structural impediments to the accurate understanding of a firm's risk profile where investment activity is undertaken on a cross-border basis.⁵⁶ For example, access to data regarding the robustness of a firm's foreign counterparties or investments may be rendered more difficult and opaque, leading to information asymmetries that limit the ability to render accurate assessments of a firm's business activities, risk profile, investors, and client-protection mechanisms.⁵⁷

Thirdly, home-country regulators may wish to champion national interests and promote the business of their home firms abroad. There may be a potential conflict of supervisory interest where regulators wish to ease the regulatory burden on ambitious firms promoting a "country brand" abroad, though it may be imperative to assure that such firms do not expand beyond their natural capacity and resources.⁵⁸ Consequently, regulatory accountability may be necessary to safeguard against regulatory capture.

Fourthly, it is not always easy, or indeed possible, to distinguish between a domestic transaction and what should be regarded as "foreign."⁵⁹ For example, how should a transaction be classified if it involves one English bank borrowing a sum in U.S. dollars from another English bank in England? In addition, intangible and dematerialized assets—notably securities—can prove troublesome to locate geographically if they are held by chains of custodians and sub-custodians, even where both the customer and her contact custodian may be located in the same jurisdiction.⁶⁰ As a result, regulators face difficulties in locating risks and determining whether, in fact, the regulators have jurisdiction to act to mitigate the risks' effects.⁶¹

Lastly, given the possibility of working through often complex organizational corporate structures, firms themselves may not be aware of the extent and type of cross-border activity in which they are engaged—for example, where business is undertaken through a network of foreign subsidiaries and branches. Accordingly, where firms operate using complex

⁵⁶ See Amer & Norton, *supra* note 53, at 112–13 (stating that regulators need to have a better understanding of the structure, business, and risks of the firm in order to prevent the failure of the international financial conglomerates).

⁵⁷ See G-20 WORKING GROUP 1, ENHANCING SOUND REGULATION AND STRENGTHENING TRANSPARENCY 1 (2009), available at http://www.g20.org/Documents/g20_wg1_010409.pdf.

⁵⁸ See *id.* at 23.

⁵⁹ See UNIDROIT Convention on Substantive Rules for Intermediated Securities, Oct. 9, 2009, available at <http://www.unidroit.org/english/conventions/2009intermediatedsecurities/main.htm>.

⁶⁰ See *id.*

⁶¹ See G-20 WORKING GROUP 1, *supra* note 57, at 10.

group structures, it may be difficult for the firm itself to keep track of the scale and scope of its activities and their overall impact on the firm's group risk profile.⁶²

II. THE CURRENT INTERNATIONAL FINANCIAL REGULATORY FRAMEWORK

The spread of the global financial crisis has thrown into relief the workings of the international regulatory system for financial services, highlighting not only the key actors involved, but also the texture of authority and influence exercised by relevant bodies. Specific responses to crisis events are detailed in Part III. However, this section sets out a brief overview of the basic design of international financial regulatory mechanisms, with a view to describing some of the central tensions underlying their operation.

A. *Standard Setting*

As set out above, international financial regulators are twice constrained: (i) their pronouncements must be sufficiently elastic to sit alongside and be eventually absorbed into a variety of country legal systems and traditions, civil and common law alike, and (ii) without the coercive authority of the state, adoption and implementation of international standards are largely left to be progressed by national country authorities.⁶³ Despite this structural check on their authority, several bodies have come to be regarded as “standard-setters” in the international regulatory arena, wielding considerable “soft” power in securing national adoption of the standards promulgated.⁶⁴ These bodies work to convene national regulators of member countries to facilitate greater convergence in regulatory standards for international finance.⁶⁵ The work of the Basel Committee on Banking Supervision (“BCBS”), the International Organization of Securities Commissions (“IOSCO”), and the International Organization of Insurance Supervisors (“IAIS”)—which come together under

⁶² In the case of Lehman Brothers, the group consisted of 2,985 legal entities operating across fifty jurisdictions. See BASEL COMM., *supra* note 1, at 14.

⁶³ See *id.* at 6.

⁶⁴ International standard-setting bodies include the Basel Committee on Banking Supervision, the Committee on the Global Financial System, the Committee on Payment and Settlement Systems, the International Association of Insurance Supervisors, the International Accounting Standards Board, and the International Organization of Securities Commissions. In addition, the World Bank has a standard-setting role in the area of insolvency and creditor/debtor regimes.

⁶⁵ Daniel K. Tarullo, Member, Bd. of Governors of the U.S. Fed. Reserve Sys., Address at the Peterson Institute for International Economics: Financial Regulation in the Wake of the Crisis 6 (June 8, 2009), available at <http://www.federalreserve.gov/newsevents/speech/tarullo20090608a.htm>.

the aegis of the Joint Forum, an organization of international financial regulators⁶⁶—has been especially prolific in the development of a body of international standards in the area of banking, securities, and insurance regulation.⁶⁷

B. BCBS

Formed in 1974, the BCBS is one of the more longstanding committees in international financial standard setting.⁶⁸ Originally formed by the central bankers of the G-10 nations, it now comprises a membership that includes not only the G-10, but also several emerging-market and transition economies.⁶⁹ The BCBS is notable for the formulation of statements of best practice on banking supervision⁷⁰ and most visibly, in light of the financial crisis, for the development of the Basel Accords on capital adequacy.⁷¹ These have been widely consumed and adopted into national legal systems to govern the domestic regulation of capital-adequacy levels for banking institutions.⁷² Accordingly, with scrutiny leveled at the deficiencies of the capital-adequacy framework to safeguard against the spread of systemic contagion (e.g. with respect to pro-cyclicality),⁷³ the BCBS has faced a test of its expertise and credibility within the regulatory framework.

C. IOSCO

IOSCO operates as the standard-setting body in the area of international securities regulation.⁷⁴ Its membership regulates approximately 95% of the world's securities markets and provides the forum for convening world

⁶⁶ BASEL COMM. ON BANKING SUPERVISION, THE JOINT FORUM: THE MANAGEMENT OF LIQUIDITY RISK IN FINANCIAL GROUPS 1 (2006), available at <http://www.bis.org/publ/joint16.pdf>.

⁶⁷ Arner & Norton, *supra* note 53, at 124.

⁶⁸ Press Release, Basel Comm. on Banking and Supervision, History of Basel Committee and Its Membership 1 (2009).

⁶⁹ *Id.*

⁷⁰ *Id.*

⁷¹ See BASEL COMM. ON BANKING SUPERVISION, BASEL II: INTERNATIONAL CONVERGENCE OF CAPITAL MEASUREMENT AND CAPITAL STANDARDS: A REVISED FRAMEWORK 2 (2004), available at <http://www.bis.org/publ/bcbs107.htm> [hereinafter BASEL II].

⁷² *Progress on Basel II Implementation, New Workstreams and Outreach*, BASEL COMM. NEWSLETTER (Basel Committee on Banking Supervision), May 2007, available at http://www.bis.org/publ/bcbs_nl11.htm.

⁷³ COMM. ON CAPITAL MARKETS REGULATION, THE GLOBAL FINANCIAL CRISIS: A PLAN FOR REGULATORY REFORM 57–69 (2009).

⁷⁴ Financial Stability Board, 12 Key Standards for Sound Financial Systems, http://www.financialstabilityboard.org/cos/key_standards.htm (last visited Apr. 27, 2010).

securities regulators.⁷⁵ The organization has developed the *Objectives and Principles of Securities Regulation*, which form the international benchmark for the regulation of securities markets.⁷⁶ In addition to this work, IOSCO has also published the *IOSCO Multilateral Memorandum of Understanding* for managing the cross-border exchange of information and for dealing with enforcement issues in relation to the operation of the securities markets.⁷⁷ Together, the IOSCO documents have as their stated objectives, among other things, the reduction of systemic risk and the better protection of consumers investing in the securities market, through the establishment of common standards.⁷⁸

D. IAIS

The IAIS brings together supervisors within the international insurance industry.⁷⁹ It ranks as one of the newer bodies but now claims a standard-setting role as a result of its expansive membership that includes regulators and supervisors in 190 jurisdictions in 140 countries.⁸⁰ It has contributed to the international regulatory framework through the dissemination of its principles for the supervision of the insurance industry, developed in the wake of the September 11, 2001 disaster and in response to the international wrangles within the insurance and re-insurance sectors that followed.⁸¹ To supplement this work, the IAIS has developed standards to delineate best practices for the supervision and regulation of specific insurance and re-insurance products.⁸² These standards are seen as representing best practices in the supervision and regulation of particular insurance products, providing a benchmark for national

⁷⁵ Letter from Int'l Org. of Sec. Comm'ns to Mario Draghi, Chairman, Fin. Stability Forum, Guido Mantega, Minister of Fin., Brazil & Henrique Meirelles, Governor, Central Bank, Brazil (Nov. 12, 2008), available at <http://www.fsa.go.jp/inter/ios/20081113/04.pdf>.

⁷⁶ *Id.*

⁷⁷ International Organization of Securities Commissions, IOSCO Historical Background, <http://www.iosco.org/about/index.cfm?section=history> (last visited Feb. 27, 2010).

⁷⁸ *Id.*

⁷⁹ See INT'L ASS'N OF INS. SUPERVISORS, ANNUAL REPORT, at iii (2009), available at http://www.iaisweb.org/_temp/2008-2009_Annual_report.pdf [hereinafter INS. SUPERVISORS-ANNUAL REPORT].

⁸⁰ See Nasser Saidi, Former Minister of Econ. & Trade, Minister of Indus. & First Vice Governor of the Cent. Bank of Leb., Remarks to the Forum on Corporate Governance in Banks and Financial Institutions in Line with International Standards and Practices: Role of Banking System in Ensuring Transparency and Disclosure 4 (2005), available at http://zunia.org/uploads/media/knowledge/CG%20Arab%20countries_OMAN%5Benglish%5D.pdf; INS. SUPERVISORS-ANNUAL REPORT, *supra* note 79, at 5.

⁸¹ INT'L ASS'N OF INSURANCE SUPERVISORS, PRINCIPLES ON GROUP-WIDE SUPERVISION 3 (2008), available at http://www.iaisweb.org/_temp/7_Principles_No_3_4_on_Group-Wide_Supervision.pdf.

⁸² INS. SUPERVISORS-ANNUAL REPORT, *supra* note 79, at 10.

authorities to assess the operation of their own domestic legal frameworks against those expounded by the IAIS.⁸³

In addition to the three key standard-setting bodies, the international regulatory architecture has sought to establish coordination mechanisms through the work of the G-20 and the Financial Stability Board (“FSB”) (formerly, the Financial Stability Forum (“FSF”)) as well as the international financial institutions, the International Monetary Fund (“IMF”), and the World Bank. A very brief overview of these mechanisms is set out below.⁸⁴

E. G-20/FSB

The G-20 was formed in 1999, and its membership of nineteen countries and the EU bloc represents approximately 90% of the world’s economic output.⁸⁵ It has supplanted in stature and function the G-8 group of countries as the main policy forum for international economic cooperation.⁸⁶ The G-20 has grown in stature and visibility since the onset of the global financial crisis, with the establishment of the G-20 Summit as the forum for convening the key industrial and emerging market economies to formulate international regulatory strategy on crisis management.⁸⁷ With respect to international regulatory action in the wake of the crisis, the G-20’s Washington, D.C. *Declaration of the Summit on Financial Markets and the World Economy* established five main principles to guide the direction of regulatory reform: (i) strengthening transparency and accountability; (ii) enhancing sound regulation; (iii) promoting integrity of the financial markets; (iv) reinforcing international cooperation; and (v) reforming the financial architecture.⁸⁸ This G-20 agenda, as reiterated through the G-20 Summit, is intended to play an important

⁸³ *See id.*

⁸⁴ It should be noted that the World Bank and the IMF both have standard-setting functions, under the mandate of the Financial Stability Board (“FSB”). INS. SUPERVISORS—ANNUAL REPORT, *supra* note 79, at 1–2.

⁸⁵ G-20, THE GROUP OF TWENTY: A HISTORY 21, 42, 127–28 (2007), available at http://www.g20.org/Documents/history_report_dm1.pdf.

⁸⁶ Claudia Schmucker & Katharina Gnath, *From the G8 to the G20: Reforming the Global Economic Governance System* 15 (Garnet Working Paper No. 73/09, 2010), available at http://www.garnet-eu.org/fileadmin/documents/working_papers/7310.pdf.

⁸⁷ *Id.* at 2.

⁸⁸ Declaration, G-20, Summit on Financial Markets and the World Economy 3 (Nov. 15, 2008), available at http://www.g20.org/Documents/g20_summit_declaration.pdf. The Washington, D.C. declaration builds upon the central bankers and finance ministers’ communication in São Paulo in the week preceding the Washington, D.C. Summit. Communiqué, G-20, Meeting of Ministers and Governors, São Paulo, Nov. 8–9, 2008, available at http://www.g20.org/Documents/2009_communique_horsham_uk.pdf.

strategic role in guiding the work of the various standard-setting bodies following the crisis.⁸⁹

The FSB was formed by the G-20 at its London Summit in April 2009 to bring regulators together to promote financial stability and provide for an early detection mechanism for financial crises.⁹⁰ Reflecting the expansion of the G-8 to the G-20, the FSF's membership has been widened under the FSB to include representatives from emerging and transition economies.⁹¹ The FSB is involved in coordinating the establishment of regulatory colleges for approximately thirty large and complex financial institutions deemed to have special systemic significance.⁹² In addition, it is mandated to work with and monitor the work of standard-setting bodies, with a special focus on determining the adoption of standards and codes within domestic legal frameworks and understanding the build-up of regulatory vulnerabilities arising at the national and international level.⁹³

Alongside the FSB, the mandate of the IMF has been brought more visibly to the fore as a monitor of financial stability and systemic risk. The IMF works alongside the FSB to monitor financial stability, systemic risks, and regulatory vulnerabilities that may ignite or otherwise exacerbate the effects of financial and economic distress.⁹⁴

III. LESSONS FROM THE CRISIS

The onset and spread of the crisis across several advanced economies simultaneously has provided ample demonstration of the consequences of regulatory failure at the international level.⁹⁵ While domestic systems have also fared badly in their institutional incapacity to prevent the seeds of this market crisis from taking root, as evidenced by the number of reform efforts

⁸⁹ Declaration, *supra* note 88, at 2, 4.

⁹⁰ Press Release, Fin. Stability Forum, Financial Stability Forum Re-established as the Financial Stability Board 1 (Apr. 2, 2009), available at http://www.financialstabilityboard.org/press/pr_090402b.pdf.

⁹¹ Press Release, Fin. Stability Forum, Financial Stability Forum Decides to Broaden its Membership 1 (Mar. 12, 2009), available at http://www.financialstabilityboard.org/press/pr_090312b.pdf.

⁹² The list of the thirty institutions that would be overseen by a college of regulators, while intended to be confidential, was leaked. Patrick Jenkins & Paul J. Davies, *Thirty Financial Groups on Systemic Risk List*, FTN. TIMES (London), Nov. 29, 2009, <http://www.ft.com/cms/s/0/df7c3f24-dd19-11de-ad60-00144feabdc0,s01=1.html>.

⁹³ Press Release, Fin. Stability Forum, *supra* note 91, at 1.

⁹⁴ *Id.*

⁹⁵ See, e.g., Robert C. Altman, *The Great Crash, 2008*, FOREIGN AFF., Jan.–Feb. 2009, at 2, 8 (“It is widely acknowledge that this crisis reflects the greatest regulatory failure in modern history.”).

underway,⁹⁶ headline events that have marked the escalation of the turmoil (and indeed tightened the turns of its negative spiral) have implicated the international regulatory system and the problematic aspects of its operation.

While the authority of international regulators is necessarily limited by their dependence upon national legal systems for the implementation and enforcement of international regulatory action, a sharper focus on the creation of a robust regulatory architecture at the international level may better support the work of regulators, strengthening the hand that has been dealt. As highlighted above, differences between the terms “national” and “international” in the financial marketplace are now necessarily complex, although often not especially meaningful. Nevertheless, institutions and bodies established for the oversight of cross-border financial activity and its interface with national systems are required to better reflect the marketplace in which they operate and the rationales that govern its regulation.⁹⁷

This section focuses on three case studies to discuss areas in which the regulatory architecture at the international level failed to fully leverage its structural potential to prevent the start and downward spiral of the crisis and that indicate some of the fault lines underlying the workings of the system. The case studies discussed are: (i) the near-failure of the American International Group; (ii) the cross-border banking crisis affecting Iceland’s Kaupthing bank; and (iii) the collapse of Lehman Brothers. The basic factual context of these cases studies is largely assumed, given media and commentator attention in the course of recent events.

A. *American International Group*

Headquartered in the United States, American International Group (“AIG”) has grown into a global giant in the insurance business, spanning over 100 countries and, at the height of its prowess, controlling assets worth over \$1 trillion.⁹⁸ While its insurance business was unsurprisingly extensive, AIG operated a key profits center from London—AIG Financial Products (“AIG FP”)—that gave the company a deep hold within the financial marketplace.⁹⁹

⁹⁶ See, e.g., NEW FOUNDATION, *supra* note 4; TURNER REVIEW, *supra* note 4.

⁹⁷ See, e.g., TURNER REVIEW, *supra* note 4, at 7.

⁹⁸ Arner & Norton, *supra* note 53, at 101.

⁹⁹ U.S. Senator Richard Shelby referred to the AIG collapse as the “largest corporate failure in history.” *American International Group: Examining What Went Wrong, Government Intervention, and Implications for Future Regulation: Hearing Before the S. Comm. on Banking, Housing, and Urban Affairs*, 111th Cong. 4 (2009) (statement of Sen. Richard Shelby, Member, S. Comm. on Banking, Housing, and Urban Affairs).

AIG sold protection to cover possible losses suffered by investors in securities (for example, for investors in sub-prime mortgage-backed securities) in return for payment of a regular premium.¹⁰⁰ To demonstrate its creditworthiness for the trade, AIG would normally be expected to provide collateral and increase the amount of this collateral in the event that its own creditworthiness fell.¹⁰¹ In this way, it has been estimated that AIG had written credit default swaps (“CDS”) with a notional exposure of \$441 billion—\$58 billion written on subprime mortgage backed securities.¹⁰² Indeed, the full extent of AIG’s obligations in the CDS market was sufficiently complex to require repeat revisions in the terms of the AIG bailout—the depth of the losses seemingly confounding the regulators long after the initial September 2008 rescue was undertaken.¹⁰³ As with the cross-border buy-and-sell of the underlying securities, the provision of the credit protection to hedge the risks involved also extended globally, the shifting of risk between investors and protection providers like AIG being carried out with little heed paid to the geographical locations of the players.¹⁰⁴ With respect to AIG, this was indicated by the U.S. Treasury’s disclosure of the identity of the larger counter-parties that received payments from AIG following the bailout, whose various bases extended from the United States and Canada to various European jurisdictions.¹⁰⁵

It is arguable that the international regulatory framework could have been well-suited to checking some of the concerns arising from the activities of a player like AIG. For one, AIG was involved in the global movement and dispersion of credit risk that not only obfuscated the locations of where risk was becoming concentrated, but also made it difficult for any one national regulator to get a full picture of the scale of the potential fallout arising from the activities in which AIG and other market players had become involved through their dealing in CDS.¹⁰⁶ Although it may have been possible for AIG’s

¹⁰⁰ See, e.g., *id.* at 3.

¹⁰¹ TURNER REVIEW, *supra* note 4, at 22 (2009).

¹⁰² *AIG Rescue: Size Matters*, ECONOMIST, Sept. 20, 2008, at 31.

¹⁰³ *AIG Gets Access to \$20.9 Billion in Fed’s Commercial Paper Program*, TRADING MARKETS, Nov. 1, 2008, <http://www.tradingmarkets.com/site/news/Stock%20News/1987530/>; Douglas W. Diamond & Anil K. Kashyap, *The F.A.Q.’s of Lehman and A.I.G.*, N.Y. TIMES’ FREAKONOMICS BLOG, Sept. 18, 2009, <http://freakonomics.blogs.nytimes.com/2008/09/18/diamond-and-kashyap-on-the-recent-financial-upheavals/>; see also, Press Release, U.S. Federal Reserve (Nov. 10, 2008), available at <http://www.federalreserve.gov/newsevents/press/other/20081110a.htm>.

¹⁰⁴ See NEW FOUNDATION, *supra* note 4, at 80.

¹⁰⁵ Mary Williams Walsh, *A.I.G. Lists Firms to Which it Paid Taxpayer Money*, N.Y. TIMES, Mar. 15, 2009, at A1; see also A.I.G. Payments to Counterparties, N.Y. Times Documents, Mar. 15, 2009, available at <http://documents.nytimes.com/aig-bailout-disclosed-counterparties#p=1>.

¹⁰⁶ See Joe Nocera, *Propping up a House of Cards*, N.Y. TIMES, Feb. 28, 2009, at B1.

home-state regulators in the United States to attempt to gauge the extent of the international interconnections (as the U.S. Treasury and the Federal Reserve tried to do following the bailout), AIG's activities in the market generated considerable cross-border vulnerabilities for investors throughout the geographical spectrum, where its counterparties and the counterparties of those counterparties operated based on the credit protection that appeared to hedge their risks in the market.¹⁰⁷ Accordingly, an optimal understanding of the risk movements underlying the financial markets and the individual accumulation of risks building on the books of firms would likely only have been possible through more careful and coordinated oversight between national regulators.¹⁰⁸ Hindsight makes such an argument almost self-evident. However, the absence of effective coordination mechanisms between national regulators, coupled with the sectoral divisions underlying the work of standard-setting bodies, meant that the international regulatory system had not evolved to match the market in which players like AIG were operating, which traded across national lines and sold products like CDS that did not fall neatly into traditionally functional categories.¹⁰⁹ The broken lines of international oversight left regulators without a fulsome understanding of the risks burdening firms, and the market more generally, in the event of financial failure.¹¹⁰

In addition, the operation of a robust international regulatory architecture can become useful in cases where home-state oversight practices may not fully capture or sanction the risky behavior of firms. By way of illustration, the regulation of insurance business in the United States is divided between the fifty state commissions.¹¹¹ Given the multiplicity of financial regulatory agencies at work at the federal level, alongside a network of state authorities,¹¹² the supervision of a firm like AIG—at once involved in the insurance as well as the securities business—was uneven and inadequate, with

¹⁰⁷ Walsh, *supra* note 105, at A1.

¹⁰⁸ See, e.g., TURNER REVIEW, *supra* note 4, at 9.

¹⁰⁹ Lisa Fairfax, *Turning a Blind Eye?*, CONGLOMERATE, Oct. 21, 2008, <http://www.theconglomerate.org/2008/10/turning-a-blind.html>.

¹¹⁰ Press Release, U.S. Dep't of the Treasury, Principles of Reforming the U.S. and International Regulatory Capital Framework for Banking Firms 1 (Sept. 3, 2009), *available at* http://www.treas.gov/press/releases/docs/capital-statement_090309.pdf.

¹¹¹ Susan Randall, *Insurance Regulation in the United States: Regulatory Federalism and the National Association of Insurance Commissioners*, 26 FLA. ST. U. L. REV. 629, 629 (1999) ("Insurance is unique among financial services in that it is regulated by the states.").

¹¹² Elizabeth Brown, *E Pluribus Unum—Out of Many, One: Why the United States Needs a Single Financial Services Agency*, 14 U. MIAMI BUS. L. REV. 1, 28–39 (2005). For a detailed discussion of the U.S. regulatory architecture and the problems raised by the operation of a fragmented framework, see also Yadav, *supra* note 9.

little regulation requiring AIG to maintain sufficient capital to buffer against the risks that it was building up in the financial markets.¹¹³ Similarly, oversight of CDS was not adequately policed by the Securities and Exchange Commission (“SEC”), the Commodities and Futures Trading Commission (“CFTC”), or the various insurance commissions, given the multi-category nature of the CDS product offering.¹¹⁴ Thus, it is possible that international oversight mechanisms may assist local regulators to grapple with the risks being created by their local charges in cases where home-state oversight mechanisms may have failed to grasp the full impact of regulatory difficulty, and where shared vulnerabilities create incentives for collective cross-border regulatory processes to check the development of risks generated by deficient home-state supervision.

B. Kaupthing

The failure of Iceland’s Kaupthing Bank highlighted the potential for systemic banking crises to transmit across jurisdictions through the operation of cross-border subsidiaries and branches of a failing bank. It underscores the importance of equipping the international regulatory system with mechanisms to prevent systemic crises better, as well as coordinated tools to equip regulators to deal with the onset of contagion.¹¹⁵

As highlighted above, the operation of complex corporate webs of subsidiaries and branches can obscure the movement of risk within an organization and give regulators assurance that legal separation between group entities (for example, through subsidiaries) can safeguard against the spread of risks between them.¹¹⁶ Kaupthing provided banking services in thirteen jurisdictions, spanning regions from Europe to the Middle East, and operated through a mix of both subsidiaries and branches.¹¹⁷ In 2007, Kaupthing Bank, including its internet arm Kaupthing Edge, controlled assets of €58.3 billion and derived approximately 70% of its profits from business undertaken outside Iceland.¹¹⁸

¹¹³ See, e.g., William K. Sjostrom, Jr., *The AIG Bailout*, 66 WASH. & LEE L. REV. 943, 986–88 (2009).

¹¹⁴ Fairfax, *supra* note 109.

¹¹⁵ See NEW FOUNDATION, *supra* note 4, at 80–88.

¹¹⁶ See generally *supra* text accompanying notes 4–8.

¹¹⁷ See generally KAUPTHING, 2007 ANNUAL REPORT, available at <http://www.kaupthing.com/library/13859>.

¹¹⁸ BASEL COMM., *supra* note 1, at 12–13 (2009).

When catastrophic losses affecting Iceland's Glitnir Bank and its Landesbanki caused both these banks to enter resolution proceedings, concern regarding the possible non-viability of Kaupthing Bank caused a severe fall in depositor confidence, leading its depositors in the United Kingdom, Luxembourg, Germany, Finland, and the Isle of Man to start withdrawing their holdings in Kaupthing.¹¹⁹ Despite initial assurances that it would survive, Icelandic banking authorities took over Kaupthing and provided limited assurance that Iceland would guarantee only domestic deposits.¹²⁰ As a result of Kaupthing's operations, which had expanded to beyond what its capital and liquidity reserves could support and had exceeded the capacity of what home regulators could cover by deposit guarantees, host-state authorities were required to underwrite customer deposits in their respective jurisdictions to prevent the further spiral of crisis through already shaken domestic banking sectors.¹²¹

The Kaupthing crisis is instructive. First, the failure raises the seriousness of the threat posed by systemic crises by highlighting the reality of cross-border contagion, with the potential for crises to spread from the operation of an international bank's subsidiaries and branches. In such cases, domestic mechanisms for controlling systemic crises (for example, deposit guarantees or lender-of-last-resort facilities) may not always be sufficient. In particular, host-country regulators may be underprepared or insufficiently resourced to manage cross-border banking spillover. This may be likely where there are shortfalls in information sharing between banking regulators or between the banks and their host regulators, such that a host-country regulator may not have meaningful information regarding operations of a foreign bank on its soil (especially where these concern branch rather than local subsidiary operations).¹²² Furthermore, where local regulators may themselves be contending with failing national banks (for example, as the United Kingdom had to handle the failure of

¹¹⁹ Iain Martin, *Kaupthing Edge Payouts Start This Morning, Says ING*, CITY WIRE, Oct. 10, 2008, <http://www.citywire.co.uk/personal/-/news/money-property-and-tax/content.aspx?ID=317137>; Rowena Mason, *Iceland Suspends Share Trades as Kaupthing Is Nationalised*, DAILY TELEGRAPH (London), Oct. 9, 2008, available at <http://www.telegraph.co.uk/finance/3165354/Iceland-suspends-share-trades-as-Kaupthing-is-nationalised.html> (“[Kaupthing chairman Sigurdur Einarsson] also blamed the mass withdrawal of funds from Kaupthing Edge for the demise of the bank in Britain.”).

¹²⁰ Mason, *supra* note 119.

¹²¹ BASEL COMM., *supra* note 1, at 12–13; see also Tasneem Brogger, *Iceland Takes Over Kaupthing as Biggest Banks Fail*, BLOOMBERG.COM, Oct. 9, 2009, <http://www.bloomberg.com/apps/news?pid=20601110&sid=a6s61daCJ2Ko>.

¹²² See Javier Espinoza, *Kaupthing Goes Kaput*, FORBES, Oct. 9, 2008, http://www.forbes.com/2008/10/09/kaupthing-iceland-nationalization-markets-equity-cx_je_1009markets04.html.

Northern Rock, Bradford and Bingley, or Halifax banks) domestic coffers may not always be sufficiently deep to support guarantees such as those provided in respect of Kaupthing.¹²³

Secondly, the crisis brings to the fore some of the tensions underlying the division of supervisory responsibilities between home- and host-state regulators. With the expansion of cross-border banking, supervisors are increasingly required to assume a degree of risk on the quality of oversight undertaken by counterparts in other jurisdictions.¹²⁴ In particular, commentators have noted that cross-border expansion can often be motivated by banks seeking to capitalize on weaker supervisory regimes to lower the regulatory costs to which they are subject and to derive higher profits from risky behavior.¹²⁵ In addition, underpriced safety nets that generously cover deposit protection, but without necessarily requiring meaningful contributions from banks themselves, can potentially give rise to moral hazard and excessive risk taking.¹²⁶ As demonstrated in the case of Kaupthing, regulators in various host states were required to assume the risk of supervisory failure at the level of the bank's home state and make amends to their own domestic depositors, when home-state regulator resources fell short.¹²⁷ In light of this burden sharing, it is arguable that the incentives towards cooperation between regulators and information sharing may not necessarily be aligned, even in the case of regulatory colleges, which are designed to stem the spread of systemic risks through mutual assistance strategies.¹²⁸ In particular, as shown in the Kaupthing case, domestic regulators take on considerable risk that the collapse of a foreign subsidiary or branch could set off systemic crisis within the host's market, requiring assistance to be provided through deposit protection or lender-of-last-resort facilities.¹²⁹ Nevertheless, if they are aware that host states would likely step in to safeguard against systemic spills, home-state supervisors may not necessarily be particularly invested in ensuring the safety

¹²³ See WORLD BANK, GLOBAL ECONOMIC PROSPECTS 2009: COMMODITIES AT THE CROSSROADS 20–21 (2009).

¹²⁴ Mattias Persson, *Crisis Resolution in a Global Context: Regulation and Supervision for Cross-Border Banking*, in GLOBALIZATION AND SYSTEMIC RISK 379, 382 (Douglas D. Evanoff, David S. Hoelscher & George G. Kaufman eds., 2009).

¹²⁵ See, e.g., Claudia M. Buch & Gayle DeLong, Cross-Border Bank Mergers: Regulatory Arbitrage or Good Business? 2–3 (Dec. 7, 2004), available at http://www.eu-financial-system.org/fileadmin/content/Dokumente_Events/first_conference/Buch_deLong.pdf.

¹²⁶ *Id.*

¹²⁷ See Brogger, *supra* note 121.

¹²⁸ Persson, *supra* note 124, at 385–86.

¹²⁹ See Brogger, *supra* note 121.

and soundness of their traveling banks. In addition, where home-state supervisors give foreign depositors access to their own deposit-protection schemes, they may be very unwilling to assist host regulators to take measures (for example, preemptively closing an overly risky bank branch) that may trigger deposit protection in their own home state. Accordingly, it would appear as if crisis management at the international level may require more than the simple establishment of regulatory colleges or information sharing talk-shops, given the asymmetry of incentives that may be at play between regulators at times of market stress.

Thirdly, the Kaupthing case indicates that it may be difficult to predict which institutions may be likely to trigger cross-border, systemic contagion. Notwithstanding its quite substantial operations, it is unlikely that Kaupthing Bank, or indeed Northern Rock, would have been regarded as systemically special so as to warrant the careful oversight promised to firms regarded as too big to fail.¹³⁰ And yet their failure entailed significant costs and raised grim prognoses of possible systemic crisis.¹³¹ As such, it may not be sufficient to provide consolidated supervision over only the larger firms in order to better control the incidence of systemic risk. Indeed, colleges of supervisors, while certainly useful as a means of improving co-operation, may possibly divert regulatory resources and attention from oversight of smaller players, which despite their relatively lower visibility may nevertheless inflict considerable damage on the international regulatory system in case of failure.

C. *Lehman Brothers*

In the immediate aftermath of the bankruptcy of Lehman Brothers Holdings International (“LBHI”), global capital markets suffered a serious constriction of liquidity, with credit risk spreads rising to record levels.¹³² Formerly “safe” repositories for investments, such as money market funds, suffered panicked runs as investors sought a flight to safety, setting off widespread market distress.¹³³ Furthermore, the international organizational complexity of Lehman’s operations contributed significantly to market uncertainty. Lehman’s clients (e.g. of its prime brokerage business), accustomed to a seamless

¹³⁰ See Jenkins & Davies, *supra* note 92; see also Yadav, *supra* note 9.

¹³¹ Jenkins & Davies, *supra* note 92.

¹³² Richard J. Herring, *Why and How Resolution Policy Must Be Improved*, in THE ROAD AHEAD FOR THE FED 171, 172 (John D. Ciorciari & John B. Taylor eds., 2009).

¹³³ *Id.* at 173–74; INV. CO. INST., REPORT OF THE MONEY MARKET WORKING GROUP 53–57 (2009), available at http://www.ici.org/pdf/ppr_09_mmmwg.pdf.

operation delivered through its weave of global operations,¹³⁴ suddenly found their assets frozen indefinitely in bankruptcy proceedings under the laws of various jurisdictions, with which they were not necessarily familiar.¹³⁵ Indeed, insolvency proceedings in respect of failed trades continue to preoccupy national authorities worldwide.¹³⁶ Before the Lehman Brothers' insolvency, thousands of trades had been put through to be settled by Lehman's broker-dealer arm and its affiliates worldwide.¹³⁷ Following bankruptcy, these trades have failed to settle, leading to proceedings across Asia, Europe, and North America. For example, the U.K. administrator reported that approximately 43,000 trades in Lehman's U.K. subsidiaries required separate negotiation with the individual counterparties involved.¹³⁸

Managing the failure of Lehman Brothers has not proceeded smoothly.¹³⁹ First, it has underscored the paucity of mechanisms within domestic legal systems to deal with the insolvency of a non-bank financial institution. Although the United States has long operated a relatively efficient wind-down process for banks under the Federal Deposit Insurance Corporation Improvement Act of 1991 ("FDICA")¹⁴⁰—which triggers early regulatory intervention when a struggling institution remains solvent—a similar device has not been readied for other types of institutions, such as investment banks like Lehman, insurers like AIG, and other systemically relevant institutions like hedge funds and pension funds.¹⁴¹ This leaves regulators exposed to market uncertainties fomented by the vagaries of corporate insolvency systems that may not be well suited to dealing with the high transactional complexity, dispersed risk allocations, and non-alignments between economic interest and

¹³⁴ Following the bankruptcy of LBHI, insolvency proceedings for Lehman's various subsidiaries have also commenced in a number of jurisdictions, such as England and Wales, Switzerland, Japan, Singapore, Hong Kong, Germany, Luxembourg, Australia, the Netherlands, and Bermuda. See BASEL COMM., *supra* note 1, at 12–13.

¹³⁵ Saijel Kishan, *R3 Capital Fund Said to Lose 31% by End of October*, BLOOMBERG.COM, Dec. 16, 2008, <http://www.bloomberg.com/apps/news?pid=20601014&sid=aHzKp17aHVLU>.

¹³⁶ See Kate Lamburn, *The Anti-Deprivation Principle and the Atlantic Divide*, MCDERMOTT WILL & EMERY NEWSLETTER, Sept. 23, 2009, http://www.mwe.com/index.cfm/fuseaction/publications.nldetail/object_id/59be9c3b-74a4-48bf-b4fd-7eb8b88128e4.cfm.

¹³⁷ Herring, *supra* note 132, at 174.

¹³⁸ *Id.*

¹³⁹ See Lamburn, *supra* note 136; Jennifer Hughes, *Lehman Creditors to Face Years of Waiting*, FIN. TIMES (London), Nov. 14, 2008, <http://www.ft.com/cms/s/0/8ea14ae8-b279-11dd-bbc9-0000779fd18c.html>.

¹⁴⁰ Federal Deposit Insurance Corporation Improvement Act of 1991, Pub. L. No. 102-242, 105 Stat. 2236 (1991).

¹⁴¹ *See id.*

creditor rights,¹⁴² as evidenced in the case of an insolvency affecting a non-bank financial institution.¹⁴³

Secondly, the Lehman collapse has highlighted the risks underlying the operation of complex weaves of branch and subsidiary operations that each require guidance through the bankruptcy process. The assets of subsidiaries may not necessarily be located in their respective home jurisdictions, as seen in the case of Lehman, but may be dispersed around the world between group entities, adding to the time and complications entailed in any bankruptcy process.¹⁴⁴ Commentators argue that the plethora of subsidiary operations may be due to regulatory or tax regimes favoring their operation.¹⁴⁵ It has been reported that the top sixteen large and complex financial institutions have almost 2.5 times as many majority owned subsidiaries as the sixteen largest non-financial firms.¹⁴⁶ Without concerted action to simplify such structures through reform of regulatory or tax regimes, international legal loopholes are likely to remain in some jurisdictions and not in others, prompting regulatory arbitrage and concentrations of complexity and risks in certain jurisdictions. Furthermore, as evidenced by the failure of Iceland's Kaupthing Bank crisis, some jurisdictions may not always be well-prepared to deal with a systemic crisis when risks materialize.¹⁴⁷

Thirdly, both the Lehman failure and the market panic that ensued—as international financial markets seemed ill-prepared for the Lehman demise—point towards the advantages of early intervention by regulatory authorities to secure the resolution of a failing institution.¹⁴⁸ On an international level, this requires some coordination and convergence on thresholds (e.g. capital adequacy or liquidity thresholds) for corrective actions to be taken. In addition, early intervention demands effective communication processes to operate between supervisors and their charges to ensure that neither party is taken by surprise in the event that a firm falls into possibly terminal distress.¹⁴⁹ A fine

¹⁴² This may come into play where creditors hedge economic risks (e.g. using derivative products) while retaining legal rights against debtors in bankruptcy, distorting the play of incentives between parties.

¹⁴³ See generally Henry T. C. Hu & Bernard Black, *Debt, Equity, and Hybrid Decoupling: Governance and Systemic Risk Implications*, 14 EUR. FIN. MGMT. 663 (2008).

¹⁴⁴ Herring, *supra* note 132, at 179.

¹⁴⁵ Lynnley Browning, *U.S. Subsidiaries in Offshore Tax Havens*, N.Y. TIMES, Jan. 17, 2009, at B2.

¹⁴⁶ Herring, *supra* note 132, at 185.

¹⁴⁷ See discussion *supra* Part III.

¹⁴⁸ U.K. FIN. SERVS. AUTH., A REGULATORY RESPONSE TO THE GLOBAL BANKING CRISIS 59 box 2E (2009) [hereinafter REGULATORY RESPONSE].

¹⁴⁹ *Id.* at 14.

line must be drawn here: If intervention comes too early, or if one international regulator jumps the gun, it may accelerate a crisis at the firm, prompting sudden loss of confidence, investor runs, and creditors imposing more stringent conditions in the grant or extension of credit.¹⁵⁰ However, as highlighted throughout the crisis (for example, with respect to each of the case studies discussed in this paper), late action can contribute to an intensification and systemization of crises.¹⁵¹

IV. RE-CONSTRUCTION AND REFORM

The global financial crisis and the headline events that have come to define it have brought into relief some of the missing pieces of the international regulatory architecture. As set out in Part II of this paper, a number of bodies have been established within the global regulatory framework to set standards, notably in banking, securities, and insurance, with coordination and oversight provided under the auspices of the G-20/FSB (formerly FSF) as well as the IMF and World Bank.¹⁵²

The steady expansion of cross-border activity in the financial markets means that the risks that are being generated through such activity may be beyond any one national regulator to control, underscoring the urgency and importance of reform.¹⁵³ This section sets out a tentative design for the future reconstruction of the international regulatory framework. This paper's proposals do not seek to completely re-draw current regulatory lines; rather, they attempt to rearrange its parts in light of the lessons that have been learned in the course of the financial crisis. The proposals are centered to deal with the following issues: (i) oversight of systemic risks, (ii) standard-setting, and (iii) prescription vs. principles in international regulation. The design is broadly outlined below.

A. *Systemic Risks*

The fear of systemic crises has been at the center of many of the reforms that have been undertaken in the aftermath of the financial crisis.¹⁵⁴ As highlighted briefly above, in response the G-20 has charged the FSB with a

¹⁵⁰ *Id.* at 104 box 5.2, 109–10.

¹⁵¹ *See supra* Part III.

¹⁵² *See supra* Part II.

¹⁵³ *See* REGULATORY RESPONSE, *supra* note 148, at 5–10.

¹⁵⁴ *Id.* at 5–6.

number of tasks designed to allow for the better management of systemic risk at the international level: (i) the formation of colleges of supervisors for the thirty main large and complex financial institutions; (ii) collaboration with the IMF on the performance of Early Warning Exercises and oversight of financial stability; (iii) better coordination and information-sharing between regulators; and (iv) monitoring of vulnerabilities within the financial system.¹⁵⁵ Accordingly, although it is early in its establishment, the FSB appears to have received a wide mandate for at least monitoring, if not controlling, systemic risk at the international level.¹⁵⁶

Nevertheless, issues remain. First, the crisis has shown numerous sources of systemic risk: (i) the interconnectedness of the financial markets through the operation of cross-border financial services firms as well as products;¹⁵⁷ (ii) asymmetries of information between regulators as well as between regulators and their charges operating abroad;¹⁵⁸ (iii) absence of an overarching monitor of market risk to assist domestic regulators in understanding global dispersal of risk patterns;¹⁵⁹ (iv) potential lack of alignment of incentives between home- and host-state regulators;¹⁶⁰ (v) absence of tools on an international scale to practically assist in the management of systemic risk;¹⁶¹ and (vi) deficient or absent resolution mechanisms for non-bank financial firms.¹⁶²

It is not yet clear how the FSB mandate will be implemented to address these factors or how the FSB will be organized going forward to ensure careful and focused oversight of these risks. In particular, the mission of the FSB is sufficiently broadly worded to permit its activities to be muscularly tailored towards the oversight of systemic risk, working alongside and bringing together the IMF and standard-setting bodies, as detailed below.¹⁶³ That being said, it is similarly possible that in view of its relatively widely worded mission, and the disappearing urgency of the crisis, old habits might return, leaving the FSB as little more than a talking shop for regulators. Accordingly,

¹⁵⁵ See *supra* Part II.E.

¹⁵⁶ Press Release, Fin. Stability Forum, *supra* note 91, at 2.

¹⁵⁷ Shymala Gopinath, Deputy Governor, Reserve Bank of India, Inaugural Address at the Fixed Income Money Markets and Derivatives Ass'n., 1–2 (Jan. 4, 2010), available at <http://www.bis.org/review/r100113d.pdf>.

¹⁵⁸ *Id.* at 3.

¹⁵⁹ *Id.* at 1–2.

¹⁶⁰ *Id.* at 3.

¹⁶¹ Arner & Norton, *supra* note 53, at 123.

¹⁶² *Id.* at 117.

¹⁶³ See Press Release, Fin. Stability Forum, *supra* note 91, at 2.

it is suggested that the FSB work alongside the IMF to capitalize on the mandate currently provided to it under the G-20, and its own expanded membership, to independently develop channeled expertise to oversee systemic risks.¹⁶⁴ To achieve greater credibility, the FSB needs to include a well-developed internal constitutional structure that includes a clear decision-making process, supported by a dedicated panel of experts charged with bringing together intelligence gathered by the standard-setting and other expert bodies, such as the World Bank and the IMF.¹⁶⁵ The FSB would be empowered to receive alerts from domestic regulators to analyze emerging systemic risks on the basis of Early Warning Assessments.¹⁶⁶

While it is unlikely that the FSB will have direct enforcement powers to act against national regulators whose local regulatory systems or supervisory habits may be imperiling their own economies and others, having oversight and greater consolidation in monitoring how risks in one jurisdiction overspill into others may work to better prepare domestic and international regulators to curb the effects of crises within their own jurisdictions. It may also allow for a more coordinated approach to managing country risks at the local level, though it is likely that national interests and incentives will continue to impact the direction of decision making.

It is certainly arguable that the more muscular role suggested for the FSB could also be played by the IMF, which has developed considerable expertise and experience in the area of assessing macro-economic financial stability and comprises a broader country membership.¹⁶⁷ However, this Article suggests, as developed further below, that the FSB may be helpful by institutionalizing greater consolidation within the international regulatory architecture; providing a coordination, data-sharing, and liaison mechanism for standard-setting bodies (including the IMF); and, more broadly, supervising the uptake and implementation of these standards and the spread of systemic risks.

Secondly, there appears to be considerable focus on the supervision of systemically significant institutions, with thirty firms initially selected as needing extra oversight in this regard.¹⁶⁸ The FSB has been charged with the

¹⁶⁴ Press Release, Fin. Stability Bd., Financial Stability Board Holds Inaugural Meeting in Basel (June 27, 2009), available at http://www.financialstabilityboard.org/press/pr_090627.pdf.

¹⁶⁵ *Id.*

¹⁶⁶ See Declaration, *supra* note 88, at 5.

¹⁶⁷ *Id.* (highlighting the IMF's universal membership and core macro-financial expertise).

¹⁶⁸ Jenkins & Davies, *supra* note 92.

coordination of colleges of supervisors for each of these institutions.¹⁶⁹ It is envisaged that these colleges will ensure greater coordination and disclosure between regulators to garner a fuller picture of a firm's cross-border activities, the products that it supplies to the market, and the degree of interconnectedness between players.¹⁷⁰ This work is to include the development of living wills that outline how firms could be wound up in the event of a crisis in an effort to better avoid the legal entanglements of the Lehman insolvency.¹⁷¹

However, while useful, this work may in fact provide a false sense of security to regulators. In particular, systemically important firms are not the only serious source of systemic risk. In many cases, smaller outfits may have considerable (and potentially systemic) impacts, as seen in the cases of Kaupthing,¹⁷² Northern Rock,¹⁷³ or indeed the ten next important institutions after the thirty chosen firms.¹⁷⁴ Failure to fully understand the implications of the activities of these smaller players may lead regulators to miss the wood for the bigger trees in the forest. It is suggested that the FSB work, as a minimum, to establish databases for host and home regulators to input data on firms undertaking cross-border business within their jurisdictions, for access by other regulators only.¹⁷⁵ In this regard, the FSB, working with national authorities, could develop a core set of information requirements for input into such databases.¹⁷⁶ Based on such information, national regulators may convene to undertake coordinated risk-based oversight of multinational firms. While colleges are certainly useful and ought to be deployed where possible, the FSB can simultaneously work to bring a supervisory umbrella over a wider cross-section of the international financial market, which although far from perfect, will nevertheless provide regulators with some trajectory of a firm's activities within and without their borders. Based on recent events, it does not appear wise to leave vast sectors of the cross-border market without some form of consolidated oversight, simply because the key actors involved are not

¹⁶⁹ *Id.*

¹⁷⁰ *Id.*

¹⁷¹ *See id.*

¹⁷² HOUSE OF COMMONS TREASURY COMMITTEE, BANKING CRISIS: THE IMPACT OF THE FAILURE OF THE ICELANDIC BANKS, 2008–9, H.C. 402, at 20–24.

¹⁷³ *See generally* HOUSE OF COMMONS TREASURY COMMITTEE, 1 THE RUN ON THE ROCK, 2007–8, H.C. 56-I.

¹⁷⁴ *See generally* Jenkins & Davies, *supra* note 92.

¹⁷⁵ FIN. STABILITY BD., THE FINANCIAL CRISIS AND INFORMATION GAPS 6 (Oct. 29, 2009).

¹⁷⁶ *Id.* at 25.

considered to be sufficiently important to warrant special regulatory attention.¹⁷⁷

In addition, while living wills provide useful disclosure, they are unlikely to be particularly helpful, given the almost constant fluxes in a firm's trading activities, such that they may provide a fairly temporary and general picture only.¹⁷⁸ In this regard, there may be uncertainty as to the extent to which such living wills will cover the full corporate group, including subsidiary or affiliate operations, especially when these are based outside of the home state.¹⁷⁹ To suggest that the very existence of a living will may trump the various insolvency laws in the jurisdictions where the firm operates, or provide anything other than an informational guide in its application, would appear to be optimistic indeed. Accordingly, unless the wills are developed and updated on a very regular basis, and simultaneously checked for compliance with local laws in which a firm does business, it may only be of limited or evidentiary value.¹⁸⁰ In view of the above, it would appear to be all the more urgent to develop principles for the insolvency of non-bank financial institutions to supplement the work of the World Bank and the IMF in the area of bank insolvency.¹⁸¹ Such principles or guidelines can serve as a guide for local regulators to develop a legal framework for regulating the insolvency of non-bank financial institutions that is compatible with internationally accepted standards as well as with the tenor of local insolvency laws and culture.

Thirdly, domestic legal systems deal with systemic risks using a number of tools—for example, lender-of-last-resort facilities to provide last-minute liquidity to struggling sectors of the economy and/or deposit insurance to dampen the spread of investor panic.¹⁸² As highlighted above, the use of these mechanisms entails taxpayer costs and therefore carries the potential for regulators to ration resort to these tools—for example, making these available

¹⁷⁷ See *supra* notes 172–74 and accompanying text.

¹⁷⁸ *Contra* David K. Tarullo, Member, Bd. of Governors of the U.S. Fed. Reserve Sys., Speech at the Institute of International Bankers Conference on Cross-border Insolvency Issues: Supervising and Resolving Large Financial Institutions (Nov. 10, 2009), available at <http://www.federalreserve.gov/newsevents/speech/tarullo20091110a.htm>.

¹⁷⁹ “Living will” requirements for institutions are contemplated as domestic legal requirements, intended for use when a financial institution collapses. See, e.g., COUNCIL ON FOREIGN RELATIONS, IMPROVING RESOLUTION OPTIONS FOR SYSTEMICALLY RELEVANT FINANCIAL INSTITUTIONS (2009).

¹⁸⁰ *Id.* at 4.

¹⁸¹ See INTERNATIONAL MONETARY FUND & THE WORLD BANK, AN OVERVIEW OF THE LEGAL, INSTITUTIONAL, AND REGULATORY FRAMEWORK FOR BANK INSOLVENCY (2009).

¹⁸² CHARLES GOODHART & GERHARD ILLING, FINANCIAL CRISES, CONTAGION, AND THE LENDER OF LAST RESORT 1 (2002).

to home-grown banks only, rather than subsidiaries of foreign banks, or branches of foreign firms, even though customers do not necessarily distinguish between domestic or international entities.¹⁸³

Accordingly, it is suggested that the international community support the supervision and regulation of cross-border systemic risk through the establishment of a dedicated fund to assist domestic regulators to top-off local depository insurance reserves and/or provide emergency liquidity to domestic central banks and national authorities where local funds for emergency aid may be depleted. Resort to such a fund would require domestic regulators to demonstrate need for addressing the eruption of sudden systemic risks. While it may be argued that this regulation may lead to moral hazard for local regulators,¹⁸⁴ who may then be less exacting in deciding when to hand out assistance to endangered banks, the international regulatory system must nevertheless be buttressed with suitable tools for addressing specific, globally relevant risks.¹⁸⁵ Given its role as a financial stability overseer for the international community, the IMF, with input from the FSB, can helpfully administer such a fund.

B. Standard Setting

As set out in Part II of this paper, the international regulatory architecture comprises a number of standard-setting bodies that develop best practice guidelines, principles, and standards for the regulation of the international financial markets.¹⁸⁶ Key bodies include the BCBS, IOSCO, and IAIS, each contributing to the development of the body of standards currently underpinning the framework for international oversight.¹⁸⁷

Nevertheless, this paper has argued that the market has moved far from the traditional sectoral classifications that once defined firms as well as the products they traded.¹⁸⁸ This has been most clearly evidenced by the abolishing of Glass-Steagall type restrictions that have permitted firms to provide banking services—investment banking services as well as insurance—to customers

¹⁸³ See *supra* Part III.B.

¹⁸⁴ See *supra* Part I.E.

¹⁸⁵ See *supra* notes 157–62 and accompanying text.

¹⁸⁶ See discussion *supra* Part II.

¹⁸⁷ See discussion *supra* Part II.

¹⁸⁸ See discussion *supra* Part I.

from within the same institution.¹⁸⁹ As detailed, firms now offer products that cannot easily be classified into one sectoral category, such as certificates of deposit or certain types of annuities. As a result of their category crossover, these products can slip between the cracks of sectorally based oversight. To further complicate the picture in the secondary markets, the definition of what is regarded by firms as banking and investment banking is also changing. The striking example of this, as witnessed through the crisis, may be seen in the high-traffic repo market that provides liquidity and cash/securities “deposit” facilities to players.¹⁹⁰ The repo market has been analyzed by some commentators as being functionally similar to a market for banking services for the secondary markets, such that the risks raised by its operation may also be analogous.¹⁹¹

Therefore, to match the evolution and structure of the market, there is little reason to continue with strict sectoral divisions between standard-setting bodies. It is therefore suggested that the BCBS, the IAIS, and IOSCO be expanded to include the establishment of an additional body (e.g. panel) that formally and functionally brings these standard setters closer together.¹⁹² The work undertaken by each of these bodies would be reviewed and approved by this panel. Such an additional consolidating layer standing above these three sectoral-standard setters can help to create an increasingly fluid boundary between their work and permit these bodies to develop a more sector-blind agenda that is better suited to market complexities. It is suggested that this panel be housed in and report to the FSB to ensure that the FSB has an even picture of the regulatory work being undertaken. This will support a move towards more broad-based and consolidated supervision and regulation by the FSB.

C. Prescription Versus Principles

This Article argues that reform of the international regulatory architecture is required to better support the operation of regulatory rationales that have underpinned the development of regulatory and supervisory frameworks in the

¹⁸⁹ J. Robert Brown, Jr., *The Consequences of Repealing the Glass-Steagall Act*, 2 STAN. J.L. BUS. & FIN. 129, 129–30 (1995).

¹⁹⁰ GARY B. GORTON, SLAPPED BY THE INVISIBLE HAND: THE PANIC OF 2007, at 15–17 (2010).

¹⁹¹ *Id.* at 15.

¹⁹² This should be done more formally and robustly than is currently organized under the fairly loose Joint Forum.

domestic context.¹⁹³ In addition, the institutional shape likely to be assumed by the rationales will necessarily differ given the particularities of international regulation and the constraints to which it is subject. Although this Article proposes that there be greater consolidation within the various international regulatory bodies to provide better breadth of oversight and more stringent “full-picture” supervisory coverage of systemic risks, the “regulations” themselves should be less prescriptive and more principles-based to provide for better absorption into the variety of country frameworks likely to be affected. The debate surrounding the effectiveness of legal transplants of model laws into national legal frameworks is necessarily complex, such that a full discussion here is not possible.¹⁹⁴ However, this Article suggests that highly prescriptive regulatory model laws for transposition across national regulatory frameworks are unlikely to be successful. Given the particularities of national legal systems, as well as of regulatory cultures that may differ in emphases between predominating rationales for regulation (for example, where one may choose to offer relatively stronger consumer protection mechanisms than others), a focus on developing a principles-based jurisprudence in this area may be fruitful.¹⁹⁵ National regulatory mechanisms may be attuned to local needs and habits, such that highly codified mechanisms may not incentivize regulators and firms to fully accept them where these do not gel well into local law and practice.¹⁹⁶ As an example, despite the detailed extrapolation of capital adequacy rules by the BCBS as a statement of international best practice and consensus on the issue, the United States retained its use of the leverage ratio as a key tool in determining appropriate levels of bank capital. This has been seen as having worked well during the crisis¹⁹⁷ and perhaps reflects the regulatory comfort with this arguably less refined, calibrated device.

Looking forward, to mitigate some of the risks set out above, it has been suggested by the BCBS that there be greater convergence in national regimes with respect to the tools available for the resolution of large and complex

¹⁹³ See discussion *supra* Part IV.

¹⁹⁴ For a more in-depth treatment see Holger Spamann, *Contemporary Legal Transplants: Legal Families and the Diffusion of (Corporate) Law*, 2009 BYU L. REV. 1813 (2009).

¹⁹⁵ See Christopher Cox, Former SEC Chairman, Speech at the FEI 2008 Current Financial Reporting Issues Conference: The Future of International Standards and Cooperation in Light of the Credit Crisis (Nov. 18, 2009), available at <http://www.sec.gov/news/speech/2008/spch111808cc.htm>.

¹⁹⁶ See *id.*

¹⁹⁷ See *id.*

financial institutions.¹⁹⁸ However, while such convergence may be theoretically desirable, particularities of national legal systems are likely to stand in the way of consensus. Staying on the point of insolvency, these laws are technical, complex, and often reflect national particularities and cultures,¹⁹⁹ therefore, binding countries that do not all share legal traditions, history, and cultures and seeking to create a harmonizing jurisprudence may be misconceived. Rather, as suggested above, it may be easier for regulators to absorb a principles-based approach that seeks to ensure that national legal systems comply with a set of internationally approved principles, reflecting best practice that nevertheless gives space to lawmakers to see to it that new laws are in tune with national legal systems, traditions, and culture.

CONCLUSION: CRISIS AND RE-CONSTRUCTION

The global financial crisis is forcing a thorough re-evaluation of the international regulatory architecture. The crisis has shown not only the cracks in regulatory oversight, but also a market operation that had long outgrown and outwitted its overseers.²⁰⁰ This Article has argued that the international financial market may be seen as having its own distinct personality, the recent expansion bringing with it a unique set of regulatory risks. Accordingly, just as with domestic regulatory systems, the regulation of the international financial marketplace ought to be rooted in the legal and economic rationales that have been advanced in support of financial markets regulation generally, in order that reform proceed thoughtfully, rather than on an ad hoc and knee-jerk basis.²⁰¹ This Article contemplates a re-organization of the current plethora of standard-setting and oversight bodies that have provided little substantial protection in the face of the crisis. In sum, it puts forward a case for a more consolidated framework for standard setting and supervision that better matches the shape that the market has assumed, and that further works to ensure a greater focus on catching and managing the dangers of cross-border systemic risk.

¹⁹⁸ Tools that should be available include rules to deal with such complex and nationally diverging tools as special resolution regimes for financial institutions, netting and collateral rights, or power to terminate contracts. *See* BASEL COMM., *supra* note 1, at 25–26.

¹⁹⁹ Different legal systems may accord varying emphases to creditor-debtor rights, or they may not in all cases provide for the operation of automatic set-off and netting; state aid rules may differ in allowing bailouts to be undertaken.

²⁰⁰ *See* discussion *supra* Part III.

²⁰¹ *See* discussion *supra* Part IV.

Nevertheless, the international regulatory framework is a slippery one. It is constrained by state sovereignty, the pernicious play of national interests, and the multiplicity of legal cultures and traditions that make regulation subject to potentially inconsistent interpretation and application.²⁰² Still, as this crisis shows, notwithstanding the frustrations of international regulation, the risks it seeks to control have become increasingly common.²⁰³ So, even if we are bound to fall short by the fickle forces that face us, the path of the stone, and its weight on our shoulders, are as inescapable as the deeds for which they are designed to atone.

²⁰² See discussion *supra* Part III.

²⁰³ See *id.*