


Fall 2013

The Political Economy of International Financial Regulation

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Verdier, Pierre-Hugues (2013) "The Political Economy of International Financial Regulation," *Indiana Law Journal*: Vol. 88: Iss. 4, Article 11.

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The Political Economy of International Financial Regulation

PIERRE-HUGUES VERDIER*

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INTRODUCTION

The worldwide impact of the subprime crisis has revealed fundamental weaknesses in the system of international financial regulation (IFR) that has emerged since the 1970s. At the same time, diagnosing and repairing these weaknesses has proven difficult because the system and its functions are poorly understood. In sharp contrast with other international regimes like trade or environmental law, IFR relies not on treaties and formal international organizations but on “soft law” standards designed by informal networks of national regulators—so-called “transnational regulatory networks” (TRNs). The development of these standards is highly uneven; detailed rules like the Basel accords on bank capital adequacy long cohabited with negligible progress in areas like insurance, hedge funds, and credit rating agencies. Scholars, for their part, differ sharply in their assessments of IFR. The conventional wisdom is that the current, informal system

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* Associate Professor of Law, University of Virginia. The author would like to thank Robert Ahdieh, Kenneth Anderson, Anu Bradford, Chris Brummer, Stavros Gadinis, Anna Gelper, Erik Gerding, Eric Helleiner, Susan Karamanian, Heidi Schooner, David Singer, Paul Stephan, Edward Swaine, Joel Trachtman, Arthur Wilmarth, David Zaring and participants in workshops and conferences organized by the International Economic Law Interest Group of the American Society of International Law, the American Branch of the International Law Association, the Society of International Economic Law, Georgetown University Law Center, and George Washington University Law School for their comments on prior drafts.

of IFR allows regulators to respond effectively and flexibly to new market and technological challenges.¹ In light of the financial crisis, however, skepticism is growing.² Some prominent legal and economic commentators have even called for a World Financial Authority—a formal, treaty-based organization to regulate international finance.³

An elementary difficulty in this debate is the lack of a convincing account of the objectives pursued by IFR. In other areas, relatively uncontroversial theories explain why unilateral action by states is suboptimal and international cooperation can produce collective gains. For instance, the logic of the international trade system rests on the premise that individual states often have economic and political incentives to impose trade barriers, even though protectionism ultimately decreases the welfare of all.⁴ Likewise, because some costs of pollution are externalized across borders, individual states may have incentives to adopt excessively lenient

1. See, e.g., CHRIS BRUMMER, *SOFT LAW AND THE GLOBAL FINANCIAL SYSTEM: RULE MAKING IN THE 21ST CENTURY* 63–67 (2012); ANNE-MARIE SLAUGHTER, *A NEW WORLD ORDER* 36–61 (2004); Chris Brummer, *How International Financial Law Works (And How It Doesn't)*, 99 GEO. L.J. 257 (2011) [hereinafter Brummer, *How International Financial Law Works*]; Chris Brummer, *Why Soft Law Dominates International Finance—And Not Trade*, 13 J. INT'L ECON. L. 623 (2010); Sungjoon Cho & Claire R. Kelly, *Promises and Perils of New Global Governance: A Case of the G20*, 12 CHI. J. INT'L L. 491 (2012); Roberta S. Karmel & Claire R. Kelly, *The Hardening of Soft Law in Securities Regulation*, 34 BROOK. J. INT'L L. 883 (2009); Yesha Yadav, *The Specter of Sisyphus: Re-making International Financial Regulation After the Global Financial Crisis*, 24 EMORY INT'L L. REV. 83 (2010).

2. See DANIEL K. TARULLO, *BANKING ON BASEL: THE FUTURE OF INTERNATIONAL FINANCIAL REGULATION* (2008); Douglas W. Arner & Michael W. Taylor, *The Global Financial Crisis and the Financial Stability Board: Hardening the Soft Law of International Financial Regulation?*, 32 U. NEW S. WALES L.J. 488 (2009); Edward F. Greene & Joshua L. Boehm, *The Limits of "Name-and-Shame" in International Financial Regulation*, 97 CORNELL L. REV. 1083 (2012); Eric J. Pan, *Challenge of International Cooperation and Institutional Design in Financial Supervision: Beyond Transgovernmental Networks*, 11 CHI. J. INT'L L. 243 (2010); Pierre-Hugues Verdier, *Transnational Regulatory Networks and Their Limits*, 34 YALE J. INT'L L. 113 (2009); David Zaring, *International Institutional Performance in Crisis*, 10 CHI. J. INT'L L. 475 (2010); Kenneth Anderson, *Squaring the Circle? Reconciling Sovereignty and Global Governance Through Global Government Networks*, 118 HARV. L. REV. 1255 (2005) (reviewing ANNE-MARIE SLAUGHTER, *A NEW WORLD ORDER* (2004)).

3. See, e.g., Peter Boone & Simon Johnson, *Will the Politics of Global Moral Hazard Sink Us Again?*, in *THE FUTURE OF FINANCE AND THE THEORY THAT UNDERPINS IT* 247, 269 (2010); John Eatwell & Lance Taylor, *A World Financial Authority*, in *INTERNATIONAL CAPITAL MARKETS: SYSTEMS IN TRANSITION* 17 (John Eatwell & Lance Taylor eds., 2002); Pan, *supra* note 2, at 249–52; Carmen Reinhart & Kenneth Rogoff, *Regulation Should Be International*, FIN. TIMES, Nov. 18, 2008; Barry J. Eichengreen, *Out of the Box Thoughts About the International Financial Architecture* 18–20 (Int'l Monetary Fund, Working Paper No. 116, 2009); David Wright, Remarks at the Atlantic Council (Dec. 10, 2012).

4. See, e.g., KYLE BAGWELL & ROBERT W. STAIGER, *THE ECONOMICS OF THE WORLD TRADING SYSTEM* 13–41 (2002); MICHAEL J. TREBILCOCK & ROBERT HOWSE, *THE REGULATION OF INTERNATIONAL TRADE* 6–8 (3d ed. 2005); Robert W. Staiger & Alan O. Sykes, *International Trade, National Treatment, and Domestic Regulation*, 40 J. LEG. STUD. 149, 166–68 (2011).

environmental rules.⁵ In both situations, states can improve collective outcomes by adopting common standards. These simple theories provide both a rationale for the existence of the trade and environment regimes and a starting point for analysis of their rules and features. By contrast, no such standard account of IFR has emerged. While there is a widely shared sense that national regulation alone cannot address the challenges of financial globalization, a more detailed account is needed to understand these challenges and assess the effectiveness of the current system.

This Article takes the first step in remedying this difficulty. It identifies five distinct objectives that cannot be achieved by states acting unilaterally, and that IFR has historically pursued. The IFR system has been largely successful at two of them: facilitating cross-border supervision and enforcement assistance among regulators, and removing barriers to international finance by harmonizing some regulatory requirements. Most of the success stories often described in IFR scholarship, such as the International Organization of Securities Commissions' (IOSCO) Multilateral Memorandum of Understanding (MMOU), the Basel Concordat on bank supervision, and international accounting standards, relate to these objectives. There are, however, three other objectives in respect of which the IFR system has performed poorly. First, it has encountered numerous setbacks in its attempts to raise regulatory standards in states where there is substantial domestic political resistance, such as offshore financial centers (OFCs) and developing Asian states after the late 1990s crisis. Second, it has struggled to secure durable collective action to raise prudential standards, such as capital adequacy rules. The 1988 Basel Accord was a major exception, but as will be seen, it stood virtually alone and was substantially weakened over time. Finally, the IFR system has generally failed to create credible collective mechanisms to address situations where unilateral action is counterproductive. For instance, there is no effective mechanism for cross-border bank resolution; often, each state simply grabs the assets it can to satisfy its own creditors.

This assessment relates directly to the debate on the institutional structure of IFR. If TRNs and "soft law" only achieve such limited success, why do they continue to dominate IFR? The conventional account draws on rational choice theories, under which states design international institutions by carefully balancing the costs and benefits and choosing the most efficient solution. In this view, TRNs and soft law dominate IFR because they provide some incentives for compliance while preserving the benefits of speed, flexibility, and expertise.⁶ This Article proposes an alternative explanation that casts doubt on the purported efficiency of current arrangements. The explanation is two-pronged. First, it draws on historical path dependence, the idea that past institutional choices shape current options in ways that can prevent the adoption of more efficient alternatives. The current IFR system has been profoundly shaped by history. As will be seen, under the postwar Bretton Woods monetary system, international capital mobility was expected to be strictly limited. Therefore, there was no need for a formal institution to regulate

5. See, e.g., Scott Barrett, *An Economic Theory of International Environmental Law*, in *THE OXFORD HANDBOOK OF INTERNATIONAL ENVIRONMENTAL LAW* 231 (Daniel Bodansky, Jutta Brunnée & Ellen Hey eds., 2007).

6. See, e.g., Brummer, *How International Financial Law Works*, *supra* note 1.

private international finance, alongside the ones established for monetary affairs and trade.⁷ When the fixed rate system collapsed in the 1970s, national regulators faced numerous new cross-border challenges. With no international framework to address them and no authority to create formal institutions or binding agreements, they instead created informal networks and non-binding standards. For better or worse, this approach remains the cornerstone of the current system.⁸

Second, the explanation draws on political economy by identifying three categories of actors that play a central role in shaping IFR: national regulators, the financial industry, and great power governments.⁹ While these actors sometimes have incentives to pursue effective IFR, they also have competing interests that can drive a wedge between the potential gains from international cooperation and actual outcomes. Thus, national regulators value some international cooperation, but also want to preserve their extensive domestic authority and resist binding rules and international oversight. The financial industry is willing to support some regulatory harmonization to facilitate cross-border activity, but resists costly prudential regulations. For their part, the great powers typically prefer fragmented and informal international governance over strong collective institutions where they can less easily wield their influence. Indeed, with respect to each of the five objectives identified above, this article shows that IFR initiatives usually succeeded when they had strong support from at least one of these actors and passive acquiescence by the others. While there are exceptions, such as the imposition of higher prudential standards after crises, such initiatives succeed only in very specific circumstances and tend to peter out over time.¹⁰ As a result, most of IFR is simply the lowest common denominator of what these actors are willing to do (or tolerate).

In contrast with conventional theories of IFR, this account grounded in historical path dependence and political economy explains several features of the current system: the substantial differences in outcomes across areas of IFR, including the virtual absence of effective standards in some of the most difficult areas; the overall preference for soft law and TRNs over formal law and institutions; and the high degree of inertia that leads to slow, incremental revision of existing standards and institutional arrangements rather than fundamental reforms—even in the wake of major crises.

While the analysis above is based on the historical development of IFR before the recent financial crisis, it illuminates the trajectory of the reforms initiated since then. The most difficult challenges revealed by the crisis—tackling systemic risk and moral hazard—fall precisely in the areas where IFR has performed poorly in the past. In response, governments and regulators have launched a major effort to reorganize the architecture of IFR by giving a leading role to the G-20 and the Financial Stability Board (FSB) in developing and implementing an array of substantive reforms in numerous areas of financial regulation.¹¹ Nevertheless, a review of three salient items on the post-crisis agenda—Basel III, cross-border resolution of financial institutions, and monitoring and enforcement of standards—

7. *See infra* Part I.A.

8. *See infra* Parts I.B., I.C.

9. *See infra* Part II.C.

10. *See infra* Part III.B.

11. *See infra* Part IV.A.

reveals that, despite ambitious goals, achievements have so far been uneven and many precrisis patterns persist.¹² The postcrisis era in IFR is characterized by tension between stronger demand for effective reforms and the historical and political constraints described above. While these constraints make radical changes unlikely, the coming years may see a gradual move away from soft law and TRNs towards more binding rules and international oversight, especially in areas where the current IFR system has shown its limitations. The Article concludes by providing some recommendations for enhancing the effectiveness of IFR within current constraints.¹³

The rest of the Article proceeds as follows. Part I explains the historical origins of IFR, laying the ground for subsequent analysis of its politics and achievements. Part II reviews conventional accounts of IFR, then proposes an alternative account that draws on historical path dependence and political economy. It identifies three categories of actors—regulators, financial firms, and great powers—that most influence outcomes, and proposes hypotheses regarding their respective interests and how they interact. Part III deploys this political economy analysis to explain variations in outcomes across five salient areas of IFR, and the overall dominance of soft law and TRNs despite their limited effectiveness. Finally, Part IV assesses the impact of the financial crisis on IFR, some of the reforms led by the G-20, and potential improvements.

I. THE ORIGINS OF INTERNATIONAL FINANCIAL REGULATION

A. *The Bretton Woods System*

To understand the origins of the current, decentralized system of IFR, one must go back to the post-World War II settlement that created the modern international economic order. As early as 1941, the Allies expressed in the Atlantic Charter their desire to “bring about the fullest collaboration between all nations in the economic field with the object of securing, for all, improved labor standards, economic advancement and social security.”¹⁴ The new system would be a multilateral alternative to the chaotic economic competition of the 1930s—what U.S. Treasury Secretary Morgenthau called the “desperate tactics of the past—competitive currency depreciation, excessive tariff barriers, uneconomic barter deals, multiple currency practices and unnecessary exchange restrictions.”¹⁵ These practices, the postwar planners believed, had deepened the Great Depression and ultimately

12. *See infra* Part IV.B.

13. *See infra* Part IV.C.

14. Atlantic Charter, U.S.-U.K., Aug. 14, 1941, 55 Stat. 1603, *available at* <http://avalon.law.yale.edu/wwii/atlantic.asp>.

15. U.S. DEP’T OF STATE, PUB. NO. 2866, PROCEEDINGS AND DOCUMENTS OF THE UNITED NATIONS MONETARY AND FINANCIAL CONFERENCE 1226 (1948) [hereinafter *BRETTON WOODS PROCEEDINGS*]; *see also* RICHARD N. GARDNER, *STERLING-DOLLAR DIPLOMACY: ANGLO-AMERICAN COLLABORATION IN THE RECONSTRUCTION OF MULTILATERAL TRADE* 76 (1956).

contributed to the war.¹⁶ In their place, they sought “to recreate a liberal world economy in which stable exchange rates and free trade were the norm.”¹⁷

The cornerstone of the postwar economic order would be a new international monetary system to replace the gold standard that had disintegrated in the 1930s.¹⁸ A stable monetary system would, in turn, provide the foundation for reviving international trade by abolishing discriminatory preferences and reducing tariffs and other barriers to trade. In both areas—monetary affairs and trade—the postwar planners envisioned a highly legalized regime based on formal treaty obligations and intergovernmental organizations. In crafting the treaties, they strived to balance multilateral obligations with domestic economic and social policy autonomy.¹⁹ The most ambitious manifestation of this vision was the IMF Articles of Agreement, which established an elaborate code of conduct for international monetary relations.²⁰

The Articles created a system of fixed exchange rates, under which all currencies were pegged to the U.S. dollar, and the dollar itself pegged to gold at a rate of \$35 per ounce. IMF member states agreed to several fundamental obligations. First, they would adopt and maintain a fixed “par value” for their currency, expressed in gold or dollars, and not change it unless necessary to correct a “fundamental disequilibrium.”²¹ In order to fulfill this obligation, they would intervene in the foreign exchange market by buying or selling their own currency near par value.²² Second, they would allow private persons to freely exchange their currency for current account transactions, such as international sales of goods and services.²³ This obligation amounted to maintaining the convertibility of their currency, at least for current transactions, and was seen as essential to reviving international trade.²⁴ Finally, under this system, a country that ran a current account deficit would eventually run out of foreign currency reserves needed to maintain its

16. See GARDNER, *supra* note 15; ROBERT SKIDELSKY, JOHN MAYNARD KEYNES 1883–1946, at 669 (2003).

17. SKIDELSKY, *supra* note 16, at 698.

18. See ERIC HELLEINER, STATES AND THE REEMERGENCE OF GLOBAL FINANCE: FROM BRETTON WOODS TO THE 1990S 25–50 (1994).

19. See John Gerard Ruggie, *International Regimes, Transactions, and Change: Embedded Liberalism in Postwar Economic Order*, 36 INT’L ORG. 379, 394 (1982).

20. For an overview, see ANDREAS F. LOWENFELD, INTERNATIONAL ECONOMIC LAW 605–17 (2d ed. 2008).

21. INT’L MONETARY FUND & INT’L BANK OF RECONSTRUCTION & DEV., U.S. TREASURY, ARTICLES OF AGREEMENT art. IV(1), (5) (1944) [hereinafter ORIGINAL IMF ARTICLES]. The term was undefined, but was “understood, it seems, to mean a situation not correctable within the time for which resources of the Fund would be made available to members under drawings.” LOWENFELD, *supra* note 20, at 623.

22. See ORIGINAL IMF ARTICLES, *supra* note 21, at art. IV(4)(b).

23. See *id.* art. VIII(2)(a); see also *id.* art. VIII(3) (prohibiting discriminatory arrangements or multiple currency practices).

24. However, members were entitled to maintain currency restrictions during an undefined “post-war transitional period.” Most industrialized countries had moved to “Article VIII status” by the early 1960s. See LOWENFELD, *supra* note 20, at 607–08; Beth A. Simmons, *Money and the Law: Why Comply with the Public International Law of Money*, 25 YALE J. INT’L L. 323, 338 (2000).

currency at par value. To address this problem, all members would contribute to a fund administered by the IMF and available for lending to deficit countries, on the condition that they take steps to restore the balance of payment equilibrium.²⁵

The crucial point is that while they prohibited restrictions on current transactions, the IMF Articles of Agreement did not prohibit—and indeed encouraged—capital controls.²⁶ The two architects of the Bretton Woods monetary system, Harry Dexter White and John Maynard Keynes, concluded from the interwar experience that unrestricted capital flows were destabilizing.²⁷ They were eager to preserve the economic and social policy autonomy of states, which they thought would be compromised by uncontrolled movements of capital.²⁸ They also believed that unimpeded capital flows would undermine the fixed exchange rate system and free trade.²⁹ Since shifts in investor sentiment could change the size and direction of capital flows much more rapidly than trade, the IMF's resources would be insufficient to sustain national reserves while policy adjustments took place.³⁰ White and Keynes' solution was to draw a line between capital and current transactions, permitting restrictions on the former but not the latter.³¹ Indeed, Keynes wrote that "control of capital movements, both inward and outward, should be a permanent feature of the post-war system."³² Some countries, such as the United States, refrained from imposing such controls, but most did impose them.³³

Thus, the Bretton Woods system "strongly encouraged closed national financial markets, with limited capital flows, and open markets for trade in goods."³⁴ To the extent that international capital flows were needed for reconstruction and

25. ORIGINAL IMF ARTICLES, *supra* note 21, at arts. III, VI. Each member state was assigned a quota, based roughly on its importance in the world economy, which it had to contribute to the Fund (25% in gold and the rest in its own currency). While in theory all currencies could be used for lending, in practice only those currencies generally accepted in international transactions—such as the U.S. dollar—were useful. *See* LOWENFELD, *supra* note 20, at 610.

26. ORIGINAL IMF ARTICLES, *supra* note 21, at art. VI(3) ("Members may exercise such controls as are necessary to regulate international capital movements."). Generally, capital controls are restrictions on cross-border flows of capital, such as loans and transactions in financial assets like stocks and bonds. They can take many forms, including taxes and government or central bank approval requirements. For the argument that capital controls were in fact encouraged under Bretton Woods, see HELLEINER, *supra* note 18, at 25–50.

27. *See* SKIDELSKY, *supra* note 16, at 676, 698.

28. *See* HELLEINER, *supra* note 18, at 33–35; Ruggie, *supra* note 19, at 290.

29. *See* HELLEINER, *supra* note 18, at 35–36.

30. In any event, the United States, which contributed most of the IMF's initial funding, was unwilling to permit it to fund capital flight. Thus, the Articles prohibited member states from drawing on the Fund to meet a "large or sustained outflow of capital." ORIGINAL IMF ARTICLES, *supra* note 21, at art. VI(1)(a).

31. *See* KENNETH W. DAM, *THE RULES OF THE GAME: REFORM AND EVOLUTION IN THE INTERNATIONAL MONETARY SYSTEM* 99–100 (1982).

32. HELLEINER, *supra* note 18, at 33 (quoting 3 J. KEITH HORSEFIELD, *THE INTERNATIONAL MONETARY FUND, 1945-1965*, at 13 (1969)).

33. *Id.* at 51–77.

34. Douglas W. Arner & Ross P. Buckley, *Redesigning the Architecture of the Global Financial System*, 11 MELB. J. INT'L. L. 185, 188 (2010) (citation omitted).

development, the postwar planners contemplated that they would occur primarily through official channels, not private investment.³⁵ Thus, the U.S. government directly financed the reconstruction of Europe through the Marshall Plan.³⁶ For its part, the World Bank initially was to play a major role in postwar reconstruction, but instead became a source of official funding for development projects.³⁷ In addition, many of the leading Treasury officials involved in postwar financial planning were New Dealers suspicious of private international banking and its role in the interwar years.³⁸ Secretary Morgenthau famously rejoiced that Bretton Woods would “drive . . . the usurious money lenders from the temple of international finance.”³⁹ Given the limited role contemplated for private international finance in the postwar order, it is unsurprising that its architects did not consider its regulation worthy of a legal framework comparable to those they designed for monetary affairs and trade. Indeed, the existing organization, the Bank for International Settlements, was a legacy of the failed interwar economic order; some accused it of collaborating with the Nazis.⁴⁰ The Bretton Woods delegates called for its abolition “at the earliest possible date.”⁴¹

Although the postwar planners succeeded in creating a new monetary system, the negotiations on trade soon foundered. The General Agreement on Tariffs and Trade, negotiated by twenty-three countries as a temporary code of conduct without any institutional framework, entered into force on a provisional basis in 1948.⁴² While representatives of fifty-three countries agreed to the much more ambitious Charter of the International Trade Organization later that year, by that time the momentum for multilateralism had passed. The ITO Charter never entered into force, and the GATT remained the central legal instrument of the multilateral trade regime.⁴³ Thus, while international monetary affairs were governed by an extensive

35. See Maurice Obstfeld & Alan M. Taylor, *Globalization and Capital Markets*, in *GLOBALIZATION IN HISTORICAL PERSPECTIVE* 121, 132 (Michael D. Bordo et al. eds., 2003).

36. See JEFFRY A. FRIEDEN, *BANKING ON THE WORLD: THE POLITICS OF AMERICAN INTERNATIONAL FINANCE* 68–71 (1987); GARDNER, *supra* note 15, at 299–304.

37. See LOWENFELD, *supra* note 20, at 750.

38. See FRIEDEN, *supra* note 36, at 60; GARDNER, *supra* note 15, at 76; HELLEINER, *supra* note 18, at 31–32.

39. *BRETTON WOODS PROCEEDINGS*, *supra* note 15, at 1227. The New Dealers also insisted that the World Bank and IMF be headquartered in Washington rather than New York to “keep them free from the taint of ‘international finance.’” SKIDELSKY, *supra* note 16, at 828. New York financial circles, as well as conservatives in the United States, strongly opposed the plan. See HELLEINER, *supra* note 18, at 39–44; SKIDELSKY, *supra* note 16, at 704–05; Richard N. Gardner, *The Bretton Woods-GATT System After Sixty-Five Years: A Balance Sheet of Success and Failure*, 47 *COLUM. J. TRANSNAT’L L.* 31, 35–36 (2008); Ruggie, *supra* note 19, at 393.

40. See SKIDELSKY, *supra* note 16, at 766; ARMAND VAN DORMAEL, *BRETTON WOODS: BIRTH OF A MONETARY SYSTEM* 204 (1978).

41. See VAN DORMAEL, *supra* note 40, at 203–06. Keynes, interestingly, fought White on this point. See *id.* at 204–05; SKIDELSKY, *supra* note 16, at 766. Ultimately, the BIS survived the postwar settlement and became an important focal point for central bank coordination. See LOWENFELD, *supra* note 20, at 754.

42. See LOWENFELD, *supra* note 20, at 27.

43. See *id.* at 28.

legal framework overseen by the IMF, trade was initially the less legalized area of international economic law. This situation changed radically in the following decades. The monetary system collapsed, while the trade system became ever more legalized, culminating with the creation of the WTO.

B. The Rise of International Finance

From the beginning, the Bretton Woods monetary system faced significant difficulties. First, the distinction between capital and current transactions was difficult to implement and led to significant “leakage” that compromised the effectiveness of capital controls.⁴⁴ Second, an extensive market developed for deposits and loans of U.S. dollars held outside the United States, so-called “Eurodollars.” The Eurodollar market increasingly circumvented attempts to control capital movements, as well as U.S. domestic regulation, such as reserve requirements.⁴⁵ Nevertheless, U.K. and U.S. authorities supported its development—the former to restore London’s importance as an international financial center, the latter to allow U.S. bankers to retain their business despite U.S. measures aimed at discouraging capital outflows.⁴⁶ Despite these developments, the fixed exchange rate system functioned more or less as planned until the late 1960s.⁴⁷ Ultimately, it was destroyed by a third problem, the persistent U.S. current account deficits that led to massive accumulation of U.S. dollars abroad. These

44. In this context, “leakage” refers to the occurrence of cross-border capital flows despite the existence of capital controls, often by disguising these flows as current transactions. For example, multinational companies could effectively transfer capital from one country to another by manipulating the prices at which they transferred goods or services between subsidiaries. The leakage problem was aggravated by the fact that, contrary to White’s original draft of the relevant provision, the IMF Articles of Agreement did not provide for true cooperative enforcement of capital controls by member states, but only for “passive” non-enforceability in each member state of agreements contrary to the capital controls of another. *See* HELLEINER, *supra* note 18, at 44–48.

45. *See* DAM, *supra* note 31, at 322; FRIEDEN, *supra* note 36, at 79–122. Ultimately, the Eurodollar market compromised the objectives pursued by the Bretton Woods system, since it created a new source of capital flows that were not covered by traditional capital controls. These flows increased pressures on exchange rates and currency reserves, reducing the ability of countries to insulate their social and economic policies. *See* E. WAYNE CLENDENNING, *THE EURO-DOLLAR MARKET* 162–68 (1970).

46. U.S. banks could accomplish this by conducting Eurodollar operations in their London branches. U.S. dollar deposits held abroad were not subject to reserve requirements and other U.S. regulations. The interest equalization tax and other U.S. quasi-capital controls of the 1960s also generally did not apply to lending by U.S. institutions in London. *See* BENJAMIN J. COHEN, *IN WHOSE INTEREST?: INTERNATIONAL BANKING AND AMERICAN FOREIGN POLICY* (1986); HELLEINER, *supra* note 18, at 88.

47. There are other qualifications. The par value system was not universally observed: France changed its peg without authorization in 1948, and Canada floated its currency in the 1950s. *See* LOWENFELD, *supra* note 20, at 624. Many countries maintained current account restrictions for extended periods, relying on Art. XIV. *See* Simmons, *supra* note 24, at 346–47. Nevertheless, most observers believe that from the mid-1950s to the late 1960s, the system functioned roughly as envisioned.

dollar holdings eventually exceeded U.S. gold reserves, triggering a crisis of confidence. Foreign central banks requested redemption of their dollar holdings, and U.S. gold reserves plummeted. In 1971, President Nixon abolished the gold convertibility of U.S. dollars.⁴⁸ By 1973, all the major industrialized countries abandoned the fixed rate system, and several attempts to reestablish it failed.⁴⁹ IMF member states can now choose their exchange rate regime and are free to change at any time.⁵⁰ Floating rates also alleviated the need for capital controls to protect foreign exchange reserves.⁵¹ Over the 1970s and 1980s, virtually all industrialized countries abolished them, and later encouraged others to follow suit.⁵²

The collapse of the fixed rate system was a watershed for financial globalization. From then on, a clear, long-term trend of increasing international capital flows took hold. The move to floating rates created an enormous foreign exchange market, from a negligible amount in the late 1950s⁵³ to a daily turnover of about \$4 trillion in 2010⁵⁴—only a small fraction of which is for trade.⁵⁵ Greater foreign exchange and interest rate volatility drove the development of global derivatives markets. Foreign exchange and interest rate derivatives still dominate these markets, with \$523 trillion out of the \$601 trillion notional amount outstanding in 2010—up from \$68 trillion in 1998, the first year for which Bank for International Settlements (BIS) statistics are available.⁵⁶ The Eurodollar market also grew exponentially in the 1970s, buoyed by large deposits of dollars from oil exporters (often lent on to Latin America).⁵⁷ The international activities of banks increased rapidly: in 1960, less than ten U.S. banks had branches overseas, with assets of less than \$4 billion; in 1977, more than 100 did, with assets of \$230 billion.⁵⁸ The external assets of banks from the forty-one BIS-reporting countries

48. President Richard Nixon, Address to the Nation Outlining a New Economic Policy: “The Challenge of Peace” (Aug. 15, 1971).

49. See LOWENFELD, *supra* note 20, at 624–33.

50. The Articles of Agreement were amended in 1978 to reflect this new regime. Most industrialized countries float their currency. Several countries peg their currency to another like the U.S. dollar or the euro; others have created regional monetary unions or currency boards. The only prohibited option is a peg to gold. ORIGINAL IMF ARTICLES, *supra* note 21, at art. IV(2)(b).

51. See Obstfeld & Taylor, *supra* note 35, at 125–26, 133.

52. See HELLEINER, *supra* note 18, at 9.

53. See *id.* at 1.

54. MONETARY & ECON. DEP’T, BANK FOR INT’L SETTLEMENTS, TRIENNIAL CENTRAL BANK SURVEY, REPORT ON GLOBAL FOREIGN EXCHANGE MARKET ACTIVITY IN 2010, at 6 (2010) [hereinafter BIS 2010 FOREIGN EXCHANGE REPORT], available at www.bis.org/publ/rpfxfl0t.pdf.

55. See Gardner, *supra* note 39, at 43–44; HELLEINER, *supra* note 18, at 1.

56. See MONETARY & ECON. DEP’T, BANK FOR INT’L SETTLEMENTS, OTC DERIVATIVES MARKET ACTIVITY IN THE SECOND HALF OF 2010, at 8 (2011), available at http://www.bis.org/publ/otc_hy1105.pdf; BANK FOR INT’L SETTLEMENTS, THE GLOBAL OTC DERIVATIVES MARKET CONTINUES TO GROW 3 (2000), available at http://www.bis.org/publ/otc_hy0011.pdf.

57. See FRIEDEN, *supra* note 36, at 88.

58. JOHN BRAITHWAITE & PETER DRAHOS, GLOBAL BUSINESS REGULATION 102 (2000).

further grew from \$687 billion in 1977 to \$30.1 trillion in 2010.⁵⁹ More recently, debt and equity markets have also become global. International debt securities outstanding went from \$896 billion in March 1987 to \$27.7 trillion in 2010;⁶⁰ international equity issues for BIS-reporting countries went from \$1.7 billion in 1983 to \$708 billion in 2010.⁶¹ Overall, the size of financial markets relative to the world economy has increased steadily.⁶² In 2007, global financial assets amounted to 343% of the world's GDP.⁶³

Scholars have proposed several explanations for the globalization of finance. Traditional accounts emphasize the importance of technological changes and market developments: greater demand arising from the growth in international trade and corporate activity; the need for diversification arising from greater foreign exchange volatility; the need to reinvest the accumulation of petrodollars in the 1970s; the demise of domestically-focused postwar cartels; and financial innovation.⁶⁴ More recent accounts emphasize the role of policy decisions by states to encourage the growth of the Eurodollar market, to refrain from imposing more effective capital controls, and to act collectively to prevent and manage currency crises.⁶⁵ While the causes of financial globalization remain a matter of debate, it is clear that multiple factors were at work, rather than a conscious policy decision by states to reverse Bretton Woods and create globalized financial markets. As U.S. Treasury Secretary Henry Fowler put it, “the Free World has backed inadvertently into a developing international capital market rather than effected a rational and conscious entry.”⁶⁶

What is the significance of this historical background? In short, the postwar settlement created a highly institutionalized and rule-based system to govern

59. See BANK FOR INT'L SETTLEMENTS, BIS QUARTERLY REVIEW A7 (June 2011), available at http://www.bis.org/publ/qtrpdf/r_qa1106.pdf. The first year for which the BIS time series is available is 1977; historical statistics are available by searching the interactive tool at <http://www.bis.org/statistics/bankstats.htm>.

60. See *id.* at A113.

61. See *id.* at A128.

62. See René M. Stulz, *The Limits of Financial Globalization*, 60 J. FIN. 1595, 1599–1601 (2005). This is not to say that international markets are fully globalized. Indeed, quantitative studies show that investors in various countries overweight domestic securities in their portfolios—the so-called “home bias” effect. See *id.* at 1601. For a discussion of various measures of financial globalization, see HAL S. SCOTT, INTERNATIONAL FINANCE 17–20 (17th ed. 2010).

63. MCKINSEY GLOBAL INST., GLOBAL CAPITAL MARKETS: ENTERING A NEW ERA 8–9 (2009), available at http://www.mckinsey.com/insights/mgi/research/financial_markets/global_capital_markets_entering_a_new_era.

64. See HELLEINER, *supra* note 18, at 6–7; TONY PORTER, GLOBALIZATION AND FINANCE 12–30 (2005).

65. See FRIEDEN, *supra* note 36, at 112–22; HELLEINER, *supra* note 18, at 8–12. Some of these accounts also emphasize the rise of neoliberal ideas. See, e.g., RAWI ABDELAL, CAPITAL RULES: THE CONSTRUCTION OF GLOBAL FINANCE (2007); JEFFREY M. CHWIEROTH, CAPITAL IDEAS: THE IMF AND THE RISE OF FINANCIAL LIBERALIZATION (2010); HELLEINER, *supra* note 18.

66. HELLEINER, *supra* note 18, at 89 (quoting ERIC ROLL, INTERNATIONAL CAPITAL MOVEMENTS: PAST, PRESENT AND FUTURE 61 (1971)).

international economic relations. This system was the outcome of ambitious negotiations made possible by the unique circumstances of World War II and the immediate postwar years.⁶⁷ Because it contemplated very limited international capital mobility, mostly through official channels, no provision was made for regulating private finance. National securities and banking regulators, such as the Securities and Exchange Commission (SEC) and the Federal Deposit Insurance Corporation (FDIC), did not take any significant part in the negotiations or the resulting regime. As a result of the collapse of Bretton Woods and a series of other technological, market, and political developments, international financial markets subsequently developed to a degree unimaginable at that time. Without a formal international framework, national regulators faced the difficult task of addressing the new challenges posed by globalized markets with the limited tools at their disposal. The constraints under which they labored are the key to understanding today's decentralized, network-based system of IFR.

C. International Regulatory Cooperation

The collapse of Bretton Woods and the dramatic increase in international capital flows immediately caused problems for economic policymakers. In the 1960s and early 1970s, the ministers of finance and central bank governors of the "Group of 10" met on a regular basis to coordinate exchange rate management and consider adjustments to the Bretton Woods system.⁶⁸ At the same time, banking and securities regulators faced their own set of challenges. The world of self-contained domestic financial systems to which they were accustomed was rapidly changing. While banks had been expanding internationally since the 1950s, the trend accelerated, making it ever more difficult for national authorities to regulate and supervise their worldwide activities.⁶⁹ Banks also found a major new source of revenue—and risk—in the massive new foreign exchange markets.⁷⁰ In 1974, the collapse of several banks—notably Bankhaus Herstatt in Germany and Franklin National Bank in the United States—disrupted interbank lending and drew attention to the cross-border impact of bank failures and the lack of regulatory coordination.⁷¹ The oil crisis was also straining financial markets and causing worries about the international banking system.

67. The most notable of such circumstances include: the (temporary) unity of purpose among the Allies; the economic dominance of the United States; the United States' willingness to fund the system and uphold its rules; and the intellectual dominance of Keynes and the New Dealers. See GARDNER, *supra* note 15; Eric Helleiner, *A Bretton Woods Moment?: The 2007–2008 Crisis and the Future of Global Finance*, 86 INT'L AFF. 619 (2010).

68. See BARRY EICHENGREEN, *GLOBALIZING CAPITAL: A HISTORY OF THE INTERNATIONAL MONETARY SYSTEM* 134–42 (2d ed. 2008). As coordination became more complex and political, leadership on these macroeconomic issues migrated to the G-7. See *id.* at 142–49.

69. See FRIEDEN, *supra* note 36, at 76–77, 112–16.

70. See ETHAN B. KAPSTEIN, *GOVERNING THE GLOBAL ECONOMY: INTERNATIONAL FINANCE AND THE STATE* 37–39 (1994).

71. See *id.* at 39–42; DAVID ANDREW SINGER, *REGULATING CAPITAL: SETTING*

In response, the governors of the G-10 central banks formed the Basel Committee on Banking Supervision.⁷² As was the case for macroeconomic coordination, the prevailing ethos of IFR was informality. The committee would be a forum for regulators “not . . . to make far-fetched attempts to harmonise the twelve countries’ individual systems of supervision, but . . . to learn from each other and to apply the knowledge so acquired to improving their own systems of supervision, so indirectly enhancing the likelihood of overall stability in the international banking system”⁷³ It was the first major TRN in financial regulation. TRNs usually share several characteristics: their members are not states but specialized regulatory agencies; they are not created by treaty and have no international legal personality; they lack formal assemblies or voting procedures; the instruments they promulgate are not internationally binding; and, at least until recently, they do not systematically monitor or enforce compliance with those instruments.⁷⁴ Over the following decades, TRNs became the backbone of IFR, with formal organizations like the IMF, World Bank, and BIS playing only a supporting role.⁷⁵

The evolution of IFR prior to the subprime crisis can be divided into three major phases. The first, between 1974 and the Asian financial crisis in 1997–98, saw the creation of the principal TRNs—the Basel Committee, IOSCO, and the International Association of Insurance Supervisors (IAIS)⁷⁶—and the development of the first generation of international standards. In response to the bank collapses of the 1970s, the Basel Committee adopted the Concordat, an informal agreement on the supervision of international banks that placed primary responsibility on a bank’s home country for supervising the solvency of a bank and its foreign branches.⁷⁷ While the Concordat allocated *supervisory* responsibility among

STANDARDS FOR THE INTERNATIONAL FINANCIAL SYSTEM 38–39 (2007).

72. The committee was originally composed of representatives of the G-10, plus Switzerland and Luxembourg. LOWENFELD, *supra* note 20, at 812 n.26. On the origins of the Basel Committee, see CHARLES GOODHART, *THE BASEL COMMITTEE ON BANKING SUPERVISION* (2011); LOWENFELD, *supra* note 20, at 804; JOSEPH JUDE NORTON, *DEVISING INTERNATIONAL BANK SUPERVISORY STANDARDS* (1995); DUNCAN WOOD, *GOVERNING GLOBAL BANKING: THE BASEL COMMITTEE AND THE POLITICS OF FINANCIAL GLOBALISATION* (2005); Arner & Buckley, *supra* note 34, at 198, 201–04.

73. KAPSTEIN, *supra* note 70, at 45 (emphasis by Kapstein omitted) (quoting George Blunden, *Control and Supervision of the Foreign Operations of Banks*, in *THE DEVELOPMENT OF FINANCIAL INSTITUTIONS IN EUROPE, 1956-1976*, at 195 (J. Wilson et. al eds., 1977)).

74. See Kal Raustiala, *The Architecture of International Cooperation: Transgovernmental Networks and the Future of International Law*, 43 VA. J. INT’L L. 1 (2002); Verdier, *supra* note 2; David Zaring, *Informal Procedure, Hard and Soft, in International Administration*, 5 CHI. J. INT’L L. 547 (2005) [hereinafter Zaring, *Informal Procedure*]; David Zaring, *International Law by Other Means: The Twilight Existence of International Financial Regulatory Organizations*, 33 TEX. INT’L L.J. 281 (1998) [hereinafter Zaring, *International Law*].

75. On the role of the BIS, see LOWENFELD, *supra* note 20, at 756.

76. The Basel Committee was established in 1974, IOSCO in 1984, and the IAIS in 1994. See Zaring, *International Law*, *supra* note 74, at 287, 292, 297.

77. COMM. ON BANKING REGULATIONS & SUPERVISORY PRACTICES, REPORT TO THE GOVERNORS ON THE SUPERVISION OF BANKS’ FOREIGN ESTABLISHMENTS (1975), available at

national regulators, it stopped short of allocating corresponding *financial* responsibility.⁷⁸ In other words, the Concordat designated which country should take the lead on various aspects of supervision, but expressly refrained from designating which country should act as lender of last resort or deposit insurer for a given bank or its foreign offices.⁷⁹ It also did not allocate authority over resolution of failed banks—individual countries remained free to set up competing proceedings and prioritize local creditors.

The Basel Committee's most important achievement during that period was undoubtedly the 1988 Basel Accord on bank capital adequacy.⁸⁰ The Latin American debt crisis of the 1980s had left international banks, especially in the United States and the United Kingdom, severely undercapitalized.⁸¹ While regulators in those countries wished to adopt more stringent capital adequacy requirements, they were hampered by concerns that they would undermine the international competitiveness of their banks.⁸² There was also concern that the growing off-balance-sheet activities of banks created risks that existing standards did not adequately reflect.⁸³ Under pressure from the United States and the United Kingdom, the other G-10 authorities agreed to a detailed framework for determining mandatory capital levels for banks.⁸⁴ Basel I defined regulatory capital, established rules for weighting assets and off-balance-sheet liabilities based on their risk, and prescribed a minimum capital ratio of 8%. Over the course of the 1990s, the Accord was adopted by many countries outside the G-10, becoming a *de facto* worldwide standard.⁸⁵

IOSCO developed in a somewhat different way from the Basel Committee. Its membership was larger and its structure closer to that of a traditional international organization, with an assembly, an executive committee, and a secretary general.⁸⁶ Its formation was prompted not by an identifiable crisis, but rather by a sense that securities regulators increasingly faced common problems, particularly in respect to cross-border transactions. For instance, an early concern was that firms could avoid U.S. securities fraud or insider trading laws by operating from countries whose authorities were unable or unwilling to cooperate with the SEC. To address this problem, the SEC entered into memoranda of understanding (MOUs) with other securities regulators and led an IOSCO effort to promote greater uniformity among MOUs, encourage more regulators to sign them, and help them secure domestic

www.bis.org/publ/bcbs00a.pdf. The 1975 Concordat was clarified and supplemented after the collapses of Banco Ambrosiano in 1982 and BCCI in 1991 revealed important gaps. See GOODHART, *supra* note 72, at 104–10.

78. See KAPSTEIN, *supra* note 70, at 49.

79. See *id.*

80. COMM. ON BANKING REGULATIONS AND SUPERVISORY PRACTICES, INTERNATIONAL CONVERGENCE OF CAPITAL MEASUREMENT AND CAPITAL STANDARDS (1988).

81. See SINGER, *supra* note 71, at 45–58.

82. See *id.*

83. See GOODHART, *supra* note 72, at 351–58.

84. See KAPSTEIN, *supra* note 70, at 114–19; SINGER, *supra* note 71, at 58–62; Thomas Oatley & Robert Nabors, *Redistributive Cooperation: Market Failure, Wealth Transfers, and the Basle Accord*, 52 INT'L ORG. 35, 49–52 (1998).

85. See SINGER, *supra* note 71, at 62.

86. See PORTER, *supra* note 64, at 36.

legal authority to provide assistance.⁸⁷ IOSCO also initiated efforts to harmonize regulation in some areas, for instance by preparing a model form for nonfinancial disclosure in securities offerings. IOSCO failed, however, in its efforts to create capital standards for securities firms.⁸⁸ The last major TRN, the IAIS, was formed only in 1994 and its activities have been much more limited; for instance, it did not agree on solvency standards for insurance firms until the 2000s.⁸⁹

During these years, some of the fastest-growing economies of Asia—Indonesia, Thailand, South Korea, and Malaysia—faced major banking and currency crises, and the first three resorted to IMF and World Bank assistance to face massive currency outflows.⁹⁰ These crises, along with the early 1990s Mexican crisis, shared several features: macroeconomic imbalances, asset bubbles, lax financial sector regulation, and tenor and currency mismatches (i.e., banks borrowing short-term in foreign currencies to make long-term local currency loans).⁹¹ After the crisis, a consensus developed among the international financial institutions (IFIs) and the G-7 that weak financial regulation in those countries had been a major cause of the crisis.⁹² In response, they placed a high priority on improving regulation in developing countries to reduce the risk of future crises. The head of the IMF declared that the “world community . . . look[ed] forward for the definition of international standards and codes of good practices, which would be progressively disseminated by the IMF through its surveillance.”⁹³

The G-7 took on a more active and detailed priority-setting role for IFR. It created a new body, the Financial Stability Forum (FSF), to coordinate the activities of the various TRNs and develop a compendium of standards whose implementation would be encouraged by the IFIs.⁹⁴ The FSF did not develop its own standards, but relied on the TRNs to provide substantive content.⁹⁵ The Basel Committee issued its “Core Principles for Effective Banking Supervision;” IOSCO, its “Objectives and Principles of Securities Regulation;” and the IAIS, its

87. See Verdier, *supra* note 2, at 143–50.

88. See SINGER, *supra* note 71, at 67–95.

89. On the IAIS’s failure to address insurer solvency, see *id.* at 96–113.

90. See generally PAUL BLUSTEIN, *THE CHASTENING: INSIDE THE CRISIS THAT ROCKED THE GLOBAL FINANCIAL SYSTEM AND HUMBLING THE IMF* (2001) (describing the Asian financial crisis and the IMF’s response.).

91. See Ethan B. Kapstein, *Architects of Stability?: International Cooperation Among Financial Supervisors* 8–9 (Monetary & Econ. Dep’t, Bank for Int’l Settlements, BIS Working Papers No. 199, 2006).

92. See, e.g., WORKING GRP. ON STRENGTHENING FIN. SYS., *REPORT OF THE WORKING GROUP ON STRENGTHENING FINANCIAL SYSTEMS* (1998); Barry Eichengreen, *The International Monetary Fund in the Wake of the Asian Crisis*, in *THE ASIAN FINANCIAL CRISIS AND THE ARCHITECTURE OF GLOBAL FINANCE* 170 (Gregory W. Noble & John Ravenhill eds., 2000); Stanley Fischer, First Deputy Managing Director, Int’l Monetary Fund, *Economic Crises and the Financial Sector* (Dec. 10, 1998).

93. MICHEL CAMDESSUS, *Toward a New Financial Architecture for a Globalized World* (May 8, 1998), in *NAVIGATING STORMY, UNCHARTED WATERS: FIVE ADDRESSES BY MICHEL CAMDESSUS* 13, 16 (1998).

94. See DANIEL W. DREZNER, *ALL POLITICS IS GLOBAL: EXPLAINING INTERNATIONAL REGULATORY REGIMES* 135–37 (2008).

95. See *id.*

“Insurance Core Principles.”⁹⁶ These principles established basic requirements across a range of issues, often referencing existing standards such as the Basel Accord. Many of the recommendations were structural, steering developing countries towards creating regulatory systems based on Western models. For example, all three sets of principles required that they set up independent regulatory agencies and give them adequate enforcement powers and resources.⁹⁷ The G-20 was also created at that time to give a voice to leading developing countries, although its influence was limited.⁹⁸ Finally, the IMF encouraged reforms by linking them to its lending programs and conducting audits of national regulation under two programs, ROSC and FSAP.⁹⁹

The third phase runs from 2001 to the subprime crisis. During that period, the IFIs’ work on implementing financial standards continued, but regulators and TRNs turned their attention to various other problems.¹⁰⁰ After September 11, 2001, a major effort was made to step up the fight against money laundering and terrorist financing. Led by the United States, the Financial Action Task Force (FATF) coordinated a campaign to compel offshore financial centers (OFCs) to improve their cooperation with onshore jurisdictions under threat of “blacklisting” and sanctions, with reluctant assistance from the IMF.¹⁰¹ IOSCO strove to strengthen cross-border assistance by adopting the 2002 Multilateral Memorandum of Understanding (MMOU). All IOSCO members were expected to sign the MMOU, which required prior screening to ensure they had the necessary domestic authority to comply with assistance requests.¹⁰² IOSCO has also been engaged in a multitude of projects to develop recommendations on credit rating agencies, mutual funds, hedge funds, securities analysts, and others. More importantly, the IASB made great strides in developing a comprehensive set of international accounting standards. The European Union decided to adopt them in 2002, followed by several other countries.¹⁰³ The SEC recently decided to permit foreign issuers to report under IFRS and is considering adopting them for U.S. issuers as well.¹⁰⁴

96. BASEL COMM. ON BANKING SUPERVISION, CORE PRINCIPLES FOR EFFECTIVE BANKING SUPERVISION (1997) [hereinafter EFFECTIVE BANKING SUPERVISION], available at <http://www.bis.org/publ/bcbs30a.pdf>; INT’L ASS’N OF INS. SUPERVISORS, INSURANCE CORE PRINCIPLES (2000) [hereinafter INSURANCE CORE PRINCIPLES] available at http://www1.worldbank.org/finance/assets/images/Insurance_Core_Principles.pdf; INT’L ORG. OF SEC. COMM’NS OBJECTIVES AND PRINCIPLES OF SECURITIES REGULATION (1998) [hereinafter OBJECTIVES AND PRINCIPLES], available at <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD82.pdf>.

97. See EFFECTIVE BANKING SUPERVISION, *supra* note 96, at 4; INSURANCE CORE PRINCIPLES, *supra* note 96, at 6–7; OBJECTIVES AND PRINCIPLES, *supra* note 96, at 11.

98. See DREZNER, *supra* note 94, at 145–47.

99. See *id.* at 139–42.

100. The IMF also saw a significant reduction in lending in the 2000s, which reduced its revenues and led to staff cuts. Chris Bryant & Krishna Guha, *IMF Cost Cuts Spur 590 Staff to Seek Redundancy*, FIN. TIMES, Apr. 30, 2008, at 9.

101. See DREZNER, *supra* note 94, at 142–45.

102. See Brummer, *How International Financial Law Works*, *supra* note 1, at 300–02.

103. See Council Regulation 1606/2002 of 19 July 2002 on the Application of International Accounting Standards, 2002 O.J. (L 243) 1 (EC) (laying the framework for the adoption of IFRS in Europe). For a current overview of IFRS adopting around the world, see PRICEWATERHOUSECOOPERS, IFRS ADOPTION BY COUNTRY (2012), available at <http://www.pwc.com/us/en/issues/ifrs-reporting/country-adoption/index.jhtml>.

104. SEC. & EXCH. COMM’N, COMMISSION STATEMENT IN SUPPORT OF CONVERGENCE AND GLOBAL ACCOUNTING STANDARDS 6 (2010), available at <http://www.sec.gov/rules/other/>

The most emblematic development of the 2000s was the decade-long effort to develop the Basel II Accord.¹⁰⁵ Over the 1990s, the original Accord came under increasing criticism, mainly on the grounds that its risk-weighting formulas were outdated relative to the internal risk measurement systems developed by the largest banks.¹⁰⁶ In 1999, the Basel Committee released a major revision that uses parameters generated by banks to calculate the risk of each exposure. The development of Basel II was long and controversial, and the committee engaged in an elaborate notice-and-comment process.¹⁰⁷ The debate did not stop with the adoption of the final international document in 2004; U.S. implementation proved intensely contentious, and Basel II is not yet fully implemented there.¹⁰⁸ Throughout the 2000s, the Basel Committee's attention was dominated, if not monopolized, by Basel II—perhaps to the detriment of other important issues like liquidity management or cross-border resolution. The IAIS, for its part, finally published a common framework for assessing insurer solvency in 2007, albeit one much less prescriptive and detailed than the Basel Committee's.¹⁰⁹ Like Basel II, the IAIS framework provides insurers considerable flexibility to use their own risk management models.¹¹⁰

This brief overview supports some general observations on the origins of IFR. First, unlike in many other areas of international cooperation, national regulators rather than governments played the leading role. Without a formal organization to coordinate their action, they stepped beyond their traditional domestic role to pursue common objectives, limiting themselves at each step to the problems immediately facing them.¹¹¹ Second, the outcome was the creation of a system based, not on binding rules and institutions, but on informal networks and soft law arrangements. Even after the Asian crisis, the role of IFIs was limited to overseeing implementation of basic standards by developing countries, and they almost always relied on TRNs to develop their content.¹¹² Third, the usual preference was to develop very general standards that outlined the essential desiderata of a sound domestic regulatory system, rather than detailed prescriptions. Looking through the FSF's compendium of standards, the few detailed prescriptive ones like the Basel Accord stand out against numerous general, sometimes hortatory, statements. Finally, several pivotal areas of financial regulation with cross-border implications, like bank resolution, deposit insurance, the lender of last resort function, bank

2010/33-9109.pdf.

105. See TARULLO, *supra* note 2.

106. *Id.* at 87–93.

107. See Michael S. Barr & Geoffrey P. Miller, *Global Administrative Law: The View from Basel*, 17 EUR. J. INT'L L. 15 (2006).

108. See Pierre-Hugues Verdier, *US Implementation of Basel II: Lessons for Informal International Lawmaking*, in *INFORMAL INTERNATIONAL LAWMAKING* 437 (Joost Pauwelyn, Ramses A. Wessel, & Jan Wouters eds., 2012).

109. See INT'L ASS'N OF INS. SUPERVISORS, *THE IAIS COMMON STRUCTURE FOR THE ASSESSMENT OF INSURER SOLVENCY* (2007).

110. See Elizabeth F. Brown, *The Development of International Norms for Insurance Regulation*, 34 BROOK. J. INT'L L. 953, 963–70 (2009).

111. See PORTER, *supra* note 64, at 33–34. In this respect, IFR by networks is analogous to informal monetary policy coordination that also emerged in the 1970s. See BRAITHWAITE & DRAHOS, *supra* note 58, at 100–01.

112. See *supra* notes 94–97 and accompanying text.

liquidity, and capital adequacy for securities and insurance firms, remained essentially untouched.¹¹³ The next Part turns to the politics of IFR to explain these outcomes.

II. THE POLITICS OF INTERNATIONAL FINANCIAL REGULATION

In its early years, IFR did not attract much attention from lawyers or political scientists. Since the mid-1990s, however, an extensive literature has emerged. A salient question has been why, unlike other areas of international cooperation, IFR relies almost exclusively on TRNs and soft law. To answer this question, most scholars draw on rational choice theories of international law and institutions. After reviewing these arguments, this Part argues that contemporary IFR is better explained by a combination of historical path dependence and political economy. It then draws on these perspectives to explain the respective role and motivations of three dominant actors in IFR—specialized regulators, financial firms, and great power governments. Finally, based on this analysis, it articulates several hypotheses to explain outcomes in IFR based on the interests of these actors. These hypotheses will be deployed in Part III to explain variations in the success of IFR across different areas.

A. Rational Choice Theories of IFR

In recent years, rational choice theories of international law have become increasingly influential.¹¹⁴ In essence, these theories posit that states rationally design international agreements and institutions in order to achieve joint gains.¹¹⁵ As a result, their features can be explained by the nature of the cooperation problem the relevant states face. For instance, states that wish to attain a collective goal like trade liberalization, but know that each will have incentives to defect, are more likely to establish institutions like the WTO with monitoring, dispute resolution, and enforcement powers.¹¹⁶ By contrast, in simple coordination problems where participants do not have incentives to cheat, such costly features are unnecessary and states will eschew them. The same reasoning has been applied to many other design choices such as more or less precise obligations, renegotiation or withdrawal clauses, membership criteria, and the scope of issues covered.¹¹⁷ In each case, states

113. On the failure of early efforts by the Basel Committee to address some of these questions, see GOODHART, *supra* note 72, at 37–40, 327–35, 378–80.

114. See, e.g., JACK L. GOLDSMITH & ERIC A. POSNER, *THE LIMITS OF INTERNATIONAL LAW* (2005); ANDREW T. GUZMAN, *HOW INTERNATIONAL LAW WORKS: A RATIONAL CHOICE THEORY* (2008); ROBERT E. SCOTT & PAUL B. STEPHAN, *THE LIMITS OF LEVIATHAN: CONTRACT THEORY AND THE ENFORCEMENT OF INTERNATIONAL LAW* (2006); Barbara Koremenos, Charles Lipson & Duncan Snidal, *The Rational Design of International Institutions*, 55 INT'L ORG. 761 (2001).

115. See, e.g., GUZMAN, *supra* note 114, at 121.

116. See Barbara Koremenos, *When, What, and Why Do States Choose to Delegate?*, 71 LAW & CONTEMP. PROBS. 151, 168–169 (2008).

117. See, e.g., Barbara Koremenos, *Contracting Around International Uncertainty*, 99 AM. POL. SCI. REV. 549, 551–53, 561 (2005); Barbara Koremenos, *If Only Half of*

rationally choose the approach that best balances costs and benefits and therefore maximizes joint gains.

Rational choice theory has important implications for the choice between “hard law” and “soft law” in international regulation. On the one hand, legally binding agreements allow states to make more credible commitments to one another. Ex ante, ratification of formal treaties is more difficult and costly, and therefore unattractive to states that do not intend to comply. Ex post, violations are easier to identify, states that commit them suffer greater reputational costs, and monitoring and enforcement can be delegated to institutions with the authority to impose sanctions.¹¹⁸ As a result, formal legal obligations are most valuable when the potential for opportunism is high and the credibility of commitments is important.¹¹⁹ On the other hand, while soft law agreements provide weaker incentives for compliance, they have several advantages. They are easier and faster to conclude because they do not require cumbersome domestic ratification procedures. Since they are negotiated by specialized regulators or other experts rather than politicians, technical questions can be resolved based on shared expert knowledge. Since they are not binding, they provide flexibility to adjust the obligations as circumstances change.¹²⁰ Finally, international regulation is often said to address technical issues where opportunism is not a threat.¹²¹ In sum, rational choice theory suggests that, where the costs of hard law exceed the benefits, states will rationally choose soft law.

Several scholars have applied such an analysis to explain why IFR relies on TRNs and soft law standards. Ethan Kapstein, after analyzing the creation and evolution of the Basel Committee up to the early 1990s, concluded that banking regulators successfully used informal cooperation to maintain effective regulatory control over international banks without compromising national responsibility.¹²² Roberta Karmel and Claire Kelly argue that soft law works well for securities regulation because it provides speed, flexibility, and experience in regulating ever-changing markets.¹²³ Chris Brummer acknowledges that IFR sometimes involves more difficult cooperation problems and the risk of opportunism. However, he argues that unlike other soft law, IFR has significant coercive power because pressures from markets and IFIs compel states to comply, and because regulators wish to protect their reputation vis-à-vis their peers.¹²⁴ Such explanations dovetail

International Agreements Have Dispute Resolution Provisions, Which Half Needs Explaining?, 36 J. LEGAL. STUD. 189 (2007).

118. See BETH A. SIMMONS, *MOBILIZING FOR HUMAN RIGHTS: INTERNATIONAL LAW IN DOMESTIC POLITICS* 118–121 (2009); SCOTT & STEPHAN, *supra* note 114, at 147–51.

119. See Kenneth W. Abbott & Duncan Snidal, *Hard and Soft Law in International Governance*, in *LEGALIZATION AND WORLD POLITICS* 37, 45 (Judith L. Goldstein, Miles Kahler, Robert O. Keohane & Anne-Marie Slaughter, eds., 2001); Andrew T. Guzman & Timothy L. Meyer, *International Soft Law*, 2 J. LEGAL ANALYSIS 171 (2010).

120. See Charles Lipson, *Why Are Some International Agreements Informal?*, 45 INT’L ORG. 495 (1991); Kal Raustiala, *Form and Substance in International Agreements*, 99 AM. J. INT’L L. 581 (2005).

121. See GUZMAN, *supra* note 114, at 157; Raustiala, *supra* note 120, at 600.

122. See KAPSTEIN, *supra* note 70, at 180.

123. See Karmel & Kelly, *supra* note 1, at 890–98.

124. See BRUMMER, *supra* note 1; Brummer, *How International Financial Law Works*, *supra* note 1; Brummer, *Why Soft Law Dominates International Finance—And Not Trade*,

with earlier theories that emphasized the beneficial role of transnational networks of experts in devising common regulatory standards.¹²⁵

Despite its strengths, I argue that rational design theory provides an incomplete account of IFR. First, it does not explain the substantial variation in outcomes across issue areas. For instance, while there are elaborate international standards for bank capital adequacy, similar rules for securities firms and insurance failed. Even in banking, some areas like cross-border resolution have seen minimal progress. In general, progress has been highly uneven across IFR, and has sometimes been reversed outright. At a minimum, this state of affairs should cast doubt on the functionalist reasoning proposed by much rational choice scholarship, which effectively “attributes the creation of an international institution to the underlying global need that it putatively addresses.”¹²⁶ Such reasoning often fails to provide a convincing explanation of the agents and processes that actually determine the emergence or failure of cooperation. It is possible that states optimally design IFR; but it may also be shaped by other factors like historical path dependence,¹²⁷ coercion by powerful states, the private interests of regulators, or the political influence of the industry.¹²⁸

Second, the assumption that IFR is optimally designed predisposes scholars to neglect issues of compliance and effectiveness. Some are impressed by the sheer multiplication of international bodies, reports, and standards. But IFR cannot be judged by the quantity of its outputs.¹²⁹ International standards can avoid difficult areas on which regulators disagree; they can paper over differences with meaningless formulas that merely restate existing practices; they can preserve

supra note 1.

125. See PORTER, *supra* note 64, at 43–44, 57; SLAUGHTER, *supra* note 1, at 167; Raustiala, *supra* note 74; Zaring, *Informal Procedure*, *supra* note 74; Stefano Pagliari, Pushed to the Sidelines? IOSCO and the Changing Role of International Regulatory Institutions After the Crisis 1011 (April 30, 2011) (unpublished manuscript) (on file with the Indiana Law Journal). Other scholars take a much dimmer view, seeing TRNs as creeping expert governance detached from genuine public accountability. See, e.g., Philip Alston, *The Myopia of the Handmaidens: International Lawyers and Globalization*, 3 EUR. J. INT’L L. 435 (1997); David Kennedy, *The Politics of the Invisible College: International Governance and the Politics of Expertise*, 5 EUR. HUM. RTS. L. REV. 463 (2001); Sol Picciotto, *Networks in International Economic Integration: Fragmented States and the Dilemmas of Neo-Liberalism*, 17 NW. J. INT’L L. & BUS. 1014 (1997); Richard B. Stewart, *The Global Regulatory Challenge to U.S. Administrative Law*, 37 N.Y.U. J. INT’L L. & POL. 695 (2005).

126. SINGER, *supra* note 71, at 5; see also Paul Pierson, *The Limits of Design: Explaining Institutional Origins and Change*, 13 GOVERNANCE 475, 475 (2000) (defining “functionalist reasoning” as “the explanation of institutional forms [by] their functional consequences for those who create them”); BRAITHWAITE & DRAHOS, *supra* note 58, at 17.

127. On this concept, see *infra* Part II.B.

128. Thus, Oatley, and Nabors argue that the Basel Accord was imposed coercively on Japan by the United States and the U.K. to protect their banks against competition. See Oatley & Nabors, *supra* note 84.

129. This point was brilliantly articulated by Kenneth Anderson: “Networks held meetings, wrote papers, made recommendations, and drafted statements. To be sure, this is what networks must do in order to create successful outcomes . . . Yet unfortunately this is also precisely the procedure followed when networks create *unsuccessful* outcomes.” Anderson, *supra* note 2, at 1278 (emphasis in original).

extensive national discretion that is then abused. Even when meaningful standards are adopted, compliance is hard to monitor,¹³⁰ later revisions can compromise the original objective;¹³¹ and seemingly well-established standards can retreat as domestic politics shift.¹³² Therefore, a satisfactory theory of IFR cannot avoid asking to what extent it actually requires states to depart from what they would otherwise do, and whether they comply when faced with competing pressures.

Third, the widespread argument that market pressures play a pivotal role in enforcing IFR standards—thus compensating for the lack of formal monitoring or enforcement—raises both empirical and theoretical difficulties.¹³³ In a study of East Asian financial reforms after the 1997 crisis, Andrew Walter finds that governments were caught between external market and IFI pressure to adopt international standards and intense resistance from powerful domestic constituencies: politically connected oligarchs, industrial conglomerates, and large banks. He finds that, since markets and IFIs are able to identify and reward formal but not substantive compliance, governments adopted a strategy of “mock compliance”—formally adopting the standards while ignoring them in practice.¹³⁴ These findings challenge the hypothesis that market pressures can deliver compliance with IFR. More fundamentally, the logic of the hypothesis is flawed with respect to prudential rules that force private firms to internalize social costs, and therefore make them less profitable.¹³⁵ In such cases, there is reason to be concerned that markets will reward firms and countries that circumvent the rules, not punish them. Thus, a better account is needed of where market pressures can play a positive role, and where they may be ineffective or counterproductive.

B. Historical Path Dependence and IFR

In fact, there are at least two major reasons to doubt that soft law and TRNs maximize joint gains for states. The first is historical path dependence—the notion that the original design of institutions can constrain their future evolution and

130. See, e.g., ANDREW WALTER, GOVERNING FINANCE: EAST ASIA'S ADOPTION OF INTERNATIONAL STANDARDS 42–43 (2008).

131. See TARULLO, *supra* note 2; see also SINGER, *supra* note 71, at 65–66.

132. See Stavros Gadinis, From Independence to Politics in Banking Regulations (Aug. 27, 2012) (unpublished manuscript) (describing the retreat of the independence of financial regulators after the financial crisis), available at <http://ssrn.com/abstract=2137215>.

133. Almost every scholar writing in the field offers some version of it, often referring to widespread adoption of standards such as the Basel Accord and the IOSCO MMOU. See, e.g., KAPSTEIN, *supra* note 70, at 13, 126, 184; SINGER, *supra* note 71, at 9–10, 123; Brummer, *How International Financial Law Works*, *supra* note 1, at 286–88; Beth A. Simmons, *The International Politics of Harmonization: The Case of Capital Market Regulation*, 55 INT'L ORG. 589, 601–05 (2001). Other standards are cited in Hyoungh-Kyu Chey, *Do Markets Enhance Convergence on International Standards?: The Case of Financial Regulation*, 1 REG. & GOV. 295, 296 n.8 (2007).

134. See WALTER, *supra* note 130, at 36–49, 166–77. Walter defines mock compliance as “a combination of considerable formal compliance with international standards and behavioral departure from their prescriptions.” *Id.* at 171.

135. See *infra* Part III.B.4.

prevent efficient adaptation to changed circumstances.¹³⁶ As scholars working in this tradition point out, institutions are often not optimally designed in the first place.¹³⁷ However, even if one assumes that they are, their original design constrains their capacity to evolve in response to changed circumstances. As Paul Pierson notes, “[a]ctors do not inherit a blank slate that they can remake at will when their preferences shift or unintended consequences become visible. Instead, actors find that the dead weight of previous institutional choices seriously limits their room to maneuver.”¹³⁸ They face path dependence, which Orfeo Fioretos defines as “a process in which the structure that prevails after a specific moment in time (often a critical juncture) shapes the subsequent trajectory in ways that make alternative institutional designs substantially less likely to triumph, including those that would be more efficient.”¹³⁹

There are several ways in which past choices may constrain future options. Some scholars have suggested psychological explanations. Douglass North argues that actors operating in highly complex and opaque areas filter new information through their existing “mental maps,”¹⁴⁰ so that mistaken intellectual outlooks remain uncorrected. Other scholars emphasize political explanations, in particular the “lock-in effect” that arises from existing commitments.¹⁴¹ Thus, Fioretos notes that “because interest groups frequently owe their position of power to the strategic position occupied at the founding moment of an institution . . . [they] often see greater benefits from reproducing extant arrangements than from embracing radical change.”¹⁴² Several other phenomena may also reinforce path dependence: institutions often create network externalities, generate increasing returns, and become interconnected with other institutions, reinforcing each other against change.¹⁴³ In these circumstances, institutional change will be limited and incremental, adaptation that would produce collective gains will not occur, and institutions will outlive their rationale.¹⁴⁴ Actors will respond to new problems with

136. On historical approaches to institutional origins and change, see, for example, Orfeo Fioretos, *Historical Institutionalism in International Relations*, 65 INT’L ORG. 367 (2011); Pierson, *supra* note 126.

137. The original design of institutions may not be optimal because the actors involved may not act instrumentally, they may be pursuing short-term goals, and their actions may have unintended consequences. See Pierson, *supra* note 126, at 477–86. The rational design hypothesis is also more problematical for political than it is for economic markets, because outcomes are difficult to measure, reforms are contentious, and the goals themselves are multifaceted and complex. See *id.* at 482 (citing Douglass C. North, *A Transaction Cost Theory of Politics*, 2 J. THEORETICAL POL. 355, 362 (1990)).

138. Pierson, *supra* note 126, at 493; see also PAUL PIERSON, *POLITICS IN TIME* 151 (2004).

139. Fioretos, *supra* note 136, at 376 (footnote omitted).

140. See DOUGLASS C. NORTH, *INSTITUTIONS, INSTITUTIONAL CHANGE AND ECONOMIC PERFORMANCE* 8 (1990).

141. See Pierson, *supra* note 126, at 491–92.

142. Fioretos, *supra* note 136, at 376.

143. See *id.* at 377.

144. See *id.* at 377–78.

“institutional layering,” creating subsidiary organizations with limited authority alongside existing arrangements.¹⁴⁵

The notion of historical path dependence provides a fruitful perspective on the development of IFR. The current system was not created in a vacuum; its formation has been deeply affected by history. The Bretton Woods negotiations were the critical juncture in the construction of modern international economic law. The participants, however, did not believe an institution was needed to regulate private international finance and did not design one.¹⁴⁶ This omission made sense in its historical context: international finance was highly atrophied after the Great Depression and World War II, and the new monetary system contemplated strict and permanent limits on private capital flows.¹⁴⁷ However, these expectations were soon defeated. The fixed rate system collapsed. Financial globalization took off and created many new cross-border regulatory challenges.

In the absence of an international institution, national regulators took the initiative, but they faced several constraints. Their options were limited by their domestic statutory authority, which they could not easily change. They did not have a clear mandate to act internationally, much less bind their state to legal obligations. They did not have a forum in which to meet; often they did not even know each other.¹⁴⁸ In that context, regulators proceeded incrementally by creating informal networks to exchange ideas, coordinate their actions, and agree on nonbinding standards. This was another critical juncture where the choices made shaped IFR for decades. Today, despite its limitations, it is difficult for politicians, regulators, and even scholars to conceive of a different system. More importantly, these foundational choices empowered specific actors—specialized regulators, financial firms, and great powers—that now occupy a central place in IFR.

C. The Political Economy of IFR

Beyond the historical dimension of IFR, the conventional account also neglects its political dimension. This section attempts to remedy this shortcoming by focusing on three important categories of political actors, the means they have to influence IFR, and the interests they try to advance. First, IFR is typically not made directly by states through their diplomatic representatives, but by specialized regulatory agencies that have some freedom to advance their own interests. This creates a principal-agent problem. Second, the financial industry has ample means and opportunities to influence IFR both at the formation and implementation stages, as well as a strong interest in doing so. This introduces an element of special interest politics. Finally, states are not homogenous in their interests and capabilities. The great economic powers disproportionately influence outcomes. Thus, interstate power relationships also matter to IFR.

145. *See id.* at 388–90.

146. *See supra* notes 40–41 and accompanying text.

147. *See supra* Part I.A.

148. *See supra* Part I.C.

1. The Role of National Regulators

In most countries, the legislature delegates extensive authority to promulgate and enforce financial regulation to expert bureaucrats. While in the past this authority was often exercised by a department of the executive branch, the more recent trend has been to delegate regulatory powers to the central bank or to create specialized independent agencies such as securities, banking, and commodities commissions. As seen above, these specialized national regulators emerged as the primary actors in IFR when the modern system took shape in the 1970s. They initiated the formation of the principal TRNs and defined their mandate; they set the agenda for developing international standards; and they typically control their domestic implementation. Therefore, in order to understand modern IFR, one must begin with the incentives and constraints under which these specialized regulators operate.

Administrative agencies are typically not subject to direct electoral discipline. Instead, they exercise powers delegated by the legislature and are subject to its oversight. In theory, the legislature has many tools to discipline regulators: it can override their policies by legislation, dismiss them from their jobs, reduce the agency's budget, or even abolish it altogether—as recently happened to the U.S. Office of Thrift Supervision¹⁴⁹ and the U.K. Financial Services Authority.¹⁵⁰ For several reasons, however, the performance of regulators is difficult for the legislature to monitor consistently. The public benefits of regulation are often hard to measure; the agency is usually insulated from competitive pressures; and the compensation of regulators is, at best, indirectly related to results.¹⁵¹ In addition, the agency possesses specialized expertise and information that is difficult and costly for the legislature to acquire.¹⁵² As a result, regulators may be able to pursue self-serving objectives rather than those intended by the legislature—such as maximizing agency budget, minimizing effort, advancing personal policy preferences, or pursuing individual career objectives.

The literature on administrative decision making characterizes the relationship between the legislature and agencies as a principal-agent problem. While it is impossible to ensure perfect compliance, the legislature has several means at its disposal to provide agencies with incentives to follow its preferred policies. It can adopt detailed legislation that delegates less discretion to regulators and exposes them to judicial review. It can reduce information asymmetry by establishing specialized committees to monitor the agencies. It can also adopt mandatory

149. See 12 U.S.C. § 5413 (Supp. IV 2010).

150. See George Parker & Brooke Masters, *Osborne Abolishes FSA and Boosts Bank*, FIN. TIMES (London), June 16, 2010.

151. See DENNIS C. MUELLER, PUBLIC CHOICE III 362–63 (2003).

152. See WILLIAM A. NISKANEN, JR., BUREAUCRACY AND REPRESENTATIVE GOVERNMENT 29–30 (1971). These characteristics are shared by most financial regulatory agencies. It should be noted, however, that some important financial regulators—including central banks like the U.S. Federal Reserve—benefit from a greater degree of independence, in the form of longer appointments, independent sources of funding, and insulation from some administrative procedure and oversight rules that apply to other parts of government. In their case, the argument developed in this section applies more strongly.

administrative procedures, such as the notice and comment requirements of the Administrative Procedure Act (APA), to ensure that new agency proposals will be publicized and that constituents will have a time and venue to air their objections.¹⁵³ The legislature also relies on interest groups to support its monitoring functions by raising the alarm if a proposed action adversely affects their interests.¹⁵⁴

This principal-agent problem is particularly acute in financial regulation. Financial transactions and institutions have become increasingly complex as a result of technological and market developments, which means that the rules are also complex and require frequent revision. Accordingly, the legislature often delegates extensive rule-making authority to financial regulators, accompanied by very general statutory objectives—the SEC’s mandate, for instance, is to “protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation.”¹⁵⁵ In turn, this means that courts can play only a relatively minor role in policing substantive policy decisions by regulators, as long as they follow applicable procedural requirements.¹⁵⁶ While agencies face direct oversight by the legislature, the expertise gap between regulators and legislators and the difficulty of measuring the effectiveness of regulatory policy means that such oversight tends to be reactive, that is, to occur after a crisis has revealed regulatory failures. Interest groups may also raise the alarm, but since the principal interest group concerned with financial regulation is the industry itself, these interventions prioritize its own interests.

David Singer’s work on international capital standards illustrates this phenomenon. In line with the literature described above, he finds that the primary concern of regulators is to avoid legislative intervention.¹⁵⁷ The problem, however, is that setting capital standards involves a tradeoff: higher requirements reduce the frequency of bank failures and their cost to taxpayers, but they also reduce the profitability of banks and harm their international competitiveness. Thus, pressure on the legislature—and ultimately on regulators—may come from two opposite directions. If standards are too low, more failures will occur and the public will demand stronger regulation; if they are too high, the industry will complain about loss of competitiveness and demand lighter regulation.¹⁵⁸

153. See Mathew D. McCubbins, Roger G. Noll & Barry R. Weingast, *Administrative Procedures as Instruments of Political Control*, 3 J. L. ECON. & ORG. 243, 253–64 (1987).

154. See Mathew D. McCubbins & Thomas Schwartz, *Congressional Oversight Overlooked: Police Patrols Versus Fire Alarms*, 28 AM. J. POL. SCI. 165, 165–69 (1984).

155. *The Investor’s Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation*, U.S. SEC. & EXCHANGE COMMISSION, <http://www.sec.gov/about/whatwedo.shtml> (last modified Oct. 12, 2012).

156. In recent years, U.S. courts have taken a somewhat more active role in striking down agency regulations. See *infra* note 178 and accompanying text. However, this phenomenon remains marginal given the enormous amount of rule-making initiated by the Dodd-Frank Act.

157. See SINGER, *supra* note 71, at 22.

158. See *id.* at 22–23. By emphasizing the private incentives of regulators, this approach is close to public choice accounts of IFR. See, e.g., Enrico Colombatto & Jonathan R. Macey, *A Public Choice Model of International Economic Cooperation and the Decline of*

In normal circumstances, regulators can balance these pressures by setting domestic regulation within a “win-set” acceptable to both constituencies.¹⁵⁹ The problem is that this win-set migrates over time and may even disappear. For instance, after a financial crisis, there is substantial pressure from the public for stronger regulation. By contrast, in favorable economic times, the financial industry presses the legislature to reduce the costs and burdens of regulation.¹⁶⁰ Thus, Singer shows that in the late 1980s, both U.S. and U.K. banks faced heavy losses resulting from the Latin American debt crisis and growing competition by Japanese banks.¹⁶¹ As a result, the interests of U.S. and U.K. regulators were closely aligned in seeking an agreement on capital standards that would satisfy domestic political demand for stronger regulation without further compromising their banks’ international competitive position. This exceptional situation resulted in the adoption of the 1988 Basel Accord. By contrast, efforts in the early 1990s to create international capital standards for securities firms failed in the absence of domestic political demand in major jurisdictions.¹⁶² Singer’s work reveals that the behavior of national regulators in IFR is driven by domestic political pressures; it also suggests that since demand for stricter regulation usually comes from the public after crises, it is likely to fade over time, allowing the industry to reassert its influence.

In sum, financial regulators face constraints on their authority due to the possibility of legislative intervention. However, such intervention is relatively unusual and its direction is inconsistent—it oscillates between laxity and stringency in response to domestic factors such as financial crises, changes in the financial industry, and changes in the legislature. It is also imperfect, because the legislature’s capacity to monitor the massive and complex body of financial regulation is limited, agencies can sometimes circumvent procedural constraints on policy making, and punishing the agency by legislative action is often politically difficult or costly.¹⁶³ In such an uncertain and changing environment, can any general prediction be made with respect to the behavior of financial regulators engaged in IFR?

As will be seen, there is one constant: regulators place a very high priority on preserving their domestic autonomy, flexibility, and discretion. They are, in Singer’s words, “reluctant diplomats” whose “penchant for international standard-setting emerges only when they are unable to fulfill their domestic mandates with

the Nation State, 18 CARDOZO L. REV. 925 (1996). The difference is that while most public choice accounts posit that financial regulators are captured by the industry, this account recognizes that they sometimes face strong pressures to adopt policies that the industry resists. See Kapstein, *supra* note 91, at 4–5.

159. See SINGER, *supra* note 71, at 23–25.

160. See *id.* at 25–30.

161. See *id.* at 41–62.

162. See *id.* at 76–95.

163. See John Ferejohn & Charles Shipan, *Congressional Influence on Bureaucracy*, 6 J. L. ECON. & ORG. 1 (1990) (proposing a model that incorporates limits on congressional action, such as the presidential veto); McCubbins et al., *supra* note 153, at 248–53 (describing various costs and limitations of legislative oversight); David B. Spence, *Administrative Law and Agency Policy-Making: Rethinking the Positive Theory of Political Control*, 14 YALE J. ON REG. 407, 421–38 (1997) (same).

unilateral regulation.”¹⁶⁴ While they welcome informal cooperative arrangements with their counterparts, they are usually unwilling to commit in advance to binding rules or specific courses of action. They are even more reluctant to submit to international oversight or to be perceived as judging the performance of their peers.¹⁶⁵ They also resist standards whose domestic implementation would require legislation and prefer less ambitious ones that they can implement under their existing authority. No doubt, these preferences can be explained to some degree by legitimate public interests, such as the need for flexibility, speed, and expertise to keep up with financial markets. But they are also driven by the private interest of regulators in maximizing their policy discretion, placating powerful domestic constituencies, and navigating changing political demands from the legislature. As will be seen, this imposes significant constraints on their ability to make credible commitments internationally and hinders cooperation in some areas of IFR.

2. The Role of the Financial Industry

The second major political actor in IFR is the financial industry itself. To understand its role in IFR, the starting point is the literature on special interest politics. Many groups try to influence public policy to favor their interests; they can do so by lobbying policymakers or the public directly, or by supplying politicians with votes or money.¹⁶⁶ In a classic work, Mancur Olson argued that such efforts suffer from collective action problems and free riding. These problems are easier to overcome if the relevant group is relatively small, the potential benefits of collective action for individual members are large, and the organization also provides noncollective services to its members.¹⁶⁷ More generally, interest groups that benefit from superior technical expertise, organization, and financial resources are thought to enjoy an advantage in influencing policy making.

In the era of financial globalization, the financial industry in developed economies has become increasingly concentrated.¹⁶⁸ In 1970, the five largest U.S. banks controlled 17% of banking industry assets; in 2010, they controlled 52%.¹⁶⁹ In major European jurisdictions, the number of banks declined steadily while total assets increased;¹⁷⁰ the market share of the five largest banks averaged 58.9% in

164. SINGER, *supra* note 71, at ix; *see also* KAPSTEIN, *supra* note 70, at 50, 56.

165. This is a recurring theme in many Basel Committee documents cited in Charles Goodhart’s recent history. *See, e.g.*, GOODHART, *supra* note 72, at 110–13, 289–91, 421–22, 549–51.

166. *See* MUELLER, *supra* note 151, at 472–500.

167. *See generally* MANCUR OLSON, *THE LOGIC OF COLLECTIVE ACTION* (1965).

168. *See* Allen N. Berger, Philip Molyneux & John O.S. Wilson, *Banking: An Overview*, in *THE OXFORD HANDBOOK OF BANKING* 1, 13 (Allen N. Berger, Philip Molyneux & John O.S. Wilson eds., 2010).

169. *See* Harvey Rosenblum, *Choosing the Road to Prosperity: Why We Must End Too Big to Fail—Now*, in *FEDERAL RESERVE BANK OF DALLAS, 2011 ANNUAL REPORT* 2, 6 exhibit 2 (2012).

170. *See* John Goddard, Philip Molyneux & John O.S. Wilson, *Banking in the European Union*, in *THE OXFORD HANDBOOK OF BANKING*, *supra* note 168, at 807, 827.

E.U. member states in 2006.¹⁷¹ In the United States, Europe, and Japan, regulatory reforms relaxed internal geographical barriers to bank expansion; abolished restrictions on integration of banking, insurance, and securities services; and facilitated access by foreign financial firms.¹⁷² Developed country banks expanded internationally, notably in Eastern Europe and Latin America.¹⁷³ Overall, as a result of market, technological, and policy changes, the trend has been towards consolidation and the emergence of large, internationally active financial firms.

These firms have many points of entry to influence policy making. The APA's notice and comment process allows them to learn of proposed agency rules, comment on them, and raise the alarm in the legislature when needed. In recent years, TRNs such as the Basel Committee have voluntarily adopted similar procedures in an effort to increase transparency. The largest institutions are actively involved in this process, both directly and through law firms and industry organizations such as the Securities Industry and Financial Markets Association (SIFMA), the Financial Services Roundtable, the Financial Services Forum, the Clearing House, the American Bankers Association, the Institute of International Finance, and the International Swaps and Derivatives Association (ISDA).¹⁷⁴ On many financial regulation proposals, virtually all comments come from major industry participants, with only a handful from smaller firms, consumer groups, or the public.¹⁷⁵ The industry also plays a leading role at the preproposal stage, where informal contacts with regulators allow crucial input in agenda setting.¹⁷⁶ Finally,

171. See Berger et al., *supra* note 168, at 15.

172. *Id.* at 9.

173. See John P. Bonin, Iftexhar Hasan & Paul Wachtel, *Banking in Transition Countries*, in THE OXFORD HANDBOOK OF BANKING, *supra* note 168, at 844; Fernando J. Cardim de Carvalho, Luiz Fernando de Paula & Jonathan Williams, *Banking in Latin America*, in THE OXFORD HANDBOOK OF BANKING, *supra* note 168, at 868.

174. These organizations typically also provide noncollective services to their members, in line with Olson's theory. See OLSON, *supra* note 167, at 145. For example, in addition to lobbying, ISDA produces standard documentation for many types of derivatives, legal opinions as to their international enforceability, and credit event determination and dispute resolution infrastructure for credit derivatives.

175. See Barr & Miller, *supra* note 107, at 24–26 (noting that most comments on Basel II, both internationally and domestically, were from the industry). In a recent study, Kimberly Krawiec finds that, while most rule-makings receive very few comments from the public, an active campaign by public interest groups produced thousands of public comments supporting strong implementation of the Volcker Rule. However, most of these comments were short and general in nature, while industry and trade group letters were usually lengthy, cogent, and specific. See Kimberly D. Krawiec, Don't "Screw Joe the Plummer:" The Sausage-Making of Financial Reform, at 25–26 (2013) (unpublished manuscript), available at http://scholarship.law.duke.edu/faculty_scholarship/2445.

176. Krawiec's analysis of logs of informal meetings with regulators—created as part of a new transparency initiative—shows that financial institutions, industry groups, and law firms accounted for 93.1% of all meetings relating to the Volcker Rule, while public interest, labor, research, and advocacy groups accounted for only 6.9%. See Krawiec, *supra* note 175, at 32.

as financial regulation becomes more complex, implementation often requires long-term cooperation between regulators and the industry.¹⁷⁷

Beyond the rule-making process, large financial firms have many other contacts with regulators. They continually interact with regulators in their supervisory function, they routinely negotiate individual authorizations and exemptions, and their employees often migrate to regulators and vice versa. When they are unsuccessful in obtaining a favorable outcome from agencies, they sometimes turn to judicial review. Although courts have historically deferred to regulators, the industry has achieved some notable successes in recent years.¹⁷⁸ Finally, the financial industry can turn directly to politicians. It “is far and away the largest source of campaign contributions to federal candidates and parties,”¹⁷⁹ with total donations of \$2.8 billion between 1990 and 2012.¹⁸⁰ Financial industry contributions to Congress go disproportionately to members who sit on banking and finance committees.¹⁸¹ Econometric studies show that industry contributions were associated with higher likelihoods of legislators supporting repeal of the Glass-Steagall Act,¹⁸² financial rescues for Latin America and East Asia,¹⁸³ pro-lender bankruptcy reform,¹⁸⁴ and adoption of the Temporary Asset Relief Program legislation.¹⁸⁵

177. See Verdier, *supra* note 108, at 466.

178. See, e.g., *Bus. Roundtable v. SEC*, 647 F.3d 1144 (D.C. Cir. 2011) (striking down SEC proxy access rule); *Goldstein v. SEC*, 451 F.3d 873 (D.C. Cir. 2006) (striking down SEC rule regulating hedge funds); *Int’l Swaps & Derivatives Ass’n v. U.S. Commodity Futures Trading Comm’n*, No. 11-cv-2146, 2012 WL 4466311 (D.D.C. Sept. 28, 2012) (striking down CFTC position limits rule).

179. Ctr. for Responsive Politics, *Finance/Insurance/Real Estate*, OPENSECRETS.ORG, http://www.opensecrets.org/industries/indus.php?Ind_F.

180. See Ctr. for Responsive Politics, *Finance/Insurance/Real Estate: Long-Term Contribution Trends*, OPENSECRETS.ORG, <http://www.opensecrets.org/industries/totals.php?cycle=2012&ind=F>.

181. See Randall W. Bennett & Christine Loucks, *PAC Contributions from Sectors of the Financial Services Industry, 1998–2002*, 36 ATLANTIC ECON. J. 407, 413–18 (2008); J. Lawrence Broz, *Congressional Politics of International Financial Rescues*, 49 AM. J. POL. SCI. 479, 492 (2005); Randall S. Kroszner & Thomas Stratmann, *Interest-Group Competition and the Organization of Congress: Theory and Evidence from Financial Services’ Political Action Committees*, 88 AM. ECON. REV. 1163, 1172 (1998).

182. See Thomas Stratmann, *Can Special Interests Buy Congressional Votes?: Evidence from Financial Services Legislation*, 45 J. L. & ECON. 345, 357–65 (2002).

183. See Broz, *supra* note 181, 485–89.

184. See Stephen Nunez & Howard Rosenthal, *Bankruptcy “Reform” in Congress: Creditors, Committees, Ideology, and Floor Voting in the Legislative Process*, 20 J. L. ECON. & ORG. 527, 553–54 (2004).

185. See Atif Mian, Amir Sufi & Francesco Trebbi, *The Political Economy of the US Mortgage Default Crisis*, 100 AM. ECON. REV. 1967, 1997 (2010). To be sure, other domestic interest groups also try to influence financial regulation: smaller financial firms, institutional investors, public companies, and consumer groups, to name a few. Their influence, however, is likely to be less pronounced. They are more numerous and diffuse, have access to less expertise, and have less consistent ties to regulators. They also are primarily interested in domestic regulatory issues, and often see IFR as remote to their interests. Finally, outside the United States, the banking industry tends to be even more

It is important to emphasize that this Article does not propose a theory of “regulatory capture” under which the industry systematically imposes its preferences.¹⁸⁶ The claim is simply that there are theoretical and empirical reasons to believe that large financial firms exercise significant influence on policy making both at the domestic and international level, and therefore play an important role in shaping IFR. What, then, are their objectives? As will be seen, this often depends on the particular policy at issue, but three general hypotheses can be advanced. First, financial firms usually prefer policies that have lower compliance costs, especially when these costs are imposed to advance a public goal like financial stability but do not generate excludable private benefits. Second, they usually favor policies that enhance their access to foreign markets, as their business model requires extensive international reach.¹⁸⁷ Third, they wish to benefit, as much as possible, from explicit or implicit government guarantees that give them a competitive edge over other firms that do not benefit from the perception of stability associated with “too big to fail” status.¹⁸⁸

3. The Role of the Great Powers

Finally, though day-to-day IFR is primarily the province of specialized regulators and TRNs, their work cannot be insulated from interstate power relationships. One manifestation of this phenomenon is that the regulators of the largest financial markets clearly have disproportionate influence. In the early years, U.S. regulators played a virtually hegemonic role in IFR, sometimes by being the key players in TRNs, sometimes simply by unilaterally imposing their own standards. Until recently, the United States required foreign companies that wished to list their shares on a U.S. exchange to reconcile their financial statements to U.S. GAAP, a costly and time-consuming process. The Basel capital accords, often seen as the most successful IFR standard to date, were originally an Anglo-American initiative, and the impetus from Basel II came from the U.S. Federal Reserve.¹⁸⁹ Likewise, the SEC was the driving force behind the creation of IOSCO and the network of bilateral MOUs. More recently, the European Union has become an important player. Other countries like China, Brazil, and India are gradually joining their ranks.

The exercise of this disproportionate influence by great power regulators in IFR cannot be completely dissociated from broader national interests as defined by their

concentrated, with smaller institutions playing a marginal economic and political role.

186. For a prominent regulatory capture argument, see SIMON JOHNSON & JAMES KWAK, *13 BANKERS* (2010); see also Geoffrey R.D. Underhill & Xiaoke Zhang, *Setting the Rules: Private Power, Political Underpinnings, and Legitimacy in Global Monetary and Financial Governance*, 84 INT’L AFF. 535 (2008). For a critique of capture arguments, see Kevin L. Young, *Transnational Regulatory Capture?: An Empirical Examination of the Transnational Lobbying of the Basel Committee on Banking Supervision*, 19 REV. POL. ECON. 663 (2012).

187. Some large firms with a dominant position in their home market might prefer policies that protect them from foreign competition, but this appears less common among the largest firms, which have become increasingly transnational in nature.

188. For a more complete discussion of “too big to fail,” see *infra* note 310 and accompanying text.

189. See TARULLO, *supra* note 2, at 89–90.

governments. First, the government usually appoints the regulators, so they tend to be politically aligned with it and responsive to its ideology and objectives. Second, great power governments often determine the locus of international cooperation and use that influence to advance their interests. For instance, when the great powers became concerned about money laundering and terrorist financing, they steered that issue away from the IFIs and broad-based TRNs towards the Organization for Economic Cooperation and Development (OECD) and FATF, narrower “clubs” over which they have better control.¹⁹⁰ Third, great power governments sometimes intervene directly to influence the development of financial standards. For example, during the Basel II negotiations, German Chancellor Schröder announced he would not support the new Accord if it was not revised to treat loans to small and medium enterprises—the backbone of German industry—more favorably.¹⁹¹

To date, there have been only a few studies on the role of interstate power relationships in IFR. Beth Simmons developed a model in which the dominant state—usually the United States—unilaterally adopts a new standard, and smaller “follower states” decide whether to emulate it.¹⁹² More recently, Daniel Drezner tried to address the decline of U.S. hegemony with a more general theory based on the interaction of “great powers” and smaller states.¹⁹³ In his model, each state must balance the adjustment costs of shifting to a new standard against the benefits of convergence, which vary across states and economic sectors.¹⁹⁴ In IFR, he argues that great powers usually desire convergence while others do not.¹⁹⁵ His main example is the effort by the great powers to impose new international standards after the Asian crisis, which was resisted by least-developed countries (LDCs), because they would lose patronage opportunities afforded by political control over the financial system, and OFCs, because they would lose their ability to attract business through lax regulation. In response, the great powers entrust “clubs” they control—such as the OECD, the FSF, and the BIS—to design new standards, then enforce them against unwilling states through coercive measures like IMF conditionality, unilateral sanctions, and shaming campaigns.¹⁹⁶

While these are important contributions, there is currently no comprehensive theory of the role of interstate power relationships in IFR. Drezner’s model, for instance, treats IFR as largely unitary and therefore does not explain variation in outcomes across different areas of IFR. Nevertheless, the literature provides important insights on the role and objectives of the great powers. First, they are reluctant to support the creation of binding international standards and centralized institutions, because a more fragmented system allows them to wield their power more freely and achieve their objectives by shifting the issue to the most favorable

190. See DREZNER, *supra* note 94, at 142–45.

191. See Verdier, *supra* note 2, at 141.

192. Simmons, *supra* note 133.

193. DREZNER, *supra* note 94, at 32–59. Drezner argues that the relevant measure is market size and that the United States and the European Union are the “great powers.” *Id.* at 35–39.

194. See *id.* at 43–47.

195. See *id.* at 123–29.

196. See *id.* at 135–45.

forum.¹⁹⁷ Thus, if there is a widely shared interest in convergence in one area, they can delegate standard setting to an intergovernmental organization; but if other states oppose the standards, they can choose a forum where those states have less voice. On a substantive level, the great powers may also gain less than other states from creating strong international standards. In some instances, their regulatory models simply diffuse to other countries because they are perceived as successful or because of the prestige of their regulators.¹⁹⁸ Finally, they can often impose their policies unilaterally when needed.

Second, there are areas in which the great powers do want stronger IFR standards because they are motivated by broader political agendas than regulators or firms. For instance, the great powers are the principal contributors to assistance packages to countries that face financial crises. As a result, especially after the Asian financial crisis, they became deeply preoccupied with the quality of regulation in developing countries and were instrumental in driving the development of the post-Asia reform agenda and shifting monitoring responsibility to the IMF and the World Bank.¹⁹⁹ Beyond preventing financial crises, other political considerations can inform their approach to IFR, including their fiscal interest in fighting tax evasion and tax competition, their security interest in fighting money laundering and terrorist financing, and their political interest in using access to international finance as a sanctions mechanism or bargaining chip against hostile groups or regimes. In such cases, great powers may intervene to compel the TRNs to take action, or shift authority to organizations that will be more responsive to their interests.

D. Explaining Outcomes

The previous section articulated a theoretical account of the political economy of IFR that emphasizes the role of three categories of actors: specialized regulators, firms, and great powers. This account provides a relatively parsimonious explanation of the relative success of major international regulatory initiatives across various issue areas, as will be shown in Part III. At a more general level, it also explains the widespread reliance on soft law and TRNs in contemporary IFR.

At the micro level of individual areas of IFR, the hypothesis is that in order to succeed, an IFR initiative must have strong support from one or more of the three major actors, and at least passive acquiescence from the others. In other words, each effectively wields a veto over the creation of effective international standards.

197. See BRAITHWAITE & DRAHOS, *supra* note 58, at 28–29; Eyal Benvenisti & George W. Downs, *The Empire's New Clothes: Political Economy and the Fragmentation of International Law*, 60 STAN. L. REV. 595, 599 (2007).

198. On the phenomenon of international policy diffusion, see generally Beth A. Simmons, Frank Dobbin & Geoffrey Garrett, *Introduction: The Diffusion of Liberalization*, in *THE GLOBAL DIFFUSION OF MARKETS AND DEMOCRACY* 1 (Beth A. Simmons, Frank Dobbin & Geoffrey Garrett eds. 2008).

199. Indeed, the Basel Committee itself was very reluctant to articulate general standards of bank regulation and supervision that would be used to judge the performance of national regulators, and only did so under pressure from the IMF. See GOODHART, *supra* note 72, at 438–40.

This veto, of course, is not a formal legal prerogative like that of permanent members of the U.N. Security Council. It simply represents the actual capacity of each actor to defeat a new standard, either by preventing its adoption or by defeating its effective implementation. There is one exception to this logic: in the wake of financial crises, international prudential standards have sometimes been adopted against the resistance of the financial industry. For example, the Basel I accord was adopted after the Latin American debt crisis, and imposed substantial costs on banks. As will be seen, however, the adoption of such standards is highly exceptional; compliance is difficult to monitor and enforce; and as the crisis recedes and the industry reasserts its influence, the standards tend to be gradually diluted.

At the macro level, the interests of specialized regulators, financial firms, and great power governments explain IFR's overall preference for soft law and TRNs over formal treaties and institutions. As a result of the historical development of IFR, each of these actors occupies a powerful position in the current system. Therefore, they have incentives to resist the involvement of new institutions and actors that might challenge their position. Instead, they prefer to rely on strategies of "institutional layering," adding new informal bodies with limited authority and autonomy to address new problems on an ad hoc basis. Thus, a heavy burden of inertia weighs against the creation of stronger cooperation mechanisms. In addition, the current system is relatively effective at achieving the objectives that these three actors privately value most and relatively ineffective at achieving other potentially desirable objectives that are of less private concern to these actors. These ideas are developed more fully in Part III.

III. WHY REGULATE INTERNATIONAL FINANCE?

This Part argues that, in order to understand IFR, a key distinction must be made among five different areas of international regulatory cooperation. In each of these areas, the rise of private international finance creates challenges for national regulation that states cannot fully address by acting unilaterally. As a result, there is a potential for states to achieve joint gains through cooperation. However, success is not purely a function of the existence of potential joint gains. Instead, the interests and capabilities of the principal political actors of IFR—regulators, large firms, and great powers—differ across the five areas and explain the substantial differences in outcomes. The interests of these actors also explain the dominance of soft law and TRNs in IFR despite their failure to support effective cooperation in several important areas.

A. The Baseline: Regulatory Unilateralism

What objectives do states pursue in cooperating to regulate international finance? The usual answer is that financial globalization has undermined the ability of individual states to regulate effectively. In this view, cooperation is the only way to manage increasing financial interdependence. By adopting common policies, states can preserve the effectiveness of national regulation in a globalized world. This view, however, is incomplete because it neglects the extent to which states prefer, if at all possible, to act unilaterally. Rather than systematically looking for

cooperative solutions, they first attempt to address new cross-border challenges by applying their own laws, even if the relevant activities also have connections to other states. The question, then, must be recast as follows: What objectives are states unable to achieve unilaterally, so that they turn to international cooperation?

This starting point is conventional in international relations scholarship. Because cooperation imposes costs on states in terms of time, resources, and sovereignty, scholars do not typically assume that states have a propensity for cooperation for its own sake. Rather, they cooperate to achieve benefits they cannot attain alone. In the case of IFR, individual states are not defenseless against cross-border finance. They often can—and do—apply their laws unilaterally to activities that affect their markets. When this approach is viable, they prefer it. International cooperation involves extensive negotiations, delays, and compromises. States have to cede some of their authority and conform their laws to international standards, which may depart from their preferred approach. These costs can be avoided by regulating unilaterally. On a normative level, unilateral regulation appeals to the idea of subsidiarity, according to which collective institutions should perform only those tasks that cannot be performed effectively at the local level.²⁰⁰

This preference for unilateralism is also supported by the history of IFR. Until the 1970s, international finance was marginal and regulation was a domestic concern.²⁰¹ With the collapse of Bretton Woods, many new cross-border regulatory challenges emerged. While regulators slowly began to develop cooperation mechanisms, unilateralism was initially the more salient approach, especially in the United States. Thus, U.S. courts and the SEC exercise jurisdiction over securities fraud that has “effects” in the United States, even if the transaction occurred abroad.²⁰² Until recent reforms, foreign firms with securities traded in the United States were required to reconcile their financial statements to U.S. GAAP, a costly and time-consuming process. Many other rules—for securities offerings, broker-dealers, securities exchanges, and tender offers—apply as soon as the activity is, even in part, directed at the United States. Over time, the SEC has clarified the territorial scope of these provisions and provided some exemptions—but all of this was done unilaterally.²⁰³ Other examples of unilateralism abound in U.S. regulation, as well as many other countries.²⁰⁴

200. For instance, subsidiarity is enshrined in the European treaties as a fundamental principle of the European Union. It also is frequently invoked in debates on global governance and federalism.

201. *See supra* Part I.

202. *See, e.g.*, *Schoenbaum v. Firstbrook*, 405 F.2d 200, 206 (2d Cir.), *rev'd on other grounds*, 405 F.2d 215 (2d Cir. 1968) (en banc). These relevant cases were reversed in *Morrison v. National Australia Bank*, 130 S. Ct. 2869 (2010), but Congress soon adopted a provision meant to restore the “conduct or effects” test for SEC enforcement actions. Dodd-Frank Wall Street Reform and Consumer Protection Act, § 929P(b), 15 U.S.C. § 77v(c) (Supp. IV 2010).

203. *See, e.g.*, 17 C.F.R. §§ 230.901–905 (2012) (securities offerings); § 240.13e-4 (tender offers); § 240.15a-6 (broker-dealers).

204. Other examples of unilateral U.S. regulation include strict access requirements and regulation of foreign bank branches, which are generally prohibited from taking retail deposits; regulation of foreign insurers by state regulators; and routine prosecution of

In sum, both theory and history suggest that, in each area of IFR, the starting point is unilateralism: each state prefers to address cross-border challenges simply by applying its own laws. As will be seen, however, unilateralism is not always an effective response. The first step, then, is to identify limitations on what states can achieve unilaterally. In areas where unilateral action has serious shortcomings, states may be able to achieve joint gains by cooperating. The second step goes beyond functionalist analysis by examining how politics—and particularly the interests of the salient actors identified above—affect outcomes in the relevant area. In other words, rather than assuming that the outcomes are driven by a rational calculation of costs and benefits by states, it examines how politics actually support or undermine beneficial cooperation in each area.

B. Five Objectives of International Regulatory Cooperation

1. Securing Cross-Border Coordination of Enforcement and Supervision

A first limitation of unilateralism is that even if a state attempts to apply its laws to cross-border financial transactions, it may be difficult to enforce those laws in practice. When trying to bring a cross-border securities fraud case, regulators may find that essential evidence or witnesses are abroad, or that local judgments cannot be enforced in other countries. These practical difficulties can undermine the effectiveness of unilateral regulation. Likewise, as financial firms become global and their structure becomes more complex, supervising them internationally becomes more challenging. Without some coordination and allocation of responsibility among national authorities, some firms may avoid effective regulation altogether. This danger was dramatically illustrated by the collapse of the Bank of Credit and Commerce International, a global bank that circumvented effective consolidated supervision for years.²⁰⁵

The first collective challenge, then, is to coordinate the actions of national regulators to close gaps in enforcement and supervision. This objective can often be achieved through relatively simple agreements on information sharing and mutual assistance. Much of the first generation of IFR standards—notably the Basel Concordat and the network of securities MOUs—relate to this type of cooperation. It has been successful overall, culminating with widespread adoption of the IOSCO MMOU and a workable regime for cross-border bank supervision under the revised Concordat. This outcome appears to support the conventional account of IFR. Regulators perceived a common problem posed by globalization and crafted a cooperative solution that produces joint gains. The story is not so simple, however,

anticompetitive activities abroad that have effects on U.S. markets. The European Union also routinely imposes its financial regulations to transnational activities that affect its markets. One salient example was its adoption in 2002 of a directive requiring all financial conglomerates active in Europe to be subject to consolidated supervision and capital requirements, which several major U.S. financial groups lacked at the time. *See* Parliament and Council Directive 2002/87/EC, 2003 O.J. (L 35) 1.

205. *See* RICHARD J. HERRING & ROBERT E. LITAN, FINANCIAL REGULATION IN THE GLOBAL ECONOMY 103–05 (1995); SEN. JOHN KERRY & SEN. HANK BROWN, THE BCCI AFFAIR: A REPORT TO THE COMMITTEE ON FOREIGN RELATIONS, U.S. SENATE (1992).

because there is another crucial ingredient in this success: the interests of the principal political actors were also aligned in favor of cooperation.

National regulators have many reasons to favor this kind of cooperation. It can be implemented relatively easily, it enhances their authority, and it does not compromise their discretion. They are not going beyond their mandate, but developing more effective ways of enforcing existing laws that might otherwise be undermined. They usually already have the legal authority to request and provide assistance; if not, cooperative agreements like the MMOU give them a reason to ask the legislature for more powers. This may be particularly true of developing country regulators, whose membership in TRNs reinforces their domestic prestige and authority over the local financial industry. Finally, regulators have little reason to fear unanticipated consequences, because these arrangements preserve ample flexibility to withhold cooperation in individual cases—for instance politically sensitive ones. The financial industry, for its part, has little to gain and much to lose by opposing this form of cooperation. While certain firms may lose from more effective cooperation, it is hard to imagine an industry association lobbying against cross-border antifraud or insider trading enforcement. There is also empirical evidence that the largest firms are rarely the targets of formal enforcement by regulators,²⁰⁶ giving them little reason to fear cooperative arrangements.

Finally, the great powers have a strong interest in promoting this kind of cooperation because they are the heaviest users of cross-border assistance in enforcing their laws.²⁰⁷ Thus, the SEC was the driving force behind IOSCO's early efforts to expand the network of MOUs.²⁰⁸ Likewise, revisions to the Basel Concordat were driven by the United States and Europe, concerned about inadequate home country supervision of banks operating in their markets.²⁰⁹ Most other countries, for their part, have little reason to resist such cooperation. There may have been some OFCs whose financial industry attracted customers by shielding them from onshore enforcement and supervision. In these exceptional cases, the relevant countries did not cooperate voluntarily and the great powers attempted to coerce them. For most countries, however, the costs are small.

2. Liberalizing International Finance by Harmonizing Regulatory Requirements

A second problem of unilateralism is that several states concurrently apply different rules to the same activities. These duplicative and often inconsistent

206. See, e.g., Julie Andersen Hill, *Bank Capital Regulation by Enforcement: An Empirical Study*, 87 IND. L.J. 645, 690–93 (2012); Stavros Gadinis, *The SEC and the Financial Industry: Evidence from Enforcement Against Broker-Dealers*, 67 BUS. LAW. 679 (2012); Philip A. Wellons, *Enforcement of Risk-Based Capital Rules*, in CAPITAL ADEQUACY BEYOND BASEL 284 (Hal S. Scott ed. 2005).

207. The SEC likely remains the heaviest user (and provider) of enforcement assistance. During its 2010 fiscal year, it made 605 requests to foreign authorities and responded to 457 requests from abroad. *Outline: Office of International Affairs*, in THE SEC SPEAKS IN 2011 813, 838 (2011).

208. See Chris Brummer, *Post-American Securities Regulation*, 98 CALIF. L. REV. 327 (2010).

209. See WOOD, *supra* note 72, at 58–62.

requirements impose costs and delays on cross-border finance, amounting to de facto barriers to trade. In some cases, duplication is merely burdensome. Thus, foreign companies issuing securities in the United States historically had to pay accountants and lawyers to reconcile their financial statements to U.S. GAAP and produce U.S. disclosure.²¹⁰ In other cases, national rules are fundamentally inconsistent, creating virtually insurmountable barriers. Foreign stock exchanges cannot place trading screens in the United States because they cannot comply with both their home country laws and U.S. requirements.²¹¹ Likewise, U.S. mutual fund rules conflict with those of other countries, effectively precluding access by foreign funds to the U.S. market.²¹² The corporate governance and auditor oversight reforms of the Sarbanes-Oxley Act raised fears that some U.S.-listed foreign companies would be unable to comply without breaking the law in their home countries.²¹³ In brief, unilateral regulation often imposes burdens on cross-border finance, and some of these burdens are unnecessary because the national rules have similar aims.

As a result, an important collective objective that can be achieved through cooperation is to reduce these barriers. There are numerous explicit liberalization initiatives in finance, such as eliminating formal capital controls or making market access commitments under the General Agreement on Trade in Services (GATS). These initiatives are necessary but not sufficient because they usually leave *regulatory* barriers untouched. For instance, many countries have financial services commitments under the GATS, but retain discretion to regulate in ways that effectively restrict access. When making GATS commitments, countries often grandfather their existing regulations; the United States did so for insurance.²¹⁴ Even without such specific carve-outs, the GATS allows states to “tak[e] measures for prudential reasons . . . or to ensure the integrity and stability of the financial system.”²¹⁵ That provision defines “prudential measures” very broadly and does not impose a necessity requirement, unlike most other GATS exceptions.²¹⁶ Therefore, even in areas where countries have made GATS commitments, domestic regulation often remains a barrier to cross-border activity. In such areas, regulatory harmonization is necessary to effectively liberalize cross-border finance.

210. See SCOTT, *supra* note 62, at 173–74.

211. See Howell E. Jackson, Andreas M. Fleckner & Mark Gurevich, *Foreign Trading Screens in the United States*, 1 CAP. MKTS. L.J. 54, 56–61 (2006).

212. See SCOTT, *supra* note 62, at 915–25.

213. See *id.* at 81–103, 133.

214. See Brown, *supra* note 110, at 957, 959–63.

215. General Agreement on Trade in Services, Apr. 15, 1994, Marrakesh Agreement Establishing the World Trade Organization, Annex on Financial Services, 1869 U.N.T.S.183, at 308.

216. See *id.* The provision defines “prudential measures” much more broadly than the common usage of that term to include measures “for the protection of investors, depositors, policy holders or persons to whom a fiduciary duty is owed by a financial service supplier.” *Id.* In addition, many other aspects of the GATS provide flexibility to regulate financial services. See generally Kern Alexander, *The GATS and Financial Services: Liberalisation and Regulation in Global Financial Markets*, in THE WORLD TRADE ORGANIZATION AND TRADE IN SERVICES 561 (Kern Alexander & Mads Andenas eds., 2008).

Some of the most important international standards fall in this category. In 1998, IOSCO adopted a standardized form for nonfinancial disclosure that reduces transaction costs and delays for international securities offerings.²¹⁷ Likewise, for more than a decade, the International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) have conducted a major effort to harmonize financial accounting standards.²¹⁸ This project is driven in large part by the potential efficiency gains. For instance, the SEC's acceptance of International Financial Reporting Standards-based financial statements for foreign issuers eliminated the need to reconcile their books to U.S. GAAP, which had long been a major transaction cost of accessing U.S. markets.²¹⁹ Greater cross-country comparability of financial statements also leads to greater efficiency in global financial markets and benefits transnational companies.²²⁰ To be sure, these successes have taken substantial time and effort to come to fruition, and there are important areas, like mutual funds and insurance, where there is little harmonization.²²¹ Nevertheless, liberalization is overall an area of relative success for the current system of IFR. Why?

This is an area where large financial firms and transnational companies have much to gain, and unsurprisingly, they have played a greater role than in other areas. As these initiatives reduce regulatory barriers to cross-border finance, they gain easier and more efficient access to foreign markets and lower capital costs. To be sure, they might be reluctant to support harmonization efforts that produce stricter rules, as compliance costs could exceed the benefits of enhanced market access. However, the international standards produced by such harmonization initiatives are rarely stricter than existing national standards. For instance, the IOSCO disclosure form was closely based on the existing U.S. form.²²² As a result, firms that already complied with U.S. rules could now access additional markets at little additional cost. Therefore, as a rule, large financial firms support international harmonization in areas like disclosure, customer protection, business conduct, and the like.²²³ Mutual recognition agreements, under which countries simply allow foreign firms that comply with their home country rules to access their markets are even better—from the perspective of the large financial firms.²²⁴

217. See SCOTT, *supra* note 62, at 172–73.

218. See *id.* at 181–82.

219. See *id.* at 175–79.

220. See TIM BÜTHE & WALTER MATTLI, *THE NEW GLOBAL RULERS: THE PRIVATIZATION OF REGULATION IN THE WORLD ECONOMY* 4 (2011).

221. On mutual funds, see SCOTT, *supra* note 62, at 915–25; on insurance, see Brown, *supra* note 110.

222. See Verdier, *supra* note 2, at 150.

223. See, e.g., Edward F. Greene & Omer S. Oztan, *The Attack on National Regulation: Why We Need a Global Framework for Domestic Regulation*, 4 CAP. MKTS. L.J. 6 (2009); Underhill & Zhang, *supra* note 186.

224. The industry generally supported the SEC's mutual recognition program, which came to a halt in 2008. See, e.g., Edward F. Greene, *Beyond Borders: Time to Tear Down the Barriers to Global Investing*, 48 HARV. INT'L L.J. 85 (2007). Its support, however, was somewhat tepid given the limited benefits of the agreement for the largest firms and institutional investors. See Pierre-Hugues Verdier, *Mutual Recognition in International Finance*, 52 HARV. INT'L L.J. 55, 89–90 (2011).

National regulators are often sympathetic to international harmonization efforts, as long as the resulting standards are consistent with the aims of preexisting national rules. From their perspective, more uniform rules and enhanced access expand the markets under their oversight, facilitate cross-border enforcement cooperation, and satisfy the most powerful industry constituencies. There may be resistance by smaller, domestically oriented firms that benefit from the existence of regulatory barriers to foreign entry. In some cases, consumers may also resist harmonization of customer protection rules and other areas that affect them. The influence of import-competing firms and consumers probably varies and might explain the relative lack of harmonization in areas that are consumer oriented and have many smaller firms, such as mutual funds and insurance.²²⁵ Despite such resistance, regulatory liberalization may be self-reinforcing, as it allows the largest firms to expand, gaining more political clout.

Finally, the great powers have reasons to favor such harmonization efforts. Given the inherent attractiveness of their markets and the greater resources and prestige of their regulators, they are in a strong position to shape the international standards. By developing standards that are as close as possible to their existing laws, they can minimize their own adjustment costs and accrue a greater share of the benefits of liberalization. Thus, the SEC was instrumental in promoting and developing the IOSCO nonfinancial disclosure form, and the outcome was virtually identical to existing SEC rules. Likewise, although IFRS are poised to supplant U.S. GAAP, the FASB played a major role in developing the global standards, so they are often close to U.S. standards, particularly on controversial issues like mark-to-market accounting.²²⁶ Moreover, most of the large firms that benefit from harmonization are based in the great powers.

As a result of this coincidence of interests, this is an area where the strengths of soft law and TRNs are most in evidence. Their monitoring and enforcement limitations are not major obstacles to success, since markets often create incentives for firms and governments to adopt and comply with international standards. In this area, private standard setting is also very important.²²⁷ Besides the role of IASB in accounting, market associations such as ISDA, SIFMA and the International Chamber of Commerce also develop standardized documentation, provide dispute resolution procedures, and even draft model statutes for adoption by national legislatures.²²⁸ Together, they have developed much of the international legal framework for financial derivatives, repurchase agreements, securities lending, and trade finance.

225. Other explanations have been suggested, such as the fragmentation of U.S. insurance regulators, which makes negotiation of international standards more difficult. *See, e.g.,* U.S. DEP'T OF THE TREASURY, FINANCIAL REGULATORY REFORM: A NEW FOUNDATION 39–40 (2009).

226. *See* BÜTHE & MATTLI, *supra* note 220, at 99–125.

227. *See* DREZNER, *supra* note 94, at 73.

228. *See* PORTER, *supra* note 64, at 103–13; Janet Koven Levit, *Bottom-Up International Lawmaking: Reflections on the New Haven School of International Law*, 32 YALE J. INT'L L. 393, 133–44 (2007); for SIFMA see *Standard Forms and Documentation*, SEC. INDUS. & FIN. MKTS. ASS'N, <https://www.sifma.org/services/standard-forms-and-documentation/>.

In a recent review of the literature on private standard setting, Tim Büthe helpfully synthesizes its major findings.²²⁹ First, he asks why private actors supply standards that amount to public goods and finds that “the supply of private regulation virtually never occurs unless it also brings private political-economic benefits to the suppliers.”²³⁰ Second, he asks why the targets of the private standards comply, and finds that except when governments enforce the standards, compliance must rely on private economic and sociopolitical incentives.²³¹ These incentives are more likely to succeed where the standard addresses a coordination problem,²³² but when the standard attempts to make the targets provide a public good or avoid negative externalities, compliance problems arise.²³³ Büthe concludes that “private monitoring and enforcement can fully compensate for this weakness of private regulation only under ideal conditions, including sustained vigilant attention by altruistically motivated volunteers and the absence of collective action problems, which rarely if ever hold.”²³⁴

In light of these considerations, the success of private standards in areas where the objective of IFR is harmonization is unsurprising. The “public good” nature of the standards does not inhibit private actors from providing them because their cost is negligible relative to the size of global financial markets and the potential private gains. IASB’s 2009 budget was a mere \$30 million—80% of which came from fundraising, mostly from large companies and accounting firms.²³⁵ Firms that contribute to IASB and ISDA very likely derive more private benefits from increased efficiency and growth of cross-border markets than they spend.²³⁶ They also benefit from being involved in the standard-setting process.²³⁷ Enforcing these standards is not a problem, because there are market incentives to comply and because governments often incorporate the standards into national regulation.

229. See generally Tim Büthe, *Global Private Politics: A Research Agenda*, 12 BUS. & POL., no. 3, Art. 12, 2010 [hereinafter Büthe, *Global Private Politics*]; Tim Büthe, *Private Regulation in the Global Economy: A (P)Review*, 12 BUS. & POL., no. 3, Art. 2, 2010 [hereinafter Büthe, *Private Regulation in the Global Economy*].

230. Büthe, *Global Private Politics*, *supra* note 229, at 6.

231. *Id.* at 9–10. On those incentives, see also Büthe, *Private Regulation in the Global Economy*, *supra* note 229, at 15–20.

232. For a theory of coordination standards, see BÜTHE & MATTLI, *supra* note 220.

233. On that distinction, see Verdier, *supra* note 2, at 122–26.

234. Büthe, *Global Private Politics*, *supra* note 229, at 17.

235. See BÜTHE & MATTLI, *supra* note 220, at 74–75.

236. On the benefits for internationally oriented firms and multinationals, see *id.* at 65–66.

237. Thus, Büthe and Mattli point out that these firms’ support to IASB likely allows them to influence the standard-setting process. See *id.* at 65–66, 74 n. 56. Likewise, the largest derivatives dealers were instrumental in creating and supporting ISDA and are closely involved in developing new forms and standards. See Sean M. Flanagan, *The Rise of a Trade Association: Group Interactions Within the International Swaps and Derivatives Association*, 6 HARV. NEGOT. L. REV. 211, 234–53 (2001).

3. Compelling States to Improve Their Financial Regulation

A third problem of unilateralism is that without international standards certain countries may maintain an inadequate level of regulation. In such cases, the goal of cooperation will be to ensure that all countries observe minimum standards that may require enhancing their existing laws and enforcement if needed. This statement raises two fundamental questions: why would some countries have inadequate regulation, and why would others care? Many countries have weak regulation because their financial markets are undeveloped. In some cases, they may now be reaching a stage where overhauling them is important to sustain their economic development. But these countries have incentives to improve regulation. They need no compulsion. They may use international standards as a model, but they might also use the laws of leading countries, or hire experts to develop new laws.²³⁸ Other countries also have limited incentives to assist—let alone compel—them to improve their laws. After all, financial regulation has historically been a domestic concern, which suggests that countries had little reason to care about each other's laws. To explain why some states might maintain inadequate regulation and others might want them to improve it, one must posit externalities.

The hypothesis, then, is that some countries have incentives to maintain inefficiently low standards because the costs are borne by others. The latter, in turn, want the former to internalize those costs by improving their regulation. While one could imagine numerous potential externalities, two concerns have historically been important. The first is that ineffective regulation in developing countries and LDCs increases the likelihood of financial crises, imposing costs on others in the form of financial assistance and potential contagion. These countries, the theory goes, will not willingly improve their standards because some of the costs are externalized and because powerful domestic constituencies benefit from the status quo. Thus, Drezner argues that elites in LDCs benefit from poorly regulated financial systems that they can manipulate for patronage, and Walter argues that businessmen tied to political leaders oppose reforms that would reduce their control over the financial sector.²³⁹ This concern motivated the post-Asia reform agenda. The second concern is that some countries may use lax regulation to attract business to their financial industry, while externalizing the costs. For instance, an OFC could turn a blind eye to money laundering and tax evasion by drug cartels from a neighboring country, thus benefitting from their business while the costs of criminality are borne by its neighbor. This concern—justified or not—motivated the campaign against OFCs.

The experience of those two campaigns indicates that enhancing regulation in countries where influential political actors resist reform is exceedingly difficult. Once again, the political factors are crucial; but this time, they point in different directions. The great powers are clearly the driving force behind these efforts, but their interests are conflicted. On the one hand, their globalized economies are

238. On various transnational diffusion mechanisms that may affect the adoption by states of domestic policies that have limited direct repercussions on other states, see KATERINA LINOS, *THE DEMOCRATIC FOUNDATIONS OF POLICY DIFFUSION* (2013).

239. See DREZNER, *supra* note 94, at 128; WALTER, *supra* note 130, at 36–39.

vulnerable to economic shocks worldwide, and they are major contributors to the IMF and World Bank, so they wish to reduce the risk of financial crises and contagion. On the other hand, they prefer to keep standard setting in specialized, informal bodies such as TRNs in which they have more influence, rather than in formal IOs with more formal processes and voting rules. The problem is that TRNs lack the authority and capacity to monitor or enforce the standards. The solution was, in one case, to delegate standard setting to TRNs and pressure the IFIs to enforce them; in the other, the solution was to use a club organization, the FATF, to apply pressure on OFCs through blacklisting and sanctions.²⁴⁰

Can such external pressures overcome political resistance in the targeted countries? Walter's study indicates, at least in East Asia, the answer was largely negative.²⁴¹ These countries, with the exception of Malaysia, formally adopted extensive regulatory reforms as a condition of financial assistance.²⁴² Walter, however, distinguishes such formal compliance from substantive compliance. The latter can fail at three different stages: the government can adopt a policy of regulatory forbearance, the bureaucracy can obstruct implementation through weak enforcement, and firms can disobey the rules in ways the government is unable to sanction effectively.²⁴³ The key to Walter's argument is that external actors, such as the IFIs and market participants, are often neither willing nor able to secure substantive compliance.²⁴⁴ The IMF, for instance, was a reluctant partner in the Asian reform effort: its mandate to oversee domestic regulation was contested; it had to answer to all its members, not just the great powers; and it had strong incentives not to declare a borrower in breach.²⁴⁵ Even if they had the right incentives, IFIs are poorly situated to verify substantive compliance. Measuring the quality of compliance is difficult as the information is not transparent, the relevant parties have incentives to conceal it, and the IFIs have limited capacity to uncover information independently. As a result, the IMF was severely criticized for its lack of expertise, its "check-the-box" approach to implementation, and its ignorance of domestic conditions.²⁴⁶

240. See DREZNER, *supra* note 94, at 139–45; Verdier, *supra* note 2, at 147–49.

241. See WALTER, *supra* note 130, at 166–69.

242. See *id.* at 1–5. Malaysia was not formally subject to IMF intervention and conditionality. *Id.* at 99.

243. See *id.* at 30–32.

244. See *id.* at 39–41.

245. See Marcel Fratzscher & Julien Reynaud, *IMF Surveillance and Financial Markets—A Political Economy Analysis*, 27 EUR. J. POL. ECON. 405 (2011) (finding empirical evidence that IMF surveillance is more favorable for countries with large outstanding IMF loans).

246. See, e.g., INT'L MONETARY FUND INDEP. EVALUATION OFFICE, REPORT ON THE EVALUATION OF THE FINANCIAL SECTOR ASSESSMENT PROGRAM (2006); Cally Jordan, *The Dangerous Illusion of International Financial Standards and the Legacy of the Financial Stability Forum*, 12 SAN DIEGO INT'L L.J. 333, 350–58 (2011). Despite their limitations, FSAP evaluations of domestic securities regulation showed "persistent weaknesses in a number of countries and . . . an urgent need for improvement," often due to weak enforcement, lack of skilled personnel, and insufficient independence of regulators. See Ana Carvajal & Jennifer Elliott, *Strengths and Weaknesses in Securities Market Regulation: A Global Analysis 5* (Int'l Monetary Fund, Working Paper No. 259, 2007).

The outcome was “mock compliance”—East Asian countries formally adopted the standards while ignoring them in practice, particularly when powerful domestic actors were concerned.²⁴⁷ Walter provides multiple examples of this “hidden compliance gap”: newly “independent” banking regulators were in fact tightly controlled by politicians, accounting manipulation and regulatory forbearance allowed banks to circumvent new capital adequacy standards, and regulators ignored violations of loan concentration and insider lending rules.²⁴⁸ In corporate governance, the situation was even worse, as Indonesian political cronies and Korean *chaebols* fiercely resisted loosening their grip on companies.²⁴⁹ The IFIs did little more than gently flag the lapses they identified, often in confidential reports.²⁵⁰ The markets also were not privy to information that would have allowed them to assess substantive compliance. In any event, they had little incentive to do so, since they expected that governments would effectively guarantee loans to important or politically connected banks. Likewise, the diffusion of Western pro-reform ideas proved a double-edged sword as resisters, who often controlled the media, denounced the standards as neocolonial impositions.²⁵¹ In sum, efforts to use IFR standards to compel unwilling states to improve their regulation raise great difficulties and, in the most salient cases, appear to have been relatively unsuccessful.²⁵²

4. Securing Collective Action to Raise Prudential Standards

A fourth limitation of unilateralism is that a country may wish to raise its prudential standards for financial firms—for instance, in response to a banking crisis—but be unable to do so unilaterally because it would place its industry at a competitive disadvantage. This situation is unlike the one described above, where some states would gain and others lose from the adoption of higher regulatory standards. Here, even if every state believes higher standards are desirable, it cannot act unilaterally without sacrificing its own competitiveness. Moreover, this problem persists over time. Even if several countries did agree to raise their standards, individual members of this pact would eventually face incentives to relax their standards in order to gain a competitive advantage. In other words, international efforts to raise prudential standards involve a prisoner’s dilemma. The challenge is to secure widespread adherence and compliance by participants who face constant temptation to defect and free ride on the efforts of others.

247. WALTER, *supra* note 130, at 166–77.

248. *See id.* at 56–70, 102–09, 130–42.

249. *See id.* at 71–72, 142–50.

250. *See id.* at 177.

251. *See id.* at 95, 150.

252. This is consistent with empirical work indicating that the benefits of implementing IFR standards depend on the preexisting quality of a country’s regulatory system. *See* Ali Burak Güven, *The Feasibility of IFI-Led Institutional Reform: Four Turkish Experiments Compared*, 30 DEV. POL’Y REV. 425, 427 (2012); Hans B. Christensen, Luzi Hail & Christian Leuz, *Capital-Market Effects of Securities Regulation: Hysteresis, Implementation, and Enforcement* 7 (Nat’l Bureau of Econ. Research, Working Paper No. 16737, 2011).

The primary obstacle to such an effort is domestic politics. Banks and other financial firms resist the imposition of stronger prudential regulation. The reason is simple: they have incentives to incur more leverage and take more risk than is socially optimal, and regulation prevents them from doing so. For instance, thinner capitalization makes a bank more profitable, but it also makes it more vulnerable to failure. In a world where bank owners and managers internalized the full costs of failure, they would have incentives to balance these considerations when deciding how much capital to maintain. However, many of these costs are externalized. Shareholders cannot lose more than their investment. Additional losses are borne by government (through emergency loans, deposit insurance, and outright bailouts) and other firms (through contagion and higher deposit insurance rates). In other words, the economic rationale for mandatory capital requirements is that they force banks to internalize the social costs of risk-taking. From the perspective of the individual bank and its shareholders, however, such requirements constitute a private cost without a corresponding private benefit. Therefore, they have strong incentives to resist or avoid them.²⁵³

In light of this rationale, the argument that market forces promote adherence and compliance with capital requirements requires reexamination. As seen above, this argument is very widespread in the political science literature on IFR.²⁵⁴ Nevertheless, its logic is questionable. Since high leverage makes financial firms more profitable, shareholders will want more of it than is socially optimal. Creditors and depositors would normally have incentives to limit leverage, but this discipline is blunted by the existence of deposit insurance and, for many banks and large firms, a government safety net that protects even uninsured creditors. To put the point starkly: if the market already imposed adequate leverage constraints on financial firms, there would be no need for capital regulation in the first place; by the same token, if one accepts the logic for such regulation, one cannot expect the market to enforce it. The hypothesis that the market will enforce capital standards is inconsistent with the economic rationale for their existence. The same point applies generally to all prudential rules that compel financial firms to minimize risk-taking and internalize social costs, like lending concentration limits, limits on affiliate transactions, or prohibitions of risky activities like proprietary trading.²⁵⁵

The empirical evidence, limited as it is, is also inconsistent with the view that markets effectively enforce prudential rules. Before the subprime crisis, U.S. commercial banks were subject to comprehensive capital rules, including an overall leverage limit, while the largest investment banks such as Bear Stearns and Lehman Brothers had to comply with a looser SEC regime based on Basel II, without a leverage limit.²⁵⁶ As a result, these investment banks were substantially more leveraged, more profitable—and more fragile. They all failed, merged, or were rescued by government during the crisis. The credit rating agencies, for their part, do not follow Basel but rather follow their own assessments of “appropriate”

253. See SINGER, *supra* note 71, at 19.

254. See *supra* note 129 and accompanying text.

255. See Eichengreen, *supra* note 3, at 13 & n.29.

256. See U.S. SEC. & EXCH. COMM'N, OFFICE OF INSPECTOR GENERAL, SEC'S OVERSIGHT OF BEAR STEARNS AND RELATED ENTITIES: THE CONSOLIDATED SUPERVISED ENTITY PROGRAM 2-4, 10-20 (2008).

capital levels for banks.²⁵⁷ In some cases, CRA ratings reflect the likelihood that a bank will be bailed out—thus giving it a better rating than its capital position would otherwise justify.²⁵⁸ To the extent that CRAs and investors take into account breach by a firm of capital rules, it is out of concern that it will be subject to enforcement action; but of course, this form of market discipline is entirely derivative of government enforcement.²⁵⁹ Even if market participants had adequate incentives to monitor leverage, it is doubtful they could detect outright manipulation like Lehman's "Repo 105."²⁶⁰

An alternative form of the argument may be that markets push countries—rather than individual firms—to adopt international standards. Indeed, authors often point to the widespread adoption of Basel I outside the G-10 as evidence of beneficial market pressure.²⁶¹ This argument, however, fails to distinguish between formal and substantive compliance. As Walter's study makes clear, market participants cannot assess the latter since they are not privy to the relevant information, such as the quality of domestic supervision and loan classifications.²⁶² Indeed, they may not even care about substantive compliance, for several reasons: systemically important or politically well-connected firms often benefit from an implicit government guarantee; formal compliance may be sufficient because "national authorities almost always effectively guarantee the liabilities of *formally* compliant banks,"²⁶³ and their compliance concerns may be swamped by market trends such as the "global search for yield."²⁶⁴ In any event, market pressures to comply with international standards undoubtedly have less influence on advanced economies, whose attractiveness does not turn on such seals of approval.²⁶⁵ In sum, market pressures likely play only a limited role in securing adhesion and compliance with international prudential standards. For the same reasons, private standard setting is negligible in this area.

257. In its credit rating methodology, Moody's expressly states that it "sees no automatic correlation between a bank's level of regulatory capital and its credit ratings." Chey, *supra* note 133, at 300 (quoting SAMUEL S. THEODORE, MOODY'S INVESTORS SERVICE, RATING METHODOLOGY 36 (1999)).

258. See *Does the Dodd-Frank Act End "Too Big to Fail?": Hearing Before the Subcomm. on Fin. Inst. and Consumer Credit of the H. Comm. on Fin. Servs.*, 112th Cong. 97 (2011) (statement of Christy Romero, Acting Special Inspector General, Troubled Asset Relief Program).

259. See WALTER, *supra* note 130, at 175; Chey, *supra* note 133, at 298.

260. On the "Repo 105" transactions, see Report of Anton R. Valukas, Examiner at 732-1053, *In re Lehman Brothers Holdings Inc.*, No. 08-13555 (Bankr. S.D.N.Y. Mar. 11, 2010), available at <http://jenner.com/lehman/>. Lehman was a public firm and was rated, but was not subject to full bank capital rules. On the difficulty of detecting "accounting games," see Erik F. Gerding, *The Shadow Banking System and Its Legal Origins* 37-39 (Aug. 23, 2011) (unpublished working paper), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1990816.

261. See, e.g., SINGER, *supra* note 71, at 123; Simmons, *supra* note 133, at 601-05.

262. WALTER, *supra* note 130, at 174-75.

263. *Id.* at 175 (emphasis in original).

264. *Id.*

265. See, e.g., Kentaro Tamura, *Challenges to Japanese Compliance with the Basel Capital Accord*, 33 JAPANESE ECON., Spring 2005, at 23, 43-44.

Therefore, the primary force behind such prudential standards must be public, not private. Until the financial crisis, great power governments had little involvement with such rules, largely delegating the task to specialized regulators acting in TRNs such as the Basel Committee. The regulators, however, have complex incentives. After a crisis, they often are under considerable pressure from politicians and the public to adopt more stringent prudential rules. However, they must also consider the impact on their financial industry. As seen above, imposing stricter prudential standards unilaterally would undermine its competitiveness and produce a political backlash. The solution, when possible, is to cooperate with their counterparts abroad to adopt common standards. Thus, Singer argues that, in the late 1980s, the United States and United Kingdom faced simultaneous shocks to their banking industries as a result of losses caused by the Latin American debt crisis, thus creating legislative demand for higher standards. Unable to raise their standards unilaterally without undermining the competitiveness of their banks, they successfully pushed for the 1988 Basel Accord.²⁶⁶

As it turns out, however, Basel is highly exceptional. By contrast, IOSCO failed to create international capital standards for securities firms in the early 1990s, because only the United Kingdom was facing a crisis and supported the effort while the United States and Japan were indifferent or hostile.²⁶⁷ For its part, IAIS did not even attempt to develop international capital rules for insurers until the 2000s.²⁶⁸ Together, Singer's case studies suggest that uniform international prudential standards only succeed when several major jurisdictions face similar crises at the same time and are willing and able to compel others to join. Indeed, Basel remains the only major international prudential standard with quantitative objectives and a precise implementation timeline.

In sum, regulators rarely have both the incentives and the capacity to act collectively to strengthen prudential standards. This situation has several implications. First, the system is highly selective in choosing areas to address. In the absence of nearly simultaneous crises in major jurisdictions, coordinated adoption of stricter standards is unlikely to occur. Second, this is an area where quantity should not be equated with significance. Since agreement is difficult to reach, numerous "codes of conduct" and "best practices"—particularly those adopted by IOSCO—tend to be phrased at a high level of generality, lay out multiple options reflecting existing national practices, and lack implementation timelines.²⁶⁹ Third, as crises recede and prosperity returns, the domestic political balance shifts back towards competitiveness. In other words, crises cause the regulators' long-term interest in financial stability and short-term interest in satisfying political pressures to converge, but soon they start diverging again.²⁷⁰

266. See GOODHART, *supra* note 72, at 167–81; SINGER, *supra* note 71, at 21, 32.

267. See SINGER, *supra* note 71, at 68–69. Singer suggests that such an accord might have been desirable. See *id.* at 71–72. The failure (or near failure) of several highly leveraged U.S. securities firms in 2008 (Bear Stearns, Lehman Brothers and Merrill Lynch) suggests as much.

268. See *id.* at 111.

269. See PORTER, *supra* note 64, at 82.

270. BRAITHWAITE & DRAHOS, *supra* note 58, at 133. Even in the aftermath of a crisis, pressures to promote economic recovery may preempt efforts to strengthen prudential

International prudential standards, which are nonbinding and lack effective enforcement, become vulnerable as regulators begin to cede to domestic pressures. This, in turn, creates pressure on other regulators to relax the standards as well.

This relaxation can take several forms. The first is noncompliance: national regulators have many ways to allow their firms to avoid complying with the letter or spirit of the international standard. In some cases, noncompliance is overt, as illustrated by the fate of the Basel Accord in the 1990s and 2000s. As the banking crises in the United States and United Kingdom subsided, Japan faced its own prolonged downturn. By the mid-1990s, peer regulators knew that Japanese regulators allowed their banks to massively overestimate their capital, which was in fact well below Basel requirements.²⁷¹ They likely were willing to tolerate this situation to allow Japanese banks to “grow out” of the crisis, and because they were no longer an important competitive threat. During that period, regulators also repeatedly ceded to industry pressure to allow dubious instruments to be counted as regulatory capital.²⁷² Thus, Germany’s admission of some preferred stock was contrary to the Accord, but other regulators could not compel Germany to comply, and by that time their own domestic politics also favored relaxation of Basel.²⁷³

Even when peer regulators care about compliance, however, it is nearly impossible to monitor and enforce with the tools available in the current IFR system. A country may remain in formal compliance—that is, its laws and regulations might follow international standards—while allowing widespread substantive noncompliance by its firms. This problem is aggravated by the fact that, to be effective, financial regulation requires constant and vigilant supervision and enforcement.²⁷⁴ A national regulator under political pressure to relax regulation does not have to change the rules; it can quietly instruct examiners to be less zealous, reduce supervision and enforcement resources, or commit “sins of omission” by failing to exercise authority it possesses.²⁷⁵ This relaxation can also happen incrementally through highly technical agency interpretations. Thus, in the 1990s and 2000s, the Office of the Comptroller of the Currency and Federal Reserve gradually allowed U.S. banks to expand their subprime mortgage and over-the-counter (OTC) derivatives activities through numerous, obscure regulatory

regulation. Tamura, *supra* note 265, at 44–45. In the United States, there is ample anecdotal evidence of pressure from the financial industry to relax many proposed rules implementing the Dodd-Frank Act. *See, e.g.*, Ben Protess, *Wall Street Lobbyist Aims to ‘Reform the Reform,’* N.Y. TIMES DEALBOOK (July 14, 2011, 11:06 AM), <http://dealbook.nytimes.com/2011/07/14/wall-street-lobbyists-try-to-reform-the-reform/>.

271. *See* Verdier, *supra* note 2, at 138.

272. *Id.* at 137–39.

273. *See id.* at 138.

274. The literature on IFR has only recently begun to take seriously the problem involved in implementation and enforcement of standards and to attempt to develop adequate quantitative measures. *See generally* Carvajal & Elliott, *supra* note 246; John C. Coffee, Jr., *Law and the Market: The Impact of Enforcement*, 156 U. PA. L. REV. 229 (2007); Howell E. Jackson & Mark J. Roe, *Public and Private Enforcement of Securities Laws: Resource-Based Evidence*, 93 J. FIN. ECON. 207 (2009). Recent empirical research confirms that “the success of regulation depends critically on how regulation is implemented and enforced and not just on how it is designed.” Christensen et al., *supra* note 252, at 36.

275. *See* Gerding, *supra* note 260, at 44.

rulings.²⁷⁶ The cumulative implications of these small steps are hard to detect and understand even for domestic regulators, let alone for foreign observers.

The second form of relaxation is that, over time, the TRNs themselves may simply modify the standards to reduce the burden on financial firms. This may even happen without any formal amendment of the standards if regulators, anticipating that domestic politics will shift over time, built flexibility into the initial agreement. For instance, Basel I gave national regulators substantial discretion to adjust their definition of regulatory capital, so many of the relaxations demanded by banks could be granted without breaching the Accord.²⁷⁷ Eventually, this flexibility was insufficient and regulators embarked upon a major reform effort. Basel II, in the end, substantially expanded national discretion. It is far more complex than Basel I, and contains numerous areas where regulators may choose among various options. It also gives them enormous discretion in assessing the adequacy of their banks' internal risk measurement systems. Unsurprisingly, Basel II was strongly supported by the largest international banks, in the expectation that it would allow them to reduce their capital levels.²⁷⁸ In sum, even in the exceptional cases where international prudential standards are adopted, they are vulnerable to changes in domestic politics, various forms of noncompliance, and modification by national regulators.

5. Making Credible Commitments to Overcome Time Inconsistency Problems

Finally, a fifth problem of unilateralism is that uncoordinated, self-interested actions by individual states can lead to inefficient outcomes. To avoid such situations, states may agree in advance to ensure they will cooperate to achieve a more efficient outcome. However, one obstacle to such agreements is the time inconsistency problem. It arises when an actor wishes to commit to a certain course of action, but the actor's preferences have shifted when the time comes to implement it. This shift, if anticipated by others, makes it impossible for the actor to credibly commit *ex ante*, and therefore precludes cooperation. A classic example relates to monetary policy. In the long term, a government may prefer to commit to a low-inflation policy; but when actual decisions on interest rates have to be made, it is likely to be swayed by short-term political considerations. Market participants, in turn, know that the government's promise is not credible; they will anticipate higher inflation and make decisions accordingly, therefore negating the benefits of the low-inflation policy. This problem can sometimes be solved by creating mechanisms that allow actors to credibly bind themselves.²⁷⁹ Thus, many countries

276. See Saule T. Omarova, *From Gramm-Leach-Bliley to Dodd-Frank: The Unfulfilled Promise of Section 23A of the Federal Reserve Act*, 89 N.C. L. REV. 1683 (2011); Saule T. Omarova, *The Quiet Metamorphosis: How Derivatives Changed the "Business of Banking,"* 63 U. MIAMI L. REV. 1041 (2009).

277. See Verdier, *supra* note 2, at 138.

278. See TARULLO, *supra* note 2, at 101; Underhill & Zhang, *supra* note 186, at 546.

279. See, e.g., Kenneth A. Shepsle, *Discretion, Institutions, and the Problem of Government Commitment*, in SOCIAL THEORY FOR A CHANGING SOCIETY 245 (Pierre Bourdieu & James S. Coleman eds., 1991); Douglass C. North, *Institutions and Credible Commitment*, 149 J. INSTITUTIONAL & THEORETICAL ECON. 11 (1993); Pierson, *supra* note

have established independent central banks with a mandate to maintain price stability.

Time inconsistency problems also arise in IFR. One manifestation, as seen above, relates to compliance with international prudential standards. Since there is no reliable mechanism to enforce the standards, they are vulnerable to opportunistic defection. Another manifestation of the time inconsistency problem is that some desirable standards may never be adopted because regulators cannot credibly commit to following them in the future. This may be the case for cross-border bank insolvency. Fundamentally, the coordination of bank insolvencies can follow either universality or territoriality. Under a universal system, a single jurisdiction—say, that of the bank’s home office—conducts consolidated proceedings. Other jurisdictions defer to the home state’s decisions and turn over the bank’s assets in their territory. The home state authority marshals the assets and distributes them to the bank’s creditors worldwide. Under a territorial system, each jurisdiction where the bank has operations or assets conducts separate proceedings. Its authorities gather the local assets of the bank and use them to pay local creditors.²⁸⁰ They may then turn over any surplus to other jurisdictions. As a result, despite the fact that the bank is a single legal entity, creditors in different countries will recover more or less, depending on where its assets and liabilities were at the time of insolvency.

Most commentators argue that, *ex ante*, it would be more efficient for all states involved to agree to a universal system, along with arrangements to share the public costs of resolution among the relevant jurisdictions.²⁸¹ Nevertheless, most states apply a territorial approach,²⁸² and very little progress has been made on proposals to create a universal system.²⁸³ As the Governor of the Bank of England famously stated, “global banks are global in life but national in death.”²⁸⁴ Why? Here too, is a time inconsistency problem. Even if a universal system were in place, some states would have strong incentives to defect *ex post*, when a bank actually fails. This is because at the time of failure, some states will be revealed to hold more assets relative to local liabilities than others. If they turn over these assets to the universal proceeding, local creditors will recover less. At this point, there will be enormous political pressure from local creditors, often including the government itself, to refuse to comply with the universal system. As three U.S. banking officials

126, at 480.

280. See Thomas C. Baxter, Jr., Joyce M. Hansen, & Joseph H. Sommer, *Two Cheers for Territoriality: An Essay on International Bank Insolvency Law*, 78 AM. BANKR. L.J. 57, 60–62 (2004).

281. See, e.g., STIJN CLAESSENS, RICHARD J. HERRING, & DIRK SCHOENMAKER, A SAFER WORLD FINANCIAL SYSTEM: IMPROVING THE RESOLUTION OF SYSTEMIC INSTITUTIONS 85–87 (2010); JONATHAN FIECHTER, İNCI ÖTKER-ROBE, ANNA ILLYINA, MICHAEL HSU, ANDRÉ SANTOS, & JAY SURTI, SUBSIDIARIES OR BRANCHES: DOES ONE SIZE FIT ALL? 18 (IMF Staff Discussion Paper 2011). *But see* Baxter et al, *supra* note 280, at 88.

282. CROSS-BORDER BANK INSOLVENCY 170 (Rosa M. Lastra ed., 2011).

283. The European Union has adopted a universal resolution system, but it only applies within the Union. See Georgina Peters, *Developments in the EU*, in CROSS-BORDER BANK INSOLVENCY, *supra* note 282, at 128.

284. Adair Turner, Chairman, FSA, Turner Review Press Conference: Speaking Notes and Slides for the Press (Mar. 18, 2009), available at http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2009/0318_at.shtml (quoting Bank of England Governor Mervyn King).

wrote, “when times are rough, [supervisors] will think like administrative officials, rather than judges. They will grab whatever they can.”²⁸⁵ These incentives make agreement on a universal resolution system virtually impossible *ex ante* because regulators will not believe each other’s promise to turn assets over to foreign proceedings or abide by burden-sharing agreements.

As a result, the territorial system, though inefficient, has not been surmounted by non-binding international standards. Instead, territoriality has become more entrenched. The United States applies a “ring-fencing” approach to U.S. branches of foreign banks, under which not only the assets of the branch, but even assets in the United States owned by the home office, are allocated first to the U.S. branch’s creditors.²⁸⁶ The European Union, for its part, has adopted a universal system for banks headquartered in one member state with branches in others, but it does not apply to non-EU banks.²⁸⁷ Moreover, host states often require foreign banks to establish pledge accounts or maintain minimum assets in their jurisdiction, impose restrictions on transactions with foreign branches or affiliates, and decline to recognize claims arising from such transactions.²⁸⁸ These requirements are meant to ensure that there will be local assets to compensate local creditors.

These rules create inefficiency in global banking: by making recovery dependent on where the transaction was “booked,” where assets are located at the time of insolvency, and what the priority rules are in each jurisdiction, they increase the cost of credit for banks. The United States also prohibits branches of foreign banks from taking retail deposits, requiring separately capitalized U.S. subsidiaries for this purpose.²⁸⁹ This type of local capitalization requirement impairs efficient cross-border capital allocation by international banks through branching.²⁹⁰ Beyond these economic costs, the absence of agreement on cross-border resolution also undermines coordinated cross-border supervision by dissociating supervisory responsibility from financial responsibility. As a bank approaches insolvency, the problems worsen. Host supervisors may require banks to move additional capital to their jurisdiction, leading to conflict with the home state.²⁹¹ They may also trigger insolvency proceedings too quickly, fearing that

285. Baxter et al., *supra* note 280, at 88; *see also* BASEL COMM. ON BANKING SUPERVISION, REPORT AND RECOMMENDATIONS OF THE CROSS-BORDER BANK RESOLUTION GROUP 4 (2010) [hereinafter BCBS REPORT].

286. *See, e.g.*, 12 U.S.C. § 3102(j) (2006) (federal branches of foreign banks).

287. For those non-EU banks, individual member states are free to follow a territorial procedure. *See* CROSS-BORDER BANK INSOLVENCY, *supra* note 282, at 168.

288. *See* BCBS REPORT, *supra* note 285, at 16; BASEL COMM. ON BANKING SUPERVISION, THE INSOLVENCY LIQUIDATION OF A MULTINATIONAL BANK 8–9 (1992) [hereinafter BCBS, INSOLVENCY LIQUIDATION]; Eva Hüpkes & Diego Devos, *Cross-Border Bank Resolution: A Reform Agenda*, in INTERNATIONAL MONETARY AND FINANCIAL LAW 359 (Mario Giovanoli & Diego Devos eds., 2010).

289. *See* 12 U.S.C. § 3104(d) (2006).

290. *See* Richard J. Herring, *Conflicts Between Home & Host Country Prudential Supervisors*, in INTERNATIONAL FINANCIAL INSTABILITY: GLOBAL BANKING AND NATIONAL REGULATION 201, 203–04 (Douglas D. Evanoff, George G. Kaufman & John R. LaBrosse eds., 2007).

291. *See* FIN. SERVS. AUTH., THE TURNER REVIEW: A REGULATORY RESPONSE TO THE GLOBAL BANKING CRISIS 99 (2009).

assets will leave their jurisdiction.²⁹² Once the bank is insolvent, rival resolution proceedings may compete with each other to access assets in third countries, increasing transaction costs and reducing total recovery.²⁹³

Attempts to agree on other aspects of burden-sharing for financial firms have also failed. Early in the history of the Basel Committee, some participants argued that the Concordat should explicitly allocate the responsibility to act as lender of last resort for international banks.²⁹⁴ The Committee could not agree, leaving “calculated vagueness surrounding official arrangements to deal with an international banking crisis.”²⁹⁵ Likewise, international standards never addressed the allocation of responsibility between the home and host state for insuring deposits held in foreign branches, leaving the outcome to be decided by national authorities. Sometimes they protect foreign deposits, sometimes not. Often, the decision is made on a case-by-case basis and is influenced by political considerations. Thus, Iceland initially declined to indemnify foreign depositors when its banks collapsed.²⁹⁶ Host countries, for their part, act unilaterally by requiring foreign bank branches to join their own insurance regimes or set up separate subsidiaries to take retail deposits.²⁹⁷ In sum, because regulators cannot credibly commit themselves to comply with ex ante arrangements under the current informal IFR system, they instead take less efficient and potentially counterproductive unilateral actions.

If states could achieve joint gains through credible ex ante commitments, why do they not create stronger mechanisms to enforce such commitments? Once again,

292. See BCBS, *INSOLVENCY LIQUIDATION*, *supra* 288, at 9.

293. See *id.* at 13–14.

294. See GOODHART, *supra* note 72, at 35–40.

295. Jack Guttentag & Richard Herring, *The Lender of Last Resort Function in an International Context* 28 (The Wharton School, Working Paper No. 9-81, 1983). The G-10 central bankers had previously released a communiqué aimed at reassuring markets by stating that “means are available for that purpose and will be used if and when necessary.” *Id.* (quoting Basel Committee on Banking Supervision, Press Communiqué of Sept. 10, 1974); see also HELLEINER, *supra* note 18, at 173. There were some reports that the central bankers had confidentially agreed to a more detailed allocation of responsibility, but this was never confirmed, and major central banks strongly resisted the idea. See KAPSTEIN, *supra* note 70, at 42–43; Guttentag & Herring, *supra*, at 28–32. When Banco Ambrosiano failed in 1982, the Bank of Italy did not consider itself bound to provide lender-of-last-resort facilities to a foreign subsidiary conducting Euromarkets operations. The Chairman of the Basel Committee supported that position, stating that the Concordat related “to supervisory responsibilities, not lender of last resort responsibilities.” KAPSTEIN, *supra* note 70, at 54 (emphasis omitted). The 1983 Concordat clarified this point by explicitly carving out the lender-of-last-resort function. See BASEL COMM. ON BANKING SUPERVISION, *PRINCIPLES FOR THE SUPERVISION OF BANKS’ FOREIGN ESTABLISHMENTS 1* (1983) [hereinafter BCBS, *PRINCIPLES*].

296. Iceland had obligations arising from its membership in the European Economic Area, but they did not clearly require it to fund the coverage. See Michael Waibel, *Iceland’s Financial Crisis—Quo Vadis International Law*, ASIL Insights (Mar. 1, 2010), <http://www.asil.org/files/insight100301pdf.pdf>.

297. Bailouts for international banks are also typically along national lines. See FIN. SERVS. AUTH., *supra* note 291, at 97.

political factors suggest an explanation. First, national regulators currently have extensive and largely discretionary authority to resolve failed banks, which they may be reluctant to relinquish under a binding universal resolution scheme. Also, since the regime would likely be treaty based, it would involve complex negotiations and direct involvement by the executive and legislature, and regulators would lack control over the outcome. Second, the interests of large international banks are somewhat ambiguous, making them unlikely to provide strong support for such an initiative. On the one hand, they might benefit from efficiency gains if they could freely allocate their worldwide capital through branching, and greater certainty for creditors might reduce their cost of funds. On the other hand, without an explicit international allocation of responsibility for bank failures, large financial firms may benefit from a market perception that they are more likely to be provided assistance because of their systemic importance.²⁹⁸ Finally, while a universal system would likely produce benefits for all, the great powers might benefit relatively less than others. This is because they are better equipped to make the best of the unilateral “race for assets”: given the importance of their financial markets and infrastructure, international banks are more likely to have assets on their territory. These governments also have more economic and political leverage to force banks to maintain assets locally by forming separate subsidiaries, pledging accounts, and observing minimum asset requirements.

C. *Why Soft Law and TRNs?*

In sum, the current system based on TRNs and soft law is relatively successful at enforcement cooperation and liberalization. However, it has struggled to secure cooperation from countries with powerful anti-reform constituencies, as well as to consistently improve prudential standards. It has also largely ignored areas where cooperation would require credible commitment mechanisms.²⁹⁹ Given these limitations, it is conceivable that alternative arrangements—such as treaties, formal organizations, or dispute resolution—would produce more effective cooperation. Indeed, such arrangements are the rule in many other areas, including international trade, the environment, and the law of the sea.³⁰⁰ Why, then, do TRNs and soft law dominate IFR?

298. See Guttentag & Herring, *supra* note 295, at 27–28.

299. See *infra* Table 1.

300. See, e.g., Marrakesh Agreement Establishing the World Trade Organization, Apr. 15, 1994, 1867 U.N.T.S. 154, 33 I.L.M. 1144 (1994); U.N. Framework Convention on Climate Change art. 1(2), opened for signature May 9, 1992, 1771 U.N.T.S. 107; United Nations Convention on the Law of the Sea, Dec. 10, 1982, 1833 U.N.T.S. 397.

Table 1: Outcomes of International Financial Regulation

	Regulators	Large Firms	Great Powers	Outcome
Enforcement/Supervisory Cooperation	++	~	+	++
Liberalization	~	++	+	+
Improving Regulation in Specific Countries	~	~	+	~
Adopting Stricter Prudential Standards	~ to ++ (varies)	--	~ to ++ (varies)	-
Committing to Cross-Border Resolution	~	~	~	--

Key: ++ = strongly positive; + = positive; ~ = neutral/indifferent; - = negative; -- = strongly negative.

The conventional answer draws on rationalist theories of international law, according to which states choose soft law and informal institutions for reasons of speed, flexibility, and expertise. As seen above, however, the history of IFR indicates that soft law and TRNs first emerged in response to the absence of a formal institutional framework to address new cross-border regulatory challenges after Bretton Woods collapsed. In turn, this suggests that their persistence may be a product of historical path dependence. The current IFR system empowers certain categories of political actors—regulators, large firms, and great powers—which in turn have an interest in sustaining that system, even though it may be inefficient at achieving some desirable international regulatory objectives.

In this respect, specialized regulators are inherently conflicted. While they want regulation to be sufficiently effective to avoid legislative intervention, they also prefer to act unilaterally whenever possible and, when cooperation is necessary, to preserve as much discretion and flexibility as possible. From their perspective, TRNs and soft law are appealing. They provide some degree of cross-border supervision and enforcement coordination while preserving their discretion to withhold cooperation in politically sensitive cases. They provide a substantial degree of liberalization, thus promoting financial development and securing important support from large firms. They can also produce some coordinated strengthening of prudential regulation in response to major crises, while preserving the flexibility to adjust stringency as domestic political winds shift back towards competitiveness. Therefore, from the regulators' private perspective, soft law and TRNs reconcile their wish to achieve short-term regulatory objectives with their desire to preserve their domestic authority and flexibility.

By contrast, more binding mechanisms would encroach considerably upon that authority and flexibility. First, national regulators typically lack the legal authority to commit their state to costly future courses of action, such as deferring to universal bank resolution proceedings. Therefore, such commitments would often require a change in law, inviting legislative intervention in their traditional responsibilities and removing the discretion they currently have in dealing with such situations. Second, creating institutions or treaties would also involve the

executive branch in their turf. For instance, U.S. agencies cannot enter into binding international commitments without approval by the State Department.³⁰¹ Third, once adopted, more robust international standards and institutions would take away some of their authority and discretion. They might no longer be able to navigate competing domestic political pressures, for instance pressures from industry to relax regulatory stringency as financial crises recede in time. Stronger monitoring and enforcement of international standards would also involve international experts reviewing and second-guessing their actions, creating the potential for embarrassment (and perhaps sanctions).

In any event, the areas in which TRNs and soft law are unsuccessful are of less immediate concern to regulators. Specialized regulators in major jurisdictions are not held responsible for the costs caused by poor regulation in LDCs and OFCs. While some of these costs are externalized, they are borne by the IFIs, governments, and taxpayers in the contributing countries, not by financial regulators. Likewise, the lack of effective monitoring and enforcement of prudential standards may over time force them to loosen their own regulation, but they may well prefer this outcome to more rigid standards that would expose them to political pressure in good economic times. Likewise, the lack of an international regime for bank resolution is inefficient, but this problem is chronic rather than acute. When these inefficiencies are pointed out, regulators can argue that only a treaty could secure better outcomes, while stressing the political and technical obstacles. In other words, since specialized regulators are not directly accountable for failures in areas where IFR performs poorly, and they prefer to preserve as much authority and discretion as possible, they have little incentive to strive for a more formal and binding IFR system.

Large financial firms, for their part, are likely to be satisfied with the current system because it is successful at achieving the objectives they favor—such as liberalization—and unsuccessful at those they disfavor—such as strengthening prudential regulation. While they might gain from deeper harmonization under a more robust IFR system, this benefit would likely be outweighed by the costs of stricter prudential regulation. Likewise, a universal resolution mechanism would allow them to better allocate their capital, but it would also compromise the competitive benefits they derive from the implicit safety net.³⁰² Moreover, their influence is self-reinforcing: as financial liberalization progresses, large firms gain market share and political influence from smaller, domestically oriented firms that oppose liberalization. Therefore, they prefer to advocate liberalization initiatives within the current system, rather than more formal treaties and institutions that might expose them to stricter regulation.

Finally, since the great powers are in a better position to act unilaterally than other countries, they benefit relatively less from cooperation. Their markets are larger and inherently attractive, giving them greater flexibility to adjust their

301. Regulators are also often divided at the national level, for example, insurance regulators in the United States, but they can join TRNs individually without losing their autonomy. See David Andrew Singer, *Uncertain Leadership: The US Regulatory Response to the Global Financial Crisis*, in *GLOBAL FINANCE IN CRISIS* 93 (Eric Helleiner, Stefano Pagliari & Hubert Zimmermann eds., 2010); Brown, *supra* note 110.

302. See *supra* note 298 and accompanying text.

regulation according to domestic needs. Because of the size of their markets and the prestige of their regulators, their standards are more likely to spread to other countries through market pressures and ideological diffusion without requiring formal cooperation. When necessary to control externalities, they can often act unilaterally or through clubs, rather than resorting to broad-based cooperation. For instance, the United States pursued a protracted unilateral campaign against Swiss banks to reduce tax avoidance, and eventually secured substantial cooperation.³⁰³ Great powers also have less need for a universal system of bank resolution, because banks are more likely to have assets in their jurisdiction. Where cooperation is needed, great powers prefer to avoid formal, independent IOs.³⁰⁴ Rather, they steer standard-setting to less formal bodies like TRNs and then deputize formal IOs or clubs to monitor and enforce the standards as needed.³⁰⁵

Thus, all three of the most influential political actors—regulators, firms, and great powers—have reasons to prefer the current system. This suggests that it may persist despite its inefficiency. At this point, however, an important clarification is needed. This Article does not claim that all the unsolved problems of IFR could be solved with certainty by treaties or formal international organizations. It may be that some problems are simply intractable. For example, agreeing on an ex ante burden-sharing formula for banks, or creating rules to designate the home jurisdiction for insolvency proceedings, would undoubtedly be difficult. The benefits of facilitating cross-border branching may also be limited given the availability of alternative channels for capital flows.³⁰⁶ The great powers may do so well out of territoriality that they would not agree to universality under any circumstances. In that case, the problem would be a true deadlock that no institutional solution could solve.³⁰⁷ The claim, then, is not that hard law or institutions would be desirable in all cases, but that there are strong historical and political factors that favor soft law and TRNs and hinder the emergence of other arrangements. As a result, undersupply of welfare-enhancing cooperation in IFR is more likely than oversupply.

IV. INTERNATIONAL FINANCIAL REGULATION AFTER THE CRISIS

A. How Did the Crisis Affect IFR?

The global financial crisis has had two major implications for IFR. First, prudential regulation, systemic risk, and moral hazard concerns have taken center

303. See, e.g., Bradley J. Bondi, *Don't Tread On Me: Has the United States Government's Quest for Customer Records from UBS Sounded the Death Knell for Swiss Bank Secrecy Laws?*, 30 NW. J. INT'L L. & BUS. 1, 7–13 (2010).

304. See Benvenisti & Downs, *supra* note 197, at 614.

305. See DREZNER, *supra* note 94, at 71–85.

306. In the domestic context, however, there is evidence suggesting that cross-border branching retains efficiency advantages over holding company structures. See Prasad Krishnamurthy, *Banking Market Integration and Firm Growth* (Sept. 20, 2012) (unpublished manuscript), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2149904.

307. On deadlock, see DREZNER, *supra* note 94; see also Anu Bradford, *International Antitrust Negotiations and the False Hope of the WTO*, 48 HARV. INT'L L.J. 383 (2007).

stage. The failure of several major institutions and the struggle by governments to manage the consequences drew attention to critical weaknesses in financial markets. These included high leverage, widespread liquidity vulnerabilities, lack of transparency of positions, inadequate risk analysis, and interconnected exposures among market participants.³⁰⁸ The sum of these weaknesses is “systemic risk,” the risk that the failure of one or more financial institutions can cause a cascading failure that leads to the collapse of the financial system.³⁰⁹ Financial institutions can be systemically significant for several reasons: some are so large that their failure affects many other market participants, others are extensively interconnected with others through financial contracts, and clusters of institutions with highly correlated exposures can be systemically significant in aggregate. Because the failure of such institutions could cause extensive economic damage, governments come under pressure to rescue them. Since these institutions know this, they have ex ante incentives to take excessive risks, a phenomenon known as moral hazard. Other market participants also expect that these institutions will not be allowed to fail and deal with them on favorable terms, exacerbating their systemic importance.³¹⁰

As a result, controlling systemic risk and moral hazard has become the central concern of post-crisis financial reform.³¹¹ Numerous approaches have been proposed: identifying systemically significant financial institutions (SSFIs) and subjecting them to enhanced prudential regulation and supervision; limiting their size or activities; establishing a credible resolution procedure for SSFIs; prohibiting

308. See Viral V. Acharya, Thomas Philippon, Matthew Richardson & Nouriel Roubini, *The Financial Crisis of 2007-2009: Causes and Remedies*, in *RESTORING FINANCIAL STABILITY: HOW TO REPAIR A FAILED SYSTEM* 1, 1–25 (Viral V. Acharya & Matthew Richardson eds., 2009).

309. Several definitions of systemic risk have been proposed in the economic and legal literature. See Steven L. Schwarcz, *Systemic Risk*, 97 *GEO. L.J.* 193 (2008). For purposes of this Article, it is not necessary to take a position on all the controversies involved.

310. There is growing, albeit still tentative, empirical evidence that: (1) CRA ratings of “too big to fail” (TBTF) banks take favorably into account the likelihood of bailouts, see Bertrand Rime, Do “Too Big to Fail” Expectations Boost Large Banks Issuer Ratings? (May 9, 2005) (unpublished working paper); Kenichi Ueda & Beatrice Weder di Mauro, *Quantifying Structural Subsidy Values for Systemically Important Financial Institutions* (International Monetary Fund, Working Paper WP/12/128, 2012); (2) TBTF banks have a lower cost of funding than other banks, controlling for other factors, see Joseph P. Hughes & Loretta J. Mester, *A Quality and Risk-Adjusted Cost Function for Banks: Evidence on the “Too-Big-To-Fail” Doctrine*, 4 *J. PRODUCTIVITY ANALYSIS* 293 (1993); Viral V. Acharya, Deniz Anginer & A. Joseph Warburton, *The End of Market Discipline? Investor Expectations of Implicit State Guarantees* (March 18, 2013) (unpublished working paper); (3) banks pay a premium for mergers that make them TBTF, see Elijah Brewer III & Julapa Jagtiani, *How Much Did Banks Pay to Become Too-Big-to-Fail and to Become Systemically Important?* (Federal Reserve Bank of Philadelphia, Working Paper No. 11-37, 2009); and (4) TBTF banks had a competitive advantage in attracting uninsured deposit during the crisis, see Raquel de F. Oliveira, Rafael F. Schiozer, & Lucas A. B. de C. Barros, *Financial Crisis and Cross-Border Too Big to Fail Perception*, (Sept. 15, 2011) (unpublished working paper).

311. See, e.g., G20 Seoul Summit 2010, *The Seoul Summit Document* para. 30, <http://www.g20.utoronto.ca/2010/g20seoul-doc.pdf>.

government bailouts to SSFIs; and regulating financial contracts that may create systemic risk, such as OTC derivatives. Other post-crisis measures aim at improving prudential regulation more generally, such as raising bank capital requirements and expanding the regulatory net to the shadow banking system.³¹² Each of these approaches is complex, and their relative effectiveness is debated. However, they share one fundamental objective: to force systemic institutions and market participants to internalize costs that would otherwise be borne by governments and taxpayers. In other words, they are precisely the type of stricter prudential regulation that IFR has historically failed to deliver consistently.

Second, the crisis has led to a major effort to update the architecture of IFR and develop new substantive international standards. The G-20, which had been created after the Asian financial crisis but played a marginal role, supplanted the G-7 as the principal forum for international economic cooperation.³¹³ It has taken a more direct role in setting priorities for regulatory reform and coordinating the work of TRNs, IFIs, and other actors.³¹⁴ It reorganized the Financial Stability Forum as the Financial Stability Board, with a broader mandate and membership, including all G-20 members.³¹⁵ The FSB's mission is to coordinate and oversee the work of other standard-setting bodies, and in some cases to develop new standards itself in areas that cut across the mandate of individual TRNs.³¹⁶ The Basel Committee and IOSCO's Technical Committee also expanded their membership.³¹⁷ The G-20 has adopted a detailed action plan for reforming IFR, including initiatives on capital adequacy, cross-border resolution, regulation of rating agencies, hedge funds and OTC derivatives, global accounting standards, executive compensation, and many others.³¹⁸ One feature of many of these initiatives is the decline in reliance on private standards and self-regulation in favor of mandatory rules.³¹⁹ The actual standard-setting work, however, typically remains in the hands of national regulators and TRNs.³²⁰

Thus, the post-crisis reforms do not fundamentally replace TRNs and soft law, but rather attempt to expand, rationalize, and strengthen the existing system in

312. On shadow banking, see Gerding, *supra* note 260.

313. See REBECCA M. NELSON, CONGRESSIONAL RESEARCH SERVICE, THE G-20 AND INTERNATIONAL ECONOMIC COOPERATION: BACKGROUND AND IMPLICATIONS FOR CONGRESS (2010); Mario Giovanoli, *The Reform of the International Financial Architecture After the Global Crisis*, 42 N.Y.U. J. INT'L L. & POL. 81 (2009).

314. See NELSON, *supra* note 313; Giovanoli, *supra* note 313.

315. See FINANCIAL STABILITY BOARD CHARTER, G-20 (2009).

316. See Giovanoli, *supra* note 313, at 113–14.

317. See Basel Committee on Banking Supervision, Expansion of Membership Announced by the Basel Committee (Mar. 13, 2009), <http://www.bis.org/press/p090313.htm>; IOSCO, IOSCO Technical Committee Invites Brazil, China and India to Join Its Membership (Feb. 19, 2009), <http://www.iosco.org/news/pdf/IOSCONEWS136.pdf>.

318. See PROGRESS REPORT ON THE ECONOMIC AND FINANCIAL ACTIONS OF THE LONDON, WASHINGTON, AND PITTSBURGH G20 SUMMITS (2010).

319. See Eric Helleiner & Stefano Pagliari, *Crisis and the Reform of International Financial Regulation*, in GLOBAL FINANCE IN CRISIS: THE POLITICS OF INTERNATIONAL REGULATORY CHANGE 1, 4, 6–8 (Eric Helleiner, Stefano Pagliari, & Hubert Zimmermann eds., 2010).

320. See Giovanoli, *supra* note 313, at 98–117.

various ways.³²¹ Nevertheless, the assumption by the G-20 of authority over IFR is an important structural development. The G-20 is not a TRN; it is a political body made up of the national leaders (or ministers) of the member states. However, it is not a formal international organization either.³²² Like TRNs, the G-20 does not have international legal personality, its decisions are made by consensus, and they are not legally binding.³²³ In theory, it has no formal authority to set goals for IFIs and TRNs. In practice, however, the G-20 members collectively control a large majority of votes in the IFIs,³²⁴ their financial regulators dominate the principal TRNs, and they comprise about 85% of the world's GDP.³²⁵ Thus, the G-20 has the capacity to exercise enormous influence on IFR and potentially overcome the constraints that have hindered progress in the past. It could play a leadership role, compelling TRNs to undertake reforms that they would not initiate on their own because of resistance by national regulators or the financial industry.³²⁶ With its broader membership, it could also balance the influence of the great powers. It could facilitate trade-offs across issues, overcoming distributive roadblocks that specialized TRNs cannot handle, and better handle issues that cut across the functional jurisdiction of individual TRNs, like OTC derivatives and shadow banking. The new system could also provide more effective monitoring and enforcement.

The potential effect of this new international architecture may be reinforced by the strong domestic political demand that has emerged for stronger prudential regulation after the financial crisis. In major financial centers like the United States, United Kingdom, and several Continental European countries, costly and well-publicized bailouts of financial institutions raised fierce political opposition and demands for reform. The salience of regulatory failures has been raised by multiple inquiries and reports criticizing the actions of regulators and the financial industry.³²⁷ In some cases, countries did not wait for an international consensus to emerge before launching major domestic regulatory overhauls. Thus, the Dodd-Frank Act was adopted in July 2010, and the massive program of rule making it initiated remains in full swing. The European Union has also already completed some initiatives, although its reform program has progressed more slowly due to

321. See Mario Giovanoli, *The International Financial Architecture and its Reform After the Global Crisis*, in INTERNATIONAL MONETARY AND FINANCIAL LAW: THE GLOBAL CRISIS 3, 36–37 (Mario Giovanoli & Diego Devos eds., 2010); Helleiner, *supra* note 67, at 632.

322. See Giovanoli, *supra* note 313, at 103–06.

323. See NELSON, *supra* note 313, at 8–9.

324. See Giovanoli, *supra* note 313, at 108.

325. See Landon Thomas Jr. & Julia Werdigier, *No Clear Accord on Stimulus by Top Industrial Nations*, N.Y. TIMES, Mar. 15, 2009, at A1.

326. Indeed, there were some early initiatives along these lines, as the G-20 pushed for new standards on executive compensation, a global bank tax, and regulation of CRAs and hedge funds. See Pagliari, *supra* note 125, at 15, 22, 29–30.

327. See, e.g., FIN. SERVS. AUTH., *supra* note 291; NATIONAL COMMISSION ON THE CAUSES OF THE FINANCIAL AND ECONOMIC CRISIS IN THE UNITED STATES, THE FINANCIAL CRISIS INQUIRY REPORT (2011); THE HIGH-LEVEL GROUP ON FINANCIAL SUPERVISION IN THE EU, REPORT (2009).

greater deference to the international process and competing preoccupations relating to Europe's sovereign debt crisis.

B. Post-Crisis Achievements

This section proposes a brief review of three salient items on the post-crisis agenda: enhanced capital regulation through Basel III, cross-border resolution of financial institutions, and stronger monitoring and enforcement of international standards.³²⁸ It shows that despite the expectations raised by the combination of strong political demand for reform and a more streamlined international architecture, many of the pre-crisis patterns described earlier in this Article persist.

1. Basel III

The G-20 made reforming capital adequacy standards a very high priority. Numerous banks failed, or would have failed, without official assistance, and many policymakers and commentators pointed to weaknesses in Basel II.³²⁹ The Basel Committee assumed responsibility over reform and made rapid progress. In December 2010, it released the principal elements of Basel III.³³⁰ The new framework aims to correct many of the problems of Basel II. It substantially increases required capital ratios and adopts more stringent and uniform definitions of regulatory capital. It also introduces several new elements that respond to risks highlighted by the crisis. Under Basel III, banks will have to maintain, in addition to the basic capital ratio, a capital conservation buffer to be drawn down in times of stress.³³¹

Basel III also introduces capital surcharges for “too big to fail” institutions, as well as a countercyclical buffer under which regulators will have flexibility to increase capital requirements to control excessive credit growth in favorable economic conditions.³³² These stronger risk-weighted capital requirements will be supplemented by a simpler and more transparent leverage ratio of 3% capital to total assets.³³³ Finally, Basel III will impose new liquidity requirements: the liquidity coverage ratio, which will require banks to hold enough highly liquid assets to survive a thirty-day freeze in funding, and the net stable funding ratio, which will require banks to maintain a minimum amount of stable sources of

328. These are not the only areas in which the post-crisis IFR reform agenda has encountered significant limitations. For a discussion of the discrepancies between the United States and European approaches to OTC derivatives reform, see Greene & Boehm, *supra* note 2, at 1127–30.

329. See, e.g., Giovanoli, *supra* note 313, at 87–88.

330. See BASEL COMM. ON BANKING SUPERVISION, *BASEL III: A GLOBAL REGULATORY FRAMEWORK FOR MORE RESILIENT BANKS AND BANKING SYSTEMS* (2010). A revised version was published in June 2011: BASEL COMM. ON BANKING SUPERVISION, *BASEL III: A GLOBAL REGULATORY FRAMEWORK FOR MORE RESILIENT BANKS AND BANKING SYSTEMS* (2011) [hereinafter *BASEL COMM.* (2011)].

331. See *BASEL COMM.* (2011), *supra* note 330, at 54–57.

332. See *id.* at 7, 57–60.

333. See *id.* at 61–63.

funding such as long-term debt and deposits.³³⁴ These ratios are meant to reduce banks' excessive reliance on short-term funding, which led to the downfall of institutions like Bear Stearns and Lehman Brothers when they unexpectedly lost access to such funding.

On its face, Basel III is a remarkable strengthening of capital requirements. The Basel Committee estimated that, had the new rules been in place at the end of 2009, large banks would have had to hold €577 billion of additional capital.³³⁵ Since the adoption of Basel III, banks have begun to rebuild their capital bases, and the gap between the new requirements and actual capital levels has reportedly fallen by 23% between 2011 and 2012.³³⁶ Basel III's stricter definition of regulatory capital will also strengthen the resilience of banks by preventing them from counting various dubious items like deferred tax assets, in favor of more common equity. Overall, policymakers have openly stated that their objective is to change the business model of banks towards a more stable, less leveraged, and less profitable one, attracting fierce industry resistance.³³⁷

In other ways, however, Basel III perpetuates pre-crisis patterns. First and most importantly, it does not replace Basel II's controversial risk-weighting methodology, but instead simply increases the percentage of capital to be held relative to the risk-weighted assets calculated according to Basel II.³³⁸ Thus, large banks will continue to internally generate the parameters used to calculate their own capital requirements. In recent years, this methodology has become increasingly controversial. Several analysts have pointed to large discrepancies in risk estimates produced by different banks based on similar asset portfolios.³³⁹ Likewise, senior regulators on both sides of the Atlantic have expressed severe doubts that the Basel II risk-weighting methodology can produce accurate and consistent measurements and have called for simpler regulatory solutions like a high leverage ratio or limits on bank size.³⁴⁰ While it seems unlikely that the Basel

334. *See id.* at 8–10.

335. *See* BASEL COMM. ON BANKING SUPERVISION, RESULTS OF THE COMPREHENSIVE QUANTITATIVE IMPACT STUDY (2010).

336. *See* Brooke Masters, *Top Banks Boost Key Capital Ratio Levels*, FIN. TIMES (London), Sept. 20, 2012.

337. *See* Tom Braithwaite, *JPMorgan Seeks Halt to New Capital Rules*, FIN. TIMES (Washington), June 16, 2011; Tom Braithwaite & Francisco Guerrero, *Regime Will Reshape Business Models*, FIN. TIMES (New York), Sept. 14, 2010; Yalman Onaran & Simon Clark, *European Banks Poised to Win Reprieve on Capital Rules*, BLOOMBERG (July 13, 2010, 7:00 PM), <http://www.bloomberg.com/news/2010-05-16/geithner-meeting-barnier-over-basel-iii-creates-pressure-on-banks-capital.html>.

338. *See supra* notes 105–07 and accompanying text. However, several specific aspects of Basel II's calculations that proved inadequate prior to the crisis, like the treatment of securitization exposures, have been revised.

339. *See, e.g.*, FIN. SERVS. AUTH., RESULTS OF 2009 HYPOTHETICAL PORTFOLIO EXERCISE FOR SOVEREIGNS, BANKS AND LARGE CORPORATIONS (2009); JAG YOGARAJAH, EXANE BNP PARIBAS, RISK WEIGHTS ON THE SKINNY SIDE? (2011); Brooke Masters, *Capital Rules: Regulators Seek to Harmonize Banks' Weighting Models*, FIN. TIMES, Apr. 13, 2012.

340. *See* Brooke Masters, *Basel Naysayers Delve into Detail in Battle to Dilute Reforms*, FIN. TIMES (U.S.), Sept. 25, 2012, at 2, (reporting criticism by Thomas Hoenig, a current FDIC director, and Andrew Haldane, a Bank of England official); Shahien Nasiripour &

Committee will abandon its current methodology, the lack of comparability is raising concerns that banks that apply it more leniently may gain a competitive advantage.

Second, Basel III might aggravate this comparability problem, because in addition to retaining considerable discretion for national regulators in approving and supervising internal risk models, it also introduces new areas of discretion. Thus, although there are common guidelines for implementing the countercyclical capital buffer, national authorities ultimately will decide how much additional capital to require based on their own judgment of the sustainable level of credit in their economy.³⁴¹ It is not hard to imagine that in good times, there will be political pressure to refrain from “taking away the punch bowl” by increasing the buffer. Likewise, the capital conservation buffer gives national regulators critical discretion as to how long to allow banks to operate within the buffer range.³⁴² Although the Committee exhorts regulators to apply them transparently and consistently, the liquidity ratios also admittedly “contain elements of national discretion to reflect jurisdiction-specific conditions.”³⁴³ Some degree of national discretion may be inevitable for complex international standards, but the fact remains that both complexity and discretion may further undermine comparability and make the standards vulnerable to domestic politics.

Third, the Basel III negotiations reflected the usual campaigning by countries to accommodate the preferences of their banks. France and Germany fought for lower capital increases and for inclusion of consolidated minority interests in foreign banks.³⁴⁴ Despite the resistance of European banks, the leverage ratio was retained, but at 3% it is significantly lower than the 5% requirement for major U.S. banks—leading to concerns that it will not compensate adequately for the defects of the risk-weighting methodology. Japanese banks tried to retain their ability to count

Tom Braithwaite, *US Regulators Urged to Outdo Basel III Rules*, FIN. TIMES (U.S.), Oct. 4, 2012, at 17 (reporting criticism by the Systemic Risk Council, a group led by Sheila Bair, the former FDIC chairman).

341. See BASEL COMM. ON BANKING SUPERVISION, BANK FOR INT’L SETTLEMENTS, GUIDANCE FOR NATIONAL AUTHORITIES OPERATING THE COUNTERCYCLICAL CAPITAL BUFFER (2010). The guidelines establish an objective “buffer guide,” but stress that the guide “does not need to play a dominant role in the information used by authorities to take and explain buffer decisions” and that they “are free to emphasise any other variables and qualitative information that make sense to them for purposes of assessing the sustainability of credit growth and the level of system-wide risk” *Id.* at 3; see also BASEL COMM. (2011), *supra* note 330, at 57–58.

342. See BASEL COMM. (2011), *supra* note 330, at 56.

343. *Id.* at 9; BASEL COMM. ON BANKING SUPERVISION, BANK FOR INT’L SETTLEMENTS, BASEL III: INTERNATIONAL FRAMEWORK FOR LIQUIDITY RISK MEASUREMENT, STANDARDS AND MONITORING 2, 3 (2010).

344. See Donna Borak, *Bair Details Inside Story of Regulatory Clash Over Basel III*, AM. BANKER, Sept. 26, 2012; Onaran & Clark, *supra* note 337. Some policymakers and commentators, including the heads of the Bank of England and the U.K. FSA, have suggested that capital ratios should be as high as 15–20%. Brooke Masters & Tom Braithwaite, *Basel III Capital Rules Too Low, Says Turner*, FIN. TIMES (London), Mar. 16, 2011, at 10; see also Francesco Guerrera & Daniel Pimlott, *Pandit and King Clash over Basel III*, FIN. TIMES, (Oct. 25, 2010, 11:54 PM), <http://www.ft.com/intl/cms/s/0/1d392ba0-e071-11df-99a3-00144feabdc0.html#axzz2QuntezGQ>.

deferred tax assets as regulatory capital, although they only gained a temporary reprieve. More controversial aspects of Basel III, like the systemic risk surcharge and liquidity requirements, were not finalized when the accord was released in 2010. The details remain to be filled in and many areas are highly controversial.

Finally, since Basel III must be implemented domestically in each jurisdiction, its adoption is only the beginning of a long and contentious process. It contemplates a long transition period, with full implementation in 2019. Already, the implementation process has become highly politicized. In the United States, regulators face strong opposition by banks. Jamie Dimon, the CEO of JPMorgan Chase, strongly criticized the systemic risk surcharge and other aspects of Basel III, calling it “blatantly anti-American.”³⁴⁵ More recently, numerous U.S. banks—large and small—have raised objections to the proposed rules and requested that implementation be delayed.³⁴⁶ In November 2012, U.S. banking regulators announced that the final rules would indeed be delayed indefinitely, missing the global deadline of January 1, 2013.³⁴⁷ In Europe, implementation of Basel III led to a political rift between the United Kingdom, which suffered high bailout costs and wanted faster and stricter implementation, and France and Germany, whose banks and economies are heavily affected by the ongoing European debt crisis.³⁴⁸ In the summer of 2012, the United Kingdom acceded to many French and German demands.³⁴⁹ The Basel Committee has criticized the resulting compromise, deeming it “noncompliant” with Basel III in two important areas including its looser capital definitions.³⁵⁰ Its implementation appears likely to be delayed beyond the international deadlines.³⁵¹

In sum, Basel III perpetuates a familiar pattern for international prudential standards: regulators, under intense domestic political pressure, agree to strengthen existing rules. At the same time, they secure concessions to favor their banks and rely on complex rules whose effectiveness depends on national supervision. Thus,

345. Tom Braithwaite & Patrick Jenkins, *JPMorgan Chief Says Bank Rules ‘Anti-US,’* FIN. TIMES (London), Sept. 12, 2011, at 1; see also Brooke Masters & Tom Braithwaite, *Tighter Rules on Capital: Bankers Versus Basel*, FIN. TIMES (Oct. 2, 2011, 10:20 PM), <http://www.ft.com/intl/cms/s/0/852fe7a4-eb4b-11e0-9a41-00144feab49a.html#axzz2QuntezGQ>.

346. Donna Borak, *Big Banks Press for More Time, Revisions on Basel III*, AM. BANKER, Oct. 29, 2012; see also Donna Borak, *Majority of Senate Demands Basel III Relief for Community Banks*, AM. BANKER, Sept. 28, 2012.

347. Donna Borak, *Community Banks Score Victory as U.S. Delays Basel III*, AM. BANKER, Nov. 13, 2012.

348. For a description of their positions, see Alex Barker & Brooke Masters, *EU Ministers Set for Clash over Banking Rules*, FIN. TIMES, May 1, 2012, at 2.

349. See Alex Barker, *Deal Reached on EU Bank Reforms*, FIN. TIMES (May 15, 2012, 8:41 PM), <http://www.ft.com/intl/cms/s/0/678bc4de-9eb5-11e1-9cc8-00144feabdc0.html#axzz2QuntezGQ>.

350. Brooke Masters & Alex Barker, *Inspectors Fault EU Bank Capital Plans*, FIN. TIMES (Oct. 1, 2012, 4:00 PM), <http://www.ft.com/intl/cms/s/0/5a2985c2-0bae011e20b8d8-00144feabdc0.html#axzz2QuntezGQ>.

351. See Jim Brunsten, *EU Said to Consider Delay in Basel Rules for Up to a Year*, BLOOMBERG (Oct. 12, 2012, 4:06 AM), <http://www.bloomberg.com/news/2012-10-11/eu-said-to-weigh-delaying-basel-bank-rules-for-up-to-a-year.html>.

they retain considerable discretion, including the capacity to relax implementation in response to political pressure.³⁵² Indeed, soon after the crisis, the industry began to reassert its influence and demand modifications to the most demanding aspects of the new rules—as did politicians who worried about the impact of stricter capital requirements on economic recovery. In turn, such modifications may increase competitive pressures on other regulators to relax their own implementation. Basel III also illustrates the role of path dependence for specific international standards: despite widespread criticism and well-recognized problems, the Basel II risk-weighting approach is deeply entrenched, and most regulators appear to see no feasible alternative but to build upon it.

2. Cross-Border Bank Resolution

At the London Summit, the G-20 directed the FSB, IMF, World Bank, and the Basel Committee to develop an international framework for cross-border bank resolution.³⁵³ So far, the results fall well short of this objective. Even before the crisis, experts believed that only a treaty could truly secure cooperation in this area.³⁵⁴ In a recent report, the Basel Committee echoes this view, stating that an enforceable agreement on burden-sharing “would be an essential element, along with other important changes in national legal frameworks, for the creation of a comprehensive framework for the resolution of cross-border financial groups.”³⁵⁵ Concluding that such an agreement is unfeasible in current circumstances, the BCBS and the IMF have effectively abandoned the initial goal of developing a comprehensive framework. Instead, they have adopted a less ambitious “middle ground” approach that recognizes that states will act unilaterally in a crisis, and tries to make such improvements as can be achieved without binding commitments.³⁵⁶

In practice, this means encouraging states to improve aspects of their domestic resolution procedures that may hinder cross-border resolution even where they wish to cooperate, for instance, by removing legal restrictions on voluntary cooperation, improving advanced planning for resolution of complex institutions, and facilitating continuity of services and contractual relationships. These standards would require assistance “only to the extent that the authorities determine that such

352. See Singer, *supra* note 301, at 104–05.

353. G20, DECLARATION ON STRENGTHENING THE FINANCIAL SYSTEM—LONDON SUMMIT 2 (2009); see also PROGRESS REPORT ON THE ACTIONS OF THE LONDON AND WASHINGTON G20 SUMMITS 11 (2009).

354. See, e.g., CROSS-BORDER BANK INSOLVENCY, *supra* note 282, at 184.

355. BCBS REPORT, *supra* note 285, at 4. The IMF has expressed similar views; see INT’L MONETARY FUND, RESOLUTION OF CROSS-BORDER BANKS—A PROPOSED FRAMEWORK FOR ENHANCED COORDINATION (2010).

356. BCBS REPORT, *supra* note 285, at 19. Later G20 documents reflect this more limited objective. See, e.g., G20, LEADERS’ STATEMENT, THE PITTSBURGH SUMMIT 9 (2010); G20, THE G20 SEOUL SUMMIT LEADERS’ DECLARATION 8 (2010); G20, THE G20 TORONTO SUMMIT DECLARATION 17–18 (2010). For a defense of this approach, see Hüpkes & Devos, *supra* note 288.

co-ordination is consistent with their own national interests.”³⁵⁷ The Basel Committee candidly concluded in July 2011 that “[t]here has been no progress towards the development of a framework for cross-border enforcement of resolution actions[.]”³⁵⁸ Even within the new, more limited objectives, results so far are modest.³⁵⁹ More ambitious projects, such as ex ante burden-sharing agreements for specific institutions, remain on the table but their prospects are unclear.³⁶⁰

Once again, familiar patterns persist. The IFR system struggles to address the commitment problem involved in developing arrangements for resolution and burden sharing for cross-border financial firms. Interestingly, some of the largest financial firms appear to have concluded that the benefits of a stronger resolution regime would outweigh its costs. Thus, several large banks and industry groups have called for binding international rules on cross-border resolution.³⁶¹ Despite this, while the need for greater cooperation is widely accepted, progress appears stalled by the lack of interest on the part of national regulators and great powers in relinquishing their discretion to address failures on an ad hoc basis.

3. Monitoring and Enforcement

The G-20 has also initiated efforts to strengthen monitoring and enforcement of international standards. As seen above, the FSAP program historically targeted developing countries, but the gravest pre-crisis regulatory failures occurred in advanced economies. At the Washington Summit, all G-20 members committed to undertake FSAP reviews. Since then, the IMF has launched a process to identify all systemically important national financial systems and conduct mandatory FSAPs every five years, and FSB members have committed themselves to “peer reviews” of their adherence to FSAP recommendations.³⁶² These country peer reviews will focus on implementation and effectiveness of regulatory, supervisory, and other financial sector policies; the reports will be published; and the FSB will follow up on recommendations.³⁶³ The FSB will also conduct thematic peer reviews of the implementation of specific standards across countries, although individual TRNs

357. INT’L MONETARY FUND, *supra* note 355, at 18.

358. BASEL COMM. ON BANKING SUPERVISION, BANK FOR INT’L SETTLEMENTS, RESOLUTION POLICIES AND FRAMEWORKS—PROGRESS SO FAR 5 (2011).

359. *See id.* at 31–39; FIN. STABILITY BD., PROGRESS IN IMPLEMENTING THE G20 RECOMMENDATIONS ON FINANCIAL REGULATORY REFORM 4 (2012).

360. In July 2011, the FSB released a consultative document that appears to set more ambitious goals for the cross-border resolution regime. *See* FIN. STABILITY BD., EFFECTIVE RESOLUTION OF SYSTEMICALLY IMPORTANT FINANCIAL INSTITUTIONS 29–30, 45, 69–70 (2011). At this point, the prospects of these proposals are unclear. They are also carefully hedged to preserve the host state’s discretion to prefer local creditors. *See id.* at 29, cls. 8.4, 8.6.

361. *See* Greene & Boehm, *supra* note 2, at 1130.

362. *See* INT’L MONETARY FUND, INTEGRATING STABILITY ASSESSMENTS UNDER THE FINANCIAL SECTOR ASSESSMENT PROGRAM INTO ARTICLE IV SURVEILLANCE (2010).

363. *See* FIN. STABILITY BD., FSB FRAMEWORK FOR STRENGTHENING ADHERENCE TO INTERNATIONAL STANDARDS 2 (2010) [hereinafter FSB FRAMEWORK (2010)]; FIN. STABILITY BD., HANDBOOK FOR FSB PEER REVIEWS (2011) [hereinafter FSB HANDBOOK].

like the Basel Committee and IOSCO will have primary responsibility for peer review of standards they designed.³⁶⁴

This new process is still in its infancy, and how much it will achieve remains unclear. On the one hand, it promises more frequent evaluations by peers with direct regulatory expertise, which may alleviate the shortcomings of existing IFI oversight. It also puts pressure on existing TRNs to improve their monitoring, since the FSB expects them to have “robust peer review mechanism[s] in place that [are] comparable to th[ose] of the FSB.”³⁶⁵ On the other hand, the peer review system has substantial limitations. The country reviews’ principal goal is to assess progress in addressing recommendations in FSAP and ROSC reports, not to independently evaluate the country’s compliance with international standards.³⁶⁶ A country that is found “compliant” or “largely compliant” by the IMF will not require further evaluation. In securities regulation, signature of the IOSCO MMOU will be considered sufficient.³⁶⁷ Based on the FSB’s Handbook, both country and thematic peer reviews will rely primarily on questionnaires filled out by the country’s own regulators, and are not expected to include on-site visits.³⁶⁸ Given this procedure, it seems likely that—like prior efforts—peer reviews will be more effective at assessing formal than substantive compliance. Their effectiveness will depend crucially on the willingness of regulators to forcefully question and challenge their peers. As seen above, however, regulators have historically been reluctant to breach a deep-seated norm of mutual deference.

The G-20 and the FSB have also announced a new “toolbox of measures” to encourage adherence to international standards by nonmembers.³⁶⁹ Under this process, the FSB will identify problem jurisdictions based on their financial importance and compliance assessments. These jurisdictions, whose identities will not be disclosed, “will be invited to engage in a confidential dialogue with the FSB in order to further evaluate their adherence and identify ways to improve adherence.”³⁷⁰ Ultimately, if the FSB identifies uncorrected weaknesses, it may recommend coercive measures such as placing the jurisdiction on a list of noncooperative countries and imposing greater due diligence obligations or outright

364. See FSB HANDBOOK, *supra* note 363, at 1–2, 4–5.

365. See *id.* at 4.

366. Press Release, Fin. Stability Board, FSB Completes Peer Review of Spain 2 (Feb. 7, 2011); FSB HANDBOOK, *supra* note 363, at 2.

367. FSB FRAMEWORK (2010), *supra* note 363, at 3. In October 2011, the FSB announced a new framework to better coordinate its role and that of the TRNs in assessing the implementation of reforms. FIN. STABILITY BD., A COORDINATION FRAMEWORK FOR MONITORING THE IMPLEMENTATION OF AGREED G20/FSB FINANCIAL REFORMS (2011).

368. See FSB HANDBOOK, *supra* note 364, at 6–9. The team may also collect information from other sources, such as TRNs and “market sources, other stakeholders and academia.” *Id.* at 8.

369. FSB FRAMEWORK (2010), *supra* note 363, at 1; G20, DECLARATION ON STRENGTHENING THE FINANCIAL SYSTEM—LONDON SUMMIT 2 (2009).

370. FIN. STABILITY BD., PROMOTING GLOBAL ADHERENCE TO INTERNATIONAL COOPERATION AND INFORMATION EXCHANGE STANDARDS 2 (2010). The expert team leading the dialogue, however, “would not itself conduct an assessment or re-assessment of compliance.” *Id.* at 8.

restrictions on cross-border transactions.³⁷¹ While this initiative appears innovative, in many respects it repeats prior efforts to target OFCs with sanctions to secure greater cooperation with onshore tax authorities.³⁷² Thus, it focuses on cooperation and information exchange rather than on substantive regulation, and prioritizes formal compliance by relying on IFI assessments and formal signature of the MMOU.³⁷³ The array of potential sanctions is impressive—in theory, they could reach so far as to effectively exclude the offending country from the international financial system. It is unclear, however, how the FSB proposes to solve the collective action problems endemic in international sanctions³⁷⁴ or the tensions between this coercive program and the consensus-based TRN process.³⁷⁵ The “toolbox of measures” is not intended to give teeth to international financial standards generally; it is merely a new installment in the campaign against OFCs.

In sum, the introduction of mandatory FSAP and peer reviews, while positive, will be relatively infrequent and appear to focus on formal rather than substantive compliance. These mechanisms also rely on the ability and willingness of national regulators to evaluate and criticize their colleagues’ compliance efforts, which they historically have been reluctant to do. The most aggressive new compliance initiative is aimed at OFCs, whose role was not central to the crisis, rather than at the developed jurisdictions where the most salient regulatory failures originated. Thus, despite these efforts, the IFR system may continue to encounter serious difficulties in ensuring effective and consistent implementation of standards.

C. Where to from Here?

In light of these limitations, the achievements of post-crisis IFR should not be exaggerated.³⁷⁶ In many ways, they repeat familiar patterns: prudential standards are enhanced in response to political pressure while preserving the authority and discretion of national regulators; some issues, like bank resolution, remain largely off limits; the financial industry can effectively oppose costly prudential standards both at the formation and implementation stages; and monitoring and enforcement of standards remains weak, in part because of the deep-seated reluctance of regulators to be seen as interfering in each others’ jurisdiction. In some cases, domestic reform initiatives driven by intense political pressure have simply outpaced international efforts. Thus, legislatures have taken a central role, eclipsing to some extent the traditional primacy of specialized regulators and forcing the G-20 and TRNs to play catch up. For example, after the Dodd-Frank Act, a clearing

371. *See id.* at 20–21.

372. *See* Giovanoli, *supra* note 313, at 121.

373. *See* FIN. STABILITY BD., *supra* note 370, at 4–5.

374. *See* Daniel W. Drezner, *Bargaining, Enforcement, and Multilateral Sanctions: When is Cooperation Counterproductive?*, 54 INT’L ORG. 73 (2000).

375. At least one TRN declined to take part in sanctions decisions. *See* FIN. STABILITY BD., PROMOTING GLOBAL ADHERENCE TO REGULATORY AND SUPERVISORY STANDARDS ON INTERNATIONAL COOPERATION AND INFORMATION EXCHANGE: PROGRESS REPORT 3, n. 6 (2011).

376. *See* Fioretos, *supra* note 136, at 390–91; Singer, *supra* note 301, at 105.

requirement for OTC derivatives was hastily added to the G-20/FSB program.³⁷⁷ The United States has moved ahead with the Volcker Rule, which has not been adopted by other countries. U.S. and European approaches differ in several areas, including hedge fund regulation, CRAs, and derivatives.³⁷⁸ Some initiatives, like the global bank tax, simply fizzled out because of disagreement in the G-20.

In response to the shortcomings of IFR, prominent commentators have proposed the creation of a formal international organization, backed by binding legal obligations, to regulate international finance.³⁷⁹ The conventional answer is that such proposals are politically infeasible because states are unwilling to delegate financial regulation to an international organization due to sovereignty concerns.³⁸⁰ On its own, this explanation seems insufficient. After all, states have created binding international treaties and institutions in several areas with profound domestic policy implications, including climate change, nuclear energy, and trade. This article suggests instead that radical reform of IFR is highly unlikely because historical path dependence and political economy create a high degree of inertia in the current system.³⁸¹ Nevertheless, the mounting challenges of financial interdependence and the recurrence of serious regulatory failures will likely continue to increase demand for stronger international rules and oversight. For the foreseeable future, then, IFR may exist in an uneasy state of tension between pressures for reform and political and historical constraints on its evolution. Over time, the trend is likely to be towards more binding agreements and stronger monitoring, at least in areas—such as prudential regulation and cross-border resolution—where the limitations of TRNs and soft law are most evident. This progress in international cooperation, however, is likely to be gradual, slow, and punctuated by crises.

In the near term, the analysis above suggests useful directions for reforms. First, the issue of substantive compliance with international standards must become much more central. One option is to further enhance the monitoring and enforcement capabilities of IFIs and TRNs, for instance, by letting international or peer country officials directly inspect large financial firms and conduct detailed independent audits of national supervision. A second, largely neglected option would be to consciously design international standards so as to facilitate effective monitoring and enforcement within the institutional constraints of IFR. From that standpoint, the best *domestic* rules may not make the best *international* standards.³⁸² Thus, from a domestic perspective, Basel II's turn towards sophisticated internal risk models may be a logical evolution of the Basel I risk-weighting framework. However, Basel II's complexity and reliance on national supervisory skill

377. See Eric Helleiner & Stefano Pagliari, *The End of Self-Regulation? Hedge Funds and Derivatives in Global Financial Governance*, in *GLOBAL FINANCE IN CRISIS* 82–83 (2010); see also Pagliari, *supra* note 125, at 16, 29.

378. See Helleiner & Pagliari, *supra* note 377, at 74.

379. See, e.g., Boone & Johnson, *supra* note 3; Eatwell & Taylor, *supra* note 3; Eichengreen, *supra* note 3; Pan, *supra* note 2; Reinhart & Rogoff, *supra* note 3.

380. See, e.g., Lawrence G. Baxter, *Exploring the WFO Option for Global Banking Regulation*, in *GLOBALISATION & GOVERNANCE* 113, 114 (Laurence Boule, ed., 2011).

381. See Helleiner, *supra* note 67.

382. See TARULLO, *supra* note 2.

undermine the goal of international uniformity.³⁸³ A less sophisticated but more transparent approach would greatly facilitate monitoring and enforcement.

Second, compliance with IFR will continue to depend on decentralized monitoring and pressures by IFIs, peer regulators, and market participants for the foreseeable future, despite the limitations of these mechanisms. To maximize their effectiveness, policymakers should design standards that are simple and transparent enough that such actors can assess substantive compliance—even if this comes at some cost in technical optimality of the rules.³⁸⁴ Concretely, this might involve greater use of regulatory approaches that reduce complexity and national discretion. For instance, the Basel Committee should consider simplifying the buffet of alternative and optional rules in the Basel II risk-weighting framework.³⁸⁵ Also, the role of market participants in monitoring financial firms could be enhanced by requiring banks to issue contingent convertible debt³⁸⁶ and by making bank disclosure more detailed and usable.³⁸⁷ In general, international standards may perform better if they incorporate structural solutions—such as limiting the size of banks or prohibiting specific activities—instead of regimes like Basel II that rely on national regulators to oversee complex risk management systems.³⁸⁸ Compliance with such solutions would be easier for IFIs, peer regulators and markets to assess.

Third, policymakers should explore the possibility of complementing soft law with binding obligations in areas where enforcement and commitment problems are most pronounced. For instance, experts have long argued that a treaty would be the only way to create a functioning system of cross-border bank resolution. While regulators recognize this, they assert that the political will does not exist.³⁸⁹ It may be worth creating a template that would be available when the next cycle of crisis and reform happens. The solution might be a treaty that lays out an umbrella of legal obligations for states, such as to comply with ex ante agreements on resolution and loss sharing, under which regulators could negotiate detailed arrangements for specific firms. These arrangements could be adapted in response to changing circumstances, thus combining the “compliance pull” of formal obligations with the flexibility of current cooperation arrangements.

383. See Daniel K. Tarullo, Member, Bd. of Governors of the Fed. Reserve Sys., Statement Before the Committee on Financial Services, U.S. House of Representatives (June 16, 2011); Masters, *supra* note 340.

384. See Masters, *supra* note 340, at 2; Singer, *supra* note 301, at 104–05.

385. On these multiple options, see Herring *supra* note 290, at 7–9.

386. See, e.g., Richard J. Herring, *The Subordinated Debt Alternative to Basel II*, 1 J. FIN. STABILITY 137 (2004); John C. Coffee, Jr., *Bail-Ins Versus Bail-Outs: Using Contingent Capital to Mitigate Systemic Risk* (Columbia Univ. Sch. of Law, Working Paper No. 380, 2010).

387. See Robert P. Bartlett, III, *Making Banks Transparent*, 65 VAND. L. REV. 293 (2012).

388. See, e.g., JOHNSON & KWAK, *supra* note 186; Jonathan R. Macey & James P. Holdcroft, Jr., *Failure Is an Option: An Ersatz-Antitrust Approach to Financial Regulation*, 120 YALE L.J. 1368 (2011); Eichengreen, *supra* note 3, at 12–13; Mervyn King, Governor, Bank of Eng., Speech to Scottish Business Organizations (Oct. 20, 2009).

389. See BCBS REPORT, *supra* note 285.

CONCLUSION

This Article has argued that the current IFR system, based on TRNs and soft law, is only partly successful at achieving desirable international cooperation. It has generally failed to secure improvements in regulation in countries with powerful antireform constituencies, to produce consistent improvements in prudential standards, and to address areas like bank resolution where cooperation requires credible commitment mechanisms. It has also argued that this state of affairs is not a product of rational design by states, but the outcome of historical path dependence and the interests of the most powerful political actors in IFR: regulators, financial firms, and great powers. While some reforms have occurred, these patterns persist. As a result, there is reason to doubt that IFR can effectively address the most salient postcrisis challenges—moral hazard and systemic risk—at least in the short-term. Instead, increasing demand for international cooperation may lead to gradual strengthening of the IFR system, including a partial move away from exclusive reliance on TRNs and soft law.

This argument has implications for broader debates about rational choice approaches to international law and financial globalization. In recent years, rationalist theories have made great strides in explaining how states can use international law and institutions to solve cooperation problems and achieve joint gains. However, such theories can also predispose scholars of specific areas such as IFR to assume they are optimally designed, overemphasize evidence to that effect, and neglect important problems of compliance and effectiveness. While rational choice theory is a major advance in international law scholarship, it is inherently probabilistic: other things being equal, states are likely to design institutions rationally. However, other things are rarely equal: international institutions may be inefficient for many reasons, including historical path dependence, principal-agent problems, interest group politics, and power inequalities. Thus, when analyzing specific institutions, scholars should carefully assess their effectiveness and the historical and political processes that shaped them. While this makes the analysis more challenging, it will allow more meaningful critique.

The framework proposed here also reveals how much research remains to be done on IFR. In particular, systematic empirical research remains in its infancy, and opportunities abound for fruitful inquiry. How are standards negotiated? Through what channels does the political influence of various actors manifest itself? To what extent do the resulting standards require departure from existing national practices? Once standards are adopted, which countries adopt them, and why? What difficulties arise in implementation? How does the formal process of adopting uniform standards interact with the informal process of transnational policy diffusion? Does the adoption of a standard actually change practices on the ground? If so, under what conditions is compliance more or less likely? Even when they are complied with, are the standards effective at attaining their policy objectives? These questions can only be answered by research on the development, implementation, and effect of specific IFR initiatives.

Finally, proponents of liberal international finance should not celebrate the current weakness of IFR. If the current system cannot effectively control the externalities of financial crises, create and sustain strong prudential standards, or handle the failure of large financial firms, the result may be an increasing burden

on governments and taxpayers. Ultimately, weak IFR may not necessarily lead to freer markets in the long run. The instability of the Great Depression ushered in the Bretton Woods system that strictly limited international finance. Not coincidentally, after the recent crisis, the IMF has warmed to capital controls.³⁹⁰ Some commentators now advocate robust “host country” regulation, requiring banks to establish ring-fenced subsidiaries in each country.³⁹¹ Over time, the alternative to effective cooperation may not be freer global markets, but increasing de jure or de facto restraints on capital mobility.

390. See, e.g., INT’L MONETARY FUND, RECENT EXPERIENCES IN MANAGING CAPITAL INFLOWS—CROSS-CUTTING THEMES AND POSSIBLE POLICY FRAMEWORK (2011); Jonathan D. Ostry, Atish R. Ghosh, Karl Habermeier, Luc Laeven, Marcos Chamon, Mahvash S. Quershi, & Annamaria Kokenye, *Managing Capital Inflows: What Tools to Use?*, IMF Staff Discussion Note (2011).

391. See, e.g., FIN. SERVS. AUTH., *supra* note 291, at 99; JOSEPH E. STIGLITZ, THE STIGLITZ REPORT: REFORMING THE INTERNATIONAL MONETARY AND FINANCIAL SYSTEMS IN THE WAKE OF THE GLOBAL CRISIS (2010); Avinash Persaud, *The Locus of Financial Regulation: Home Versus Host*, 86 INT’L AFF. 637 (2010); Dani Rodrik, *Economics Focus: A Plan B for Global Finance*, ECONOMIST, Mar. 14, 2009, at 80.