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Regulation: Capacities, Coordination and  
Learning

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# Restructuring Global and EU Financial Regulation: Capacities, Coordination and Learning

Julia Black \*

**Abstract:** It is said that ‘generals fight the last war’. Regulators can do the same. The question is whether in the plethora of reforms that are being developed, the financial regulators are building the regulatory equivalent of the Maginot Line or whether they are devising strategies that will enable them to counter, or at the very least anticipate, the next crisis. The paper focuses on regulators’ capacities for anticipation rather than resilience *per se*. It argues that for these capacities to be developed, the current mechanisms by which the financial regulators learn of their own and each others’ performance need to be quite fundamentally reoriented and regulators need to build in stronger mechanisms for cognitive challenge. The paper analyses the cognitive shifts prompted by the crisis, and associated policy developments. It then considers the changes in organisational structures of financial regulation at the global and EU levels, linking those to the cognitive shifts identified, and focusing on current mechanisms of observation, communication, enforcement and coordination. In particular it examines how key actors are positioning themselves within the regulatory system as a whole and the modes of coordination they are developing. It then considers how the system’s existing and potential capacities for reflexive learning and dynamic responsiveness can be strengthened. It focuses on two elements of that challenge: building capacity through enhancing information and knowledge, both about what is happening outside the system in the markets and the performance of the regulatory system itself, and developing mechanisms of challenge.

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## INTRODUCTION

It is said that ‘generals fight the last war’. Regulators can do the same. In the wake of the crisis, regulators and politicians are currently fighting on a number of battlefronts. New policies are rapidly proliferating from the international committees of regulators, from international organisations such as the OECD and IMF, from national governments, and from the EU. New provisions are being brought in, regulatory structures are being reconfigured, and new regulators are being created.

The question is whether the financial regulators are building the regulatory equivalent of the Maginot Line, or whether they are devising strategies that will enable them to counter, or at the very least anticipate, the next crisis. Given that regulators usually lack the powers of psychics or soothsayers, the likelihood is that the measures being put in place now will not prevent another crisis; they may not even prevent the same type of crisis recurring, but that is a separate argument. We know there will be another crisis, but do not know where it will come from. The question is whether the regulatory structures being created at the global and EU level are building in sufficient capacity for regulators and others to anticipate future crises, and sufficient resilience to withstand them when anticipation fails.

There is no doubt that policymakers recognise these demands. In particular, the need to build a greater capacity for surveillance has been recognised in reforms to the organisational structure of financial regulation at the global, EU, and in some cases national level. However, regulators failed not just because they did not look hard enough at what was happening in the markets. It was also that their cognitive understandings of the way markets operated, and the way markets and regulation interacted, were flawed. Conventional wisdom has been overthrown by the power of events, prompting a paradigm shift in some aspects of financial regulatory policy. However, just what paradigm should replace the old is still unclear, although the contours of the new conventional wisdom are becoming clearer. Part of the challenge for regulators going forward is whether they can put in place ways to challenge conventional wisdoms, including their own, before another crisis does it for them.

The paper analyses the impact that the cognitive shifts prompted by the crisis are having on the organisation of global and EU financial regulation, and on the mechanisms which currently exist or are being developed to enable regulators to observe and evaluate both the markets and the regulatory regime itself and to facilitate dynamic responsiveness to changes in both. The paper focuses on regulators’ capacities for anticipation rather than resilience *per se*, and argues that for these capacities to be developed the current mechanisms by which the financial regulators learn of their own and each others’ performance need to be quite fundamentally reoriented. In addition, regulators need to build in mechanisms for cognitive challenge. As senior economists advised the Queen, the

crisis was caused by a ‘collective failure of imagination’.<sup>1</sup> The crisis created a series of cognitive as well as financial shocks. But despite the various changes being introduced, it is not clear that some of the main lessons have really been learnt. There is some recognition by regulators of the complexity, fragmentation, interdependencies, and dynamic adaptability of the system they are attempting to regulate. However, rather than move to build flexibility and scope for variety and learning into the regime, the policy dynamic at the moment is to retreat into hierarchical regulation that seeks to control both markets and other regulatory actors through detailed rules, and within the EU, harmonised control. The dynamics driving these policy processes are understandable, but there is a significant risk of introducing new rigidities into the system. Instead, reflexive learning and dynamic responsiveness to the regime’s own performance need to become the central principles on which the global and EU regulatory regimes operate.

The paper argues that in order to develop structures and strategies for dynamic responsiveness we need first to understand the changes in the organisational structures of global and EU financial regulation and the cognitive shifts which underlie them. The crisis has prompted significant re-evaluation of the previous assumptions and understandings of how the financial markets operate and of the nature of risks in the market. However, it has also prompted an awareness of how the regulatory regime itself performs: the feedback loops and dependencies regulation can create and the inter-dependencies that exist between regulators and firms within and between countries. With respect to financial markets, the assumption that the ‘sum of the whole is greater than its parts’ has been replaced by the recognition that ‘the whole is only as strong as its weakest link’.<sup>2</sup> It is increasingly recognised in some quarters that this aphorism applies equally to the regulatory system as it does to the markets. No longer is it seen as sufficient to focus on the monitoring and supervision either of individual institutions or of individual countries; what is important is the operation of the system as a whole.

Linked to these cognitive changes is a normative reassessment of what regulation should be trying to achieve. Although there is broad consensus on the normative goals of financial regulation, *viz* financial stability, investor protection, and prevention of market abuse, there is far less agreement as to just what these mean in different instances,<sup>3</sup> and even less as to what measures should be taken to

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<sup>1</sup> On a visit to the LSE in November 2008, the Queen asked, ‘Why did no one see this coming?’ The British Academy forum of economists convened to answer the Queen’s question wrote to her concluding that ‘the failure to foresee the timing, extent and severity of the crisis and to head it off, while it had many causes, was principally a failure of the collective imagination of many bright people, both in this country and internationally, to understand the risks to the system as a whole’. Letter dated 22nd July 2009. See also FSA, *The Turner Review: a Regulatory Response to the Global Banking Crisis* (London: FSA, 2009).

<sup>2</sup> IMF, *The Fund’s Mandate – An Overview* (January 2010), 12.

<sup>3</sup> On the issues in defining and identifying financial stability see eg A. Crockett, ‘The Theory and Practice of Financial Stability’ (1996) 144(4) *De Economist* 531; C. Goodhart and D. Tsomocos, ‘Analysis of Financial Stability’ (Special Paper 173, Financial Markets Group, London School of Economics, 2007); O. Aspachs, C. Goodhart, M. Segoviano, D. Tsomocos, and L. Zicchino, ‘Searching for a Metric for

attain them. There are also conflicting policy dynamics, with centrifugal pressures to move regulation to the international level being countered by centripetal pressures for unilateralism either by individual countries or the EU.

The pace of policy development is so great and the proliferation of proposals currently emanating across the regime so numerous that there are significant risks of creating further tensions and internal conflicts if their development is insufficiently coordinated.<sup>4</sup> Coordination is not simply a matter of technical agreement, however; the tensions and conflicts are often deeply rooted, raising significant issues of regime management across all the regime's dimensions and enhancing the need to develop capacities for reflexive observation and dynamic adaptation.

This article analyses the current policy developments in financial regulation at the global and EU level, linking these to cognitive and normative changes. It groups these developments into four main areas: surveillance, resilience, stability, and regime management. It then considers the developments in the institutional structures at the international level, focusing on the re-formulated Financial Stability Board (FSB), the IMF, the EU multi-lateral arrangements for coordination through colleges of supervisors. In both it considers current mechanisms of observation, communication, and enforcement mechanisms within different parts of the regulatory regime. The discussion then turns to examine in more depth the difficult issues of regime management, coordination and learning. The article analyses the different strategies being used at the international and EU level. In particular it focuses on the significance of the cognitive frameworks of different actors in shaping responses and analyses how key actors are positioning themselves within the regulatory system as a whole and the modes of coordination they are developing. It then considers how the system's existing and potential capacities for reflexive learning and dynamic responsiveness can be strengthened. It focuses on two elements of that challenge: building capacity through enhancing information and knowledge, both about what is happening outside the system in the markets and the performance of the regulatory system itself, and developing mechanisms of challenge.

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Financial Stability' (Special Paper 167, Financial Markets Group, London School of Economics, 2006); H. Davies and D. Green, *Banking on the Future: The Rise and Fall of Central Banking* (Princeton University Press, 2010), 54-59.

<sup>4</sup> For example the potential for statutory schemes for bank resolution that impose moratoria on payments can conflict with the status of private netting agreements in insolvency law: see P. Paech, 'Systemic Risk, Regulatory Powers and Insolvency Law: The Need for an International Instrument on the Private Law Framework for Netting' (Working Paper Series no. 116, Institute for Law and Finance, Goethe Universität, 2010).

## FINANCIAL REGULATION – A POLYCENTRIC REGIME

It is fashionable now in financial regulation circles to emphasise the complexity and adaptability of the financial system and the unpredictability of regulation.<sup>5</sup> However, more generic analyses of regulation and governance have been emphasising these themes for some time.<sup>6</sup> Regulatory systems and the systems they attempt to regulate are often complex and dynamic, with significant interdependencies existing within and between them.<sup>7</sup> Power and knowledge are fragmented between different actors, with significant implications for the construction and operation of regulatory regimes. The performance of ‘regulation’ is also often disaggregated into a number of different functions that are dispersed between a number of actors at the international, regional, national, and sub-national level who co-exist in a range of different relationships. Complex interactions and interdependencies exist between social actors, and between social actors and government in the process of regulation, some of which regulation itself creates.<sup>8</sup> Those being regulated have significant operational autonomy, and their response to regulation is often unpredictable. Those attempting to regulate others thus face significant challenges. Some of these are unique to the particular task or task environment – such as managing particular risks or structuring certain markets; others, such as attempting to manage behaviour, are generic across regulatory regimes.

Regulation thus is a messy, complex, and largely imperfect process. In order to have some hope of regulating effectively regulators, or more accurately the system of regulators as a whole, need some capacity to regulate, and to regulate dynamically. Regulatory capacity, it is suggested, is a composite of resources, attitudes and interests.<sup>9</sup> Resources comprise: information, knowledge and expertise, financial resources, organisational capacity, power or strategic position, and authority and legitimacy. However, resources are only one aspect of capacity; what is also important is an understanding of motivations of those in possession of resources, their ‘motivational postures’ or ‘attitudinal settings’, which may be

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<sup>5</sup> eg S. Schwarcz, ‘Regulating Complexity in Financial Markets’ (2009-10) 8(2) *Washington University L Rev*, forthcoming.

<sup>6</sup> eg G. Teubner, ‘After Legal Instrumentalism: Strategic Models of Post-Regulatory Law’ in G. Teubner (ed), *Dilemmas of Law in the Welfare State* (Berlin, 1986); N. Rose and P. Miller, ‘Political Power Beyond the State: Problematics of Government’ (1992) 43(2) *British Journal of Sociology* 173; J. Kooiman (ed), *Modern Governance: New Government-Society Interactions* (London, 1993).

<sup>7</sup> See J. Black, ‘Decentring Regulation: Understanding the Role of Regulation and Self Regulation in a “Post-Regulatory” World’ (2001) 54 *Current Legal Problems* 103; J. Black, ‘Constructing and Contesting Legitimacy in Polycentric Regulatory Regimes’ (2008) *Regulation and Governance* 1.

<sup>8</sup> See eg J. Kooiman, ‘Findings, Speculations and Recommendations’ in J. Kooiman, n 6 above 253; N. Rose, *Powers of Freedom: Reframing Political Thought* (Cambridge: CUP, 1999); L. Hancher and M. Moran, ‘Organizing Regulatory Space’ in L. Hancher and M. Moran (eds), *Capitalism, Culture and Economic Regulation* (Oxford: OUP, 1989).

<sup>9</sup> J. Black, ‘Enrolling Actors in Regulatory Processes: Examples from UK Financial Services Regulation’ (2003) *Public Law* 62.

based in norms of self interest, appropriateness, or both.<sup>10</sup> Moreover, where either or both regulatory actors and capacities are dispersed, then there needs to be some way in which they are coordinated to achieve the particular outcome or outcomes sought, either by the whole or each of its participants.

The challenges facing the global financial regulatory regime are thus not unique in all respects, but they are severe.<sup>11</sup> The regime comprises non-state and state actors operating at the global level, at the regional level, at the national level, and within individual firms. The focus here is not on the relationship between regulators (state or non-state) and firms.<sup>12</sup> Rather it focuses on the interactions between regulators themselves within the regime.<sup>13</sup>

At the global level, the regime is characterised by a multiple of committees and organisations, each with different memberships, legal bases, mandates, and powers.<sup>14</sup> There are individual committees of securities regulators (International Organisation of Securities Commissioners, IOSCO), central bankers from the G8 countries (now the G20) (Basle Committee on Banking Supervision (BCBS), a committee of the Basle Institute of Settlements (BIS), and insurance regulators (International Association of Insurance Supervisors (IAIS)). These coordinate in the development of principles for financial conglomerates in the Joint Forum. In addition, the International Accounting Standards Board (IASB), a group of professional experts, sets accounting rules, the International Financial Reporting Standards, which are used by most major economies apart from the US. The international financial institutions (IFIs), the World Bank, and the International Monetary Fund (IMF) have to date played only a peripheral role in global financial regulation, notwithstanding their role in the current bail out of Ireland, and in effect its banks. They have not participated in the development of principles or standards, but they have played a role in monitoring the implementation of some of those principles within individual countries as part of their broader FSAP activities (Financial Services Assessment Process). In 1999, following the rescue of a hedge fund, Long Term Capital Management, the Financial Stability Forum (FSF) was created to coordinate these different bodies and bring in others, notably the OECD and the IFIs, and to bring G7 finance ministers closer to the standard-

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<sup>10</sup> J. March and J. Olsen, 'The New Institutionalism: Organisational Factors in Political Life' (1984) 78 *American Political Science Review* 734; V. Braithwaite, K. Murphy, and M. Reinhart, 'Taxation Threat, Motivational Postures, and Responsive Regulation' (2007) 29(1) *Law & Policy* 137.

<sup>11</sup> The term 'regime' here is used to refer to a set of interrelated units that are engaged in joint problem solving to address a particular goal; its boundaries are defined by the definition of the problem being addressed, and it has some continuity over time: C. Hood, H. Rothstein, and R. Baldwin, *The Government of Risk* (Oxford: OUP, 2001), 9-17.

<sup>12</sup> Firms themselves are regulatory actors in that they have internal systems of regulation (eg compliance, risk management, internal audit), though on significantly different scales depending on their size, and in that they are actors whose behaviour contributes to the overall performance of the regulatory regime.

<sup>13</sup> By regulators I am referring to those state or non-state actors who have been given a mandate to regulate the behaviour of others (though not necessarily by all those they purport to regulate), ie engage in organised attempts to influence their behaviour.

<sup>14</sup> See H. Davies and D. Green, *Global Financial Regulation: The Essential Guide* (London: Polity Press, 2008).

setting processes of the different regulatory committees.<sup>15</sup> As a consequence of the crisis the membership of the FSF and BCBS was broadened to comprise the G20 countries, and the FSF reconstituted as the Financial Stability Board (FSB). With the exception of the IFIs all the organisations operate on the basis of soft law.

At the European level, in addition to the usual lawmaking institutions, there are separate committees of finance ministers that advise the Commission on securities, banking, and insurance legislation. Of more importance have been the 'level 3' committees of regulators in each of these areas: the Committee of European Securities Regulators (CESR), the Committee of European Insurance and Occupational Pension Supervisors (CEIOPS), and the Committee of European Banking Supervisors (CEBS). As their name suggests, these are committees of regulators established formally as part of the reforms to the structure of EU lawmaking in the area of financial regulation.<sup>16</sup> Their role to date has been to advise and facilitate consultations on draft legislative proposals and to develop technical guidance on the implementation of legislative provisions. The European Central Bank has to date played almost no role in financial regulation. As discussed below, this structure is about to be radically altered with the introduction of the European System of Financial Supervision.

## **CURRENT DEVELOPMENTS AND POLICY BATTLEFRONTS**

The financial crisis is prompting significant changes in the organisational structures of financial regulation at the global and EU levels. Underlying these changes is a complex set of policy and institutional dynamics. The political talk is of harmonisation, coordination, and cooperation, but on key issues we see Balkanisation as countries go it alone.<sup>17</sup> Centrifugal pressures that push regulation towards certain central points are being counteracted by significant centripetal pressures which are pushing it back towards national governments. So on the one hand, although normative consensus may be hard to achieve, regulators and governments recognise that international harmonisation can be in their own interests for a number of reasons. The markets are peripatetic and can easily engage in regulatory arbitrage. Countries that introduce tougher regulation can

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<sup>15</sup> According to Davies and Green, the ECB 'turned up at the first meeting uninvited and has never been shown the door', *ibid*, 114. The European Commission, on the other hand, was invited but refused to attend: *ibid*. Given the Commission's insistence after the crisis that it be a member of the FSB, its priorities had clearly changed.

<sup>16</sup> 'Final Report of the Committee of Wise Men on the Regulation of European Securities Market' (February 2001), at [www.europa.eu.int/comm/internal-market/securities/docs/lamfalussey/wisemen/final-report-wise-men\\_en.pdf](http://www.europa.eu.int/comm/internal-market/securities/docs/lamfalussey/wisemen/final-report-wise-men_en.pdf).

<sup>17</sup> For example the deep disputes over whether banks should be broken up.

suffer ‘first mover disadvantage’ as financial business moves elsewhere. It is therefore preferable to increase regulatory requirements on a harmonised basis.

However, it is not just the threat of loss of business that is driving the move to international harmonisation. The crisis demonstrated that the globalised markets create significant interdependencies between regulators for each to be able to achieve its objectives, both in normal times and in times of crisis. In particular, within the EU the principle of home country control, combined with the global nature of financial markets, makes one country significantly dependent on the quality of regulation in another. Through the passporting regime, one country’s weak regulation can be brought into another country through a cross-border bank.<sup>18</sup> At the same time there is less willingness to trust other national governments to deliver regulatory regimes that are robust enough to be relied upon. Harmonisation, supported by mechanisms of enforcement, can increase control by a group of countries over another’s regulatory regime and thus reduce the vulnerabilities that such interdependencies create.

Further, as the handling of the crisis demonstrated, unilateral actions by one country can have negative spillover effects on others. For example, when Ireland introduced a full deposit guarantee for all its banks in September 2008 there was an immediate flight of capital from the UK to Ireland, prompting the UK and then the EU to raise deposit guarantee limits within a matter of days. Again, coordinated action is sought to prevent such negative spillover effects recurring. These ‘bottom up’ pressures accord with attempts from international bodies and the EU authorities to enhance the control that they exert over the financial regulatory regime, or at least parts of it. All of these factors exert centrifugal pressures, pushing regulation to the international level.

On the other hand, national governments have become acutely aware of the potential cost that the financial system can impose on their own taxpayers. As has been acutely observed, banks are global in life but national in death.<sup>19</sup> There are clear signs that this ‘mortality mismatch’, as I call it, is exerting a fundamental influence on policymaking. There is a recognition that international harmonisation or at least co-ordination is necessary to manage financial institutions in life (for example through colleges of supervisors) and when they are critically ill (through cross-border crisis management procedures). However, the process of managing their death (powers and procedures for the resolution of failing banks) and dealing with its consequences (funding bail-outs and / or deposit guarantees) remains national, at least for the moment. In 2007-2009, governments in the US, the UK, and the rest of the EU were forced to inject USD 4.89 trillion directly into banks and other financial institutions, equivalent to six

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<sup>18</sup> The UK Treasury Select Committee has recommended the abandonment of the passporting regime for banks, which would be a significant move contrary to one of the EU’s central principles of freedom of movement: Treasury Select Committee, *Banking Crisis: Regulation and Supervision* (Fourteenth Report of Session 2008–2009, HC 767, London: HMSO, 2009).

<sup>19</sup> M. King, evidence to UK Treasury Select Committee, *ibid*, response to Q146.

per cent GDP in each country / region and to issue guarantees on bank borrowing and bank assets that, if called upon, would equate to USD14 trillion gross: the equivalent of 50 per cent of the GDP in each country / region.<sup>20</sup> Governments are understandably concerned to ensure that they will not have to do this again and are putting in measures to prevent such calls on their budget deficits, often unilaterally. Whilst it remains national governments and their taxpayers that have to pick up the bill for financial failure, those governments will be concerned to protect their fiscal position and to retain the right and ability to do so.

Banks' 'mortality mismatch' and national governments' fiscal protectionism thus create a fundamental source of tension between the centrifugal forces which push agenda-setting to the international level, and centripetal forces which push it out to national governments as countries 'go it alone'. Part of the reason for the Commission's proposal for an EU-wide resolution fund for banks (as distinct from that for sovereign debt), is to reduce, or preferably eliminate, this tension. The requirement for pre-funding by the banks is intended to reduce the burden on taxpayers from bank failures. However, one of the reasons for its pan-European nature is to minimise the incentive effects for EU member states to act unilaterally in a crisis to protect their own taxpayers on the insolvency of a cross-border bank.<sup>21</sup>

The organisational restructuring, it is suggested, is integrally linked both to these policy dynamics and to cognitive shifts in the understanding of the nature of the markets, the nature of the problems, and the solutions that need to be imposed. It is important to understand these developments, as they both demonstrate the need for reflexive learning and dynamic adaptability and indicate some of the impediments to achieving those aims. The plethora of current policy initiatives is potentially overwhelming, but in an attempt to impose at least analytical coherence on them they are divided here into four interlinked groups: surveillance, resilience, stability, and regime management.

#### SURVEILLANCE

Getting information, and just as importantly, making sense of it, is a critical element of any regulatory system and has been shown to be deeply lacking in financial regulation. As the FSB/IMF report on information gaps observed, '[T]he recent crisis has reaffirmed an old lesson — good data and good analysis are the lifeblood of effective surveillance and policy responses at both the national and international levels.'<sup>22</sup> Successive inquiries into the crisis have come up with the same conclusion, that regulators need far better information than they have

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<sup>20</sup> Bank of England, *Financial Stability Reports* (October 2008) and (June 2009).

<sup>21</sup> European Commission, 'Communication to the European Parliament, Council, European Economic and Social Committee and the European Central Bank, Bank Resolution Fund', COM 2010 254 FINAL (26 May 2010).

<sup>22</sup> FSB and IMF, *The Financial Crisis and Information Gaps – Report to the G20 Finance Ministers and Central Bank Governors* (November 2009), 4.

had before on the both on individual financial institutions and on the build-up of risk within the system.<sup>23</sup> With respect to institutions they need to know their liabilities, their consolidated position, and the nature of their maturity mismatch. With respect to the system, they are seeking to understand the build-up of risk within the system, the nature of the inter-linkages between participants in the markets and between different types of risk, and the nature of maturity mismatches that exist on banks' balance sheets and within and between currencies. In particular, the challenge is to understand the interrelationship between macro-economic developments at the global and national level, their relationship with movements in the financial markets, and their impacts on the stability of individual financial institutions, and in turn of those institutions on financial stability – the 'macro-micro' link.<sup>24</sup>

The crisis showed that these links had been either ill-understood or significantly underemphasised. For example, the links between aggregate leverage, valuation, and liquidity, particularly in a mark-to-market environment created by accounting rules and margin requirements, had simply not been recognised prior to the crisis.<sup>25</sup>

The crisis also revealed significant blind spots in the regulator's vision. There was very little data on inter-institutional exposures, including intra-group exposures, and on cross-border exposures.<sup>26</sup> Some countries had only patchy information on their payment and settlement systems.<sup>27</sup> Particular activities of some financial institutions were firmly in the spotlight, but others operated very much beyond the regulators' gaze. The 'shadow banking system' should be more accurately described as the 'invisible banking system'. 'Over the counter' dealings in derivatives equate to 'under the radar' dealings, so little is known by regulators about the details of these deals or of the inter-linkages and risk concentrations that are thereby created.

Visibility is now sought over all activities of all participants, notably hedge funds, OTC derivative dealings, and intra-group exposures, in a relentless search for 'synoptic legibility'.<sup>28</sup> However, whilst improved legibility is necessary, what is also important is the development of a cognitive framework in which to make sense of the information collected and convert it from data to knowledge.<sup>29</sup> Here the central challenge at the moment is to understand the exact nature of the links between macro-prudential developments and the adjustments that need to be

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<sup>23</sup> eg FSF, *Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience* (April 2008); IMF, n 2 above; IOSCO, *Report on the Subprime Crisis - Final Report*, Report of the Technical Committee of IOSCO (IOSCO, 2009).

<sup>24</sup> eg FSB and IMF, n 22 above; H. Hannoun, 'Information Gaps – What has the Crisis Taught Us?' (Speech delivered 20 April 2010).

<sup>25</sup> Joint FSF-CGFS Working Group, *The Role of Valuation and Leverage in Procyclicality* (March 2009), 2.

<sup>26</sup> FSB, *Guidance on Systemic Risk* (November 2009).

<sup>27</sup> *ibid.*

<sup>28</sup> J. Scott, *Seeing Like a State: How Certain Schemes to Improve the Human Condition Have Failed* (New Haven: Yale UP, 1998).

<sup>29</sup> K. Weick, *Sense Making in Organisations* (Thousand Oaks: Sage Publications, 1995).

made to the micro-prudential supervision of individual financial institutions. Surveillance is important, but until those links are better understood it remains only a partial basis for dynamic adjustment of the regulatory regime to the changes in risk profiles of products, markets, and actors that comprise the financial system.

## RESILIENCE

Secondly, regulators are struggling to find ways to enhance the resilience of the financial system. There are strong arguments for making resilience an essential part of risk regulation; indeed some argue that it should be the dominant strategy for responding to uncertainty.<sup>30</sup> Wildavsky, for example, argues that as we cannot know which risks will crystallise, we should proceed on the basis of trial and error, and ensuring resilience in systems if things should go wrong. In engineering terms, and particularly when dealing with complex systems, regulators should ensure that systems have built-in buffers between parts that may fail to prevent a failure in one part affecting other parts, and ‘redundancies’, controls which come into operation when others have failed.<sup>31</sup>

The rationale for regulating banks has always focused on the potential for the failure of one institution to have systemic consequences, but the channels for that systemic crisis have traditionally been seen to be inter-linkages through the payment system and inter-bank market, and through contagion effects arising from loss of investor confidence (failure of one bank can cause depositors to create runs on other banks).<sup>32</sup> The regulatory system has traditionally built in resilience through the lender of last resort facility, and failing that, through the contained collapse or managed takeover of the bank. The crisis showed that in many countries there was no further backstop plan. There were no legal structures in place which were adequate to the task of managing the failure of a bank. Those that existed were based on an assumption that bank failures could be managed within national boundaries; there were no robust cross-border procedures. In some cases, for example the UK, putting these structures in place had been on policymakers’ ‘to do’ lists, but in the benign macro-economic environment that prevailed, they were not seen as particularly urgent matters that needed priority.<sup>33</sup>

Building in resilience to the financial system is proving an extremely challenging task. That said, part of the battle is relatively straightforward, at least conceptually. It involves enhancing the types of resiliency structures and mechanisms that already existed, or creating new techniques which follow the same logic and understandings of how the financial system works as operated in the past. These include the introduction of special legal regimes for the failure of

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<sup>30</sup> A. Wildavsky, *Searching for Safety* (London: Transaction Books, 1988).

<sup>31</sup> C. Perrow, *Normal Accidents: Living with High-Risk Technologies* (New York: Basic Books, 1984).

<sup>32</sup> C. Goodhart, et al, *Financial Regulation: Where, Why, How and What Now?* (London: Routledge, 1998)

<sup>33</sup> In the UK the Tripartite Authorities had conducted a series of ‘war games’ on the possible failures of different banks which had revealed the weaknesses in the UK regulatory structure for managing the failure of a large bank, but the matter had not been pushed up the legislative agenda: Treasury Select Committee, *The Run on the Rock* (5th Report of Session 2007-8 HC 56-1).

banks, such as the UK's Special Resolution Regime,<sup>34</sup> now being adopted in some form in the US and the EU,<sup>35</sup> the requirements, initiated in the UK, for firms to produce 'living wills' or 'resolution plans',<sup>36</sup> and initiatives to enhance the cross-border crisis management and the resolution of cross-border banks.<sup>37</sup>

The hardest part of the battle is coming to grips with the realisation that the system simply did not operate in the way that regulators, banks, and economists had thought it did. If you do not understand how the system works, it is very hard to build in mechanisms either for managing risk or for ensuring the system's resilience when those risks crystallise. As emphasised above, the crisis has prompted fundamental cognitive shifts in understandings of how the financial system operates. Regulators and others are struggling to create a new cognitive framework in which to develop policy responses.

As a result there is less consensus on issues that had previously been almost unquestioned. What characteristics mark out a 'systemically important' financial institution, for example, are now recognised to be only poorly understood. Few now consider size to be the main risk factor; interconnectedness, leverage, or maturity mismatches are seen to be more significant, but exactly how significant is contested. Asset management and money market funds are now seen to pose systemic threats, whereas previously they were well outside the systemic regulator's radar, but just how great a threat is also a matter of dispute.<sup>38</sup>

There is also a deeper conflict as to how systemic significance is created. Views differ as to whether systemic significance is determined by certain properties of financial institutions and their interactions that can be identified *ex ante* or whether systemic significance is in fact a dynamic phenomenon produced by particular configurations of market interactions: certain institutions become systemic in the course of a crisis.<sup>39</sup> The first obviously is more comforting for policy makers, as it gives a reassuring sense of predictability and therefore control; the latter far less so.

Linked to these cognitive shifts is the realisation that the technologies of risk management that both regulators and financial institutions had used were deeply inadequate, if not fundamentally flawed. They also gave regulators and firms a highly distorted view of the nature and distribution of risks in the financial system. There is widespread recognition that liquidity risk was underestimated.<sup>40</sup> As was

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<sup>34</sup> Banking Act 2009.

<sup>35</sup> Dodd-Frank Act 2010 in the US; European Commission, 'Communication on an EU Framework for Cross-Border Crisis Management in the Banking Sector' (October 2009).

<sup>36</sup> FSA, 'Turner Review Conference Discussion Paper' (DP09/4, October 2009); BCBS, *Report and Recommendations of the Cross Border Bank Resolution Group* (Basle, March 2010).

<sup>37</sup> *ibid*; European Commission, n 35 above.

<sup>38</sup> FSB, 'Guidance to Assess the Systemic Importance of Financial Institutions, Markets and Instruments: Initial Considerations – Background Paper' (November 2009).

<sup>39</sup> For example the discussions as to whether there should be a list of systemically important financial institutions identified in advance or not: eg IMF, *Responding to the Financial Crisis and Measuring Systemic Risks* (Global Financial Stability Report, IMF, 2009)

<sup>40</sup> eg de Larosiere Report, The High Level Group on Financial Supervision in the EU, at

leverage: risk-adjusted leverage measures failed to capture the multiples of exposure created by pooling and tranching structured credit instruments, or the compounding of that embedded leverage through re-securitisation.<sup>41</sup> Further, there is dawning awareness that although regulators and risk managers can tend to put risks into ‘buckets’: market, credit, liquidity, and so on, risks can quickly overspill from one to the other: liquidity risk quickly evolved into market and credit risk, as lack of liquidity caused a drop in market value and prevented firms from rolling over short-term borrowing.<sup>42</sup>

Risk models were also found to be deeply flawed. Value at Risk (VaR) models, the darling of risk managers and banking regulators since the early 1990s, were found to have procyclical effects as their measures of market risks fell during the boom, creating incentives to take on additional risk and leverage. Once the market turns, falling asset prices leads to higher asset price volatility and higher measures of VaR, creating incentives to deleverage. As all follow the same models, there is a herd effect, further enhancing volatility. As a result there are now calls for VaR models to ‘see through the cycle’.<sup>43</sup> Model-based risk assessments were also based on limited historical data, often restricted to the ‘Golden Decade’ of the last ten years that had seen particularly benign economic conditions.<sup>44</sup> Even worse, in the case of residential mortgage-backed securities, they were based on no empirical data at all.<sup>45</sup> Correlation risks were not understood, again particularly with respect to CDOs.<sup>46</sup> Stress tests were woefully inadequate. Even in late 2007, before the most intense periods of the crisis, the Chief Financial Officer of Goldman Sachs, David Viniar, was reported as commenting that events that were in most models assumed to happen only once in several billion years (once every  $6 \times 10^{124}$  lives of the universe in fact) were happening several days in a row. Models will always be wrong to an extent, but as Andrew Haldane commented, the models failed Keynes’ test, which is that it is better to be roughly right than precisely wrong. ‘With hindsight, these models were both very precise and very wrong’.<sup>47</sup>

Moreover, it has been recognised that regulation does not operate as a neutral instrument, but can create negative feedback loops, amplifying the very risks they are meant to be controlling. The potential procyclical effects of Basle II have long been noted,<sup>48</sup> but their effects were not fully felt; this was predominantly a crisis

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[http://ec.europa.eu/internal\\_market/finances/docs/de\\_larosiere\\_report\\_en.pdf](http://ec.europa.eu/internal_market/finances/docs/de_larosiere_report_en.pdf); FSF, n 23 above.

<sup>41</sup> Joint FSF-CGFS Working Group, *The Role of Valuation and Leverage in Procyclicality* (March 2009); CRMPG III, *Containing Systemic Risk: The Road to Reform* (2008).

<sup>42</sup> eg Joint Forum, *Credit Risk Transfer – Developments from 2005-2007* (April 2008).

<sup>43</sup> *ibid.*

<sup>44</sup> *ibid.*; A. Haldane, ‘Why Banks Failed the Stress Test’ (speech delivered 13 February 2009).

<sup>45</sup> Joint Forum, n 42 above.

<sup>46</sup> *ibid.* In particular, the exposure of senior tranches of CDOs to worst-case correlations (eg recession in the macro-economy) as that generates the largest losses on the underlying portfolio.

<sup>47</sup> Haldane, n 44 above.

<sup>48</sup> eg J. Danielsson, et al, ‘An Academic Response to Basle II’ (Special Paper 130, Financial Markets Group, LSE, 2001); C. Goodhart, ‘Financial Regulation, Credit Risk and Financial Stability’ (2005) 192 *National Institute Economic Review* 118; C. Goodhart, B. Hofmann, and M. Segoviano, ‘Bank Regulation and Macroeconomic Fluctuations’ (2005) 20 *Oxford Review of Economic Policy* 591.

that occurred under Basle I rules. However, the failure of the leverage measures to capture the full extent of leverage or the multiples of exposure incentivised greater leverage and did nothing to abate the risk concentrations that were accumulating. The problems did not only lie with capital rules for banks. Accounting rules on loan loss provisioning based on incurred losses, and in particular mark-to-market accounting requirements have been shown to have profoundly procyclical effects.<sup>49</sup> Private sector risk management techniques had the same impact, enhancing the links between valuation techniques, leverage, and asset prices. Triggers in debt or OTC derivative contracts and haircuts on financing transactions based on market valuations or credit ratings added liquidity during the boom but drained it out when conditions were stressed, exacerbating deleveraging and asset sales in a vicious downward spiral.<sup>50</sup>

#### STABILITY

Thirdly, there is a focus on developing strategies for macro-economic stability. Here too there has been a significant cognitive shift. In particular there is a recognition of the inter-linking and inter-dependencies between the stability of macro-economy and the stability both of individual financial institutions and of the financial system as a whole. The mechanisms of these inter-linkages are still only partly understood, but there is broad agreement emerging on four issues.<sup>51</sup> Firstly, that ensuring stability of each individual bank (and thereby the protection of its depositors) cannot be ensured just by looking at the performance and activities of that institution but is intrinsically linked to developments in the wider economy and in the markets: the stability of the financial system is linked to stability of the macro-economic system, and vice versa (the macro-micro issue). Secondly, that ensuring the stability of one does not ensure the stability of the whole (the interconnectedness issue). Thirdly, though more tentatively, that financial stability is not a ‘banks only’ issue but is affected by the activities of all market players, including those not normally within the remit of banking supervisors, such as hedge funds, OTC dealings, insurance and reinsurance companies, and mutual funds (the silo issue).<sup>52</sup>

There is far less consensus on the policy implications that should flow from these diagnoses, however. There are significant divides on key issues, for example whether banks should be broken up and how;<sup>53</sup> whether monetary authorities or

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<sup>49</sup> FSB, Working Group on Loan Loss Provisioning; FSF-BCBS, Joint Working Group on Capital (March 2009); de Larosiere Report, n 40 above; Joint FSF-CGFS Working Group, n 41 above.

<sup>50</sup> Joint FSF-CGFS Working Group, *ibid*; Joint Forum, n 42 above.

<sup>51</sup> FSF, n 23 above.

<sup>52</sup> A development illustrating this cognitive shift is IOSCO’s recent creation of a research group to investigate systemic risk in the securities markets, previously considered to be an issue confined to banks. Its initial focus is hedge funds, and it has sent out a data collecting template to funds for them to complete. IOSCO/MR/03/2010.

<sup>53</sup> eg the ‘Volcker’ rule provisions in the Dodd-Frank Act 2010; the UK banking commission inquiry.

financial supervisors can spot ‘bubbles’ and have the political authority to pierce them;<sup>54</sup> what the relationship is between monetary policy and financial supervision;<sup>55</sup> whether trade imbalances can and should be addressed;<sup>56</sup> and whether short selling should be prohibited either at all or by certain actors, or in certain markets or instruments, such as commodity derivatives (US) or ‘naked’ short-selling of sovereign debt (Germany).<sup>57</sup>

#### ORGANISATIONAL RESTRUCTURING AND REGIME MANAGEMENT

Fourthly, there is a concern to put in place institutional structures which can develop and deliver a regulatory system that will ensure that these battles are successfully fought at every level, from international committees, through regional and national systems of regulation, down to firms’ internal governance structures. Here too there has been a cognitive reframing, but this time as to the needs, capacities, and resources of different actors in the regulatory system, the nature of their inter-linkages and interdependencies, and the negative feedback loops and externalities that thereby can be created.

As explained above, regulatory capacity is a combination of the possession of certain key resources and the ability and willingness to deploy those resources in pursuit of a certain set of normative goals. Critical resources are information, organisational capacity, expertise, financial resources, strategic position, and legitimacy and authority. The crisis demonstrated that regulators did not have adequate information nor did they have a means of making sense of what they had. They did not have sufficient technologies to manage and regulate risks. They did not have the organisational capacities to coordinate and perform regulation in conjunction with other national authorities or overseas regulators. The strategic position of those purporting to perform regulation, over firms or other regulators, was often weak.<sup>58</sup> At the international level, and indeed at the EU level, there are significant questions of the legitimacy and authority of some those purporting to manage the regulatory regime by those they hope to manage.

There are four discernible themes in the current organisational realignments. First, there are ‘re-centrings’ occurring: changes in the distribution of regulatory

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<sup>54</sup> D. Gruen, M. Plumb, and A. Stone, ‘How Should Monetary Policy Respond to Asset Price Bubbles?’ (2005) 1 *International Journal of Central Banking* 1; J. Dokko, et al, ‘Monetary Policy and the Housing Bubble’ (Federal Reserve Board, Finance and Economics Discussion Series 2009-49).

<sup>55</sup> Davies and Green, n 3 above, ch 3.

<sup>56</sup> R. Portes, ‘Global Imbalances’ in M. Dewatripint, X. Freixas, and R. Portes (eds), *Macro Economic Stability and Financial Regulation: Key Issues for the G20* (London: Centre for Economic and Policy Research, 2009); S. Dunaway, ‘Global Imbalances and the Financial Crisis’ (Special Report No 44, Council of Foreign Relations, March 2009); H. Davies, *The Financial Crisis: Who is to Blame?* (London: Polity Press, 2010).

<sup>57</sup> Compare eg Dodd-Frank Act 2010; the German banning of naked short selling of sovereign debt in May 2010 prompted the Commission to adopt EU wide measures: European Commission, ‘Proposal for a Regulation of the European Parliament and of the Council on Short Selling and Certain Aspects of Credit Default Swaps’ (September 2010); see also CESR, ‘Measures Adopted by Member States on Short Selling – Updated’ (CESR/08-742, September 2010).

<sup>58</sup> See for example, FSF, n 23 above; FSA, n 1 above.

powers and functions between actors within the system and attempts by various actors in the system to pull more regulatory powers back to themselves. These are happening at the national level as national governments reorganise their national systems of regulation.<sup>59</sup> They are evident at the regional level, as the EU radically restructures its regulatory regime and the balance of responsibilities and powers between the EU and member states. They are occurring at the international level, as participation is broadened and functions redistributed between the ‘siloes’ international committees and the coordinating role of the Financial Services Board. They are also visible within firms themselves, as regulators focus in far more detail on the internal governance structures of firms, and on the role of shareholders within them.<sup>60</sup>

Secondly, there is a re-evaluation of the regulatory capacities and resources of different participants within the regime, including regulated firms and other market actors. In particular there is a growing recognition that regulators do not have the resources necessary by way of information, tools and technologies, organisational capacities, leverage, and, at the international level in particular, legitimacy and authority to perform regulation effectively. However, this is also matched by a recognition that firms and markets do not possess these resources either.<sup>61</sup> In many areas self-regulation is politically dead, or at least in intensive care.<sup>62</sup> The OTC derivative markets, credit rating agencies, and hedge funds are all finding the regulators’ spotlights turned firmly on them, though often for very different reasons.<sup>63</sup> Firms’ internal governance structures and remuneration policies are also firmly in the regulators’ sights.<sup>64</sup>

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<sup>59</sup> For example Ireland, Germany, the UK, and the US.

<sup>60</sup> eg D. Walker, *A Review of Corporate Governance in UK Banks and Other Financial Industry Entities – Final Recommendations* (November 2009).

<sup>61</sup> eg Senior Supervisors Group, *Observations on Risk Management Practices during the Recent Market Turbulence* (March 2008); *ibid*, *Risk Management Lessons from the Global Banking Crisis of 2008* (October 2009); OECD, *Corporate Governance and the Financial Crisis: Key Findings and Main Messages* (June 2009).

<sup>62</sup> However, in other respects, there is still reliance on private market actors to perform significant coordinating roles. A key example is the role of ISDA, not only in developing the standard form contracts on which the derivatives markets are built, but in providing a coordinated mechanism for settlement of contracts at the height of the crisis. Its ‘big bang’ protocol incorporated into its standard documentation the auction settlement of contracts after a default or other credit event on a company referenced in credit default swap transactions: Auction Supplement to the 2003 ISDA Credit Derivatives Definitions (the ‘Big Bang Protocol’); 2009 ISDA Credit Derivatives Determinations Committees, Auction Settlement and Restructuring CDS Protocol (the ‘Small Bang Protocol’). Notably, in an attempt by ISDA to control the interpretation of its contracts and not leave this to the courts in individual jurisdictions, the protocols include provision for the ISDA Determinations Committee to make binding determinations for issues such as whether a credit event has occurred; whether an auction will be held; and whether a particular obligation is deliverable. The auction process provided a crucial and largely successful mechanism for settling transactions at the height of the crisis. ISDA, however, remains outside the main coordinating body of international regulators, the Financial Stability Board, a point to which we will return below. On the question of who should have the interpretive authority over ISDA contracts, and in particular the role of the courts, see J. Golden, ‘The Future of Financial Regulation: The Role of the Courts’ in I. MacNeil and J. O’Brien (eds), *The Future of Financial Regulation* (Oxford: OUP, 2010).

<sup>63</sup> See the US Dodd-Frank Act 2010; in the EU see, Regulation (EC) N° 1060/2009 of the European Parliament and of the Council on Credit Rating Agencies; EU Commission, Proposal for a Directive Of

Third, and linked to this, are changes in patterns of enrolment, in particular the role of credit rating agencies. Much attention has been given to the reliance that investors placed on ratings and there have been calls from regulators for investors to perform their own due diligence.<sup>65</sup> However, the regulatory system has been just as negligent. In significant areas, credit ratings are hardwired into the regulatory regime, often acting as thresholds or triggers for regulatory action. In the EU, for example, the investment portfolios permitted for collective investment schemes are defined in terms of products with certain credit ratings.<sup>66</sup> The standardised approach introduced under Pillar 1 of Basle II relies on credit ratings of borrowers assigned by ‘external credit assessment institutions’ (ECAIs) where these are available to compute banks’ regulatory capital for credit risk. It has been estimated that 30 per cent of European banks will adopt this approach; the figure is higher outside the EU.<sup>67</sup> Central banks have relied on credit ratings to determine what they will accept as collateral.<sup>68</sup>

Enrolment can confer benefits, extending regulatory capacity. However, as the crisis has demonstrated, enrolment can enhance regulatory capacity but it also creates significant dependencies and vulnerabilities.<sup>69</sup> Moreover it can create negative feedback loops, as illustrated in the effects of the mark-to-market accounting rules noted above. It can also create opportunities for gaming the regulatory rules – as where banks guaranteed the liabilities of their SPVs, which gained a high credit rating as a consequence. Banks then bought the commercial paper of their SPVs, relying on the high credit rating to reduce their capital requirements.<sup>70</sup> There is thus a significant re-evaluation of the nature and extent of this particular enrolment relationship. Credit rating agencies are now to be regulated within the EU.<sup>71</sup> Central banks have indicated that they will no longer

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The European Parliament and of the Council on Alternative Investment Fund Managers, COM(2009) 207 (Final).

<sup>64</sup> eg FSB, *Principles for Sound Compensation Practices* (2009); EU Commission, ‘Green Paper on Corporate Governance in Financial Institutions and Remuneration Policies’, COM(2010) 284 final (June 2010);

<sup>65</sup> eg FSF, n 23 above, 37-38; CESR, *Second Report to the European Commission on the Compliance of Credit Rating Agencies with the IOSCO Code and the Role of Credit Rating Agencies in Structured Finance* (CESR/08-277, May 2008); ESME, *Report to the European Commission on the Role of Credit Rating Agencies* (4 June 2008); FSB, *Improving Financial Regulation: Report of the Financial Stability Board to G20 Leaders* (September 2009).

<sup>66</sup> DG Market Services, *Tackling the Problem of Over Reliance on Ratings* (2009).

<sup>67</sup> P. Van Roy, ‘Credit Ratings and the Standardised Approach to Credit Ratings in Basle II’ (ECB Working Paper Series, No 217, August 2005); FSI, ‘2008 FSI Survey on the Implementation of the New Capital Adequacy Framework in Non-Basel Committee Member Countries’ (BIS 2008).

<sup>68</sup> For example, the European Central Bank only accepted ‘A’ rated products; however, as the Greek crisis has demonstrated, in times of crisis this strict stance may have to be adjusted, and the ECB has had to say it will accept Greek bonds regardless of their rating. *Financial Times* (5 May 2010).

<sup>69</sup> Indeed, the crisis and its aftermath have demonstrated the fundamental reliance of monetary authorities on banks to act as sluice gates to push money out into the economy; when banks refuse to do so, monetary authorities are almost paralysed.

<sup>70</sup> BCBS, *Enhancements to the Basle II Framework* (July 2009); the revised rules now introduce a ban on banks recognising ratings gained through such guarantees.

<sup>71</sup> Regulation (EC), n 63 above, on credit rating agencies.

rely on credit ratings agencies to determine what collateral they will accept.<sup>72</sup> Under the revised Basle II requirements on securitisation exposure have been amended to include requirements to ensure that banks perform their own due diligence and do not simply rely on credit ratings given by the agencies.<sup>73</sup>

Fourthly, new actors are being created, existing ones reconstituted, and relationships between regulators are being rearticulated and reformed. As detailed further below, the IMF is being given a far wider role in global financial regulation, though whether its current mandate supports that expectation is a matter of debate. The FSB has been reconstituted. New multi-lateral groupings of regulators have been formed to manage banks in life, in the form of colleges of supervisors, and in death, in the form of crisis-resolution groups. Within the EU, there are significant changes being introduced to the regulatory structures and a parallel formation of multilateral colleges and crisis-resolution mechanisms. Throughout these restructurings there is a notable thread running, which is that there needs to be a greater focus on managing the regime as a whole. However, this management process is fraught with difficulties, all of which have a bearing on the ability of the regime and its different components to develop capacities for reflexive self-observation (capacity to know how the regime itself is performing) and dynamic responsiveness (ability to adapt rapidly to changes in the market and its own performance).

### **EMERGING STRUCTURES OF COORDINATION: THE GLOBAL LEVEL**

We are still in the midst of the aftershocks of the crisis and so the situation is in a state of flux. Nevertheless, the main contours of the restructuring of the global and EU financial regulatory regimes are emerging. At the global level there have been three key developments in the structure and management of the regulatory system. These are the extension and enhancement of the central coordinating body, the Financial Stability Board, the new role of the IMF, and the creation of colleges of supervisors: multi-lateral supervisory arrangements for firms in normal times and times of crisis. At the EU level, legislation that will radically restructure the relationship between the EU and member states in financial regulation is in its late legislative stages.<sup>74</sup> This section considers each of these, asking whether and

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<sup>72</sup> Bank of England, *Financial Stability Report* (December 2009) on the need to reduce reliance on credit ratings in capital adequacy regulation; on collateral see Bank of England, *Market Notice – Expanding Eligible Collateral In The Discount Window Facility And Information Transparency For Asset-Backed Securities* (July 2010).

<sup>73</sup> BCBS, n 70 above.

<sup>74</sup> At the time of writing, the Council of Ministers is due to consider the legislation with a view to implementation by January 2011.

how these developments are likely to enhance the capacity of the global and EU regulatory regimes for reflexive learning and responsive adaptation.

#### FINANCIAL STABILITY BOARD – ‘HEAD OF GLOBAL’?

Potentially the most significant change in the organisational structures of global financial regulation has been the reconstitution of the Financial Stability Forum (FSF) into the Financial Stability Board (FSB).<sup>75</sup> Its membership has widened to include the G20 countries and the European Commission. Its role is also changing from one of a loose coordinator to putative regime manager and regulator.<sup>76</sup> There have also been suggestions that it may break out of the usual communicative circle of regulators and international bodies and engage directly with financial institutions.<sup>77</sup>

The transformation of the FSF from a loose coordinator to regime manager and even direct regulator is not a straightforward one, and it is not clear either that it is desirable or that it will be achieved. The FSF, the FSB’s predecessor, was itself born out of a crisis, the near collapse and rescue of Long Term Capital Management. Although seen as a significant crisis at the time, LTCM was a minor local difficulty in comparison with the events of 2007-2009. The Forum was a delicately struck balance between the interests of national governments, national regulatory authorities, central banks, the international financial institutions (the IMF and the World Bank), the existing international committees of regulators, and various other inter-governmental bodies, notably the EU, ECB, and the OECD.<sup>78</sup> Its creation was in part a further step in the search for coordination between the existing international committees of securities, banking, insurance, and accounting regulators and other global actors. However, by introducing financial ministers directly into the structure it also forced politicians and regulators to confront each other at the international level.<sup>79</sup>

The extension of membership of the FSB to G20 countries gives it greater legitimacy as an overall coordinator and even standard-setter for a wider group of countries, but complicates its dynamics. It is not yet clear whether it is a political body that is an arm of the G20 or a separate institution with its own institutional identity, position, and agenda, and thus akin to the other international committees of regulators. Moreover, clearly tensions exist between the members, though at

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<sup>75</sup> G20, *Declaration Summit on Financial Markets and the World Economy* (15 November 2008); this also prompted the expansion in the membership of the BCBS to the G20 countries. According to the de Larosiere Report, the G20 initiative originated with the EU Commission, which was keen to ensure it had adequate involvement in the international standard-setting bodies: de Larosiere Report, n 40 above, para 220.

<sup>76</sup> On the role of the FSF in its early years, see Davies and Green, n 14 above, 113-118.

<sup>77</sup> FSF, n 23 above.

<sup>78</sup> It was formed at the proposal of Hans Tietmeyer, then President of the German Bundesbank, after an inquiry instigated by the BIS. H. Tietmeyer, *Report on International Cooperation and Coordination in the Area of Financial Market Supervision and Surveillance* (BIS, 1999). For a discussion of the FSF’s work and the problems of its institutional position, see Davies and Green, n 14 above, 113-118.

<sup>79</sup> Davies and Green, *ibid.*, 117-118.

present these are not paralysing. The FSB comprises politicians, international organisations, international organisations of national regulators, and national regulators. Some of its members are hosts to significant financial markets, others, such as Argentina, have almost none. Finance ministers can be expected to pursue their own national agendas, and are shaping the global regulatory agenda in a way that they have arguably not done since the decision to set up the first Basle Capital Accord.<sup>80</sup> However, there can be tensions with the international committees of regulators who find their technocratic world now politicised in unpredictable ways. Furthermore the presence of both international organisations and a selective group of their members can create uneasy dynamics. The Larosiere Report, for example, indicated frustration that some of the EU member states have a separate voice at the international level and can use these international fora to oppose and outmanoeuvre it. It argued that only the EU should be represented in international organisations, including the FSB,<sup>81</sup> though this is not a suggestion that has been adopted with the alacrity of some of its other recommendations. Others have criticised the over-representation of EU member states, though for different reasons.<sup>82</sup>

The membership of the FSB was a political decision taken in the heat of the crisis, though, not the result of careful planning and consideration of what should be the criteria for membership. Further, whatever its composition, like other international organisations there will be tensions between members as each national government pursues its own national agenda and interests. The financial markets take a different form in each country, and have different lobbying powers, both of which shape the policy agendas each state is pursuing at the international level. National governments recognise the need for international harmonisation but are reluctant to surrender sovereignty to international financial institutions.

The FSB has to manage these tensions. Its reformulation as an independent actor is one that is in its infancy, and the process of developing its own identity as an organisation, distinct from the aggregate views and interests of its members, will evolve over time. Nevertheless there are signs that the FSB is being positioned as regime manager by the G20 governments, and is positioning itself in this role. In particular, it is expected to develop a role in systemic surveillance, together with the BIS and the IMF. It is developing a greater role as a standard-setter, formulating principles for regulators to implement. It is also actively developing a role in promoting and overseeing the implementation of international financial regulation by national governments, both G20 and non-G20 member states.

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<sup>80</sup> See E. Kapstein, 'Resolving the Regulator's Dilemma: International Coordination of Banking Regulations' (1989) 43 *International Organisation* 323; Davies and Green, n 14, 34-39.

<sup>81</sup> de Larosiere Report, n 40 above, paras 208, 256.

<sup>82</sup> *ibid.*

*FSB as a regulator: Setting standards*

The international financial regulatory committees have been enthusiastic standard-setters since their various inception. The principles and rules they issued were directed at member state regulators and focused both on the organisation and operation of regulation by national governments and their regulatory authorities, including central banks (for example requirements that regulators be independent and transparent), and on the regulation of market actors (for example, IOSCO's principles for the regulation of credit rating agencies). The FSB's predecessor, the FSF, was content largely to leave the function of standard-setting to the existing international organisations, principally IOSCO, the BCBS, the IAIS, and the IASB. However, since its reconstitution in 2008 it has become a standard-setter itself. It has issued two sets of Principles in the last six months (on remuneration and cross-border crisis management), more than it did in the last 10 years in its old formulation as the Financial Stability Forum. Pre-crisis, the FSF issued recommendations but otherwise simply compiled a compendium of a selected set of principles issued by others.<sup>83</sup>

The issuance of the FSB's principles could be viewed as simply a pragmatic allocation of functions between the different organisations that are involved in the international financial regulatory regime. They could have been issued by any or all of the other sectoral regulatory organisations, but as they apply to all financial institutions it makes sense for the FSB to issue them. However, it is suggested that there is a deeper significance to this development. It is important to recognise the different roles that principles can play in any regulatory regime, including the international financial regulatory regime. They are not simply regulatory instruments used in an attempt to affect behaviour. They can have a broader role and significance. First, they have symbolic significance: they are used to establish their authors' own institutional position within the regulatory regime. Secondly, they have a broader functional role: not just to regulate the behaviour of market actors but to be used in the monitoring and assessment of the regime's own performance. Principles are increasingly being used as benchmarks of performance against which national regulatory regimes are assessed, and thus as criteria of accountability.<sup>84</sup> Consequently, the development of the FSB's role as standard-setter is a step towards establishing its position as overall coordinator, manager, and enforcer of the international regulatory regime.

However, the process of developing principles is not necessarily a linear, hierarchical, 'flow down from the top' process, but more complex. The development of principles on remuneration provides a good recent illustration of the dynamics of 'principles production' in this polycentric system of financial regulation, and of the challenges facing the FSB if it wants to become 'head of global'. Despite the rhetoric of the need for greater international coordination and harmonisation, the UK's FSA was a 'first mover', declaring that it was prepared to

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<sup>83</sup> FSB, n 64 above; FSB, *Principles for Cross Border Cooperation and Crisis Management* (April 2009).

<sup>84</sup> See further J. Black 'The Rise, Fall and Fate of Principles Based Regulation' in K. Alexander and N. Moloney (eds) forthcoming, *Law Reform and Financial Markets* (Cheltenham: Edward Elgar, 2011).

act unilaterally. It issued its draft code on remuneration in February 2009. This was followed by the communiqué from the G20 that principles governing remuneration should be developed. As a consequence, the Financial Stability Forum (as it still was) issued its Principles on Sound Compensation Practices in April 2009, followed by Implementation Standards for the Principles in September 2009. Two of the international committees of regulators, IOSCO (securities) and the BCBS (banking) are developing proposals to implement these Principles. Separately, regulators in Australia, Switzerland, France, and the Netherlands published principles on remuneration practices, broadly following the FSF's, and the US indicated its intention to do so. Meanwhile, various initiatives were emanating from the EU. The Committee of European Banking Supervisors (CEBS) issued the final version of its high-level principles on remuneration just after the FSB in April 2009, and the Commission published a recommendation,<sup>85</sup> and draft amendments, to the Capital Requirements Directive (CRD). These were formalised and sent to the EU Parliament and Council in July 2009.<sup>86</sup> None of these principles are exactly aligned with one another. The FSA code, for example, is broadly aligned to the FSB's principles, but is 'super-equivalent' in a number of respects.<sup>87</sup> Further, notwithstanding the fact that the FSA will have to implement the CRD's eventual provisions on remuneration, it decided that should act unilaterally and in advance of any EU provisions that may eventually emerge. The FSA's Code on Remuneration was finalised in October 2009 and came into force in January 2010. The picture was further complicated by the EU Commission's announcement in July 2010 to develop legal rules on remuneration.<sup>88</sup>

The process demonstrates the 'multi-authorship' of principles, and the multiple roles that individual regulators play in each of these rule-writing fora: the FSA, for example, is both contributing author of and subject to the principles emanating from the FSB, IOSCO, BCBS, and CEBS. It also illustrates the difficulties of system management and the lack of coordination that can characterise norm formation in polycentric systems, as each regulator wants to develop its own norms to suit its own local conditions and priorities.

#### *Peer review - Monitoring, assessment, and putative enforcement*

Setting principles may be a necessary part of regulation but it is by no means sufficient. As all regulators know, the greater challenge is ensuring they are complied with. One of the outcomes of the crisis was a recognition that national regulation itself can be a source of negative externalities, adversely affecting other countries' fiscal positions, and thus their taxpayers. The goal of international

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<sup>85</sup> at [ec.europa.eu/internal\\_market/company/directors-remun/index\\_en.htm](http://ec.europa.eu/internal_market/company/directors-remun/index_en.htm).

<sup>86</sup> at [ec.europa.eu/internal\\_market/bank/docs/regcapital/com2009/Leg\\_Proposal\\_Adopted\\_1307.pdf](http://ec.europa.eu/internal_market/bank/docs/regcapital/com2009/Leg_Proposal_Adopted_1307.pdf).

<sup>87</sup> For discussion, see FSA, *Reforming Remuneration Practices in Financial Services* (PS 09/15, London, August 2009).

<sup>88</sup> EU Commission, 'Recommendation on Remuneration Practices of Risk Taking Staff within Financial Institutions' (IP/09/674); Proposal to Amend the Capital Requirements Directive (IP/09/1120).

harmonisation of regulation is thus no longer pursued simply to prevent the regulatory equivalent of the market for lemons emerging, in which regulatory arbitrage by firms leads either to countries with high quality, and high cost, regulatory regimes being bypassed by financial markets, and /or to a 'race to the bottom', in which regulatory standards converge at the lowest level to the detriment of broader social and economic goals. Whilst these concerns are still present, there is now the additional motivation arising from the recognition that the manner in which regulation is conducted in one country can have other negative spillover effects affecting not just the country's share of the financial market, but the stability of its financial system as a whole.

Negative spillovers can be caused through one-off, unilateral actions, as the example of Ireland's extension of its deposit guarantee for Irish banks illustrates. But negative spillovers can arise from more deep-rooted failures of national financial regulation which are transmitted to other countries by global financial systems. Thus did the Florida dream turn into a global nightmare. It is not only global markets that can transmit the consequences of national financial failures. They also can be transmitted through channels created by the design of regulation itself. In the EU and EEA, for example, the passporting system was put in place to facilitate cross-border banking. It became a transmission belt for cross-border instability, as the collapse of the Icelandic banks illustrated.<sup>89</sup>

As a consequence, whether or not a national government is implementing internationally agreed regulatory standards is no longer a matter of concern principally to the international organisations of regulators who issue and monitor them. It is now recognised to be a matter of direct concern to all national governments. As the FSB has observed: '[f]inancial markets are global in scope and, therefore, consistent implementation of international standards is necessary to protect against adverse cross-border, regional and global developments affecting international financial stability.'<sup>90</sup> Moreover, whether or not there is compliance is no longer seen to be a matter that can remain private to the government and the international monitors, in the way that information about a firm's compliance record remains restricted to it and its regulator until enforcement action is taken. Rather it is information that all need to know, as the financial stability of one country can be dependent on the regulatory performance of another.

From a global, system-wide perspective, it is thus significant that the G20 member states have now agreed to submit their national financial regulatory regimes to assessment by the international financial institutions, and for those assessments to be published. These assessments have of course been carried out for a number of years by the IMF and the World Bank in their Reports on the Observance of Standards and Codes (ROSC), which form part of the Financial

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<sup>89</sup> For criticism of the passporting system, see UK Treasury Select Committee, *Banking Crisis – The Impact of the Failure of the Icelandic Banks* (Fifth Report of Session 2008-9, HC 402, HMSO, 2009).

<sup>90</sup> FSB, *Framework for Strengthening Adherence to International Standards* (January 2010).

Sector Assessment Program (FSAP). The reviews have been concerned with compliance with IMF codes on fiscal and monetary transparency as well as with a selection of principles concerning the organisation, content, and operation of national financial regulatory regimes. However, the drive for all members to be reviewed and for reports to be published will require some changes in the attitudes of national governments to the review processes. There are signs that this will not be an easy process, however, as different countries have already demonstrated that they are more open to criticism than others. Three of the new FSB members had not previously agreed to being assessed: Indonesia, China, and the USA. Reviews of them are currently underway. Not all have previously agreed to have their reports published (eg Brazil, and Russia for its 2008 report). Ten countries had only agreed to have their reports published in summary form, including Germany, Mexico, Japan, and Singapore. All are now expected to agree to publication.<sup>91</sup>

Under the ROSC and FSAP processes, the FSF's role was limited to assembling the compendium of such principles. In contrast, the FSB is now being positioned by the G20, and is positioning itself, at the centre of this monitoring and assessment process by establishing its own separate system of peer reviews. The FSB is putting in place a system of peer review monitoring for members to be conducted on a country and thematic basis.<sup>92</sup> The first thematic review has already been completed, on the actions taken by firms and national authorities to implement the FSB Principles and Implementation Standards for Sound Compensation Practices.<sup>93</sup> Priority is also being given to compliance with the principles contained in various codes of BCBS, IOSCO, and IAIS concerning international cooperation and information exchange. The peer reviews will be conducted separately from the FSAP and ROSC processes, although the intention is to reinforce the ROSC and FSAPs by ensuring that recommendations made in those reports are implemented.<sup>94</sup> Notably, however, the review process will also focus on monitoring implementation with the FSB's own principles, not just those of the other committees.

The added value of the peer review process, the FSB hopes, will come from 'the cross-sector, cross-functional, system-wide perspective brought by its members' and from dialogue with peers'.<sup>95</sup> Peer reviews will be the responsibility of the FSB's Standing Committee on Standards Implementation. However, the final responsibility for approving FSB peer reviews lies with the Plenary, as the decision-making body of the FSB. Peer review reports and any commentaries provided by the reviewed jurisdictions will be published. Following publication of

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<sup>91</sup> The first country peer review was recently completed of Mexico: FSB, *Country Review of Mexico - Peer Review Report* (September 2010). The review assessed Mexico's implementation of the recommendations made in its 2006 FSAP report.

<sup>92</sup> FSB, n 90 above.

<sup>93</sup> FSB, *Thematic Review on Compensation – Peer Review Report* (March 2010); two more peer reviews have been initiated, on risk disclosure and residential mortgage underwriting practices: [www.fsb.org](http://www.fsb.org).

<sup>94</sup> This was the focus Mexico's peer review.

<sup>95</sup> FSB, n 90 above.

the report, jurisdictions' implementation of agreed actions will be monitored by the FSB and, if implementation lags, peer pressure may be applied.<sup>96</sup> The initial focus of the FSB is on jurisdictions that could pose a risk to financial stability because of their importance in the financial system and their weak adherence to the relevant standards. It will evaluate areas of weakness, consider cooperation with international assessment processes, examine where further information is needed, identify priorities for reform, and recommend actions to address weaknesses.<sup>97</sup> Capacity-building mechanisms will be made available to provide technical assistance.

There is an ambiguity in the role of peer reviews, however, as to whether they are primarily aimed at providing technical assistance or whether they are aimed at ensuring compliance. The FSB's stance at present is tending towards the latter. However the FSB has no direct means of promoting or enforcing compliance, though it has indicated that it will name and shame those who are not compliant. It is nonetheless developing a 'toolbox' of positive and negative measures that could be deployed.<sup>98</sup> This comprises a combination of carrots and sticks (and some orange-painted, carrot-shaped sticks). At the softer end are 'compliance'-based strategies such as advice and technical assistance. Moving up the sanctions pyramid,<sup>99</sup> borrowing from IOSCO, the FSB suggests that those who are not adherent should sign a multilateral MOU on information sharing and cooperation as a condition of membership of various international bodies or their working groups (but note that it does not include membership of itself in its list of examples, raising questions as to the extent that the FSB as an organisation separate from the G20 can determine its own membership).<sup>100</sup> It suggests that national regulators could vary their stance to financial institutions that are based in non-compliant countries, for example in making decisions relating to market access, or enhancing their supervision of such institutions in a number of ways, including higher capital requirements. At the top of the pyramid it suggests that the IFIs could consider withholding financial assistance from such countries. The toolbox thus contains a wide range of tools, but the FSB can exercise very few of these itself. Whether in practice there is the political will to adopt these measures when they are needed remains to be seen.

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<sup>96</sup> *ibid.*

<sup>97</sup> *ibid.*

<sup>98</sup> FSB, *Promoting Global Adherence to International Cooperation and Information Exchange Standards*, Annex D, Toolbox of possible measures to promote the implementation of international financial standards (FSB, March 2010).

<sup>99</sup> I. Ayres and J. Braithwaite, *Responsive Regulation* (Oxford: OUP, 1992).

<sup>100</sup> Applicants to become IOSCO members are required to apply to become signatories to the IOSCO MMoU and to sign the IOSCO MMoU as a condition for being accepted as IOSCO members: [www.iosco.org](http://www.iosco.org).

## THE CHANGING ROLE OF THE IMF

The IMF is not a new actor in the financial regulatory regime. It was a founding member of the Financial Stability Forum (FSF). As noted above, with the World Bank it has been monitoring countries' compliance with certain principles of regulation issued by the international committees of regulators as part of its FSAP since 2002. Consistent with the IMF's mandate, these reports were focused on individual country compliance. They did not consider the systemic implications of one country's regulatory regime.<sup>101</sup> The IMF also performed macro-economic surveillance. However, in a reflection of the pre-crisis cognitive and institutional divide between macro-economic surveillance and micro-prudential supervision, there were no mechanisms in place for their reports to be integrated into the processes of banking supervision.

In the wake of the crisis, the expectations of the role the IMF should play in the global financial system have increased, though the exact nature of this role remains somewhat unclear. It is clearly expected to have a far greater role in macro-economic surveillance, and has been enhancing its surveillance of financial sector activities as part of its Article IV surveillance since 2007. It has also begun to play a more active role in financial regulatory policy, most notably with its recent proposals for how banks could contribute to the cost of bailouts,<sup>102</sup> and there are signs that this role is likely to continue. In a recent statement, the IMF's Director of Strategy, Policy, and Review, Reza Moghadam, emphasised the IMF's 'near-universal membership, close and regular engagement with country authorities, and technical expertise on financial sector issues' (in implicit but unstated contrast to the FSB), meant that it was 'well positioned to lead on financial sector issues', albeit working closely with others.

There are also indications that it is moving to play a greater role as an enforcer.<sup>103</sup> In the same statement, Moghadam suggested, 'a key aspect of the IMF's ability to be an effective guardian of global macroeconomic and financial stability includes overseeing the implementation of rules that govern financial regulation,' in particular through the FSAP process. The IMF has been making significant changes to the FSAP process. This can be adapted more easily as it is at present still a voluntary process which in legal terms is simply a form of technical assistance. It is introducing a strong risk-based element to the assessments, moving to having shorter, 'modular' assessments on particular issues, and greater use of cross-country thematic reviews. The changes are intended 'to sharpen the focus of assessments; make them more flexible and nimble; strengthen the analytical content of stability analysis, comparability, and

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<sup>101</sup> See the discussion in IMF, n 2 above.

<sup>102</sup> C. Cottarelli, 'Fair and Substantial – Taxing the Financial Sector' at <http://blog-imfdirect.imf.org/2010/04/25/fair-and-substantial-%e2%80%94taxing-the-financial-sector/>.

<sup>103</sup> IMF, 'IMF Pushes Reforms to Its Governance and Mandate' (June 2010) *IMF Survey Magazine: Policy, IMF Strategy*.

dissemination of assessments; ensure effective Bank-Fund coordination; and improve resource utilization, cost control, and internal processes'.<sup>104</sup> The FSAP is to be more closely integrated into the bilateral surveillance activities under Article IV, where there is also now a greater focus on the financial sector.<sup>105</sup> As with the FSB, however, there is an ambiguity in the peer review process. On the one hand it is portrayed as best practice sharing and a way to bring peers up to the community's standards; on the other a tool of implementation and enforcement. In the shift to risk-based FSAPs, moreover, the question is whether the FSAP will be orientated to risk and outcomes, or to compliance and enforcement of international standards.

More fundamentally, it has become apparent that there is a considerable gap between the role that is now expected of the IMF, and that which it legally can play. In January 2010 the IMF launched a review of its mandate, arguing that its legal powers and purposes are addressed at 'matters important to a bygone age'. In the past the focus was on trade and balance of payments; what is needed now are powers to conduct multilateral surveillance, to require action to be taken in the interests of the system as a whole, for crisis response, and to ensure stability of reserves.<sup>106</sup>

The IMF argues in the Review that 'the central lesson of the crisis has been that surveillance for crisis prevention needs to be much more rigorous, with greater coverage of financial sector and regulatory issues, and better appreciation of systemic risks and spillovers. Equally, lending for crisis response has to be of a speed, coverage and size far beyond previous assumptions'.<sup>107</sup> In order to respond 'new modalities and outputs may be needed to tackle the systemic implications and interactions of country policies, along with a new conception of cooperation, data provision and peer review'.<sup>108</sup>

It suggests that the Fund could act as a global systemic risk board, taking the lead in identifying and prioritising macro-systemic risks through its macroeconomic, early warning, and macro-financial analyses, working with national authorities, the FSB, and BIS to assess and respond to systemic risks and vulnerabilities.<sup>109</sup> Amongst other things, it proposes enhancing multilateral surveillance and reducing the gap between its bilateral surveillance activities, which are based on detailed dialogues with policymakers, and its multilateral surveillance, which looks at systemic outcomes, for example by building on the G-20 Mutual Assessment Process.<sup>110</sup> However, it cautions that given its current organisational structures and expertise that the logistical challenges of achieving this should not

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<sup>104</sup> IMF, *Financial Sector and Bilateral Surveillance – Toward Further Integration* (IMF, August 2009), 7; see also IMF, *The FSAP After 10 Years: Experiences and Reform for the Next Decade* (IMF, 2009); *Revised Approach to Financial Regulation and Supervision Standards in FSAP Updates* (IMF, 2009).

<sup>105</sup> IMF, *Integrating Financial Sector Surveillance Issues and FSAP Assessments into Surveillance* (IMF, 2009).

<sup>106</sup> IMF, n 2 above, 3.

<sup>107</sup> *ibid.*, 3.

<sup>108</sup> *ibid.*

<sup>109</sup> *ibid.*, 6.

<sup>110</sup> *ibid.*

be underestimated. It also suggests that its bilateral surveillance mandate could be strengthened by increasing expectations regarding financial sector policies, for example by making FSAPs mandatory for countries with regionally or systemically important financial sectors and improving the effectiveness of the bilateral surveillance process, although it has also argued that FSAPs should remain voluntary.<sup>111</sup> With respect to lending, it proposes several ways in which lending to countries in times of financial crisis could be provided more flexibly, and perhaps without the stigma that IMF financing has for many countries, such as collateral-based lending and guarantees.<sup>112</sup>

However, there are several constraints to achieving these outcomes, both legal and organisational. Its legal and organisational structure limits it to a series of bilateral relationships with individual countries; it does not permit it to operate multilaterally as a system-wide coordinator or to engage with private sector actors. For example, members' legal obligations regarding domestic policies under the Articles are limited to the adoption of policies that promote domestic stability; the Fund has no formal legal powers to require them to take action in the interests of the financial system as a whole. It has only limited and episodic access to supervisory data (eg in the context of FSAPs), and members often decline to provide systemically relevant information on grounds of confidentiality.<sup>113</sup> Further, the Fund has no authority to require confidential data on entities such as large complex financial institutions as the Articles expressly provide that members are under no obligation to furnish information on individual corporations, regardless of their systemic significance.<sup>114</sup>

As amendment of the Articles to require such disclosure is unlikely to find broad support, it suggests that alternative arrangements will be needed. These could include voluntary agreements with national and regional regulators / systemic risk boards, and with the FSB and BIS. It also suggests that a 'Financial Data Dissemination Standard' could be developed for countries with systemically important financial sectors.<sup>115</sup>

The expectations, at least of the G-20, of the role that the IMF can and should play in financial regulation going forward clearly envisage a significant shift in its role. However, as the IMF points out, it is not so clear that its mandate permits this, or at least will require some creative interpretation in order to permit it to take on a number of these roles. Its current mandate review also illustrates the uneven role that law plays in the international financial regulatory system and its implications for regulatory capacity. The FSB has been reconstituted without need for any such debate, but in contrast does not have hard-edged legal powers

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<sup>111</sup> IMF, *Financial Sector and Bilateral Surveillance*, n 104 above, 12.

<sup>112</sup> It also makes several proposals for the management and provision of reserves, and floats the possibility of the creation of a global currency which could act as a reserve: Mandate Review.

<sup>113</sup> *ibid.*

<sup>114</sup> *ibid.*; art VIII, section 5(b).

<sup>115</sup> IMF, n 2 above, 6.

that it can deploy. Colleges of supervisors (discussed below) have been created to coordinate supervision; again they have the advantage that they can be rapidly constituted, but they rely on each individual member having the legal powers in their own jurisdictions to get the information that the supervisors need, and to instigate the supervisory response that is deemed to be necessary. The IMF has some considerable legal powers, but in order to fulfil its new role it has to engage in a series of creative interpretations that it hopes its members will accept in order to avoid the difficult process of amendment to its articles.

### **RESTRUCTURING AT THE REGIONAL LEVEL: RECONFIGURING EU FINANCIAL REGULATION**

The radical restructuring of the institutional structures of EU financial regulation is an excellent example of how not to waste a good crisis. Indeed the Larosiere Report, on whose recommendations the restructuring is based, admitted that its proposals were more about the enhancement of the European single market than they were a response to the financial crisis. Nevertheless it did argue that uncoordinated crisis management action had led to negative spillover effects which needed to be addressed.<sup>116</sup>

The Larosiere report and subsequent legislation are the manifestation of a desire for order, control, and above all, for the elimination of differences. The main problem the Larosiere Report identified in the system of EU financial regulation was inconsistent implementation. In a notable backtracking from the tiered approach to rule design advocated by Lamfalussy, in which Level 1 measures would be formulated as principles, supplemented by detailed rules and guidance at Levels 2 and 3, Larosiere argued that the ‘fundamental cause of this lack of harmonisation is that the level 1 directives have too often left, as a political choice, a range of options to member states as to their implementation. In these circumstances, it is unreasonable to expect the level 3 committees to be able to impose a single solution. Even when a directive does not include national options, it can lead to diverse interpretations which cannot be eliminated at level 3 in the present legal set-up.’<sup>117</sup> Some examples the Larosiere Report identified are crisis-related, notably the differences in the definition of regulatory capital regarding financial institutions. The treatment of subordinated debt as core tier 1 is the object of different adaptations, which as the Report notes, goes at the heart of the efficiency and the enforcement of the Basel directive on capital requirements. There is also no single agreed methodology to validate risks assessments by

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<sup>116</sup> de Larosiere Report, n 40 above, 27.

<sup>117</sup> *ibid.*

financial institutions.<sup>118</sup> Other examples are unrelated, for example differences in the regulation of insurance mediation and accounting provisions for pensions.

Nonetheless, the report's central concerns were coordination and consistency in the regulatory structure itself: coordination between macro and micro-prudential supervision; coordination in crisis management; and above all coordination and consistency in the standards that apply throughout the EU. The new structure that is to be established consequent on the report has these issues at its centre.

The legislative reforms will establish a European level body charged with overseeing risk in the financial system as a whole, the European Systemic Risk Board (ESRB) and create a European System of Financial Supervisors (ESFS).<sup>119</sup> The ESRB will monitor and assess potential threats to financial stability that arise from macro-economic developments and from developments within the financial system as a whole ('macro-prudential supervision'). Its role is to provide an early warning of system-wide risks that may be building up and, where necessary, issue recommendations for action to deal with these risks. The ESFS, in the words of the Commission,

will be built on shared and mutually reinforcing responsibilities, combining nationally based supervision of firms with centralisation of specific tasks at the European level so as to foster harmonised rules as well as coherent supervisory practice and enforcement. This network should be based on the principles of partnership, flexibility and subsidiarity. It would aim to enhance trust between national supervisors by ensuring, *inter alia*, that host supervisors have an appropriate say in setting policies relating to financial stability and consumer protection, thereby allowing cross-border risks to be addressed more effectively.<sup>120</sup>

Central to the ESFS is the endowment of a legal basis and set of powers to the existing Level 3 committees, converting them into new European Supervisory Authorities (ESAs). A central aim of the creation of the new system is to create a single rulebook for the whole of the EU that is consistently interpreted and applied throughout the EU by all member state financial regulators. This process is to be strengthened by introducing more directly applicable rules at the EU level wherever possible.

The authors of the new EU regime have extensive ambitions to establish the EU authorities as the central regime managers of the network of financial supervision within the EU, but are approaching the task in a very different way than the FSB or even IMF. This is partly because they can: the EU has the

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<sup>118</sup> *ibid*, 28.

<sup>119</sup> European Commission, 'Communication from the Commission: European Financial Supervision' COM(2009) 252 final, (May 2009).

<sup>120</sup> *ibid*, 3.

institutional and legal structures that it can deploy to implement its strategies. Its authors are searching for control, and for the elimination of discretion, variety, and difference in financial supervision across member states.

As with the FSB and IMF, a key tool is to be the peer review process.<sup>121</sup> There has been an uneven development of peer reviews thus far, with CESR clearly leading the way. Thus far, however, the reviews have been largely formal assessments of powers and practices, with an orientation to promoting best practice. Peer reviews were introduced by CESR in 2003, and institutionalised through the creation of a Review Panel. Its Review Protocol, issued in March 2007, emphasises the need to develop coordination and best practices,<sup>122</sup> but the reviews done to date have been limited to comparative surveys of formal supervisory powers and practices, for example with respect to market abuse,<sup>123</sup> or the practical operation of financial reporting standards and the UCITS passporting regime.<sup>124</sup> Following CESR's initiative, CEBS, the Level 3 banking committee, adopted substantively the same Protocol as the basis for initiating its own peer review process in October 2007. Thus far it has focused on methods of model validation under the Capital Requirements Directive,<sup>125</sup> and at the request of the Commission, in 2008-2009 its Review Panel has conducted a mapping of supervisory powers and objectives across EU banking authorities, with special focus on early intervention measures and the actual use of sanctioning powers.<sup>126</sup> It is currently conducting a review of the conduct of supervisory colleges. CEIOPs (insurance and occupational pensions) was the last to initiate peer reviews, establishing its panel in 2008 and adopting a similar Protocol to the others.<sup>127</sup> Its initial reviews have thus far consisted of self-assessments by member states on provisions of information exchange and supervisory cooperation across its remit,<sup>128</sup> and a current review of the application of the Common Principles for Colleges of Supervisors, shared with CEBS.<sup>129</sup> It is clear that the significance of the peer review process is intended to increase in the new structure. The proposed Regulations establishing the ESAs emphasise that peer reviews will form a central mechanism of coordination, not simply mechanisms of providing technical assistance. The ESAs are legally required to conduct regular peer

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<sup>121</sup> CESR, 'General Methodology for Implementation Reviews Undertaken by CESR', CESR/04-711b (April 2005).

<sup>122</sup> CESR 07/070b.

<sup>123</sup> CESR/09-1120 and CESR/07-380; there have also been reviews of powers with respect to MiFID (CESR/08-220); 'Transparency Directive' (CESR/09-058); and 'Prospectus Directive' (CESR/07-383).

<sup>124</sup> See eg CESR/09-1034 (UCITS); CESR/09-374 (Financial Reporting) and associated member state self-assessments.

<sup>125</sup> CEBS, *Peer Review on CEBS's Guidelines on the Implementation, Validation and Assessment of Advanced Measurement (AMA) and Internal Rating Based (IRB) Approaches* (April 2009).

<sup>126</sup> CEBS/09-47.

<sup>127</sup> CEIOPS-DOC-28/08.

<sup>128</sup> For details, see <https://www.ceiops.eu/review-panel/index.html>.

<sup>129</sup> CEBS, CEIOPS, and IWCFC, *Colleges of Supervisors – 10 Common Principles*, CEIOPS-SEC-54/08; CEBS 2008 124 (January 2009).

reviews, though national authorities are not formally bound to follow the ESAs' recommendations but are to 'endeavour' to do so.<sup>130</sup>

## MANAGING THE FINANCIAL REGULATORY REGIME: ORCHESTRATING INTERACTIONS

The crisis has created a series of 'cognitive shocks' for financial regulators, prompting a series of policy changes and, of main focus here, of organisational restructurings and realignments. There are clearly a number of challenges going forward, but the remainder of the discussion focuses only on three: system coordination, reflexive self-observation or 'learning', and responsiveness.

One of the key challenges of polycentric regulation, particularly when it is multi-level, is coordination or 'orchestration'.<sup>131</sup> In the financial sphere, the question is how best to manage a complex, interlocking network of regulatory actors and their relationship with an even more complex, dynamic, and interlocking financial system. Both the FSB at the global level and the EU authorities at the regional level are attempting to become 'regime managers', and in some respects are being positioned in this role by other actors in the regulatory arena. However, this is a far from straightforward trajectory, particularly for the FSB which, unlike the EU authorities, cannot rely on a complex institutional infrastructure and legal fiat to accomplish this task. But with respect to both the FSB and the new EU regulators, the issue of 'who governs' remains contested and is underlain with a number of tensions and conflicts.

There are four main types of institutional structures for control: hierarchy; community, markets / competition, and managed networks.<sup>132</sup> The FSB is attempting to use three of these – hierarchy through the promulgation of rules and a system for their enforcement; community in attempting to deploy peer pressure, and peer cooperation through support and capacity building; and network

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<sup>130</sup> Article 15 of the proposed Regulations establishing ESMA, EBS, and EIOPS respectively: European Parliament Legislative Resolution of 22 September 2010 on the Proposal for a Regulation of the European Parliament and of the Council Establishing a European Insurance and Occupational Pensions Authority (COM(2009)0502 – C7-0168/2009 – 2009/0143(COD)); Position of the European Parliament Adopted at First Reading on 22 September 2010 with a View to the Adoption of Regulation (EU) No .../2010 of the European Parliament and of the Council Establishing a European Supervisory Authority (European Banking Authority), P7\_TC1-COD(2009)0142; Position of the European Parliament Adopted at First Reading on 22 September 2010 with a View to the Adoption of Regulation (EU) No .../2010 of the European Parliament and of the Council Establishing a European Supervisory Authority (European Securities and Markets Authority), P7\_TC1-COD(2009)0144 (September 2010).

<sup>131</sup> K. Abbot and D. Snidal, 'International Regulation without International Government: Improving International Organization Performance through Orchestration' (June 2010), at <http://ssrn.com/abstract=1487129>.

<sup>132</sup> Part of the discussion section comes from a paper drafted jointly with Rob Baldwin, 'Regulatory Cohabitation' (presented at the Regulation conference, Dublin, June 2010); I thank Rob for agreeing to the use of part of that paper here.

management strategies in that it is attempting to facilitate concerted actions by developing or steering processes that either encourage negotiations and interactions or foster the conditions for collective behaviour by building levels of consensus to points that allow for action on a given issue, for example as in cross-border crisis management. The EU is opting only for one: hierarchy. Although there are indications that the system should in practice be managed on a 'hub and spoke' basis the ESAs' powers to settle disputes among national financial supervisors, to impose temporary bans on risky financial products and activities, and to directly prevent or remedy any breaches of EU law by financial institutions should national authorities fail to act, mean that the 'hub' has overall powers of control to ensure the spokes do not fly off. The only strategy not being used strongly by either is markets: There is little faith at present in the idea that co-ordination can be achieved 'through the "invisible hand" of the self interest of participants' who are willing to exchange resources and conclude agreements in order to attain mutually beneficial solutions and higher levels of collective welfare.<sup>133</sup> The crisis has shown the limits of that approach as a strategy for management of an international regulatory regime.

A difficulty is that each of these modes of control has quite distinct logics that are hard to combine, and often a demanding set of institutional preconditions for them to operate successfully which are simply not present. Hierarchies are top-down institutional and control structures in which a central control body lays down rules and policies that provide direction to the network of inferior institutions. This works best if there is a high degree of organisational integration from top to bottom, there is a clear and commonly understood mandate, and the control body has the authority, tools, and capacity to organise the network.<sup>134</sup> Hierarchical controls work less well where networks are loosely constituted and where the member organisations are numerous, independent, divergent in characteristics, and oriented to different objectives.<sup>135</sup> Hierarchies also depend on recognition by those within them that there is an apex, and that the regulatory process is one of implementing goals formulated *ex ante* by a central authority. They struggle in a context in which there are a number of constellations of actors operating in the same policy space,<sup>136</sup> and moreover where participants see the nature of the task not to be one of rule implementation but as an interactive process of exchanging information about problems, preferences, responses, and

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<sup>133</sup> See B.G. Peters, 'Managing Horizontal Government: the Politics of Co-ordination' (1998) 76 *Pub Admin.* 295, 298; B. Marin, 'Generalised Political Exchange' in B. Marin (ed), *Generalised Political Exchange* (Frankfurt: Campus Verlag, 1990); R. Fisher and W. Ury, *Getting to Yes* (Boston Mass., Houghton Mifflin, 1981); E. Ostrom, *Governing the Commons* (Cambridge, CUP, 1990).

<sup>134</sup> See eg B.G. Peters, 'Managing Horizontal Government: the Politics of Co-ordination' (1998) 76 *Pub Admin.* 295.

<sup>135</sup> D. Chisholm, *Co-ordination without Hierarchy* (Berkeley, Univ. of California Press, 1989).

<sup>136</sup> See W. Grant, W. Paterson, and C. Whitston, *Government and the Chemical Industry* (Oxford, OUP, 1988). A government motive for creating a network may be the desire to opt out of control over a difficult issue – to 'offload a headache' – see S. Goldsmith and W. Eggers, *Governing by Network*. (Washington DC: Brookings, 2004), 43.

trade-off goals and resources.<sup>137</sup> This is a message that EU policymakers would do well to reflect on.

Community controls are based on recognition of a stable group of peers who share a common set of interests, and whose main concern is to remain accepted by the community. Self-interest is either emasculated or is recognised to be dependent on or identical to the community interest. Regulatory strategies based on peer pressure and peer support work less well where participants have conflicting goals, objectives, and interests and have motivations to compete with one another, and where non-participation in the group is not fatal to the survival of the outsider. There are aspects of the international and EU regulatory system where these institutional structures are present, but they are by no means pervasive.

Network management strategies are directed towards harnessing the different control capacities of the involved actors,<sup>138</sup> or developing processes that change perceptions and allow collective actions to be taken. Network management strategies are arguably better suited to polycentric regimes in which diffused regulators interact and bring different capacities to bear on issues without there being any hierarchical linkages but instead there are wider dispersions of authority to a number of autonomous bodies who may only be loosely coordinated. These strategies involve creating a governance mechanism for the network which establishes agendas rather than common goals; creates communications channels; makes *ad hoc* arrangements to support collective action; brokers solutions by bringing problems, solutions, and parties together; promotes favourable conditions for joint action; or manages conflicts through mediation and arbitration.<sup>139</sup> Mediation processes may, indeed, involve the establishing of units dedicated to liaising between different actors with the aim of effecting bridges between parties with different interests and orientations so as to build relationships and inter-organisational trust.<sup>140</sup> However, for the network manager, the problems of network management are that these strategies are messy, complex, fluid, and their outcomes uncertain. There are strong arguments that it is strategies of network management that are needed to regulate complex adaptive systems, such as the financial system and the system for its regulation. Regulatory systems have to be adaptable, dynamic, and match variety with variety. However, these are not messages that governments and regulators currently want to hear.

Despite the differences in their formal organisational structures, both the FSB and the EU authorities face a number of similar challenges in trying to position themselves as hierarchical 'leaders'. First, both are operating in a crowded policy

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<sup>137</sup> W. Kickert, E-H Klijn, and J. Koppenjan, (eds), *Managing Complex Networks* (London: Sage, 1997).

<sup>138</sup> See Black, n 9 above; CRI 2006; K. Jayasuriya, 'The New Regulatory State and Relational Capacity' (2004) 32(4) *Policy & Politics* 487.

<sup>139</sup> See Kickert, Klijn, and Koppenjan, n 137 above, 47.

<sup>140</sup> See N. Machado and T. Burns, 'Complex Social Organization: Multiple Organizing Modes, Structural Incongruence and Mechanisms of Integration' (1998) 76 *Public Administration* 355, 370. On trust as the 'bedrock of collaboration' see Goldsmith and Eggers, n 136 above, 111.

space. In many respects the FSB is competing with its members as a standard setter, and potentially as the guardian of implementation. Further, its members have significantly different regulatory capacities, enhancing the dependence of some on the FSB, but reducing that of others. The OECD, for example, is here a 'norm entrepreneur' – a body that issues principles or standards in the hope that others will adopt them and implement them. The OECD has issued its own principles for financial regulation, but they need adopting by the FSB if these principles are to be integrated into the peer review process either of the FSB or of the IMF / World Bank. In contrast, the EU has far greater regulatory capacity as it has legal powers to act unilaterally, as of course do individual nation states who are members of the FSB.

However, as a standard-setter the EU is also operating in a crowded policy arena. It is competing with international regulators and, to the extent it has left them any room to create their own rules, with member states. Some member states are making as much use of this remaining room for policy independence as they can, whilst they can. For example, the drive for national fiscal protectionism has led the UK to introduce its own rules on liquidity and remuneration. As the discussion of remuneration principles below illustrates, these rules can then percolate through to the international level and then down to the EU level, informally inverting the EU's legal hierarchy. Moreover, through their own membership of the international committees of regulators its member states can leapfrog it, exercising influence in the decisions made in other fora which the EU then has to decide whether or not to accept (which was one of the reasons Larosiere recommended that member states should not have separate representation on international committees – a proposal of profound constitutional significance). So although the EU can be a critical and selective adopter of transnational standards, as its approach to the IASB's rules indicates,<sup>141</sup> in crafting its rules it is often working on a canvas on which the main outlines have already been drawn by others.

There are differences between the challenges the FSB and the EU Commission face, however, arising from the differences in the organisational infrastructure in which they are situated and in their regulatory capacities. The FSB is still in an ambiguous institutional position. It may evolve to be the overall coordinator of the international regulatory regime, but it faces the main problems of network management: conflicting objectives and interests of participants; difficulties of surveillance over the regime; the use of regulatory tools with conflicting logics within the regime; differential capacities and resources of participants; lack of its own resources and capacities to effect change or manage the network; and the difficulty of getting recognition from participants that they

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<sup>141</sup> The EU Commissioner, Michel Barnier, has indicated that the EU may not adopt the IFRS rule on fair value accounting, and indeed that continued EU funding of the IASB will be contingent on it making changes to its governance structure: see eg M. Christodoulou, 'Europe's IASB Concerns Voiced at Global Meeting' (1 April 2010) *Accountancy Age* 1. That debate, as well as the creation of the Monitoring Board, illustrates the price the IASB is being required to pay in return for the EU adopting its standards.

are in a network that should be managed and that the manager is the FSB. A critical issue will be success in getting members and non-members to implement the principles that the FSB issues. For this, countries and other members of the FSB have to afford it sufficient recognition of its legitimacy and authority to govern. It also has to be able to exercise sufficient leverage through peer pressure or other means to get compliance from members, and more problematically perhaps, from non-members. Neither of these is a straightforward challenge to meet.

Further, the FSB still faces the fundamental issue that it is national governments who, at least under present arrangements, underwrite the financial institutions operating in their jurisdiction. The ‘mortality mismatch’ of financial institutions, combined with an understandable policy of fiscal protectionism, means that national governments are deeply unwilling to confer sovereignty to international bodies or to sign up to common standards or modes of supervision if these would compromise their ability to protect their fiscal position in times of crisis. The creation of a global common resolution fund through the IMF may in part be an attempt to mitigate this challenge, but its realisation is still some way off.

The EU authorities also face a number of challenges at the regional level. As in the case of the international regulators, a critical issue is not just the creation of standards but their implementation. The EU can use legal fiat to achieve its objectives, but it would be a mistake for it to think that the use of legal powers removes the need to actively build legitimacy and authority with respect to member state regulators. It would also be a mistake to assume that complete harmonisation in the interpretation and implementation of its rules is either attainable or desirable, though all the indications are that this is exactly what is being attempted. Although the Authorities now have legal powers to take action against infringers, this should be used as a last resort. The focus should be on building recognition and authority independently through their processes and day-to-day operation. Here the conflicting rhetoric and powers create a further ambiguity, however. The insistence on complete harmonisation cannot easily be reconciled with rhetoric that it should be created ‘fully respecting the proportionality and subsidiarity’.<sup>142</sup>

Moreover, there are conflicting objectives both at the EU level and between the EU and member states. The structure itself is still ‘siloesd’, as at the international level, between securities, banking, and insurance, and with an institutional divide between macro and micro-prudential regulation, reinforcing at the organisational level the cognitive constructions of financial markets which the crisis has shown to be flawed. Ensuring coordination between these different actors is clearly essential, but all too often each organisation can remain bounded by its own job description and institutional focus.

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<sup>142</sup> de Larosiere Report, n 40 above, para 184.

Furthermore, the new EU Authorities have a set of legal powers but very little operational or regulatory capacity to effect change or manage the network of member state regulators, although the rapid increase in their staffing levels may enhance this. Nonetheless, they are likely to continue to rely heavily on a small number of member states for expertise. This ‘asymmetric Europeanisation’ is a familiar feature of the operation of other EU regulatory agencies, and there is little reason to think the regime for financial regulation will be any different.<sup>143</sup> Further, although again the legal structures create a clear legal hierarchy for managing the regime, this does not on its own resolve the problem of how to gain recognition from participants that they should be managed and that the managers are the Authorities.

Moreover, the policy dynamics created by banks’ mortality mismatch exert a significant centripetal force at the EU level, just as they do at the international level. The Larosiere Report’s insistence on harmonisation was shot through with exceptions to allow member states to act in the interests of national financial stability, and these have been embedded into the new regulatory structures and processes. The passporting regime for banks, the central plank of European financial integration, has been put into question, and as noted above has been strongly criticised in some quarters as providing the channels through which financial instability can spread.<sup>144</sup> The focus is less on the ability of banks to do cross-border business, and far more on the protection of national deposit holders and the national fiscal position.

Finally, the EU regime itself sits in an interesting position within the global regime. To the extent that the EU is attempting to create a single system of financial regulation it creates a potentially ambiguous position for itself in the international regulatory sphere, one which raises interesting questions. If the EU institutions are not just coordinators but are themselves the key regulators in the EU system, should they not be subject to monitoring by the FSB, or by the IMF (albeit under a revised IMF mandate)? Arguably they should, if they are really to be setting the single rulebook and single set of supervisory strategies. This may not be a process the EU institutions would be entirely comfortable with, however. This would create an interesting dynamic between EU institutions and their member states, who may welcome an FSB / IMF assessment of the ESAs, particularly if they think there are deficiencies in the EU regime, and may use their individual membership in these bodies to push for one.

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<sup>143</sup> L. Barroso, *The European Regulatory State* (PhD thesis, London School of Economics, in progress).

<sup>144</sup> See UK Treasury Select Committee, n 18 above.

## MULTI-LATERAL SUPERVISORY ARRANGEMENTS

In addition to the restructurings outlined above, there has been a move to strengthen multi-lateral regulatory arrangements for the regulation of firms themselves. In the past, the main focus of the international regulatory efforts has been member states: this has been a ‘regulator to regulator’ conversation, not regulator to private market actor. It has moreover been a ‘governmental regulator to governmental regulator’ conversation. The membership of the global and EU regulatory organisations reflects this divide. The IASB is the only non-state regulatory body that is a member of the FSB. ISDA, the only central actor in the derivatives markets, that organised the successful auction in March 2010, is not a member of any of the international committees of regulators.

One of the weaknesses of ‘regulator to regulator’ conversations is that they can be too removed from what is happening in the markets. A key difficulty for regulators, as for governments, is having information of sufficient granularity. They are in a better position than individual market actors to have aggregate, system-wide information; but the latter have the detailed, ‘on the ground’ information.<sup>145</sup> A further difficulty for polycentric regulatory regimes is ensuring adequate information flows between different parts of the regime. The crisis demonstrated that the ‘regulator to regulator’ nature of the structures, combined with the ‘silo-ing’ of regulation into insurance, securities, and banking creates significant impediments to information flows between regulators at the EU and global levels.

It has been suggested in other contexts that building resilient systems of information and surveillance, particularly in conditions of uncertainty and which are subject to rapid change, and where knowledge is gained through the process of implementing regulation, requires multi-scale networks, in which different types of information is gathered, aggregated, and tested at different points within a network.<sup>146</sup> The global, including EU, financial regulatory regime has a number of points at which information is currently collected about firms. In addition, national regulators have generally good arrangements in place for exchanging information with respect to individual firms in the context of enforcement processes. IOSCO in particular has required all members to agree to multilateral MOU on information sharing.<sup>147</sup>

However, as yet there is only a weak linking between these points and other parts of the regime at both global and regional (EU) level, and indeed between the two levels. Two notable examples are the weak linkages between colleges of

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<sup>145</sup> Scott, n 28 above.

<sup>146</sup> P. Sheridan, D. Watts, and C. Sabel, ‘Information Exchange and the Robustness of Organizational Networks’ (2003) 100(21) *PNAS* 12516.

<sup>147</sup> IOSCO, ‘Multilateral Memorandum of Understanding Concerning Consultation and Cooperation and the Exchange of Information’ (IOSCO, 2002); the requirement was for members to sign by 1 January 2010, or to be taking steps to ensure they had the requisite legal powers to enable them to sign.

supervisors at all levels, between colleges and the peer review process, and between both of those and the standard-setting processes of the international committees and potentially the different European authorities.

#### COLLEGES OF SUPERVISORS

Colleges of supervisors are at present the only place where ‘regulator to firm’ conversations occur outside the national setting. The notion of colleges of supervisors for banks pre-dates the crisis, but their crisis gave significant impetus to their development, and they have now been mandated by the G-20 governments for global financial institutions.<sup>148</sup> In the EU they have received legal foundation via amendments to the Capital Requirements Directive.<sup>149</sup> International colleges of supervisors (ICSs) are permanent, although flexible, structures for cooperation and coordination among the authorities responsible for and involved in the supervision of the different components of global cross-border banking groups. They have also been more recently developed for insurance companies. They provide a forum intended to facilitate sharing of information, views, and assessments among supervisors in order to allow for a more efficient and effective consolidated and solo supervision and timely action; enable supervisors to develop a common understanding of the risk profile of the group as the starting point for risk-based supervision at both group and solo levels; coordinate supervisory review and risk assessment, establishing supervisory plans, arranging any division of tasks and joint onsite visits, thus avoiding duplication of work and reducing the regulatory burden; and coordinate decisions taken by individual authorities.<sup>150</sup> They can also help to develop a consistent interpretation and application of regulatory provisions across the group and build trust between supervisors.<sup>151</sup>

Colleges of supervisors are also intended to work alongside firm-specific cross-border crisis management groups under the FSB’s *Principles for Cross-border Cooperation on Crisis Management*. National authorities from the relevant countries are to meet regularly alongside core colleges to consider the specific issues and barriers to coordinated action that may arise in handling severe stress at specific firms, to share information where necessary and possible, and to ensure that firms develop adequate contingency plans.<sup>152</sup> There are nonetheless significant issues to be negotiated in securing cross-border cooperation. These arise from differing national institutional structures for financial regulation and insolvency and in some

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<sup>148</sup> G7 Interim Report

<sup>149</sup> Adopted May 2009, CRD Article 131(a).

<sup>150</sup> CEBS (December 2007).

<sup>151</sup> House of Lords, ‘Evidence of the European Banking Federation to House of Lords: The Future of EU Financial Regulation and Supervision’ (June 2009).

<sup>152</sup> FSB’s *Principles for Cross-border Cooperation on Crisis Management* (2009), Preface. The FSB’s recent implementation report, in April 2010, stated that firm-specific cross-border crisis management groups have been established for the major global financial institutions requiring FSB core supervisory colleges; and discussions are underway for development of effective contingency planning and resolution plans.

cases national laws inhibiting cross-border solutions, differences on policy issues, lack of crisis management tools and experience in managing crisis, concerns that cross-border cooperation can reduce national discretion, and key issues in relation to burden-sharing.<sup>153</sup>

Focusing here on the day-to-day process of supervision, there has been a rapid evolution in the colleges' operation, and on the whole they have been positively received by the banks and others.<sup>154</sup> However as the FSB has reported there are still several issues to be resolved in the way the colleges operate. These included the issue of membership, the balance between inclusiveness and effectiveness, communication between a core group of supervisors and the wider group, and the need for supervisors to start changing their approaches and undertaking more joint supervisions in the light of the new information and risk profiling of the financial institution in question.<sup>155</sup>

Further, because the EU has established its own EU supervisory colleges for European global banks, a bank can have two colleges, the international and the European, raising further issues of coordination between the colleges. There is at present no systematised process or structure in which the two colleges can confer or exchange information with respect to the same financial institution, or indeed merge to operate as a single college when supervising a cross-border bank.<sup>156</sup> At the European level, there are also issues of coordination between the supervisory colleges and the new European authorities, both of whom are concerned with developing common practices of supervision and implementation between their members.<sup>157</sup>

Not only that, but there are issues as to who should be setting the principles by which the colleges operate. Although firms may be multi-functional, regulation at the global and EU levels remains siloed into securities, banking, and insurance. Thus far the securities regulators have not had a significant role to play in the colleges. In the EU, only the banking and insurance supervisors have coordinated in developing principles.<sup>158</sup> There is even less coordination apparent at the global level.<sup>159</sup> There is the additional question of who should be the prime author of principles for supervisory colleges, and whether the principles should be nested in

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<sup>153</sup> See *ibid*; see eg C. Goodhart and D. Schoenmaker, 'Burden sharing in a Banking Crisis in Europe' 2006(2) *Economic Review* 34.

<sup>154</sup> eg British Bankers Association Report (June 2008); House of Lords, n 151 above.

<sup>155</sup> FSB, 'Overview of Progress in Implementing the London Summit Recommendations for Strengthening Financial Stability, Report of the Financial Stability Board to G20 Leaders' (September 2009).

<sup>156</sup> For criticism, see eg House of Lords, European Union Committee, *Future of EU Regulation and Supervision* (Fourteenth Report, Session 2008-2009), paras 196-197.

<sup>157</sup> The Principles require colleges to coordinate with the authorities (*ibid*), but clearly this is going to be a matter to be worked out in practice.

<sup>158</sup> CEIOPS, CEBS, and IWCFC, n 129 above; CEBS, n 129 above; IWCFC 08 32 (January 2009).

<sup>159</sup> The IAIS adopted a supervisory guidance paper on the use of supervisory colleges in groupwide supervision in October 2009. In March 2010 the BCBS released a consultative document on good practices on supervisory colleges, outlining expectations in relation to college objectives, governance, communication, and information sharing.

a (non-legal, but normatively accepted) hierarchy of norms. So although the EU committees have formulated their own principles, they are not the only actors in the regulatory space; the international committees clearly have a role in setting principles for the ICSs. The international regulators for banking and insurance are developing their own principles but the FSB has not led this process, though there has been suggestion that the FSB has issued guidance but has not made it public.<sup>160</sup> However some, notably the European Banking Federation, have argued that it should be the FSB who takes the lead in setting principles for the colleges' operation, though drawing on EU principles.<sup>161</sup> It is far from clear how these issues are going to be resolved at either the EU or the global level.

POTENTIAL STRATEGIES FOR DEVELOPING CAPACITIES, RESPONSIVENESS, AND LEARNING — CREATING MULTI-LEVEL POINTS OF COORDINATION AND INFORMATION EXCHANGE

The regime for financial regulation at both global and EU levels thus faces a significant set of challenges with respect to how it manages itself, let alone how it attempts to regulate market actors. Orchestrating the terms of cohabitation between participants is difficult where there is no completely agreed score for each to play, little agreement over who should be the conductor, only weak consensus as to whether all need to follow him, and only muted ability of each to hear what those in other sections of the orchestra are playing. Faced with such challenges, issues of how to ensure the system is able to anticipate future crises or challenge conventional wisdoms can appear mere fripperies: nice to have, but there is more important business to be getting on with.

This reaction is understandable, but short-sighted. Both the regulation and the markets have suffered significant cognitive shocks: the assumptions on which they based regulation and the technologies they used to manage risks turned out to be based on fundamentally flawed cognitive models of markets, behaviour, and risk. Regulators and others are struggling to create a new cognitive framework in which to develop policy responses.

Part of that process requires gaining knowledge. Gaining knowledge requires acquiring information and making sense of it through a cognitive framework. However, there is a 'chicken and egg' dynamic at work here: the cognitive framework shapes the search for information as well as its interpretation. Like the drunkard who only searches for his lost wallet under a street lamp because that is where the light is, regulators can focus only on information that is easily visible, systematisable, and quantifiable, and not look elsewhere.<sup>162</sup> However, the dangers of using only limited sources of information in managing risks are well noted in

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<sup>160</sup> EBF, *International Colleges of Supervisors and Global European Banks* (EBF Ref.: D1239E-2009, September 2009).

<sup>161</sup> *ibid.*

<sup>162</sup> Scott, n 28 above; T. Porter, *Trust in Numbers: The Pursuit of Objectivity in Science and Public Life* (New Jersey: Princeton University Press, 1995).

the risk management literature,<sup>163</sup> and were manifested in the crisis. In Rumsfeld's well-worn trichotomy, there are the known knowns, the known unknowns, and the unknown unknowns. In risk management, different strategies are appropriate for each state of knowledge.<sup>164</sup> Regulators can never know all, and therefore never can anticipate everything: that is the nature of risk management. But they can at least improve on their ability to limit the extent of the unknown unknowns and respond accordingly.

Work therefore needs to focus on two interlinked fronts. Firstly, regulators need to gain information from a wider range of sources than at present and coordinate its collection and analysis, in order to help them overcome problems of scale – how those developing strategies at a systemic level can have sufficient granular knowledge of how different parts of the system are working ‘on the ground’. Secondly, they need to develop mechanisms for cognitive challenge.

Focusing first on information and problems of scale, work done to date on network management systems suggests that a fruitful coordination strategy for managing complex systems is to develop intermediators, links in the system between its component parts.<sup>165</sup> Creating points for the collection and dissemination of information about the performance of the different parts of the regime is a good place to start. To give two examples, there are two existing mechanisms that are currently not utilised in this way but that offer some potential: colleges of supervisors and the peer review process.

Colleges of supervisors have their own challenges, as discussed above, but they are in an extremely good position to gain a global view of a financial institution. That view is of course not perfect, as the information asymmetries that exist between regulator and regulated will always remain. But it is a better vantage point than any national regulator has, or any regional or international committee of regulators. However, at present there are four and potentially up to six different colleges operating (two or three at the international level for banking, securities, and insurance; two to three at the EU level, again for banking, securities, and insurance), and on a number of occasions with respect to the same financial institution. There is as yet little or no coordination between them at either level or between the EU and international level. Moreover, there is no clear way in which the reports or observations of the colleges are reviewed or otherwise incorporated into the activities of the international committees of standard-setters.

In failing to provide adequate coordination the regulatory regime as a whole is missing a significant opportunity to gain valuable information as to what is happening within financial institutions themselves, and thus to address, at least in

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<sup>163</sup> eg B. Wynne, ‘May the Sheep Safely Graze? A Reflexive View of the Expert-Lay Knowledge Divide’ in S. Lash, B. Szerszynski, and B. Wynne (eds), *Risk, Environment and Modernity: Towards a New Ecology*, (London: Sage, 1996).

<sup>164</sup> A. Klinke and O. Renn, ‘Precautionary Principle and Discursive Strategies: Classifying and Managing Risks’ (2001) 4(2) *Journal of Risk Research* 159.

<sup>165</sup> Sheridan, et al, n 146 above.

part, the problem of scale. There is an existing forum where that information could be exchanged: the Joint Forum. The Joint Forum, it is suggested, could be leading both on setting principles for the conduct of colleges, but also and perhaps more critically, on gathering information from them with respect to cross-border financial institutions and providing a point for aggregating and testing that information and then disseminating it around the rest of the regime, and further integrating it into the standard-setting process.

Moreover, there is a case for linking the colleges with the peer review process, and indeed, more radically, for using '360 degree' review in the peer review process. At present a peer review, either via an FSAP or via the 'Level 3' committee processes, consists of a self assessment and / or a review of national regulators by regulatory officials from other countries, supported by a secretariat from the World Bank / IMF or relevant committee. This process is an important facet of the regime, as noted above. The peer review process, however, is also overlooking potentially valuable sources of information. National regulators can gain a good insight into the performance of each other within the colleges of supervisors. Indeed early reports on their operation indicated that much of the time was spent in regulators giving technical assistance to other regulators.<sup>166</sup> It is always a sensitive matter to ask one country what it thinks of another's performance, but not impossible. Integrating an assessment of a regulator's fellow members in a supervisory college into the peer review process could provide a greater insight into the quality of a regulator than an assessment against the formal indicators which are predominantly used at present. Going further and asking financial institutions themselves for an assessment of their supervisors' performance is probably a step too far for many national regulators, but it would bring the peer review assessment process closer in line with common management practices within both public and private sector organisations.

The second task that regulators need to focus on is to create mechanisms for cognitive challenge. Risks are things that may happen in the future. As we have seen, scenario analysis is a key aspect of risk management for financial institutions and is a necessary and inevitable part of regulating risk. Managing risks requires managers to imagine how they may arise and what their consequences may be. But the scenarios that they imagine can be too bounded and conservative. In short, regulators need to be more imaginative. They need to use an enhanced knowledge of the past and the present to build more imagined, and imaginative, futures. Furthermore, rather than searching for harmonisation, the regulatory regime needs to build in structures for challenge and experimentation.<sup>167</sup> Regulatory reviews need to focus not just on impact assessments and sunshine reviews, but on what risks and activities it may be ignoring. This includes developing the equivalent of the 'near miss' analysis so important to risk management in a number of domains, including air traffic control, nuclear power,

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<sup>166</sup> EBF, n 160 above.

<sup>167</sup> eg C. Sabel and W. Simon, 'Minimalism and Experimentalism in the Administrative State' (Columbia Public Law Research Paper No. 10-238, 2010), at <http://ssrn.com/abstract=1600898>.

and medicine.<sup>168</sup> But it also requires a cognitive openness to different understandings of markets, risk, and behaviour, that requires gaining information and understandings from multiple sources. The claim is often brought that regulators need to be experts, to know how the markets operate. To this end, the Bank of England used to have ‘grey panthers’, senior bankers who advised officials on the markets. There is no doubt a place for grey panthers, but there is arguably a greater need for mavericks, of any hue. Greater diversity in the membership of key decision making bodies and in the people that they talk to could help to promote a different way of thinking. There needs to be someone to say when the Emperor has no clothes.

### SUMMARY AND CONCLUSIONS

Regulation is a messy, complex, and often thankless task. In theoretical terms, the regime for financial regulation provides a clear illustration of a complex polycentric regime operating in a complex and dynamic environment where interactions and interdependencies are ill understood, in which power is fragmented and contested and regulatory capacities are highly variable. The putative ‘regime managers’ are attempting to steer the regime or different parts of it, but their role remains contested as existing actors seek to maintain their own policy autonomy. Further, all regulators are in a complex institutional position, in that the crisis has demonstrated to them and the markets that both sets of actors were operating on fundamentally flawed assumptions. The cognitive shocks caused by the crisis have prompted a series of critical self-observations. Whilst this learning process is essential, it poses two problems. The first is that regulators are learning from a limited range of experiences. The crisis was an experience of major significance, but it took regulators into largely uncharted waters. There had been banking crises before, but none that affected so much of the global financial system at one time and on such a scale. There are well-recognised difficulties for organisations who attempt to learn from limited experiences: the lessons drawn may relate well to this crisis but may not be relevant for the next crisis that will take a different form.<sup>169</sup> Secondly, regulators have to engage in processes of critical self-reflection if they are to learn, but in so doing they risk jeopardising their claim to expert authority. Leaders and experts are expected to know the answers. To be constantly questioning what one is doing can look to

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<sup>168</sup> eg P. Barach and S. Small, ‘Reporting and Preventing Medical Mishaps: Lessons from Non-Medical Near Miss Reporting Systems’ (2000) March *British Medical Journal* 320.

<sup>169</sup> J. March, L. Sproull, and M. Tamuz, ‘Learning from Samples of One or Fewer’ (1991) 2(1) *Organization Science* 1.

outsiders as if one is trapped in self-doubt.<sup>170</sup> This paradoxical position is difficult for an organisation to avoid when it operates in the public gaze and where transparency of its operations and discussions is demanded by its various legitimacy communities, including other regulators within the regime.<sup>171</sup>

There is no simple answer to the multiple challenges that financial regulators face. The easy solution is to advocate organisational reform. This may have the advantage of making policymakers and regulators look busy, but it can often avoid problems rather than confront them. There is also a limit to what organisational structures can achieve. Coordination is a difficult challenge, but the solution advocated here is not the creation of a single ‘world financial regulator’, although this has been proposed by some.<sup>172</sup> It could be argued that this is the natural solution: that what is also needed is clearer leadership from the top, so that all regulators in the world are operating to a single set of rules and using a single set of supervisory processes. Such a development at the global level is politically hard to envisage at present, but it is exactly this which is being attempted at the EU level. At either level, it is not clear it is desirable. There are still significant problems of scale to overcome; a global and EU financial regulator would still have to rely on national regulatory authorities to implement regulation; many rules would still have to be at the level of general principles to be able to accommodate local conditions and cultures; the political difficulties of gaining agreement on rules and sanctioning recalcitrant national governments or their regulators would still remain; there would still be significant differences in regulatory capacities between different regulators and different countries; and it is by no means clear that such a system would be any more or less transparent, representative, or ‘democratic’ than the present one. It would be neater to depict on an organisational chart, but that should not be its principal virtue.

As for rules and practices, harmonisation is certainly tidy, and cross-border firms like it, or at least say they do – in fact they can benefit from differences between regimes by regulatory arbitrage. However the dangers of harmonisation, as evidenced in part by the crisis, are that it creates endogenous risk. Just as uniformity of risk models meant all market actors responded in the same way, magnifying the risks they were meant to be mitigating, standardisation of regulatory requirements meant to mitigate risks, if flawed, can cause risks to spread far more quickly than a variety of standards.<sup>173</sup>

Rather the solution proposed is modest and partial – less likely to grab the headlines but probably more likely to make a difference. It is to recognise that regulators need different types of information, they need to be open to challenge

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<sup>170</sup> B. Levitt and J. March, ‘Organizational Learning’ (1988) 14 *Ann. Rev. Soc.* 319. See eg M. Zollo and S. Winter, ‘Deliberate Learning and the Evolution of Dynamic Capabilities’ (2002) 13(3) *Organization Science* 339.

<sup>171</sup> See further J. Black, n 7 above.

<sup>172</sup> eg J. Eatwell and L. Taylor, *Global Finance at Risk: The Case for International Regulation* (London: Polity Press, 2000).

<sup>173</sup> eg N. Pidgeon, D. Blockley, and B. Turner, ‘Design Practice and Snow Loading: Lessons from a Roof Collapse’ (1986) 64A(3) *The Structural Engineer* 67.

and they need to be imaginative. That requires two, possibly contradictory, strategies: building in more resilience and creating linkages between the component parts to enable information to flow through, but also creating scope for greater imagination, experimentation, and challenge: a place for mavericks as well as panthers. Without these, regulators will indeed be trapped fighting the last war.