

# **The Need for Consolidating International Financial Regulatory Architecture**

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Abstract

*The existing international financial regulatory architecture is multifarious. Prevalent regulatory forums are numerous, with over-lapping spheres of activity, where all such forums share a lack of consolidated authority. Bodies like the Basel Committee on Banking Supervision (BCBS), Group of 20, Financial Stability Forum, and OECD are all working to reform the international financial architecture. This multiplicity of opinions and disagreement on a minimum set of common standards due to existence of multiple forums with an absence of any concentration of authority is the subject of this paper. There is an argument by various scholars that this can be achieved through the appointment of a Global Supervisor, or a World Regulatory Authority. This paper is an attempt to explore this thesis, and this study goes beyond exploring the structure of various financial law organizations to suggest that there is a need to consolidate the existing structures not only by reducing the number of platforms available but by consolidating the authority into one efficient body.*

Key words: Financial Regulation, Financial Crises, Banking Regulations, International Financial Institutions

JEL Classification: G01, G15, G18, G28, G38, K23, K20

## **1. Introduction**

The years from 1945-1970 are generally considered as the years of peace and stability. The reasons for this peace and development may cover a range of factors but from the financial stability perspective, it can safely be assumed that the existence of a centralized body like Bretton Woods ensured uniform practices across borders. A single controlling and managing factor for exchange rates and balance of payments ensured effectual absence of major disruptions during that era in the international financial markets. However, with the advent of internationalization in 1980s, the financial markets became increasingly complex and financial transactions more complicated. This was further aggravated during the globalization period in 1990s and by that time the pace of development and innovation in financial products and financial markets defeated the capacity of regulators to regulate them. Efficient regulation demands that the domain of the regulator should be

same as the domain of the market that is being regulated, according to Eatwell (Ferran and Goodhart 2001).

This research emphasizes the need to have a global regulatory-cum-supervisory body that, at the minimum, should harmonize dissenting and sometimes opposing regulatory practices across jurisdictions. This research reviews the regulatory structures existing during the last quarter of the 20<sup>th</sup> century that came into being after the breakup of the Bretton Wood system and have overlapping spheres of jurisdiction but all with no authority to enforce their regulations. For conceptual simplifications, references have been made to the International Monetary Fund (IMF), the World Bank (WB) and the World Trade Organization (WTO) frameworks which are based on hard law and the authority rests in a single body. International financial law, however, is based on soft-law and the authority it commands springs from consensus-based regulations and their voluntary-adoption. Absence of a hard law mechanism carrying the force of sanction dilutes the moral authority that it derives from the consensus based adoption of mutually agreed upon standards.

## **2. Evolution and development of The International Regulatory Framework**

The international financial markets witnessed unprecedented growth and expansion after World War II. With the establishment of cross border branches and subsidiaries of financial institutions, the international financial markets became more interconnected and dependent on each other. The financial markets continued to flourish rapidly until the late sixties; however, it came to a halt with the collapse of the Bretton woods system of managed exchanged rates in 1973.

The fact that international finance is critically needed for furthering the growth and development process globally is undisputed (Arner 2007). The problem is that the entry of finance at the global level has altogether changed the fundamental conceptions about money, domestic finances and regulations. The emergence of finance (financial intermediation) as a distinct activity has posed totally different regulatory challenges compared to the conventional regulations required for orderly functioning of markets for goods and services.

International financial regulations have always been conceptualized as “soft law,”<sup>1</sup> based on the laissez-faire principle (Larsen 2009). The process started off from informal negotiations among the central bank governors and finance authorities of various countries to build a mutually agreed framework. It also involved consultations with the stakeholders (the shareholders of Banks and financial institutions, legal and technical experts). The evolutionary process of developing a regulatory framework continued taking various forms in various jurisdictions. For example, in England, it was a customary convention based system, run by the ‘raised eye-brow’<sup>2</sup> of the Bank of England. Later, it followed the supervisory approach, backed by the force of ‘moral suasion’<sup>3</sup> and supervisory best practices<sup>4</sup> as were consented to from time to time. In England, strong respect and adherence to the convention system provided the necessary sanction required for the working of ‘force of example’. However, at a global level, internationally agreed ‘high standards’<sup>5</sup> through voluntary adoption generally prevailed in the sphere of regulation and supervision (Kaufman 2009). More recently, this sanction did come (though less effectively), from the moral pressure created by the credit ratings of sovereigns and other financial institutions given by rating agencies. However, the

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<sup>1</sup>Soft law is based on implementation and monitoring of nonbinding standards of international financial architecture, as cited by Douglas W. Arner, in “Financial stability, Economic Growth, and Role of Law”, Asian Institute of International Financial Law, The University of Hong Kong.

<sup>2</sup> Bank of England’s raised eyebrow was enough to regulate financial institutions. However, this force of authority got diluted gradually by the slush of foreign financial institutions in the UK who were not accustomed to abide by the strong conventional system as prevalent in UK.

<sup>3</sup> Unwritten rules of the city of London based on consultation, persuasion & informal dialogue.

<sup>4</sup> The original principle came forth from the Cassis de Dijon case Judgment of the European Court of Justice, Feb 1979, EC reports 1979

<sup>5</sup> Issued in the final communiqué of G-20, London Summit, in April 2009

crisis in 2008 was a setback to the authenticity that was attached to the ratings given by these agencies which now is almost a black swan <sup>6</sup>(Taleb 2007).

As the financial markets keep growing, financial products become ever more complex, and this complexity makes the task of regulation of financial markets challenging. Therefore, it is difficult or impossible to apply a one size fits all formula in regulation and supervision of international financial markets and banks (Ashraf et al. 2011)<sup>7</sup>. Regulations can be defined as a set of rules and standards that govern financial institutions; their main objective is to foster financial stability and to protect the customers of financial services (Larosiere 2009). The correlated second term is supervision, which is “the process designed to oversee financial institutions in order to ensure that the rules and standards are properly applied<sup>8</sup>”. However, in practice both the terms intermingle.

To summarize, the significant regulatory developments made after the Second World War, to bring systemic stability include the Bretton Woods Institutions<sup>9</sup> and their collapse followed by BIS<sup>10</sup>, BCBS<sup>11</sup> (which gave Basel Capital Accords I<sup>12</sup> and Basel Capital Accord II<sup>13</sup> and later Basel Accord III<sup>14</sup>), and also IOSCO<sup>15</sup>, IAIS<sup>16</sup> and IASB<sup>17</sup> for banking, securities and insurance sectors respectively. The crisis in 2008 was the most serious blow after 1929 to the international regulatory framework and made policy makers re-think the design of regulations from newer perspectives. For broader systemic stability, international financial regulations need to be redesigned in a fashion as to address the systemic risk factors<sup>18</sup> (BIS 2001). Arner states, “the global credit crisis of 2008 highlights the urgent need to redesign both the global and domestic financial regulatory systems not only to properly address systemic risk but also to support its proper functioning”(Arner 2009).

The need for a comprehensive and consolidated mechanism of regulation for the global financial markets was felt more than ever from almost all the supervisory and regulatory authorities. For example, the Financial Services Authority (FSA), emphasizes the need to have international coordination of bank supervision enhanced through the establishment and effective operation of

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<sup>6</sup> A Black Swan is a highly improbable event with three principal characteristics: It is unpredictable; it carries a massive impact; and, after the fact, we concoct an explanation that makes it appear less random, and more predictable, than it was. The astonishing success of Google was a black swan; so was 9/11.

<sup>7</sup> Forthcoming in May 2011.

<sup>8</sup> As above

<sup>9</sup> 1944

<sup>10</sup> Bank of International Settlement established on May 17, 1930, Basel, Switzerland. It comprised of central banks and international organizations. Its purpose was to act as trustee to receive reparation payments from Germany, but its focus changed quickly into enhancing cooperation among central banks. Soon it acquired a reputation for economic analysis and research, and for providing emergency and crisis support to central banks throughout 1930s to 1990s

<sup>11</sup> BCBS, It was established after the collapse of Bankhaus Herstatt of Germany and Franklin National Bank of USA, in 1974, by G-10 Central Bank Governors to promote monetary and financial stability.

<sup>12</sup> Basel Accord I, 1988, Committee’s members come from Belgium, Canada, France, Germany, Italy, Luxembourg, the Netherlands, United Kingdom and United States. Countries were represented by their Central Banks

<sup>13</sup> In 2003

<sup>14</sup> In 2010, Basel III proposals have been forwarded by BCBS for discussion and adoption by 2014.

Can be accessible at <http://www.bis.org/press/p100912.pdf>

<sup>15</sup> The International Organization of Securities Commission

<sup>16</sup> International Association of Insurance Supervisors

<sup>17</sup> International Accounting Standards Board

<sup>18</sup> For discussion on the potential implications of financial consolidation on financial risk, see BIS publication, available at <http://www.bis.org/publ/gten05ch3.pdf> . It analyses the impact of consolidation on risk.

colleges of supervisors for the largest complex and cross-border financial institutions. There came another unique proposal from FSA which also underlined the need for consolidation and harmonisation, though at a regional level by establishing a new European institution, to be called as European cross-border bank, and this body to serve as an independent authority with regulatory powers, a standard setter and overseer in the area not only of supervision, but also significantly involved in macro-prudential analysis. This body should replace the Lamfalussy Committees. (Financial Services Authority March 2009).

The above discussion gives an overview of the evolution and development of the international financial regulatory framework. Now an overview will be made for important regulatory structures to highlight overlapping areas of activity and lack of harmonization. BCBS' work in the form of Basel I, II and III will be analyzed in detail, while the emphasis will be drawn on need to harmonize while highlighting comparable areas from G-20, and FSB.

### **3. The International Financial Regulatory Structures:**

#### **3.1. Basel Committee on Banking Supervision (BCBS)**

The landmark achievement in the global regulatory efforts came in the form of Basel Capital Accords. The Basle Committee was constituted to fill in these gaps by G10 Governors for setting standards for international financial markets.<sup>19</sup> They established a standing committee, renamed later as Basle Committee on Banking Supervision, (BCBS) for the purpose (BIS 2009).

The Basel Committee or BCBS started with the issuance of recommendations, called First Concordat<sup>20</sup> in 1975. Its significance lies in the fact that it was the first time in the history of international financial regulation that the principle of joint responsibility between home and host supervisors was established for the supervision of foreign banking establishments<sup>21</sup>. Following the collapse of Banco Ambrosiano in 1982 along with the problems that were confronted in regulation of holding companies and mixed activity groups, the Basle Committee issued the revised concordat<sup>22</sup> in 1983 (Walker 2001). The revised concordat in addition to earlier principles also held the principle of consolidated supervision to be adopted by the authorities. It also said that the health of financial institutions should be judged on both a stand-alone and consolidated basis (Ashraf et al. 2011). The 1983 revised concordat was subsequently examined by the Basle Committee to issue an information supplement<sup>23</sup> and this way the process of regulation based on the consolidation principle took wheels/ became established.

The Basle Committee's recommendations, like other financial law forums, though they had no legal status, yet these signify an agreement on the minimum standards in the supervision of international financial markets, thereby the concept of harmonization appeared. It also provided a platform to discuss issues of mutual concern in the international financial markets. However, this process was not one-time episode rather followed a successive series of Basel I, II and III Accords.

##### **3.1.1. Basel I Capital accords- A critique:**

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<sup>19</sup> G-10 Governors, the Communiqué, September 1974

<sup>20</sup> Basel Committee, "Report on the supervision of banks' foreign establishments", September 1975, available on BIS website.

<sup>21</sup> "Road to Financial stability," paper presented at the International Business & Finance Research Conference, 2-5 Jan 2011, USA, forthcoming in the Global Journal on Business & Finance Research, May, 2011.

<sup>22</sup> See also Basle Committee, "Consolidation of Banks' Balance Sheets: Aggregation of Risk-Baring Assets as a method of Supervisory Bank Solvency, October 1978

<sup>23</sup> See Basel Committee, "Information flows between banking supervisory authorities", April 1990

Basel I was adopted universally. In the simplest terms, Basle I<sup>24</sup> fixed a minimum capital ratio of 8% to the total risk adjusted assets and provided a tiered definition of the capital and divided the assets of the bank in different risk buckets on the basis of underlying risks involved. The factors behind its uniform acceptance and application were its relative simplicity and minimum costs involved. However, it also drew criticism and subsequently proved not only insufficient but also failed to provide the necessary systemic stability.

The main criticism that also contributed towards its subsequent failure was in its inability to create a level playing field for all international financial institutions through its classification system. For simplicity purposes, Basel I assigned a zero percent risk figure to the OECD Governments and central bank credits while a 100 percent for all other claims irrespective of the credit standing of the counter-party concerned. The second important criticism leveled at Basel I was in its lack of coordination between host and home country supervisors. More harmonization between the operating mechanisms of both the supervisors still needed to be strengthened.

### *3.1.2. Basel II capital accords*

Basel II thus started with what was lacking in Basel I. The Basel Committee while focusing on harmonization principle came up with significant achievements in the form of establishment of minimum standards in 1992<sup>25</sup> and the core principles for effective banking supervision in 1997<sup>26</sup>. Although the market charge (market risk) was also included in Basle I through Market Risk Amendment in 1996<sup>27</sup>, due to its crude classification system and failure to adjust to subsequent changes in the structure and operation of financial markets, the single measurement mechanism became obsolete and the need was felt to overhaul the whole system.

Therefore, the Basle Committee started working to devise a more risk sensitive and adaptable to change mechanism. After extensive consultations, Basle II<sup>28</sup> was introduced in 2001. The purpose of this framework was to improve the safety and soundness of financial systems through its three pillar structure; (i) capital adequacy, (ii) supervisory review, and (iii) market discipline<sup>29</sup> through necessary disclosures.

This new system was intended to be more risk sensitive as varying risk buckets were included in the calculation of minimum capital requirements along with the addition of an altogether new operational risk charge. The system was kept flexible, innovative and adaptive to changing banking structures, operations and products.

### *3.1.3. Failure of Basel II*

It was a mistake to relax trading capital requirements in 1996 through the amendment to the Basel Accords. Again, a second mistake was made by compromising the quality of the capital while setting the quality standards for the capital requirements for banks. This framework underestimated some important risks and over-estimated banks' ability to handle those risks. "The perceived wisdom that distribution of risk through securitization took risk away from the banks turned out, on a global basis, also to be incorrect". Thus the Basel II was inherently weaker in its contents (Larosiere 2009). On one hand, the requirements that it levied were not very strict while on the other, even these softer standards were not yet adopted by all the member states. And, the world witnessed the Asian financial

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<sup>24</sup> See Basel Committee, International Convergence of Capital Measures and Capital Standards, July 1988

<sup>25</sup> See Basel Committee, Minimum Standards for the Supervision of International Banking Groups and their Cross Border Establishments, July 1992

<sup>26</sup> See Basle Committee, Core Principles for Effective Banking Supervision, September 1997

<sup>27</sup> See Basel Committee, Amendment to the Capital Accord to Incorporate Market Risk, January 1996

<sup>28</sup> <sup>28</sup> See Basel Committee, The New Basel Capital Accord, January 2001, New Accord

<sup>29</sup> See Basel Committee, Overview of the New Basel Capital Accord, 2001 (Overview Document)

crisis despite having a Basel II framework which was an amended set of regulations supposed to rectify the short comings in Basel I accords.

In response to the Asian financial crisis, the regulatory bodies came up with amended capital accords by incorporating market risk into the risk management criteria. Basel II in 2006 was offered as a bulwark for any foreseeable systemic crisis in the banking sector. Also, at that time, the Financial Modernization Act (GLBA), was being promulgated in USA which was based on the European style of banking model (Financial Services Modernization Act: Gramm-Leach-Bliley Act, 1999). It was meant to repeal the old New Deal's strict system<sup>30</sup> based on sectoral separation in the financial sector in US. At that time, the supervisory authorities were aware of the fact that the cross border exposures and inter dependency of financial institutions together have given birth to a new banking model comprising of several elements, like the universal banking model and the originate-distribute business model (Arner 2009).<sup>31</sup>

#### *3.1.4. The Basel II structural Problems*

However, this new framework, due to limitations in scope, could not save the world from new crisis. The Basle Committee's recommendations were adopted only in a limited manner, both in terms of number of countries and the stages to implementation. Secondly, it had (and still has) no formal status, therefore, it is not possible to get the recommendations made under Basel II implemented and adopted across the board. Although, from hindsight, there are opinions that even if Basel II had been implemented/ adopted by all the countries, the financial crisis that happened would not have been avoided. This argument stems from the content matter approach that Basel II recommendations or the requirements are not sufficient to make a bulwark for any threat to systemic stability. Taking this same argument one bit further, consolidation is the missing element, this consolidation is not only in the number of regulatory bodies but a real consolidation in matters of authority, in ascertaining a common line of action, of the contents and sphere of mutually agreed regulations, to be enforced by a consolidated authority vested in a single body, as is available in the case of trade law or monetary law, but altogether missing in the financial domain.

The voluntary compliance structure model which is common in all the financial law forums, however, remains weak in the sense that it is still ineffective in delivering binding international standards. On the other front, as we will see in the section below, it worked fairly well in developing a consensus on the application of minimum standards at not only Basel Committee but also at various other platforms including G-20 and FSF in the supervision of financial markets. Even these standards were formulated and agreed coherently, but again harmonious and across the board enforcement remained yet a dream to come true mainly because of the fact that there is a need to consolidate not only the regulations but also the regulatory forums.

#### *3.1.5. GSA 1930's*

Going back to the previous episodes, when systemic stability was questioned in the United States after the 1929 financial crisis broke out and stringent policy measures in the form of the Glass - Steagull Act 1933 were adopted. The act restrained financial activities into respective separate sectors to safeguard the functioning of financial markets.

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<sup>30</sup> Roosevelt gave the new deal which formed a part of financial reforms package after 1929 depression. New Deal was promulgated to induce discipline in the financial sector by enforcing strict separation across financial services in the economy. However, in 1999 GLBA was introduced to liberalise the financial markets and through this Act, the provisions of New Deal were emended.

<sup>31</sup> See for detail discussion on originate-distribute model of securitization.

Roosevelt's financial package "regulatory capitalism," aimed at separation of all three financial sectors i.e., banking, insurance and securities, was put forward to restrain the contagious risks and threats to the systemic stability (Wood 2008). The whole system of legislation was re-adopted from free market ideology to Keynesian model of command and control, propagating upon a tough closed system of regulations.

Critics, however, differ in what Glass-Steagall propagated at that time. Wood thinks that markets are more efficient in making decisions and in imposition of discipline rather than the governments. Randall also supports the market view and welcomes the GLBA (Financial Services Modernization Act: Gramm-Leach-Bliley Act, 1999). To him, the regulation played the contrary effect and the regulatory safety net has often had the unfortunate impact of undermining rather than promoting financial stability (Kroszner 2005). Santos also calls it a costly cat and mouse game between banks and regulators (Santos 1996).

### **3.2. Post- Crisis Regulatory Frameworks**

In response to the changes that have been taking place in financial markets during the first decade of the 21<sup>st</sup> century, different regulatory responses were forwarded by the Basel Committee and other global forums including some national level legislation were enacted to address discrepancies and lacunas at home by various countries. This section will explore what the various responses were.

The events following the Lehman Brothers collapse reflected on the dispersed regulatory architecture. The chaos was general as the crises broke out in various countries, and a similar pattern was found in almost all of the national regulatory bodies in that none had any contingency plans for such kind of shock. Another important factor was a fragmented approach of the supervisors across jurisdictions, and the time taken by even national supervisors in coming up with a firm stance to tackle the crisis became an additional factor in spreading uncertainty among the public. Thus, the price-tag for resolution of crises kept mounting while the regulators and supervisors were contemplating their response to the crisis. The prime example was in the case of Northern Rock in September 2007 and then again, almost a year after, in the case of Lehman Brothers, and in both the cases, a timely support might have avoided the greater loss of confidence that affected the whole industry from these episodes. The authorities nurtured the assumption that these crises would not be sporadic for systemic stability, so they almost allowed them to fail (Arner 2009).

The enactment of the GLBA in 1999 seemed a revolutionary event in the world of financial services. It marked the end of regulations that were specifically enforced for the perceived defects in the banking system which caused the Great Depression of 1929 (Jolina and Cuaresma 2002). Furthermore, the GBLA was also implemented to address the financial innovations (in product line) that the financial services industry has introduced since the 1930's. It came out as a commonly held belief that now the time when the market forces should define the fire walls. Increasing market competition is enough to propel the banks voluntarily to adopt Chinese walls structures, hence no need for the obsolete arbitrary regulations.

To supplement this, the Dodd-Frank Act came as a sweeping set of changes aimed at introducing new trends of regulatory reforms. The act, mainly focused on putting limitations on proprietary trading,<sup>32</sup> but enhanced consumer protection laws along with providing for the establishment of a body to manage systemic risk.

Volcker's package came as part of the legal reforms that are to be implemented in the US through the Dodd-Frank legislation. It aims to curtail big bank's risk, especially the proprietary trading, which is in the process of being outlawed from the US system within a span of two years. The looming fear is that these country specific legal reforms coupled with the Basel III capital requirements which alone are almost three times higher than the requirements under Basel II, are

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<sup>32</sup> It is referred to a bank's taking bets with its own money rather than from clients' deposits.

likely to push these highly risk-oriented products from regulated banking sector to the other sectors of economy which are either loosely regulated or do not fall under the restrictive regulatory preview. These sectors comprise hedge funds, private equity firms, trading houses, speculative arbitrage and the newest being the energy companies.

### **3.3. G-20**

The most significant response from the perspective of consolidation came from G 20. In fact, it appeared as the greatest effort other than the Basel work where almost all the states endorsed the common cause.

As the time went on, the regulatory bodies around the globe, realizing the seriousness of the threat of systemic failure and the severe nature of the financial crisis that were on the roll out, a series of responses initiated across the globe. The most significant in the series came from G-7's comprehensive statement in Oct 2008. The surprising move was that this statement was endorsed by full membership of IMF, World Bank, European Union and also in the FSF report (Financial Stability Forum April 2008). Its main focus remained on 5 major regulatory areas and 7 issues (Arner 2009). Lastly, the G-20 issued a Declaration to support an open global economy by laying the foundations for reforms in an Action Plan in November 2008, to ensure that such a crisis would never happen again.

### **3.4. Financial Stability Board (FSB) & BCBS**

The year 2009 kept policy makers occupied in redesigning and modifying the financial supervisory-cum-regulatory structure to ensure transparency, accountability and across the board adoption. Basel III was announced in September 2010 which enhanced the minimum capital (common equity) requirements from 2% to 4.5%, along with prescribing a conservation buffer of 2.5% for the banks. These capital enhancements are supplemented by a non-risk based leverage ratio for the banks. These are the additional measures proposed and are being finalized for adoption to stop further erosion of the global financial architecture<sup>33</sup> (Bank of England Oct 2008).

In October 2007, the FSF was asked to report to the G7 Ministers and Governors at their meeting in Washington in April 2008. FSF draw on a large body of coordinated work, comprising that of almost all the actors not only in the banking regulations but also authorities in associated fields like Insurance and securities etc. The consultation process was not only limited to the regulatory bodies but was also inclusive of IMF itself. This mechanism again recommends for establishment of a single body to consolidate the regulatory practices in the financial markets. FSF consulted the Basel Committee on Banking Supervision (BCBS), the International Organization of Securities Commissions (IOSCO), the International Association of Insurance Supervisors (IAIS), the Joint Forum, the International Accounting Standards Board (IASB), the Committee on Payment and Settlement Systems (CPSS), the Committee on the Global Financial System (CGFS), the International Monetary Fund (IMF), the Bank for International Settlements (BIS) and national authorities in key financial centers. Insights have been gained, as well, from private sector market participants (Financial Stability Forum April 2008).

FSB and BCBS provide a supervisory forum for regular cooperation to design an enforceable universal risk-based management mechanism. The international efforts are aimed, more

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<sup>33</sup> On 8 October the UK authorities announced a comprehensive and system-wide support package that to addressed weaknesses in the balance sheets of banks in UK. The package aimed at increasing resilience of UK banks by raising the capital requirements in addition to the Special Liquidity Scheme and the provision of guarantees on new debt. Subsequently, other countries adopted system-wide measures with similar underlying principles. Available at <http://www.bankofengland.co.uk/publications/fsr/2008/fsrfull0810.pdf>

than ever, at devising a system of shock absorbers. But these efforts are simultaneously being carried out not only at diverse levels but also at multifarious platforms. Thus, there is hardly a consensus even on the broader paradigms whether it was weak regulations or the implementation mechanism that needed strength and reform.

#### **4. Challenges to Regulations and the Need for Consolidation**

One of the underlying causes of the 2008 crisis was “divergence” between domestic regulatory structures and that of global finance (Arner 2009)<sup>34</sup>. This aspect emphasizes the need for enhancing not only the linkages between home country (domestic national) policy considerations but also the need to have more harmonization between various regulatory bodies, in the wake of financial disruptions and international regulatory requirements. For cross border wholesale banks, and investment banks, FSA and most of the other regulators were following an almost similar approach that assumed primary responsibility for ensuring prudential soundness with the home country supervisor, given extensive information sharing between home and host supervisors.

International financial institutions become national in death,<sup>35</sup> and it was demonstrated by the failure of Northern Rock in Sep 2007 and Lehman Brothers in September 2008. The decisions about fiscal and central bank support for the rescue of a major bank are ultimately made by home country national authorities focusing on national rather than global considerations (Financial Stability Forum April 2008). Therefore for resolution of such crises which are affecting the international financial architecture, a coherent approach must be adopted so that uncertainties attached to the collapse of such institutions may be minimised to restrain the collapse of confidence in such institutions. The Financial Stability Forum’s report<sup>36</sup> suggests that a college of supervisors should be made for more intense cooperation and coordination in crisis management.

##### **4.1. Failure of regulations to keep pace with the innovation in products**

The changing nature especially the increased risk of systemic failure requires a formalized structure of focused international standards and effective supervision and enforcement. The challenge for financial institutions in the wake of new regulations turned out to be twofold; either to find more (new) capital for the banks or to reduce the bank assets to meet the new capital adequacy regulations (Valdez and Molyneux 2010). This race for finding new capital resulted into bombardment of newer products into the market during the 2000’s. Financial gurus call it financial engineering, or rather re-engineering. Innovative financial products kept finding their way into the market, at a higher societal cost. Given the interconnectedness of financial markets, the costs of failed experiments for these so-called “technological innovations” would be borne out by the taxpayers, as the lender of Last Resort (LoLR) would remain the Central Banks.

Federal Reserve Chairman, Paul Volcker, commented on these financial innovations: “the most important financial innovation that I have seen the past 20 years is the automatic teller machine,”<sup>37</sup> so no real innovation with all these fancy products. He further went on to add, “I wish someone would give me one shred of neutral evidence that financial innovation has led to economic growth — one shred of evidence”<sup>38</sup>.

The second avenue available to the finance “jingoists” was to off-load balance sheet assets so as to make room for extending new loans. This cleanup of balance sheet was done again by

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<sup>34</sup> Page 11

<sup>35</sup> Probably Mervyn King said that; Find out source from the Basel article (?)

<sup>36</sup> P 37-38

<sup>37</sup> In December 2009, Volcker addressed the Wall Street Journal Future of Finance Initiative in the UK

<sup>38</sup> December 2009, The times, ‘Wake up, gentlemen’, world’s top bankers warned by former Fed chairman Volcker

resorting to the “innovative strategies”, mainly by selling off the loans to other banks or purpose-built legal bodies like SIVs, SPVs<sup>39</sup>, hedge funds etc. The assets on the bank’s balance sheet were converted into securities and then sold out to these vehicles through the process called, ‘securitization’. Securitization gained much momentum throughout the 2000’s and resulted into dried up markets that ultimately crashed in 2007. Brealey writes, “Why do Investment banks continue to invent, & successfully sell, complex new securities that outstrip our ability to value them?” (Brealey et al. 2006)

#### **4.2. Perforated Controls by Regulators**

At individual country level, e.g., in the USA, as this lacuna was acknowledged in the aftermath of current crisis so Dodd-Frank and Volcker’s Package were forwarded to redress these issues but on the global level, this needs more attention. The practice of pigeon-holing the financial sector institutions especially in the European Union, must be revised. This is because the cross-sector risk transfer mechanisms are on an increase, more than ever due to the tremendous growth in the derivatives and hedge markets. This mushrooming growth in such hybrid products is parallel to the perforated controls on such activities. “Banking supervisors cannot sleep safely solely on the basis of their own work. The financial stability authorities need to attend to the dynamics of the overall system”.<sup>40</sup> Thus, in this newly emerged scenario of financial innovations and tremendous growth of hybrid products, its even more important to have a centralized policy response and consolidated mechanism to address these common issues in a well coordinated manner.

The transition from a ‘developing international financial standards’ status to a ‘developed financial standards’ status does not require some degree or certificate of graduation<sup>41</sup> (Carmen M. Reinhart and Rogoff 2009). Jean-Claude Trichet<sup>42</sup> says, “The important thing right now is that we have acted to strengthen bank regulations. The biggest danger would have been doing nothing. But, the greater need is now, to centralize the regulatory efforts.

### **5. Conclusion**

The single goal of all these organizations and committees is to make the financial system resilient to future threats. However, simultaneously, apart from sharing a common goal, these organizations also share the character of regulations they design which are soft law based under international financial law. Thus, despite having multiple bodies working for the same cause, it has become even harder to develop a common course of action. Therefore, it took a considerably longer time to respond to the crisis and absence of standard procedures and lack of a centralized authority added to the domino effect and crises spread to otherwise stable institutions also. Arguably, in International Trade Law and International Monetary Law, WTO and IMF & WB are working as almost sole and authoritative organizations respectively. The success of the financial architecture during the Bretton Wood era itself confirms the hypothesis taken in this research that harmonizing the working of organizations in international financial law would introduce more harmony and stability into the success of the international financial system.

Regulation and supervision cannot be held apart. The two respective bodies in any jurisdiction may work separately but they cannot work independent of each other. An accomplished supervision would not let absolute failures in the regulatory policy, though not the vice versa. Supervision has two dimensions; micro and macro. Both dimensions complement each other, and compromising on either of the two, would be detrimental to the other. The objective of the micro-supervision is to oversee and limit the distress of individual financial institutions i.e., a protection

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<sup>39</sup> Structured Investment Vehicles and Special purpose vehicle

<sup>40</sup> Paul Tucker, Deputy Governor Bank of England

<sup>41</sup> ‘Developed’ -the terminology has been used by Reinhart

<sup>42</sup> President of European Central Bank, EU

which is extended to the individual customers of a particular bank or a financial institution. On the other hand, macro-supervision focuses on the system as a whole. Its obvious objective is the protection and regulation of the economy as a whole, including overall performance of the state institutions. Furthermore, the risk fragmentation strategies are associated with shadow banking which fall into an area yet to be brought under the regulator's domain. It clearly implies risk moving out from the regulated sector to the unregulated territories i.e. to the hedge funds, derivative and swaps markets. In a similar fashion, A World Financial authority is needed to macro-supervise the International Financial Institutions. Paul Volcker says, "Has there been one financial leader to say this is really excessive? Wake up, gentlemen. Your response, I can only say, has been inadequate".<sup>43</sup>

Alexander argues that since financial markets are global, we need to have a global financial regulator (Ferran and Goodhart 2001). He emphasizes the point that the domain of the regulator should be the domain of the regulated. Since the regulated markets have become international, so the regulators should also have their authority and domain necessarily international.

The paper has analyzed the global regulatory-cum-supervisory efforts done so far toward enhancing systemic stability. It has tried to highlight the risky ground the financial sector is treading upon. It always seems attractive to feel and say 'this time is different, the Lucas Critique in (Carmen M. Reinhart and Rogoff 2009).<sup>44</sup> But the need is not only to focus on the isolated sectors of financial markets at domestic or regional levels but the greater concern is the mega canvass of the international financial markets and the global financial architecture. There is an absolute need to reform the existing regulatory forums to make them effective and meaningful in their universal role around the globe through centralization and consolidation.

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<sup>43</sup> December 2009, The Times published the report titled, 'Wake up, gentlemen', It was addressed to world's top bankers who warned by former Fed chairman, Paul Volcker

<sup>44</sup> it is naive to try to predict the effects of change in economic policy entirely on the basis of relationships observed in historical data, esp. when observing highly aggregated historical data

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