REGULATION AND SUPERVISION OF THE GLOBAL FINANCIAL SYSTEM

A PROPOSAL FOR INSTITUTIONAL REFORM

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“A liquid, highly innovative financial system is necessary for the growth of modern economies. It is not only the lubricant that smooth the friction of exchange from the neighbourhood shop to global money markets, it is also when mixed with entrepreneurship, skills and innovation, the fuel in the engine of economic growth (...) But finance is highly volatile material, liable to explode and destroy the very engine is oils and fuels. It must be managed with care.” (Eatwell & Taylor, 2000, p. 208)

Introduction

The financial crisis that surfaced in the United States of America in late 2007 and unfolded in 2008 has significantly brought to light the vulnerability of global financial markets. *Haute finance* appeared to be a high risk game of financial engineering where profits and losses may be significant (because of so-called leveraging) and insolvency of even a few major financial institutions (investment banks, securities firms, insurance companies) may inflict serious damage upon the global economy.

The causes of the financial crisis have been extensively discussed elsewhere.¹ High risk loans based on sub-prime mortgages appeared to be a profitable business for those who were able to collect the upfront fees. Subsequently, these loans were ‘sliced and diced’ (the process of securitisation), and sold to investors who did not bother to invest in an adequate due diligence. Each time a loan was sold, packaged, securitised and resold, banks took their transaction fees. Until the crisis began, the banks erroneously believed that securities were secure and profitable.

Deeper roots of the crisis may be found in the development of financial markets since the 1980s. In traditional financial markets, banks were holding deposits, attracting savings and lending money. In this marketplace there is a common interest that risks must be known and restrained. Voluntary and mutual self-restraint are necessarily involved, and are easily explained, since banks lend and borrow to one another. They are willing to do so as long as each bank is satisfied that the other bank does not take excessive risks in its financial operations. Should a bank take higher risks than is acceptable for its

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peers, it will no longer be eligible for inter-bank lending. In this system of self-regulation a ‘gentle’ form of supervision\textsuperscript{2} would be adequate.

In recent years financial markets have changed drastically.\textsuperscript{3} New institutions emerged that are in the business of banking, insurance and securities. Hedge funds, investment banks and similar institutions deal in innovative and high-leveraged financial products. In this heterogeneous system of traditional and innovative banking, the absence of self-restraint may easily disturb mutual confidence. Once confidence is gone, the financial markets desist from lending and borrowing. For an economy that thrives on credit, this has a devastating effect.

Fierce competition may be cited to explain why financial institutions were forced to innovate and accept higher risks. A bank that was not in the business of high-leveraged and profitable securities would ‘disappoint’ its shareholders. In addition, risk-taking was a ‘one-way-bet’ for Chief Financial Officers (CFOs) whose income depended to a significant degree upon bonuses. It is true that gluttony has contributed much to the conditions in which financial markets find themselves today. Bankers may be blamed for what they have done but there is little reason to assume that greed in the banking sector is more prominent than in any other economic sector.

More worrying is that exogenous corrective mechanisms for controlling risks have collectively failed. Domestic supervisors such as central banks, financial authorities and comparable institutions (hereinafter: supervisors) did not ring alarm bells well before markets failed. A major explanation is that such domestic supervisors were unable to keep pace with innovative markets and had little understanding of products that came from complex financial engineering. In addition, supervisors had only limited jurisdiction over hedge funds and investment banks for two reasons. First, supervisors did not cover ‘blind spots’ in financial markets; a deposit-taking bank would be supervised but a non-deposit bank or ‘hedge fund’ operated without supervision. Second, supervision did not extend beyond borders. It is therefore only partly justified that the role of supervisors has been heavily criticised because they were not paying attention, “failing to appreciate the scale of risks being built up in the ‘shadow’ banking system that modern finance had created.”\textsuperscript{4}

Following the collapse of financial markets political leaders have urged for firm reforms. The Prime Ministers of the UK and Germany insisted on stronger global regulation and coordinated supervision. Gordon Brown

\textsuperscript{2} Supervision is in the Oxford English Dictionary defined as “(…) less commonly, supervision for the purpose of direction or control, superintendence.” Other synonyms of supervision are ‘oversight’ and ‘surveillance’. The scope depends of the functions attached in legal texts.


\textsuperscript{4} ‘A monetary malaise. Central bankers helped cause today’s mess. Will they be able to clean it up?’, The Economist, 9 October 2008.
asked for “an early warning system of risk on any continent in the world economy” as well as replacing “the patchwork of current regulation.” He would also push for an agreement on international standards of transparency and disclosure for financial institutions and products. In addition, he insisted on the need to reform and strengthen international institutions, giving them power and resources to invest at the global level.

Similar pleas for a stronger international regulation and supervision were made by President Nicolas Sarkozy and Chancellor Angela Merkel. In a confrontational statement, Bundeskanzlerin Merkel said she would “react very strongly” if the financial community tried to block government’s efforts to tighten regulation.

The G20 framework is currently at the stage where world leaders meet on reforms. The G20 aims at revising the system of global financial governance and pursue a global early warning system to identify and mitigate future risks. The group is assigned to develop globally accepted standards of supervision and regulation, effective cross-border supervision of global firms and mechanisms for co-operation and concerted action in a crisis.

This contribution looks at the stance of intergovernmental and governmental institutions in supervising financial markets. The focus lies on the global framework. Should domestic supervisors be adapted to the intricacies of international financial markets or does the world need international supervisors? How well are domestic banking supervisors equipped to deal with seamless global financial markets? If global supervisors must take responsibility, which international institutions would be equipped for this task? In this contribution it is argued that the crisis of 2008 has also exposed a crisis of institutions responsible for overseeing financial markets. A dedicated system of international and national supervisors is necessary and politically feasible.

I. Central Banks as Custodians of the Financial System

In the turbulent financial markets of today, central banks are expected to be the anchor of stability and throw a lifeline in case of financial distress. Central banks are not the only institutions that oversee financial institutions. States have created dedicated supervisors to oversee insurance companies and security traders.

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For the banking sector the central bank will be the most frequent supervisor. Central banks find their roots in private institutions, which were given special statutory powers such as the monopoly to issue banknotes or the prime responsibility to provide short term credit to state-institutions. From the 1930s onwards these institutions evolved into public organs through increasing state involvement in the appointment of governors or by outright nationalisation. In our time each state is expected to have its own currency and have its own central bank for the management of the currency. There are some exceptions. A limited number of economically less important states do not have their own currency and may use the currency of another state. In the European Union a currency is shared by a number of member states.

Central banks are the prime institutions in preserving the stability of the financial system. They operate through two methods. First, they have a particular responsibility for promoting price stability and employment. Several instruments are available to achieve price stability: managing liquidity (controlling the circulation of money in the national economy) or setting short-term interest rates. A central bank may also have a mandate to promote employment. A central bank is expected to balance the need to promote price stability against the objective of promoting employment. A policy too strict on price stability may stifle economic growth, and, alternatively, unimpeded economic growth may stimulate inflation. To achieve a balance, central bank officials must be in constant dialogue with finance ministries and other relevant institutions. A responsible central bank is expected to resist demands of governments to finance state projects or increase money supply if this would result in price inflation above a particular level. These rules would normally apply in a stable economy, but may be set aside in emergency situations.

A second task is regulating and supervising banking institutions to secure the safety and soundness of the financial system. The objective of supervision and regulation is to manage risks of market failure. A number of supervisory tasks may be identified. These are, *inter alia*, licensing, (testing business plans, 

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9 Interests may be balanced in different ways. The European Central Bank governs the European System of Central Banks (ESCB). It distinguishes primary and secondary objectives. Art. 105 of the Treaty on European Union reads: “The primary objective of the ESCB shall be to maintain price stability. Without prejudice to the objective of price stability, the ESCB shall support the general economic policies in the Community with a view to contributing to the achievement of the objectives of the Community as laid down in Article 2. The ESCB shall act in accordance with the principle of an open market economy with free competition, favouring an efficient allocation of resources, and in compliance with the principles set out in Article 3a.” The US Federal Reserve System puts price stability on an equal footing with employment. The goals of monetary policy are spelled out in the Federal Reserve Act, which specifies that governing bodies should seek “to promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates.” For a comparison between single (price stability) and dual (price stability and employment) mandates see G. Fontana, ‘The Federal Reserve and the European Central Bank: a theoretical comparison of their legislative mandates’, *Journal of Post Keynesian Economics*, Spring 2006, Vol. 28. No. 3. 433ff.
checking integrity of executives), compliance with minimal capital requirement (such as those agreed in Basel II – see below), review of disclosure requirements, compliance with anti-laundering regulation and overseeing mergers and acquisition.

II. Regulators and Supervisors

A distinction should be made between regulating and supervising markets. Regulators create rules aimed at financial institutions; their main objective is to foster financial stability and to protect those who use financial services. Overseeing compliance with regulations is the responsibility of supervisors. A supervisor which finds that a financial institution does not meet legal requirements may decide to enter into a dialogue or reprimand a non-compliant institution.

Regulation of the banking sector is primarily a matter within national jurisdictions. To a limited extend international regulation takes place. The Bank for International Settlements (BIS) is an important example of an international regulator that operates by consensual agreement between central banks. Being a vehicle for central banks, the BIS produced the Basel II framework that describes the minimum standard for capital adequacy. These standards are expected to be implemented by national legislators and supervised by national authorities. The objective of Basel II is to tailor regulatory capital requirements to the underlying risks that banks face in market operations. Closely related to the BIS is the Financial Stability Forum (FSF) which keeps a small secretariat at the BIS headquarters. The FSF is an informal, non-institutionalised body, bringing together senior representatives of national financial authorities (e.g. central banks, other supervisory authorities and treasury departments), international financial institutions, international regulatory and supervisory groupings, committees of central bank experts and the European Central Bank. The FSF holds an unfocussed mandate. It is expected to assess vulnerabilities affecting the international financial system, identify and oversee action needed to address these and improve co-ordination and information exchange among the various authorities responsible for financial stability. In the Leader’s Statement at the London Summit of 2 April 2009 the FSF was replaced by the Financial Stability Board (FSB). The FSB was assigned to a number of tasks aimed at


11 http://www.fsforum.org/about/mandate.htm (accessed on 22 March 2009).

improving and harmonising international regulation of financial markets, and strengthened collaboration amongst national supervisors, *inter alia* by the establishment of supervisory colleges.\(^{13}\) These proposals should improve macro-prudential oversight.

The BIS and comparable institutions only make a moderate contribution to the regulation of financial markets. Attempts to harmonise standards through non-binding instruments have had half-hearted results. Moreover, even if adequate legislation exists it is far from certain that domestic supervisors will effectively implement such legislation because domestic economic and political interests may warrant a distinctive approach.

In contrast to regulation, supervision is *exclusively* a domestic matter. The task of supervision may be in the hands of central banks, financial markets authorities or other institutions. While it is important to discern regulatory and supervisory powers, there is considerable spill-over in the exercise of these powers.

**III. Dynamic Supervision**

The need to make a distinction between regulators and supervisors is less obvious in the context of financial markets. Discrete responsibilities for regulation and supervision may be in accordance with textbooks on the separation of powers but denies the dynamic interaction between creation and enforcement of rules. If it is accepted that the objective of both regulation and supervision of markets is managing systemic risk, then the supervisor must have competence and a wide degree of discretion. In a rapidly changing world, risk assessments are subject to continuous changing perceptions, and, accordingly, supervisory competences must be frequently re-adjusted. In other words: if financial market engineer new high risk

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\(^{13}\) The FSB will: “*assess vulnerabilities affecting the financial system, identify and oversee action needed to address them; promote co-ordination and information exchange among authorities responsible for financial stability; monitor and advise on market developments and their implications for regulatory policy; advise on and monitor best practice in meeting regulatory standards; undertake joint strategic reviews of the policy development work of the international Standard Setting Bodies to ensure their work is timely, coordinated, focused on priorities, and addressing gaps; set guidelines for, and participate in, supervisory colleges, including through ongoing identification of the most systemically important cross-border firms; support contingency planning for cross-border crisis management, particularly with respect to systemically important firms; and collaborate with the International Monetary Fund (IMF) to conduct Early Warning Exercises to identify and report to the International Monetary Fund Committee (IMFC) and the G20 Finance Ministers and Central Bank Governors on the build up of macroeconomic and financial risks and the actions needed to address them.*” [http://www.londonsummit.gov.uk/resources/en/PDF/annex-strengthening-fin-sysm](http://www.londonsummit.gov.uk/resources/en/PDF/annex-strengthening-fin-sysm) (accessed on 23 April 2009).
products, a supervisor must respond instantly without having to wait for action by the regulator.

A law describing static rules and principles is therefore inappropriate for supervising markets. Legislators may not anticipate the financial engineering of advanced banking. They also may not foresee the emergence of the so-called ‘shadow banking system’ that includes financial institutions that are not de jure banks, and therefore beyond supervision, but are heavily involved in the banking business. Prescriptive rules and a product-based regime are therefore too inflexible and cannot respond to new financial products. There is a need for an authority that “continuously adapts the scope and content of regulations to the changing structure of international markets and the changing character of firms.” Accordingly, supervisors should be able to track the dynamics of the financial markets where the pace of innovation is high and markets are creative in finding ways to circumvent regulations in order to maximise profits. From this dynamic approach it follows that a dogmatic distinction between regulation and supervision is inadequate to deal with markets. Only a supervisor with discretionary regulatory powers may effectively monitor financial markets.

IV. Are Domestic Banking Supervisors Capable?

In light of the current crisis a more fundamental question concerns the capabilities of domestic supervisors. Staffed with dozens highly qualified analysts, they failed to recognise the systemic risks or declined to take preventive measures. Banking supervisors are expected to evaluate banking policies, practices and procedures related to the granting of loans and making of investments. This means that the supervisor needs to ensure that the credit and investment function of a bank is grounded on sound principles and that policies derived from such principles are transparently written down. In 1997 the Basel Committee on Banking Supervision issued core principles for Effective Banking Supervision. Principles include licensing requirements, prudential regulations, methods of supervision, information requirements and cross-border banking. The core principles underline the need for consolidated supervision in case of cross-border banking. It states that

14 These may take various forms, such as hedge funds and investment banks. These entities are primarily based in the US and were outside Federal Reserve supervision because they are not depository institutions. For their role in the financial system see ‘Barbarians at the Vault’, The Economist, 15 May 2008.
17 Meaning regulation of deposit-taking institutions and supervision of the conduct of these institutions, and set down requirements that limit their risk-taking. The aim of prudential regulation and supervision is to ensure the safety of depositors’ funds and preserve the stability of the financial system.
18 Consolidated supervision means that supervision may also take place with regard to branches of a bank established abroad.
“banking supervisors must practise global consolidated supervision” by which “a key component of consolidated supervision is establishing contact and information exchange with the various other supervisors involved, primarily host country supervisory authorities”.19 An example of such co-operation is the Committee of European Banking Supervisors (CEBS) which is comprised of high level representatives from the banking supervisory authorities and central banks of the European Union. The CBES has adopted guidelines on supervisory disclosure based on Basel II provisions.20

There are some explanations why domestic banking supervisors face difficulties in effectively supervising financial markets.

- Financial markets operate on a global scale, while domestic supervisors operate on a national scale. Major commercial banks jointly create a seamless global financial system in which transactions are virtually beyond what the ‘patchwork’ of national supervisors can ‘see’. Accordingly, domestic banking supervisors cannot provide macro-prudential supervision. While, central banks focus on the performance of individual bank (micro-prudential supervision) they miss a broader picture. Macro-prudential supervision would encompass all sectors of finance and deals with the wider economic context, on the regional level and the global level.21 This deficiency might explain why early warning signals, well before the crisis surfaced, were not provided.

- Domestic regulation and supervision offer ample room for regulatory arbitrage. Regulatory arbitrage refers to structuring a financial product in such a way that it brings about the lowest regulatory burden, both in terms of capital requirements and in terms of administrative burden, or that it even evades a regulatory regime. Regulatory arbitrage created the development of offshore banking in low tax jurisdictions, providing legal and regulatory advantages.

- There is a lack of expertise of supervisors because ‘those who understand the market best are likely to be employed in the markets in positions that pay far more than those funded by the public purse’.22 It is not unlikely that only a limited number of regulators have thorough understanding of all the intricacies of financial markets. Dutch regulators argued that had they understood risks on and off balance sheets, they would not have approved the acquisition of ABN AMRO by Fortis in 2007.23

- Domestic banking supervisors may have a national interest not to ‘harass’ domestic commercial banks in order to avoid a ‘bank run’. An

19 Supra note 16, Principles 23 and 24.
20 Basel II requirements are implemented in the EU by Capital Requirements Directive 2006/48/EC.
21 De Larosière Group, supra note 10, p.39.
early warning system bringing bad news about a commercial bank’s performance may cause a run on liquidity of (international) clients. This is not in the interest of the national economy and a supervisor may fear a collapse of more local banks. This is probably what happened in Iceland in late 2008 when its central bank did not provide information to other central banks because of commercial confidentiality or legal constraints.24

- Domestic supervisors may have questionable independence vis-à-vis financial markets. Even if adequate legislation is in place and expertise is available, staff of regulators may seek job opportunities or have a professional background in commercial banking; under such circumstances decision-making may be biased by sentiments or undue empathy for the ailing financial conditions of banks.25

V. Will International Supervision Work?

The establishment of an international supervisor takes away some of the limitations that national supervisors face but may have disadvantages too. Advantages are obvious: a global supervisor would be able to exercise jurisdiction that truly covers the global marketplace. Unimpeded by jurisdictional borders, it can oversee cross-border movement of capital in whatever form. Nourished with a constant flow of data the global supervisor is able to understand financial innovative products, track the origins of financial products and appreciate how products disperse through the financial system. An international supervisor may also bring better expertise because they should be able to afford top salaries for top experts. Moreover, being part of an international institution and having no bonds to national

24 Also De Larosière Group, supra note 10, p. 41.
25 This point was made when Henry Paulson was appointed US Treasury Secretary in the Bush administration in 2006. Prior to public service Paulson was working for Goldman Sachs. “The question isn’t how it’s a conflict of interest for Paulson to preside over our country’s economy but how it’s not. (...) Even if Paulson ultimately sells all his stock and finds a way to offload his restricted stock, he will wield in the meantime enormous influence over the Treasury bond and foreign currency trading positions of Goldman, with every policy decision on debt issuance or the dollar that he makes. What’s good for Goldman isn’t necessarily good for Middle America. Therein lies the conflict of a man whose entire career has been predicated on successfully promoting corporate welfare over public interest.” The Nation, 26 June 2006. Former IMF chief economist Simon Johnson criticizes the warm relationship between supervisors and those supervised. “One channel of influence was, of course, the flow of individuals between Wall Street and Washington. Robert Rubin, once the co-chairman of Goldman Sachs, served in Washington as Treasury secretary under Clinton, and later became chairman of Citigroup’s executive committee. Henry Paulson, CEO of Goldman Sachs during the long boom, became Treasury secretary under George W. Bush. John Snow, Paulson’s predecessor, left to become chairman of Cerberus Capital Management, a large private-equity firm that also counts Dan Quayle among its executives. Alan Greenspan, after leaving the Federal Reserve, became a consultant to Pimco, perhaps the biggest player in international bond markets.” The Quiet Coup, The Atlantic Online, May 2009. http://www.theatlantic.com/doc/200905/imf-advice/ (accessed on 1 April 2009).
jurisdictions, officials may likely be more independent and less reluctant to put into effect an early warning system on domestic bank performance.

However, a single global supervision, even for key players in financial markets, is difficult to achieve politically and practically. It would be unlikely that current financial centres in the US, Europe and Asia would be willing to surrender supervisory jurisdiction to an international body. Lobbyists from financial market will likely be successful to convince decision making bodies that a global supervisor would stifle innovation, and incur more bureaucracy and higher costs. A major practical disadvantage would be the sheer size of the financial system and the remoteness to local markets. A distant global supervisor is unable to be in constant dialogue with the numerous players on the financial markets.

A more acceptable and realistic model might therefore be based on a system of supervisors whereby an international supervisor will need to work with and through national (or regional) supervisors. The Federal Reserve System or the European System of Central Banks may serve as an example. In these structures a balance is struck between decentralised and centralised institutions. In the EU the European Central Bank (ECB) governs the ESCB, a system of central banks (ECB and National Central Banks (NCBs)). In this system the ECB and NCBs each have there own responsibility according to the Treaty on European Union and the ESCB Protocol.

VI. Creating a System of Regulators and Supervisors

Currently, a disorderly patchwork of intergovernmental institutions has been assigned to develop proposals for improved oversight of financial markets. There is no clear authority and the legal status of recommendation, communiqués, decisions and reports issued by various bodies is ambiguous. For instance, what is the status of a G20 communiqué? Does it create a binding commitment for participating states, or even non-participants? What are the consequences if a major industrialised state fails to implement regulations? How does the FSB decide on regulations? Unanimity, consensus or majority? Does it have any legal authority to do so? What would be the consequence if two institutions propose conflicting regulations? Even if agreement is reached, states may reject the adoption of regulations or adapt regulations to their own needs, thereby creating divergence in the application of standards. The current institutional framework for international regulation is inherently weak.

An authoritative centralised institution is required that adopts and protects global standards. A parallel can be found in the world trading system. Since 1995 the world trading system is governed by a single institution: the World Trade Organisation (WTO). The WTO oversees a system where at least some universally accepted standards for international trade are cast in stone, such as the need to ensure national treatment for imported goods or the
prohibition to retaliate unilaterally in case of a trade conflict. Considering the fact that it was possible to overcome considerable obstacles and create the WTO, it may also be feasible to establish a World Financial Organisation (WFO) for regulating financial markets. The establishment of a WFO would create a proper counterweight in the international economic system. By reconciling distinct objectives – liberalisation of international trade flows (WTO objective) and creation of stability in the international financial system (WFO objective) – trade protectionism and financial crises may be given less chance to disrupt the international economy. The WTO and WFO share objectives on a more elevated level as their raison d'être is the desire to promote national and international prosperity.26

The system aims to regulate and supervise states and financial markets. It will be designed to oversee macroeconomic policies of governments and behaviour of financial markets. The system recognises that financial markets are an important non-state actor on the international plane and that their behaviour can only be effectively controlled by international regulation and dedicated supervision. The WFO runs the system and its constituent parts are subordinate to the WFO. The system incorporates a number of relevant institutions. It streamlines their activities – preventing overlap and lacunae –, creates hierarchy and allocates responsibilities. Its constituent elements are discussed below. Most elements already exist; new are the WFO and the systemic risk councils.

VII. The World Financial Organisation

The proposed WFO would accept universal membership of states and be an institution that brings together relevant financial and monetary authorities.27 Its establishment reflects the new reality of the financial system by focussing on both states and financial markets. The WFO will have a dual function in

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26 Compare to the key objectives of the WTO in the preamble of the Agreement establishing the World Trade Organisation, i.e. promoting sustainable development and to develop “an integrated, more viable and durable multilateral trading system.”

that it considers macroeconomic policies of governments on the one hand and behaviour of financial markets on the other hand. Addressing both spheres makes sense because macroeconomic policies (including balance of payments, reserves, foreign indebtedness, exchange rate policies, liberalisation of capital movement) strongly affect financial markets. Conversely, financial markets behaviour may have a deep impact on the macroeconomic performance of states.\(^\text{28}\)

To ensure its authoritativeness WFO-members annually meet on ministerial level and consider reports of the IMF, International Bank for Reconstruction and Development (IBRD) and joint prudential supervisors. The WFO will employ the best financial experts and award them a competitive remuneration. The primary task of the WFO would be to gather information, harmonise standards and procedures and oversee enforcement. The WFO does not itself enforce regulations. Rather, it will oversee and coordinate the enforcement activities of national regulators in international cases.\(^\text{29}\) The WFO issues regulatory standards assisted by the BIS, FSF and other standard setting expert bodies. Through adoption of standards the WFO instructs the system’s constituent parts and its membership. Standards will be adopted by the WFO executive body in which weighted votes are fairly distributed.

In the new system the status of IMF and World Bank will be downgraded by subordination to the WFO. Their mandate will be unaffected but they need to operate within the system. They will serve not as political bodies but as technocratic institutions. The WFO would take over the political nature of the IMF by convening annual meetings of finance ministers and national regulators. The WFO may also provide for a dispute settlement system when states fail to comply with agreed standards or decline to exercise adequate supervision. A parallel may be found in the dispute settlement system of the WTO. The system may also settle disputes between the Bretton Woods Institutions and countries.

**VIII. Overseeing Sovereign Actors**

Established in 1945, the IMF and World Bank are designed to promote stability in the international monetary system and advance economic development. The object of their activities is macro- and microeconomic policies of countries. Their role in the system will be much the same as it is now. However, the WFO may steer their activities in a particular direction. For example, the WFO may ask the IMF to address the problem of international liquidity in times when financial markets face a shrinkage of credit facilities.

\(^{28}\) The financial crisis in the 1990s was caused by abrupt withdrawal of capital from emerging economies. These economies were in decline and running out of foreign reserves.\(^{29}\) Eatwell & Taylor 2000, supra note 15, p. 223.
How do IMF and World Bank perform today? The International Monetary Fund oversees macro-economic policies in general and monetary policies of countries in particular. Article IV Section 3 of its Articles of Agreement stipulates that the Fund shall oversee the international monetary system in order to ensure its effective operation. In consultations with monetary authorities of each member country, the Fund exercises ‘firm surveillance’ over the economic and financial policies and lays down ‘firm basic principles’ to which member countries must adhere. Oversight is also exercised in order to promote stability in the international monetary system and avoid manipulated exchange rates with the purpose to achieve competitive advantages.

Article IV consultations include discussions on policies with all members on an annual basis. An IMF member must be willing to provide information and receive advice from the Fund. The objective of the co-operation is to ensure orderly exchange arrangements\(^{30}\) and to promote a ‘stable system of exchange rates’ and, through this, the facilitation or trade of goods and services amongst countries. The IMF does not have unimpeded jurisdiction over monetary matters. It may only deal with the liberalisation of current transactions, i.e. transactions related to trade.\(^{31}\) The IMF does not have a mandate that promotes cross border movements of capital.

The Fund’s provisions on surveillance are couched in vague terms and the resulting softness is generally considered a major weakness. The surveillance procedure has in practice only limited effect for the simple reason that the obligations have no far-reaching consequences: soft obligations do not make for strict oversight. In the consultations, only the weight of arguments and, to a certain extent, peer pressure play a role in persuading a country to bring its economic policy more in line with what the IMF finds desirable. Effective IMF surveillance thus crucially depends on the willingness of members to take the Fund's advice. Unfortunately, many countries tend to ignore the Fund’s advice.

The World Bank activities are focused on the micro-economic management of developing countries. A major activity of the Bank is lending money for project financing. Countries that borrow from the World Bank (often in joint operation with the IMF) are expected to carefully consider the micro-economic management of their economy. A major tool for restructuring the national economy is the Poverty Reduction Strategy which addresses budget allocations, problems of fragmented budgets and the absence of budget discipline. The Bank urges countries to be accountable and efficient in the management of public resources. Accordingly, public finance management must achieve an overall fiscal discipline and ensure that public spending is in line with available resources. In this process the Bank also oversees that resources are allocated effectively to priority needs. This means that

\(^{30}\) Exchange arrangement is the policy of a member on the exchange rate of its currency.

\(^{31}\) Cf. Art. XXX(d) IMF Articles of Agreement.
resources are used in such a way that they provide maximum value for money.\textsuperscript{32}

In sum, the IMF and World Bank assess economic performance of states (and not of financial markets). The IMF focuses on macro-economic management, whereas the World Bank focuses on micro-economic management. Each institution operates in its own domain, but they are expected to cooperate.\textsuperscript{33}

\section*{IX. Overseeing Financial Markets}

International oversight over financial market is highly deficient. The de Larosière Group finds that there is an “evident lack of a coherent framework for designing and enforcing minimum regulatory standards, for identifying risks to financial stability and for coordinating supervisory policies at the global level. Moreover, there are practically no arrangements for cross-border financial crisis management at the global level and for enforcement. What is needed now is a strengthened, more coherent and streamlined international financial regulatory and surveillance system, building on the better use of existing international institutions.”\textsuperscript{34} Both the de Larosière Group and the G20 believe that supervision over commercial actors should be based on a

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\item \textsuperscript{32} http://go.worldbank.org/YTBYFB2A10 (accessed 2 April 2009).
\item \textsuperscript{33} For this purpose the IMF and World Bank have concluded an agreement on cooperation. ‘Memorandum to the Executive Board of the International Monetary Fund and the Board of Executive Directors of the World Bank’ 30 March 1989. The division of labour is described as follows:

“The Fund has among its purposes the promotion of economic conditions conducive to growth, price stability, and balance of payments sustainability and is required to exercise surveillance on a continual basis over the performance of its members as defined by Article IV. The Fund is empowered to provide temporary balance of payments financing to members to enable them to correct maladjustments in their balance of payments without resorting to measures destructive of national or international prosperity. Thus, the Fund has focused on the aggregate aspects of macroeconomic policies and their related instruments – including public sector spending and revenues, aggregate wage and price policies, money and credit, interest rates and the exchange rate. The Fund has to discharge responsibilities with respect to surveillance, exchange rate matters, balance of payments, growth oriented stabilization policies and their related instruments. These are the areas in which the Fund has a mandate, primary responsibility, and a record of expertise and experience.

The Bank has the objective of promoting economic growth and conditions conducive to efficient resource allocation, which it pursues through investment lending, sectoral and structural adjustment loans. Thus, the Bank has focused on development strategies; sector and project investments; structural adjustment programs; policies which deal with the efficient allocation of resources in both public and private sectors; priorities in government expenditures; reforms of administrative systems, production, trade and financial sectors; the restructuring of state enterprises and sector policies. Moreover, as a market-based institution, the Bank also concerns itself with issues relating to the creditworthiness of its members. In these areas, except for the aggregate aspects of the economic policies mentioned in the previous paragraph, the Bank has a mandate, primary responsibility, and a record of expertise and experience.”

\item \textsuperscript{34} De Larosière Group, \textit{supra} note 10, p. 59.
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two-tier system. First, national supervisors will continue to exercise micro-prudential oversight. Second, macro-prudential oversight will be a new feature in the system; this form of oversight needs to be established in such a way in order to oversee financial markets as a whole, and not merely the individual actors in the market. Supervisors providing macro-prudential oversight are expected to recognise systemic risks well before they become a threat.

X. Micro-prudential Oversight

Micro-prudential supervision refers to the supervisory activities towards a single financial institution. The purpose is to protect the bank from distress or insolvency. In this process bank A is considered sound when it meets all regulatory requirements and the customers of bank A are protected. Micro-prudential supervisory tasks are exclusively in the hands of domestic supervisors. National supervisors must follow international agreed regulations. Supervisors are generally restricted by jurisdictional borders and may only operate within their territory. However, supervision may be extended extra-territorial in case a bank registered in the home state establishes subsidiary offices abroad. The 1992 Minimum Standards for the Supervision of International Banking Groups and Their Cross Border Establishment states that “All international banking groups and international banks should be supervised by a home country authority that capably performs consolidated supervision”. Only to the extent that home country authorities are “unable or unwilling to initiate the effort to take measures to meet these standards, the host country authority should prevent the creation in its jurisdiction of any cross-border establishments by that bank or banking group.” Therefore the burden of proof when not meeting standards lies at the host country. The problem is, however, that the host country depends on the home country for information on the financial condition of the banking group and its subsidiary.

A proposal to substantially improve co-operation between domestic supervisors is the establishment of colleges of supervisors. Colleges of supervisors are permanent but flexible structures for co-operation and co-ordination among the national supervisors involved in the supervision of significant cross-border banking groups. The composition of a college

35 G20 Working Group 1 on Enhancing Sound Regulation and Strengthening Transparency, February 2009.
depends on the banking group that is supervised. Thus a parent banking institution in country A with subsidiaries or branches in countries B, C and D would bring together the supervisors of the countries involved. For this purpose the supervisors would conclude an agreement on co-operation, information sharing, sharing and delegation of tasks, on-site examinations, responding to crisis situations, et cetera. Accordingly, the organisation of a College reflects the legal structure of the banking group.

Colleges of supervisors do not replace domestic supervisors; it merely forces them to cooperate. A major problem continues to lie in the poor performance of domestic supervisors. Some feeble attempts have been made to scrutinise domestic supervisors. The IMF and the World Bank have set up Financial Sector Assessment Programs (FSAP) in 1999 through which states participate voluntarily. The FSAP monitors the resilience of the financial system and to what extent the supervisors comply with standards.\(^{38}\) About three-quarters of IMF and World Bank members have been reviewed under the programme. The US did not participate in this programme. The effectiveness of the FSAP is dubious. In 2003 the IMF did not anticipate any problems with the financial market in the UK, even though its financial sector was already situated under a volcano that was about to erupt in 2007. The IMF also expressed that there was little to worry about the functioning of UK’s supervisory regime. The IMF reported that “the UK’s large, sophisticated and internationally oriented financial sector features fundamentally sound institutions, markets and infrastructure. The banking sector appears sufficiently profitable and well-capitalised overall to be able to absorb the more likely shocks without major distress, although a number of key risks need to be watched”. On supervision the report concludes that “the supervisory framework complies or largely complies with most international standards and codes, and there is a constant drive amongst the authorities to rectify weaknesses (...) supervision in the UK is in its turn supported by a well functioning safety net, systemic liquidity, system level surveillance, and insolvency arrangements and a high quality accounting and disclosure regime”.\(^{39}\)

**XI. Macro-prudential Oversight**

Macro-prudential supervision refers to the supervisory activities towards the financial system as a whole. The purpose is to protect the overall economy from collapse. This may occur when a series of financial institutions are exposed to a similar risk. In the credit crisis exposure to subprime mortgage securities loans appeared wide-spread; an early warning system recognising the deplorable state of banks’ balance sheets, might have contained the


damage. The G20 of finance ministers has urged to improve the financial system by macro-prudential oversight and international co-operation to prevent and resolve crises. The G20 proposes to achieve this by reinforcement of the FSB and the launch of an Early Warning Exercise (operated jointly by the IMF and FSB).

In line with this approach the de Larosière Group proposes the establishment of a European Systemic Risk Council (ESRC) that would bring together national central banks of EU members and representatives of other supervisory bodies (overseeing insurance companies, pension funds and securities traders). These bodies must cooperate and provide information to the ESRC. The council’s objectives would be to provide oversight over the financial markets by making recommendations on macro-prudential policies and issue risk warnings when market failures pose a threat. Accordingly, for example, the ESRC could act when credit expansion is becoming excessive or there is a threat to the global financial system because of abuse of off-balance sheet transactions or illegitimate regulatory arbitrage. The proposal of the de Larosière Group would not replace central bank supervision by establishing a European supervisor. Other proposals make similar suggestions or even suggest a supranational supervisor. Along the same lines, similar systemic risks councils could be set up in financial relevant regions such as in Latin America and South East Asia. Major actors such as the US and China could set up their own risk councils. Systemic Risk Councils should meet frequently and report to the WFO.

Concluding Observations

The current system of regulating and supervising international financial markets is primarily a matter dealt with by national authorities. To a limited extent regulation is harmonised by the Bank for International Settlements

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41 A similar proposal has been to create “A European System of Financial Supervision (ESFS), modelled on the European System of Central Banks [that] would comprise a new EU-level institution – a European Financial Services Authority. This system would supervise those systemically relevant financial institutions that operate on a pan-European basis, and it would be the final authority for interpreting and implementing EU financial market rules whenever there is a conflict between national regulators”. Cf. Bernhard Speyer and Norber Walter (researchers at Deutsche Bank), *Europe’s World*, Spring 2009. See also ECB Board Member Bini Smaghi, urging for unified banking supervision (by the ECB) thereby taking over responsibilities from the national central banks. ‘Move to strengthen ECB gains support’, *Financial Times*, 13 February 2009.
42 A call for a macro-prudential supervision was made by the chairman of the US Federal Reserve Bank. ‘Bernanke calls for powerful regulator’, *Financial Times*, 11 March 2009. Mr Bernanke said that a broader approach was also needed. “We must have a strategy that regulates the financial system as a whole, in a holistic way, not just its individual components,” he said. “In particular, strong and effective regulation and supervision of banking institutions, although necessary for reducing systemic risk, are not sufficient by themselves to achieve this aim.”
(and its Committee on Banking Supervision), the International Organization of Securities Commissions, and the International Association of Insurance Supervisors. The impact of international regulators is limited. Adoption of internationally agreed regulation is voluntary and national supervisors may refrain from complying because they believe that national conditions warrant a different approach. Moreover, national supervisors are likely to protect national interests; they are tempted to relax enforcement of internationally agreed standards if risks can be shifted to other jurisdictions. Domestic financial markets and national supervisors have a common interest to conceal the exposure of high risks.

Current proposals continue to express political statements without substantially improving the institutional framework of supervisors. The G20 in its communiqué of 2 April 2009 recognises the importance of ensuring strong domestic regulatory systems: “we each agree to ensure our domestic regulatory systems are strong. But we also agree to establish the much greater consistency and systematic co-operation between countries, and the framework of internationally agreed high standards, that a global financial system requires”. The G20 appears not to aim at an international authority or allocate responsibility at the international level. It merely underscores the need for international standards and better co-ordination between domestic supervisors.

Unless a firm international regulatory and supervisory system is created, the international financial system is inherently vulnerable. A system of regulators and supervisors under the umbrella of the World Financial Organisation is therefore proposed. The system aims to regulate and supervise states and financial markets; it recognises the interaction between macro-economic policies of states and behaviour or financial markets. The WFO runs the system. The system streamlines activities, creates hierarchy and allocates responsibilities. It ensures that overlap and lacunae in oversight are avoided.

The political feasibility of creating a system guided by the WFO may be doubted for good reasons. States cling to sovereignty and supervision over financial markets is a politically sensitive issue. However, post war history has proven that important institutions can be created, provided that proposals come at the right time. The Bretton Woods institutions, created in 1945, and the establishment of GATT in 1947 were truly innovative institutions at a time when states agreed that trade protectionism must be banned and the international monetary system must not be abused. The establishment of the World Trade Organisation in 1995 (including a mandatory dispute settlement system) was another major achievement. A system of regulators and supervisors builds on existing institutions would properly balance the desire to preserve sovereignty and the need to supervise global financial markets.
## A Patchwork of Actors in Financial Market Regulation / Supervision

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<tr>
<th><strong>objective</strong></th>
<th><strong>composition</strong></th>
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<tr>
<td><strong>International Monetary Fund</strong>&lt;br&gt;oversee macro-economic policies of member countries and developments in the global economy, provide balance of payments support to members in need;</td>
<td>virtually universal membership of countries represented by central bank or treasuries</td>
</tr>
<tr>
<td><strong>International Bank for Reconstruction and Development</strong>&lt;br&gt;oversee micro-economic policies of developing countries through the Poverty Reduction Strategy Process; project financing in development countries; encourage foreign direct investment</td>
<td>virtually universal membership (membership open for IMF-members only)</td>
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<tr>
<td><strong>Bank for International Settlements</strong>&lt;br&gt;promote discussion and policy analysis among central banks and within the international financial community; provide a centre for economic and monetary research; participate in financial transactions and operations</td>
<td>central banks or monetary authorities of Algeria, Argentina, Australia, Austria, Belgium, Bosnia and Herzegovina, Brazil, Bulgaria, Canada, Chile, China, Croatia, the Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hong Kong SAR, Hungary, Iceland, India, Indonesia, Ireland, Israel, Italy, Japan, Korea, Latvia, Lithuania, the Republic of Macedonia, Malaysia, Mexico, the Netherlands, New Zealand, Norway, the Philippines, Poland, Portugal, Romania, Russia, Saudi Arabia, Singapore, Slovakia, Slovenia, South Africa, Spain, Sweden, Switzerland, Thailand, Turkey, the United Kingdom, the United States, and the ECB</td>
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<tr>
<td><strong>G-20</strong>&lt;br&gt;promoting open and constructive discussion between industrial and emerging-market countries on key issues related to global economic stability</td>
<td>informal group of finance ministers and central bank governors of 19 countries: Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, Mexico, Russia, Saudi Arabia, South Africa, South Korea, Turkey, the United Kingdom, the United States of America and the European Union, plus representatives of IMF and IBRD</td>
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<td><strong>Financial Stability Board</strong>&lt;br&gt;assess vulnerabilities, promote co-ordination, monitor and advice on market developments, undertake joint strategic reviews, set guidelines for supervisory colleges, support cross border crisis management, collaborate with IMF on early warning</td>
<td>informal group of G-20 national financial authorities and standard setting bodies (central banks, supervisory authorities and finance ministries), plus Australia, Hong Kong, Netherlands, Singapore and Switzerland and international financial institutions (precise composition remains unclear, however)</td>
</tr>
<tr>
<td><strong>Colleges of supervisors</strong>&lt;br&gt;permanent but flexible structures for co-operation and co-ordination among the national supervisors involved in the supervision of significant cross-border banking groups</td>
<td>national supervisors; composition of a college depends on the banking group to be supervised.</td>
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<tr>
<td><strong>National Central Banks and other domestic supervisors</strong>&lt;br&gt;promote stability through money supply, interest rates, short term credit; provide micro-prudential oversight by regulating and supervising national financial markets; however, mandates may differ depending on political priorities</td>
<td>not applicable</td>
</tr>
<tr>
<td><strong>Coordinating international bodies: BIS Committee on Banking Supervision, The International Organization of Securities Commissions, and the International Association of Insurance Supervisors.</strong>&lt;br&gt;develop common standards for supervision to be implemented by domestic supervisors</td>
<td>national regulators; various compositions</td>
</tr>
<tr>
<td>European Systemic Risk Council and other systemic risk councils</td>
<td>exercise macro-prudential supervision over the financial system as a whole; protect the overall economy from collapse by giving early warning signals in case of systemic risks</td>
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