Institutional Incentives and Geopolitical Representation in Global Financial Governance:

Explaining the Puzzle of Regulatory Forbearance before the Crisis

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**Preliminary Draft:**
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This paper asks how, and to what extent, the current crisis can be related to characteristics of the system of global financial governance. We approach this question by examining the particular form in which global financial governance took in the decade before the onset of the worst of the financial crisis so far, i.e. between approximately mid-1998 and mid-2008. Our central argument is that the interests represented within the key institutions of global financial governance had perverse effects on the way in which the evolution of financial risks was being matched with the evolution of financial governance. This contributed to a massive increase in unaddressed systemic risk, which ultimately lead to the financial crisis. We contend that one way of understanding this dynamic is by examining the country representativeness of institutions of global financial governance.

As a starting point to our analysis, we see the regulatory failure as more the result of forbearance and ‘sins of omission’ (actions which were not taken) as opposed to specific policies (actions which were taken). In this vein it is was the slow and distorted level of public regulatory ‘catch-up’ to developments within private financial markets that must be contextualized and explained. In this regard, we refer to the lack of regulatory attention on developments within the financial sector such as the rapid growth of off balance sheet transactions of banks leading to increases of bank leverage, the explosive growth of the CDS markets and sophisticated securitized financial instruments, as well as other systemic risk factors that are presently widely regarded as prime contributors to the crisis.¹ We do not seek to describe or diagnose the crisis itself. Instead, we make the case that the dominance of a few countries within institutions of global financial governance contributed to a particular approach to the governance of financial markets which was inadequate to the form and scale of the risks involved. That approach put a high premium on regulatory omission and forbearance, and a low premium on the kind of ‘constructive conservatism’ that might have sought to address new forms of systemic risk that accumulated in developed financial markets during this period. While this dynamic must be seen as one among many factors contributing to the crisis, we contend that it provides a valuable answer to understanding the governance environment that contributed to the crisis.

The paper proceeds as follows. We first posit the general form of our argument, which emphasizes the relationship between the representativeness of a governance institution and expected outcomes. We then select two institutions of global financial governance that were at the core of the system of global financial governance, and briefly describe their functions, their country composition, and the ways in which the latter may have affected their approach to financial risk and regulation in the decade before the crisis. The decisions and non-decisions of institutions of governance don’t represent the entire story behind the crisis, but they do offer a useful starting point of analysis.\footnote{For an excellent explications of why institutions in global financial governance, and especially in the context of the current crisis, see Tony Porter, “Why International Institutions Matter in the Global Credit Crisis” Global Governance, Vol.15 (2009), pp. 3-8.}

The first of these institutions, the Bank for International Settlements (BIS), is a paradigmatic example of an institution responsible mainly for coordination and communication in global financial governance. We point out that in this regard the BIS was able to expand its representativeness at the same time as fulfill some of its principal roles. The second institution examined, the BCBS, is a paradigmatic example of an institution responsible mainly for regulatory policymaking in global financial governance. We argue that the level of representativeness of this institution was extremely restrictive, and can help to explain an approach to financial regulation which contributed to the crisis. We analyze this relationship by pointing out how the regulatory policies which were pursued – ‘what was done’ – reflected interests particular to those countries represented. Conversely, the regulatory policies not pursued – ‘what was not done’ – also reflected this composition of interests represented within this institution during this period.

\textit{Composition, Institutional Incentives, and Global Financial Governance}

The system of global financial governance that has evolved over the past three decades is a highly complex one, not comparable to its equivalent in trade. We acknowledge that it is comprised not only of formal institutions of governance, but also shared discourses, overlapping epistemic communities, and informal institutional arrangements.\footnote{Randall Germain, “Global finance, risk and governance”, Global Society, Vol. 21, No. 1 (2007), pp. 71- 93; Randall Germain, “Globalizing accountability within the international organization of credit: financial governance and the public sphere”, Global Society, Vol. 18, No. 3 (2004), pp. 217- 42; Tony Porter and Karsten Ronit, “Self-Regulation as Policy} Moreover, unlike the international trade
regime, for example, the international financial architecture is composed of a much more diffuse set of institutions carrying out specific functions, often with a lack of coordination between each. Moreover, there is not always a clear dividing line where public authority begins and private initiatives ends. Despite these features of the system of global financial governance, there is an important role for formal institutions – without which the system simply could not be understood. While these institutions do not derive their authority from sovereign power, but often from a networked relationship among specialist agencies, it is nevertheless possible to conceive these as institutions of governance.

What drives the behavior of these governance institutions? While multiple answers are possible, we posit that one central determinant is the composition of decision-makers. Irrespective of the formal remit of an institution, the composition of decision-makers will have a bearing on outcomes because different kinds of decision-makers pursue different interests. We argue that one indicator is the composition of country representatives within such institutions. This is not only because different states have different ‘national interests’ and may pursue them through such institutions, but perhaps even more importantly that organized interest groups can find their way into these organizations more easily if their national representatives are represented, and vice versa.

Before we apply our argument to institutions of global financial governance, two brief examples may help to clarify the mechanisms of our argument. Consider the relationship between the composition of a national legislature in a federal system of government and the kinds of laws that legislature is likely to make. If the US Congress, for example, only represented southern states, this would affect the kinds of laws that were passed, and the general strategies taken. This is not only because each US state in the union has a different interest (‘raison d’état’, in the classical sense) as an entity, but because each state is composed of a different constellation of interests within it – interests that can more easily find expression if they have a representative in Congress than not. This relationship can be easily transposed to the international level. An institution seeking to provide standards for the world coffee trade would produce very different outputs if it were composed of representatives of Italy, Belgium, France, the United States and Australia (coffee consuming states),

4 For example, the International Accounting Standards Board (IASB) formulates the de facto global standards for the accounting profession in its many guises, and is a private sector-driven institution. See Tony Porter, "Private Authority, Technical Authority, and the Globalization of Accounting Standards", Business and Politics Vol. 7, No. 3 (2005).
as opposed to representatives from Brazil, Kenya, and Vietnam (coffee producing states). Clearly in each scenario the output would be different – the actions that the world coffee organization would produce would be different in each case, reflecting the different composition of decision-makers, and the interests that each are bound up with.

These two examples help to illustrate a simple point: the composition of representatives within a governance institution has a bearing on how such an institution is likely to behave. This relationship has already been well established in an extensive literature on the IMF, whereby formal country representation in IMF governance in the form of voting rights has skewed representativeness with often unambiguous effects regarding the way the IMF has pursued its remit. In what follows below, we apply our argument to two institutions which are less well known in public policy debates or to the general public, but are nonetheless highly significant institutions in the system of global financial governance: the Bank for International Settlements (BIS) and the Basel Committee on Banking Supervision (BCBS). The BIS can be understood as an institution primarily concerned with coordinative and communicative roles, while the BCBS is an institution of regulatory policymaking.

The Bank for International Settlements

Unlike more well-known institutions such as the International Monetary Fund and the World Bank, which were forged out of the agreement at the Bretton Woods summit in 1944, the Bank for International Settlements (BIS) was established a decade and a half before, in 1930. While its initial remit was to manage the system of German war reparations payments, in subsequent decades it expanded to its focus on facilitating a system of cooperation and communication among central bankers, and to conduct research and disseminate monetary policy ideas. Acting in its core function as a bank for central banks, most central banks from around the world deposit a substantial proportion of the world’s foreign exchange reserves within the BIS. Aside from its core functions, the BIS headquarters in Basel Switzerland has also acted as a hub for the secretariats of the Financial Stability

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Forum and the Basel Committee on Banking Supervision, and thus can be seen to be interwoven in the story of governance more generally.\footnote{While these institutions are highly autonomous from the BIS itself, they also share an overlapping epistemic community, and they rely on research and expertise from each other’s institutions.}

Decisions within the BIS are voted on and votes are distributed on the basis of the number of shares held by every central bank which is a member. The BIS’ general membership includes central banking institutions from 56 different countries, of various sizes and levels of development. The BIS’ founding members are from Belgium, France, Germany, Italy, the UK and the United States, and these founding six members hold the majority of the votes within the institution. As such, they are entitled to two seats each at the twenty-one seat executive: effectively giving the founding members a permanent majority.\footnote{Article 38 of the BIS’ Constitution. See Hetty Kovach, Caroline Neligan and Simon Burall, \textit{Global Accountability Report 2003: Power Without Accountability?} (London: One World Trust, 2003), p. 9.} The additional nine places are open to other BIS member representatives on a rotating basis, and are nominated by the founding members. On 12 January 2009, the BIS elected its new Chairman, the Governor of the Central Bank of Mexico.

There are many different ways to characterize the internal governance characteristics of the BIS. On one level, its decision-making is highly opaque; agendas, draft papers and minutes of meetings are not available publically – though some of this material is available with a 30-year delay in their permanent archive. Decisions are sometimes publicized through press releases, though press are not involved otherwise. A survey of the accountability features of various international institutions conducted by the One World Trust in 2003 concluded that the BIS’ member control was rated 10 out of 100, which was the lowest of the inter-governmental organizations that it surveyed for that year.\footnote{Ibid.} A similar, but much more extensive survey was carried out in 2006. Once again, compared to other institutions of global economic governance such as the World Bank, the IMF, and the WTO, the BIS has scored very low in terms of its transparency – far below other international institutions such as the World Bank, the IMF, and the WTO.\footnote{Monica Blagescu and Robert Lloyd, \textit{2006 Global Accountability Report} (London: One World Trust), p. 26.} It scored better – both absolutely and in relation to its peers – on the GAR’s index of evaluation capacities, which measures the extent to which an international organization has capabilities in place to ensure consistently high quality evaluations that
lead to learning and strengthen accountability.\footnote{For an account of the methodology, see Ibid., p. 42.} In terms of the capacity for an institution to respond to complaints from internal and external stakeholders, and to respond to these complaints, the BIS also scored very poorly – though notably not much lower than other international institutions such as the IMF and the WTO.\footnote{Ibid, p. 47} In terms of engagement with inside stakeholders and outside parties, the BIS scored dead last among the 10 international economic institutions surveyed.\footnote{Ibid, p. 32} Equally striking is its barely existent score on engagement with civil society organizations.\footnote{Ibid, p. 37.}

These observations are striking, and should not be discounted out of hand. However it is notable that more recently the BIS has experienced two significant reforms during the period in question. First, throughout the decade it increasingly interacted with a wider variety of states than it had previously. The BIS’ Markets Committee began holding bimonthly meetings of senior officials responsible for market operations at G10 central banks. It also began inviting representatives from the central banks and monetary authorities of Australia, Brazil, China, Hong Kong, India, South Korea, Mexico, Singapore, and Spain.\footnote{Bank for International Settlements, \textit{2007 Annual Report} (Basel: BIS, 2008), p. 166.} Similarly, the BIS’ Committee on the Global Financial System also regularly invited representatives from these central banks as well.\footnote{Ibid, p. 165} This reflected an expanding sphere of participation that sought to match changing geopolitical distributions in financial market power.

Second, the BIS experienced a significant reform not in its formal governance structure, but in its degree of country representativeness. On 26 June 2006, in accordance with Article 27(3) of the BIS’ Statutes, the Board of Directors of the BIS elected three new members of the Board – the President of the European Central Bank, the Governor of the Bank of Mexico, and the Governor of the People’s Bank of China.\footnote{Ibid, pp. 157, 187} By various measures of representativeness, these latter changes were significant. When measured in terms of the share of the world’s population, the effect is dramatic. In 2001, the BIS Board of Directors had a country representativeness of 12% of the world’s population. By 2007, with the inclusion of China and Mexico in the BIS Board of Directors, this increased substantially, to 33\% - see Figures 1 and 2, below. By other measures of representativeness, the changes within the BIS were more modest, while the starting point of representativeness was far
higher to begin with. Measuring representativeness by percentage of world savings, the change increased the BIS' representativeness from approximately 62% to 64% of the world’s savings, as represented in detail in Figures 3 and 4. When measured by gross national expenditure, the representativeness of the BIS' Board of Directors moved from approximately 69% to approximately 71%, as per Figures 5 and 6 below.
How might these various features of the BIS’ internal governance have had a bearing on its approach to the international financial system? We have seen that while the a variety of the BIS’ internal governance features, including its country representativeness leave much to be desired, it did nevertheless experience a significant expansion in its country representativeness – by various measures – toward the end of the decade in question. Commensurate with the expectations of our argument, these changes in geopolitical representation are associated with a changing approach to financial risks. Especially in its monitoring of the international financial system, the BIS has been remarkably good at detecting and describing forms of systemic fragility in the decade before the crisis. Even when the crisis was in its pre-Lehman period (i.e. between the summer of 2007 and September 2008), the BIS’ warned of systemic instability.\textsuperscript{18} It is perhaps notable that the BIS did not act on these signals; in fact, as an institution, it did not have a clear remit to do so. Whilst it is true that there are steps that it might have taken that they didn’t, in its remit to conduct and disseminate research on the sources of financial instability, the BIS did fulfill some of its main function, for example though it’s excellent research and Annual Reports. As Seabrooke has established, the BIS has occupied a special place within the system of global financial governance, yet it has very limited

capacities. Nevertheless it is still possible to consider the BIS’s absence of action on these issues as a contributing factor to the general environment of forbearance in the system of global financial governance. More essential to the puzzle, however, is the institution with more direct responsibility for addressing gaps in banking regulation: the Basel Committee on Banking Supervision.

**The Basel Committee on Banking Supervision**

The Basel Committee on Banking Supervision (BCBS) is an international institution which constructs the common set of standards by which banks are to be regulated. It arose as a highly informal network of central bankers and banking supervisors in 1974 in response to some of the problems that occurred when the Bretton Woods system of financial governance broke down, and international banking activities began to cause new problems for international financial stability. Subsequently it has acted as a forum for cooperation among banking regulators; for decades the BCBS has been devising a system of agreed-upon standards for how banks are to be regulated.

Until only very recently (March 2009), the BCBS has been composed of financial supervisors and central bankers from what is known as the ‘G10’ – a club of countries which actually includes 13 countries: Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Spain, Sweden, Switzerland, the United Kingdom, and the United States. During this period there was notably no representation from developing countries. Scholars of financial governance have long examined this institution for this and other unique characteristics of this institution. Decisions are typically made on the basis of deliberation under a consensus rule, and policies are purportedly constructed on the basis of scientific studies on highly technical issues. However, in practice lobbying by private actors and specific countries (for example, for Germany to give more favorable treatment to SME lending in Basel II) are well documented. In the last decade, the BCBS has regularly consulted with non-state actors, but these have primarily been limited to international private sector

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associations like the Institute of International Finance (IIF) and the International Swaps and Derivatives Association (ISDA), the transparency and accountability of its decision making have proved wanting. In terms of interlocution with states, while the delegates to the BCBS have come under scrutiny in countries such as the US, Japan, and Germany, the BCBS is not accountable to any legislature, while the European Commission has participated in deliberations as an observer. It is primarily in the realm of implementation that legislatures have exerted their influence, as evinced by the fact that the European Parliament approves and translates Basel II into EU Directives once agreed by the BCBS.

The BCBS’ engagement with outside actors expanded in the decade in question, but only to a limited extent. As Porter and Wood have pointed out, by the late 1990s the BCBS had institutionalized some engagement with countries outside its membership, such as through the regionalized groupings of financial supervisory authorities and its biannual conferences of supervisors from all over the world. The drafting of the BCBS’ Core Principles for Effective Banking Supervision also involved a formal process of consultation which included 15 developing countries in the drafting group and the establishment of a Liaison Group with representatives from 20 countries as well as a Consultation Group of outsiders as well. The BCBS liaised with groups of 13 non-BCBS-member states, to review developments in banking regulation and periodically gather information. The BCBS’ major project over the decade, the design of the Basel II Accord, demonstrated some greater inclusivity than in previous endeavors, though notably less developed country participation still remained extremely limited. Generally this kind of participation seems to have been limited to the solicitation of comments, and developing countries did not participate at all in the decision-making process.

While much can be said of the BCBS’ internal structure of governance and its external engagements, in the decade under analysis its country composition reflects a very conservative and

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23 In this regard, it is notable that, at the very earliest stages in Basel II design, some of this consultation with LDCs did however lead to some, albeit very modest, concrete changes. For example, some of the comments made by India and other LDCs on the first consultative document released in 1999 led to the elimination of the sovereign floor in assigning risk weights and to the elimination of the proposed use of the IMF’s Special Data Dissemination Standards (SDDS). See No Author, Submission of the Reserve Bank of India to BCBS Secretariat, May 2001, p. 1.
exclusive approach to membership. This can be measured in a number of different ways – all of which reveal a similar picture: as the decade progressed the country composition of the BCBS looked increasingly arbitrary. There was no developing country representation within the institution, and (with one notable exception) even states with significant growing financial resources were excluded from formal participation. As we shall see below, this was reflected in the approach that was taken to regulation.

Measuring Representativeness

Country representativeness of the BCBS can be measured in terms of how much of gross domestic savings and net reserves existed within the group of BCBS countries versus outside that group. Because data depicting global values are patchy in time series, we aggregated the values for every country where values were available, using the World Banks’ World Development Indicators. To depict the transformation in the geopolitical shares of these indicators, we took the time series back as far as the data was relatively complete: from 1992 to 2005. Figure 7 below illustrates the trend for the case of gross domestic savings: an upward trend which begins in the new millennium, as the BCBS countries still surpass the gross domestic savings of the non-BCBS group at the last point where comparative data is available, but by a clearly decreasing amount. The trend can also be illustrated through a static comparison of gross domestic savings in 1992 and 2005. Such a comparison, made in Figure 8 below, helps to illustrate as a percentage of world gross domestic savings, the BCBS group lost considerable ground during this 12 year period. As other evidence

24 For these figures the ‘BCBS Group’ includes aggregated data from: Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, Netherlands, Spain, United Kingdom, United States Sweden, Switzerland, Spain. While Spain was only included into the BCBS in 2001, it remains in the sample to facilitate relevant comparison. For the gross domestic savings and net reserves figures, the ‘non-BCBS Group’ includes aggregated available data from: Albania, Algeria, Angola, Antigua and Barbuda, Argentina, Australia, Bahrain, Bangladesh, Barbados, Belize, Benin, Bhutan, Bolivia, Botswana, Brazil, Bulgaria, Burkina Faso, Burundi, Cambodia, Cameroon, Cape Verde, Central African Republic, Chad, Chile, China, Colombia, Comoros, Dem. Rep. Congo, Rep. Congo, Costa Rica, Cote d’Ivoire, Czech Republic, Denmark, Djibouti, Dominica, Dominican Republic, Ecuador, Egypt, El Salvador, Equatorial Guinea, Estonia, Ethiopia, Fiji, Finland, Gabon, The Gambia, Georgia, Ghana, Greece, Grenada, Guatemala, Guinea, Guinea-Bissau, Guyana, Haiti, Honduras, Hong Kong, Hungary, Iceland, India, Indonesia, Iran, Ireland, Israel, Jamaica, Jordan, Kenya, Republic of Korea, Kuwait, Kyrgyz Republic, Latvia, Lebanon, Lesotho, Libya, Lithuania, Macao, Macedonia, Madagascar, Malawi, Malaysia, Mali, Malta, Mauritania, Mauritius, Mexico, Moldova, Mongolia, Morocoo, Mozambique, Namibia, Nepal, New Zealand, Nicaragua, Niger, Nigeria, Norway, Oman, Pakistan, Panama, Paraguay, Peru, Philippines, Poland, Portugal, Romania, Russia, Rwanda, Saudi Arabia, Senegal, Seychelles, Sierra Leone, Singapore, Slovak Republic, Slovenia, South Africa, Sri Lanka, St. Kitts and Nevis, St. Lucia, St. Vincent and the Grenadines, Sudan, Suriname, Swaziland, Syria, Tajikistan, Tanzania, Thailand, Togo, Tonga, Trinidad and Tobago, Tunisia, Turkey, Turkmenistan, Uganda, Ukraine, United Arab Emirates, Uruguay, Uzbekistan, Venezuela, Vietnam, West Bank and Gaza, Yemen, Zambia, and Zimbabwe.
suggests that trends in national savings rates only exacerbated themselves from 2005-2008, it is probable that this relationship became more stark post-2005.

**Figure 7: Gross Domestic Savings (in Billions of $US), 1992-2005**

![Graph showing gross domestic savings from 1992 to 2005 for BCBS and non-BCBS countries.](image)

In the case of net reserves, reliable time series data are available from 1992 to 2006. Figure 9 below illustrates how non-BCBS countries have far surpassed the BCBS countries in their share of net reserves.

![Pie charts showing share of world gross domestic savings in 1992 and 2005 for BCBS and non-BCBS countries.](image)

In the case of net reserves, reliable time series data are available from 1992 to 2006. Figure 9 below illustrates how non-BCBS countries have far surpassed the BCBS countries in their share of net reserves.

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25 This sample covers 98% (1992) and 97.67% (2005) of the available world total values.
reserves. Figure 10 compares the share as a percentage of the estimated quantity of world net reserves, in 1992 and 2006.

**Figure 9: Total Reserves (Includes Gold, in Billions of $US), 1992-2006**

![Total Reserves Graph](image)

**Figure 10: Share of World Reserves\(^{26}\):**

![Share of World Reserves Graph](image)

The sources of these transformations are complex and are outside of the scope of this paper to discuss. What the above figures help to illustrate is declining degree of representativeness that the

\(^{26}\) This sample covers 92% (1992) and 93% (2006) of the world total.
BCBS commanded in the period in question. This relationship can be illustrated not only in terms of national economic aggregates, but by the size of banks within each country, and the capital they commanded during this period.

As the BCBS effectively provided the global standards for banking regulation, its country representativeness can be measured in terms of how much of the world’s Tier 1 capital was actually supervised by the ‘G10’, and this value can be compared across time. Consolidated and internationally standardized measurements of Tier 1 in the largest banks in the world provide a yardstick with which to measure this function. In the figures below, the largest 100 banks in the world (ranked by Tier 1 capital) are assigned nationalities (based on their home regulator). After aggregating the total Tier 1 capital belonging to each country, a value is calculated for each country, which represents the total Tier 1 capital under stewardship of that country relative to the top 100 total – for example in 1998 Italy had 4.03% of the capital in the top 100. This simple representation allows for a simple comparison of bank capital in the global economy over time. Figure 11 below illustrates how the shares of capital of the top 100 banks in the world was changing, between 1998 and 2008. As Figure 11 below highlights, countries such as France, Germany, Japan, Switzerland, and the USA experienced significant decreases in their share of top 100 banks’ capital, whereas Belgium, Spain, Sweden, the United Kingdom, China, Ireland, and South Korea have experienced significant increases in their share over this period. Yet the only change to membership made during this period was the addition of Spain during this period.

**Figure 11: Changes to the Composition of Top 100 Tier 1 Bank Capital, from 1998 to 2008, Segmented by Nationality**
These changes led to a picture at the beginning of 2008 in which the country composition of the BCBS looked highly arbitrary. As Figure 12 below illustrates, by the beginning of 2008, the country composition of the Basel Committee excluded several financially significant countries from its membership. This led to a situation by 2008 whereby those countries excluded combined had more Tier 1 capital in their banks than even the US, as Figure 13 illustrates.

Figure 12: National Composition of Tier 1 Capital (measured in Millions of $US), Differentiated by members of BCBS (dark shade) and non-BCBS members (light shade), beginning of 2008

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Given the BCBS’ role in constructing the de facto global standards for banking regulation over this period, the increasing gap between the realities of the geographical dispersion of large banking organizations and BCBS membership during this period is striking. As Figures 12 and 13 above illustrate, countries outside of the BCBS had more Tier 1 capital in their banks than many BCBS member countries. Rather than trying to explain these trends, we think they make an important point as indicators of transformations in the global economy in the decade before the crisis. That point is that the geopolitical balance of financial power was changing, and yet the representativeness of an important institution of financial governance was not.

The link between lack of developing country representation within the BCBS and impacts on developing country prospects has already been established in a number of studies. But what has been the impact of the BCBS’ skewed representativeness in terms of the current crisis – which by all
accounts began within the developed world? The composition of the BCBS has been critiqued by numerous authors, from various vantage points. But what has this meant for the governance of financial risks? The effects of the country composition of the BCBS during this period can be analyzed in three ways. In what follows we first ask 1) how this approach to country membership affect the way that banking regulation was pursued during this period, and 2) how did this influence the policies the BCBS did not pursue? We pursue this line of inquiry not to provide a thorough diagnosis of the BCBS as such, but to interrogate its activities during this period in order to make a more general point about the character of global financial governance during this period.

The country composition of the BCBS influenced the policies that the BCBS pursued during this period in a number of ways. It meant for example that the goal for the overall level of regulatory capital that was pursued was the same in the second Basel Accord as in the first Basel Accord of 1988. While the new Accord was designed ostensibly to better match regulatory capital requirements with the risks that banks took in their activities, the total level of regulatory capital that this was to add up to remained at the level of 8%. This reflected the interests of financial institutions within the members of the BCBS at the time in that an increase in the overall level of regulatory capital would have represented a contentiously conservative move on behalf of regulators. Indeed, several studies conducted after the completion of the Accord in 2004 showed that capital requirements of most banks fell for most groups of countries and most approaches taken when they applied the Accord’s methodologies (between -6.8% and -20.7% reductions from the status quo levels of regulatory capital).

There is some evidence that if the BCBS had expanded its membership during this period, the level of regulatory capital pursued may have been higher, reflecting a higher average level of regulatory capital outside of the G10 during this period. In 2000 for example, the average minimal level of capital adequacy requirements for the G10 group of countries in 2000 was 8% - a figure which unambiguously reflected these countries’ membership in the BCBS. Many countries outside this group however had higher levels of minimal capital adequacy. Data compiled at the time by

30 See Basel Committee on Banking Supervision, Results of the Fifth Quantitative Impact Study (Basel: BCBS, 15 June 2006), p. 2 (Table 1, last column ‘most likely approach’).
Barth, Caprio and Levine\textsuperscript{31} suggest that the average minimal capital asset ratio requirement for non-G10 countries (data is available for 99 non-G10 countries in total) was higher – at 8.94.\textsuperscript{32} When the average value for risk-adjusted capital is considered, the situation is even starker. Again, the non-G10 group had a higher level of capital required in their banking systems, with a G10 average of 12.16, whereas the average for non-G10 countries (88 non-G10 countries with data available) was 15.79. Given the fact that the absolute level of capital in the world’s banking systems is now acknowledged to be too low, and that low levels of capital may have contributed to the depth of the crisis, we contend that this is not a trivial point. An expanded pre-crisis membership in the BCBS could have increased demands for a truly global level playing field – and in so doing may have raised levels of capital in the world’s banking system, instead of the opposite.

Another consequence of the country representation within the BCBS was that the prevailing attitude toward risks in the financial sector was both model-driven and fundamentally microeconomic in character. It was model-driven in the sense that many banking regulatory agencies within the BCBS sought to manage risk through a mathematical quantification of risks. This was put at the heart of Basle II. This approach, it might be said, reflected more of a concern with quantification than the applicability of regulatory policies, or even the big picture behind the nature of systemic risk. Moreover, many of these models reflected a confidence with the capacity of banks to measure risk parameters within their own institutions which, given present hindsight, must be called into question. The dominant approach was microeconomic in the sense that the policy initiatives that were pursued by the BCBS explicitly attempted to provide a framework for the management of risks within each individual banking institution. This is in contrast to a systemic approach to risk, which develops indicators and management processes not only for individual institutions, but for the system wide effects when bank failures catalyze other bank failures, culminating in a crisis. The microeconomic focus that the BCBS pursued ignored externalities in terms of approaching risk.\textsuperscript{33}

\footnote{The raw data used here is available in the statistical annex that is provided with their extensive overview and critique of the political economy of banking regulation. See James R. Barth, Gerard Caprio, Jr., and Ross Levine, \textit{Rethinking Bank Regulation: Till Angels Govern} (Cambridge: Cambridge University Press, 2006).}

\footnote{Author’s calculation. This reflects a well understood concern of many less developed banking supervisory systems to surpass the international regulatory minimum in order to ‘signal’ the soundness of their banking systems in order to attract foreign investment flows.}

Changes to the country composition of the BCBS during this period would have meant that concentrated interests would have been diluted. Given that the dominant mode of decision-making within the BCBS is deliberation and consensus, the particularities of any one country’s representatives within the ‘G-10’ would have been amplified relative to what an expanded ‘G-N’ would have looked like. This may have had the consequence that the regulatory approaches of representatives from the US, for example, would have had a greater voice than they would have otherwise had with a broader BCBS. This is not a trivial point, since regulatory agencies participate in international forums such as the BCBS not only to achieve domestic objectives, but also to project their regimes of governance internationally in order to ensure the global environment matches better with their own domestic regulatory regime. Arguably one of the consequences of the homogeneity of interests within the BCBS during this period was that the frontier of quantitative methods was pursued very vigilantly – a particular specialty of many G10 banking regulatory agencies such as the US Federal Reserve and the UK FSA. Evidence available on the regulatory attitude of many developing country regulatory authorities shows a marked divergence in the attitude toward the methodology of regulation. During the consultation period of Basel II’s development, for example, many of these concerns voiced by central bankers and bank supervisors from less developed states had a fundamentally different approach to banking regulation that reflected their less ambitious view of advanced risk models, and a more skeptical view of increased bank autonomy. Many developing country banking supervisors expressed concern with the approaches pursued, favoring simpler approaches to financial regulation that were not fundamentally model-driven. Others expressed


34 For example, agencies as diverse as the Bank of Indonesia, the Central Bank of Mauritius, the Central Bank of Thailand, and the Central Bank of Sri Lanka all expressed concerns during this period regarding the fact that they would have insufficient staff resources in order to assess internal ratings within banks. See Djoko Sarwoso, Submission of Bank Indonesia to BCBS Secretariat, 31 May 2001, p. 1; No Author, Submission of Bank of Mauritius to BCBS Secretariat, 4 June 2001, p. 4; No Author, Submission of the Central Bank of Sri Lanka to BCBS Secretariat, May 2001, p. 2. The Central Bank of Thailand argued that not only would this create difficulty, but would unevenly distort the internationally competitive playing field for banking markets. See No Author, “Comments on New Basel Capital Accord Consultative Document issued January 2001” Submission of the Bank of Thailand to the BCBS Secretariat, May 2001, p. 6.

35 For example, before they signaled they would drop out of formal adoption altogether, the People’s Bank of China implored the BCBS to “explore the possibility of building an equally robust but simplified standardized approach that can be useful for applications across the world, preferably with the direct participation of emerging markets.” India had a similar proposal, and while some Latin American countries also wanted to develop their own tailor-made version of the IRB approach, the People’s Bank of China argued that the BCBS should create a prototype IRB system as an option for use in LDCs, which national supervisory authorities could then use and adapt to suit local circumstances. See Chin Liu Tingshuan, Submission of the People’s Bank of China to BCBS Secretariat, 30 May 2001, pp. 2, 4; No Author, Submission of the Reserve Bank of India to the BCBS Secretariat, May 2001, p. 7; Joint Submission of the Banking Regulatory
concerns with the lack of acknowledgement of diversification effects, and the potential dangers of the pro-cyclical nature of the Accord.\textsuperscript{36}

A further consequence of the country composition of the BCBS during this period was that there was a strong set of incentives to promote the financial services sector in addition to managing risks within it. The diversity of the representatives within the BCBS during the decade in question should not be discounted.\textsuperscript{37} However, when a national regulatory agency or central bank participates in an international forum for a regulatory objective, irrespective of the approach taken there are still strong incentives for each participant to ensure that their domestic financial interests are not adversely affected. These incentives are stronger, and the sensitivity of the participants greater, when the financial services sector in question is large and sophisticated, and vice versa when it is small and elementary. Having the largest, and thus most regulation-sensitive, countries at the helm meant that regulation was treated with caution and restraint. If the BCBS membership was expanded during this period, the adversity toward regulatory conservatism would have been weakened. While France, the UK and Switzerland clearly needed to ensure that their financial systems were not disadvantaged relative to their peers, the approach taken by Brazil, India, or Togo would have been different. The latter countries had less of a stake in protecting their own sectors, which relative to their economies as a whole were less significant (and still are). While there were significant banking institutions within countries outside of the BCBS during that time, the frontier of financial market innovation emanated from within the G10, not outside of it. When considering whether to regulate the CDS market or re-securitizations, who would have a greater incentive for forbearance on that issue, the US or Togo? For Togo the costs of conservatism are virtually non-existent; for the US they would have been large, since it would have meant penalizing a highly profitable part of the US financial services sector.

This difference in incentive structures can be quantified and measured. One way of illustrating the dominant approach to banking regulation during this period is by analyzing the different set of incentives faced by different countries in terms of the sensitivity that they might have toward the regulation of their banks. While all banking supervisory authorities are faced with a set of incentives

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\textsuperscript{37} Indeed, there were substantial debates between representatives from continental Europe and the Anglo-American countries, for example, and even debates among regulatory agencies from the same country – the differences between the FDIC and the Federal Reserve being a case in point.
to ensure regulatory stringency (in order to achieve their remit of safety and soundness within the banking sector), they are also faced with a set of disincentives (in order to ensure that such regulatory stringency does not damage their banks). What determines this relative mix of incentives? While it is undoubtedly true that many factors inevitably go into a regulators’ ‘sensitivity function’, there are at least two dominant considerations at play: the level of independence of the supervisory agency on the one hand, and the size of the banking sector on the other. The former bears a positive relationship to regulatory stringency, and the latter a negative relationship.

To provide a rough quantification of such incentives, we took the largest 1000 banks in the world in 2001 (measured by Tier 1 capital), and aggregated the total Tier 1 capital for banks domiciled in each country. We then ‘discounted’ this value by each country’s score on an index of banking supervisory independence. This index measures the presence or absence of a number of institutional factors such as the independence of the supervisor from the national government, and the frequency to which banking supervisors retire to the private sector. This is based on membership scores from a large international survey conducted by Barth, Caprio, and Levine in 2001, and details are provided in the Appendix.

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\text{Regulatory Sensitivity} = \frac{\text{(Percentage of Tier 1 bank capital in top 1000 largest banks in the world)}}{\text{Banking Supervisory Index}}
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Full data is available for 53 countries in total, 10 of which are BCBS countries, 43 of which non-BCBS countries during this period. Figure 14 below reveals the results, with countries with BCBS membership at the time represented on the bottom, and other countries listed alphabetically on top of this group.
This data illustrates that many countries within the BCBS scored high on the regulatory sensitivity index. This would mean that, relative to their peers in the international community, these countries would have been more likely to err on the side of regulatory caution than on the side of regulatory conservatism, ceteris paribus. While this should not be seen as the last word on what is ultimately a complex process of preference determination by and among regulatory agencies, we think it stands to reason that a country with a large banking sector and much at stake is likely to have a regulator more sensitive to regulatory costs than would otherwise be the case. This can be seen as a significant factor.
in the way the system of global financial governance functioned during this period: countries with high sensitivities to regulatory costs dominated; those with lower sensitivities were largely excluded.

The country composition of the BCBS during this period also influenced the policies that were not pursued. It is now well known that the buildup of new forms of financial risks, such as re-securitizations and structured investment vehicles within banks were not being actively pursued as sources of new forms of risk. It would be incorrect to point the blame here to the BCBS for many of the dimensions of the crisis, as it was not in control of regulatory standards for all financial markets, but only the banking industry. However the explosive growth of many complex financial instruments were not pursued with vigor – even when they were strongly linked to the practices of the banking industry. A concerted attempt was made in Basel II to institute regulatory standards for securitization practices, but ultimately this was not ambitious or conservative enough for the market realities that would develop. There were simply not enough voices on the BCBS that were critical of the new forms of risk that securitization brought with them: too many had a stake in these markets. Some of this lack of catch-up may reflect the sluggishness characteristic of many international institutions. However it also stands to reason that the states, whose banks had a large stake in profiting from the growth of these developments at the time had less of an incentive to regulate them.

A counter-cyclical approach to financial regulation was not pursued, perhaps because this would have entailed the buildup of regulatory capital during the boom period of financial market activity, and consequently the diminution of both profits for many financial firms during this period, as well as a slowdown in the flow of credit. Instead, the regulations that the BCBS produced during this period were for the most part strongly pro-cyclical – i.e. their effects exacerbate economic cycles. This was not only widely understood during this period, it was also widely critiqued. The irony is that today, with many countries in recession, a counter-cyclical approach is finally being pursued with great ambition – both by members of the BCBS and by the BCBS as a whole.39


39 See, for example, UK Financial Services Authority, The Turner Review: A Regulatory Response to the Global Banking Crisis (London: FSA, March 2009); Nout Wellink, “Basel Committee Initiatives in Response to the Financial Crisis”,
Conclusion:  
Institutional Incentives and Country Representativeness before the Crisis

This paper has engaged with the question of how the system of global financial governance between mid-1998 and mid-2008 may have contributed to the crisis. We have approached this question by offering one simple answer to a complex question – a simple answer that is best considered along others. We have argued that the interests represented within the key institutions of global financial governance had perverse effects on the way in which the evolution of financial risks were matched with the evolution of financial governance. We examined this dynamic by investigating the country representativeness of two significant institutions of global financial governance: the Bank for International Settlements (BIS), and the Basel Committee on Banking Supervision (BCBS).

Our analysis revealed that, as an institution with primary functions of coordination and communication in the system of global financial governance, the BIS was able to both expand its degree of country representativeness at the same time as fulfill some of its principal roles. The second institution examined, the BCBS, was treated as a paradigmatic example of an institution responsible mainly for regulatory policymaking in global financial governance. We found that, by various measures, the level of representativeness of this institution was extremely restrictive, and can help to explain an approach to financial regulation which may have contributed to the crisis. We analyzed this relationship by pointing out not only what regulatory policies were pursued during this period, but also by pointing out which policies were not pursued. We argued that both these dimensions reflected the composition of interests represented within this the BCBS during this period. Here representativeness – a quality that we measured in various dimensions – was explicitly linked to both decisions and non-decisions within this governance institution.

Neither of the arguments regarding the BIS or the BCBS should stand alone as explanations for the crisis. Clearly the causes of the crisis are complex, and involve a variety of factors – many of which have to do with regulatory dynamics within the US and UK political economies. However, one

Remarks Before the Committee on Economic and Monetary Affairs of the European Parliament (ECON), Brussels, 30 March 2009.
of the central absences of the crisis so far is a lack of understanding of the international governance dynamics that may have acted as contributors. We have posited a number of reasons why the geopolitical distribution of representation should be considered. Other factors are worthy candidates for consideration as well, and can be seen as complementary to our analysis, such as the influence of dominant pro-liberalizing financial market discourses at the time, dynamics of regulatory influence and capture by private financial interests, the lack of politicization of financial regulation, and thus of democratic accountability in many countries, and the lack of institutional capacity at the international level.

Without a doubt, the financial crisis since the period examined in this paper has had profound effects on the geographical distribution of financial power. Furthermore, the most significant financial crisis since the Great Depression of the 1930s has also contributed to the strongest politicization of financial regulatory politics since that period. One of the outcomes of such attention to the system of global financial governance has been an effort to reform existing global institutions. In their efforts to reform the existing system of global financial governance, the G20 asked the international standard setting bodies of the world to consider revising their memberships. This led to some marked changes in institutions such as the IOSCO, the IASB, and the BCBS. The latter had the latest, but also a most significant expansion of membership among standard-setting bodies (the FSF had a more significant expansion of representativeness in all institutions, to include the entire G20). The dramatic expansion of the BCBS in terms of country representativeness is illustrated in Figures 15, 16, and 17, below. Though only a few major developing countries were added, these represent a very significant proportion of market capitalization – 96% of the top banks by this measure (see Figure 17).

40 See Kevin Young, “Encouraging signs of reform among world firefighters” Financial Times, 19 March 2009, p. 12
41 See: Author’s calculation - based on data from Peter Thal Larsen and Simon Briscoe, “The Fearsome Become the Fallen” Financial Times, 23 March 2009, p. 9 (UK edition). Spanish banks are included in the 1999 calculation for the purposes of comparison. Unfortunately the changes in the national composition of Tier 1 capital in the world cannot be illustrated because cross-nationally standardized data is not available for end-of fiscal year 2008. Data on market capitalization, however, is available.
This amounts to a highly significant expansion of representativeness within one of most important institutions of global financial governance. Whether this change and the several others that have accompanied it in past months will amount to a fundamental reformulation in the way financial markets is matched by financial governance at the international level remains to be seen. Despite the enhancement to representativeness, broader governance issues remain. Both the BIS and the BCBS, for example, still remain highly opaque by any measure. The current Chairman of the BCBS appears fully committed to addressing counter-cyclicality of regulation. Furthermore, in his previous post as Chairman of the BIS from 2002 to 2006, he oversaw governance reform including the enhancing the transparency of its structure. This suggests some reason for optimism for further institutional reform within the BCBS in the future.

At the same time, the logic behind the recent expansion in membership – i.e. which countries were chosen and why – raises its own governance and transparency issues. Developing countries with smaller financial sectors and institutions are not at all represented, and thus the interests of the largest financial interests are likely to dominate in the future. This would be supported by our analysis of

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regulatory sensitivity (as per Figure 14 above), in which financially significant country regulators have an incentive to err on the side of regulatory caution rather than regulatory conservatism. If this imbalance is to be addressed, the active participation of other stakeholders should be considered, which have less of an interest in financial risk-taking. Participation of other stakeholders such as unions and non-financial businesses, whose perspectives and concerns (for growth and financial stability) could balance those of the financial industry. Moreover, a more balanced approach to representativeness may help to correct the now well-understood bias in international financial regulation to be backward, rather than forward-looking in character. Finally, given that at least some developing countries are playing an increasingly important role in institutions of global financial governance – witness the expansion of the FSF in addition to the BCBS – there may be a case for them to emulate the highly successful G24 that represents developing countries in IMF affairs. A similar body, possibly linked to the G24, could be created by developing countries that would help define developing country positions in these institutions, and by providing research and a forum for debate amongst them. Furthermore, the design and creation of a global financial regulator still remains one of the main institutional challenges that the international community faces. This would go a long way toward ensuring that the regulation of financial markets is truly comprehensive – such that the domain of the regulator will be the same as the market. The paths toward the design of such institutions, and the reform of existing ones, are better approached if we can first make sense of past governance shortcomings.
