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Perspectives on the Governance of Global Financial Regulation

Paper for the Commonwealth Secretariat*

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Introduction

In the wake of the major 2007-2009 global financial crisis, the most severe since the 1930s, the effectiveness of financial regulation has been called into question. Fundamental discussions -and quite significant reforms of financial regulation - are taking place, both within countries and internationally.

2. Global institutions which provide the international standards and rules for the world are increasingly important as financial markets have become increasingly integrated across borders. Yet they have also been - and been seen to be - undemocratic and of reduced effectiveness since developing countries were not represented in the relevant fora. This was clearly recognized by the Group of Twenty leaders, when in their November 2008 statement, they said "Emerging and developing countries, including the poorest ones, should have greater voice and representation. The Financial Stability Forum must expand urgently to a broader membership of emerging economies and other major standard setting bodies should promptly review their membership."

3. Following the crisis, and the G-20's reaction to it, significant reforms have taken place in 2009 to include members from developing countries for the first time in regulatory financial bodies. In the following sections the paper will first examine these reforms and suggest further improvements that would not only improve governance but also make regulation more effectively support global and national financial stability. The paper also makes suggestions for a possible role for Commonwealth countries and the secretariat in improving the global regulatory system and supporting each other. The paper will then examine broad principles for regulatory reform and discuss how global regulation could be strengthened, including through the possible creation of a global regulator.

A Critique of Past Governance

4. In the years leading up to the current global financial crisis, critique of the composition of global financial regulatory institutions was widespread. In 2002, the United Nations International Conference on Financing for Development produced what was known as the Monterrey Consensus. Among the many points agreed by over fifty Heads of State and two hundred Ministers of Finance, Foreign Affairs, Development and Trade was that the institutions of global financial governance such as the Bank for International Settlements (BIS), the Basel Committee on Banking Supervision and the Financial Stability Forum should "…enhance their outreach and consultation with developing countries…" and should "…review their membership to allow for adequate participation of developing countries." The lack of any developing country representation had before and since been critiqued extensively by the Commonwealth Finance Ministers, and since the late nineties by various academics and NGOs around the world. Similarly, developing countries had repeatedly voiced their wish to be represented in bodies that designed regulatory standards (such as Basel banking regulation), which they then had to implement in their own economies. While the BIS expanded its membership somewhat,[1] institutions such as the Financial Stability Forum (FSF) and the Basel Committee on Banking Supervision (BCBS) continued until

[1] Not only did the BIS expand its central bank membership, in 2006 it also included central bank governors from developing countries (Mexico and China) on its Board of Directors. Furthermore, currently, the Chairman of the Board of BIS is the Governor of the Mexican Central Bank.

recently to exclude any formal participation from developing countries. An exception was IOSCO (the securities regulator) which had a broad country membership. However, its Technical Committee - where the key regulatory initiatives stem from - had only exclusively OECD countries as members.

5. Because of the BCBS' important and authoritative role in setting the international banking standards for the world, it received the lion's share of the critique. The Basel Committee's exclusion of developing countries, it was pointed out, distorted and biased the policies designed. As a result they were both ineffective to help achieve financial stability and contrary to the interests of the developing world.[2] It is interesting that the former Director of the UK Financial Stability Authority, Howard Davies, pointed out that many countries with large financial sectors (including developing countries) were then not members of the Basel Committee, and argued that membership should be revised.[3] In spite of all this criticism, there was no reform of governance of international regulatory bodies, till the global crisis and G-20 November Statement led to rather significant changes.

6. Most relevant in the context of the 2009 meeting of Commonwealth Finance Ministers and Central Bank Governors are the guiding principles defined in the June 2008 Marlborough House Statement on Reform of International Institutions. These principles refer to both reform of existing, and construction of new, international institutions, where necessary. The Marlborough House Statement starts from the premise that "well designed international institutions have a fundamental role to support all countries to meet their economic, political, humanitarian and security challenges." The principles include: 1) legitimacy (not only to their member status, but also to the wider international community to command confidence and commitment), 2) fair representation of all countries (giving them equal voice), 3) responsiveness, so the interests of all members, including the smallest and poorest, are listened to and reflected in decision-making, 4) flexibility, to respond to new challenges and global realities, national priorities, and specific circumstances of member status 5) transparency and accountability, to the entire membership and wider public and 6) effectiveness, and capability to address current global challenges. As the paper evaluates recent and suggested reforms, it will emphasise how these governance arrangements match or not the above Marlborough House principles.

Problems Generated by the Old System

7. Deficiencies in the governance of the international financial regulatory institutions generated a number of weaknesses in regulation. This view is based on a simple but important point: the composition of representatives with a governance institution has a bearing on its decision-making. This relationship has been well established in literature on the IMF, whereby voting rights at the Executive Board influence the institutions decisions.[4] There was a similar effect in regulatory bodies, which were made less effective for supporting global financial stability by their very skewed governance structure.

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[2] See for example Stephany Griffith-Jones and Avinash Persaud, "The Pro-cyclical Impact of Basle II on Emerging Markets and its Political Economy" in Joseph Stiglitz and José Antonio Ocampo (Eds.), *Capital Market Liberalization and Development* (Oxford: Oxford University Press, 2008).

[3] See Howard Davies, "A Review of the Review", *Financial Markets, Institutions & Instruments* Vol. 14, No. 5 (December 2005), pp. 247-252.

[4] See Cyrus Rustomjee, "Why Developing Countries Need a Stronger Voice" in Finance and Development. September 2004; Cyrus Rustomjee (2005) Improving Southern Voice on IMF Board: Quo Vadis Shareholders?; also Ngaire Woods and Domenico Lombardi (2006) "Uneven patterns of Governance: How developing countries are represented in the IMF?" International Political Economy, August 2006.

8. As a result, while the system of informal information sharing, coordination and communication witnessed some advances, the formal regulatory policies pursued were inadequate. This reflected a strong set of incentives to promote the financial services sector that competed with the focus to manage risks within it, especially for countries with extensive and sophisticated financial sectors. Under-regulation meant that systemic risk was allowed to build up.

9. Changes to the country composition of regulatory bodies during this period could have meant that concentrated interests would have been diluted. Many of the approaches taken, such as the drive toward quantitative, model-driven, and fundamentally microeconomic approaches to risk reflected a confidence that large banks could measure risk parameters themselves, view that was pushed by the large banks. As discussed below, this implied embedding the main market failure of financial markets, pro-cyclicalty into bank regulation, which on the contrary should be counter-cyclical. Several major developing countries were much more skeptical of such approaches, their feasibility and effectiveness, and were more fearful of the pro-cyclical dimensions of the regulations developed (i.e. their capacity to exacerbate swings in the economic cycle). Perhaps above all, developing countries had experienced a series of financial crises and were therefore far more aware of their costs, and gave a higher priority to crisis prevention. Had they been allowed a seat at the BCBS and other regulatory bodies' table, their positions might have improved decision making and policy design.[5]

Recent Reforms: Important Steps in the Right Direction

10. In the midst of the global financial crisis, there have finally been significant expansions of the memberships of global financial regulatory institutions. These reforms demonstrate that global financial regulatory institutions can reform their memberships in response to constructive suggestions.[6] In the context of a major crisis in the core countries, the collaboration of developing countries is needed to resolve the dilemmas of both legitimacy and effectiveness of these institutions. Following the Washington G-20 Summit in November 2008, which as described above, clearly encouraged the international financial standard setting bodies to review their governance, a number of important institutions expanded their memberships, particularly to developing and emerging countries. As pointed out, previously most of these bodies had no participation from developing countries. Table 1 summarizes these changes in the public regulatory bodies. Early in 2009, the Technical Committee of the International Organization of Securities Commissions Organization (IOSCO), which before had no developing country members aside from Mexico, expanded its membership to include Brazil, India, and China.[7] In March 2009, approaching the deadline set by the G-20 for reform, two more expansions occurred. Firstly the Basel Committee on Banking Supervision expanded its membership to include developing countries for the first time, adding Brazil, China, India, South Korea, and Mexico in addition to Australia and Russia. In June 2009, the

[5]For a more detailed discussion, see Griffith-Jones and Young, "Institutional Incentives and Geopolitical Representation in Global Financial Governance," 2009. www.policy dialogue.org

[6] See David Held and Kevin Young, "Global Financial Governance: Principles for Reform" *LSE Ideas*: *Special Report on the Financial Crisis* (London: London School of Economics and Political Science, March 2009) pp. 13-18.

[7] Private international standard-setting bodies such as the International Accounting Standards Board (IASB) also expanded their membership, committing to an expansion from 14 to 16 members, and guaranteed some greater geographical diversity on their Board, in a way that guaranteed developing country representation. It required that four members were from Asia/Oceania, four from Europe, four from North America, one from Africa, one from South America, and two others, In spite of its other limitations, this regional representation is an interesting approach, as we discuss below.

Basel Committee expanded further to include all G20 countries that were not yet members (Argentina, Indonesia, Saudi Arabia, South Africa and Turkey), along with Hong Kong and Singapore. As Figure 1 illustrates, this closed a remarkably large gap in the degree of representation in the Basle Committee in terms of the countries which supervise the largest fifty banks in the world. However, countries with relatively smaller banks are still not adequately represented, which means that banking regulation may continue to reflect excessively the interests of large banks.

11. Secondly, the Committee on Payments and Settlement System has welcomed in July 2009 the following new members: Australia, Brazil, China, India, Mexico, Russia, Saudi Arabia, South Africa and South Korea. The CPSS is another Basel-based body which serves as a forum for central bank to monitor and analyse development in domestic payment, settlement and clearing systems as well as in cross-border and multicurrency settlement schemes.

Table 1: Recent Membership Reforms (1)(2)

12. Major Global Financial Regulatory Standard Setting Institutions: Country membership as of July 2009 (new country since September 2008 **in bold and capitalized;** members before September 2008 pale and small).

	FSB	BCBS	IOSCO Technical Committee	CPSS
Argentina	**X (1)**	**X**		
Australia	x (2)	**X**	x	**X**
Belgium		X		X
Brazil	**X (3)**	**X**	**X**	**X**
Canada	x (3)	X	x (2)	X
China	**X (3)**	**X**	**X**	**X**
France	x (3)	X	x	x
Germany	x (3)	X	x	x
Hong Kong	x (1)	**X**	x	x
India	**X (3)**	**X**	**X**	**X**
Indonesia	**X (1)**	**X**		
Italy	x (3)	X	x	x
Japan	x (3)	X	x	x
Luxembourg		X		
Mexico	**X (2)**	**X**	x	**X**
Netherlands	x (2)	X	x	x
Russia	**X (3)**	**X**		**X**
Saudi Arabia	**X (1)**	**X**		**X**
Singapore	x (1)	**X**		x
South Africa	**X (1)**	**X**		**X**
South Korea	**X (2)**	**X**		**X**
Spain	**X** (2)	x	x	
Sweden		x		x
Switzerland	x (2)	x	x	x
Turkey	**X (1)**	**X**		
UK	x (3)	x	x	x
US	x (3)	x	x	x

(1) Numbers in parentheses show number of members per country.
(2) Source: Helleiner Eric, and Stefano Pagliari (forthcoming), "Crisis and the Reform of International Financial Regulation". In Helleiner E., Pagliari S., and Zimmerman H., *Global Finance in Crisis: The Politics of International Regulatory Change*. London: Routledge

13. Thirdly, in the spring of 2009, the Financial Stability Forum increased its membership to include the entire G-20, (this including the largest developing countries) plus Spain and the European Commission, and has since been renamed the Financial Stability Board, to reflect that it would be given additional powers. This expansion of membership was also significant, as shown by Figures 2 and 3 below which illustrate that, measured both in terms of distribution of world reserves and world savings, the Financial Stability Board now has much more equitable representation than its predecessor.

Figure 1: Percentage of Top Fifty Banks (by Market Capitalization) with Regulators Represented in the Basel Committee, March and April 2009

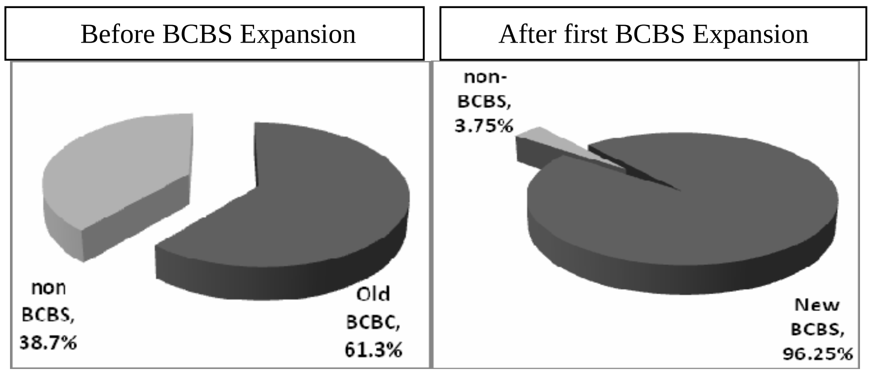
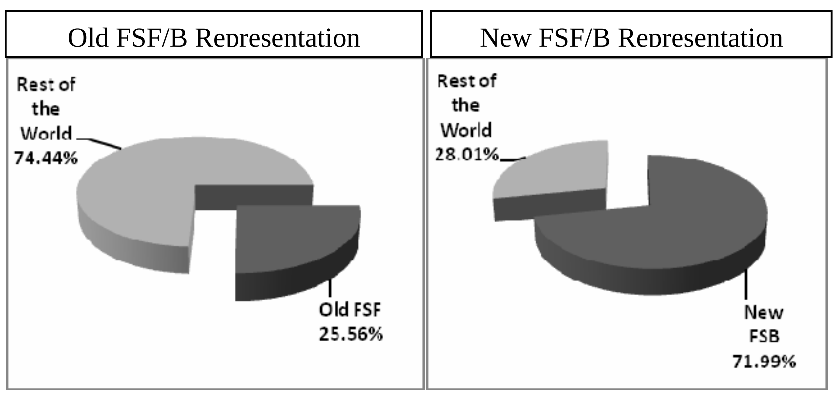
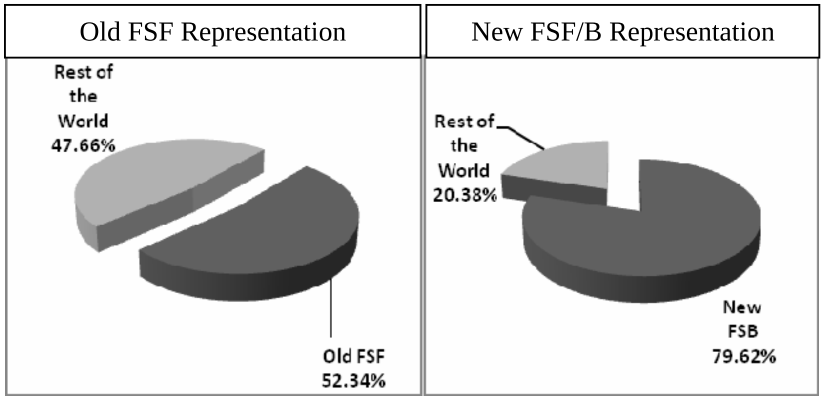


Figure 2: Representativeness of the Financial Stability Forum/Board Measured by World Reserves[8]



[8].Values, for total reserves in US dollars, and exclude Gold holdings, from end 2007. Source: World Bank World Development Indicators. Based on Griffith-Jones and Young (2009), IPD Hewlett Policy Brief: Reforming governance of international financial regulation: have the G-20 done enough? www.policydialogue.org

Figure 3: Representativeness of the Financial Stability Forum/Board Measured by World Savings[9]



14. The changes in the FSF/B imply a dramatic increase in the representation of developing countries, which is to be greatly welcomed. There are however two rather important caveats. The first one refers to the number of representatives. Even before the expansion, the Financial Stability Board had two classes of members: the G7 each had three representatives (finance ministry, central bank and supervisory authority), whereas the other five member countries (Australia, Hong Kong, the Netherlands, Singapore and Switzerland) were only allowed one. With the new 2009 expansion, three classes of countries were created: the BRICs (Brazil, China, India, Russia) joined the G7 countries with three representatives each, while Australia, Mexico, the Netherlands, Spain, South Korea and Switzerland were now assigned two, and everyone else was left with one (Argentina, Hong Kong, Indonesia, Singapore, Saudi Arabia, South Africa and Turkey). Therefore (except for the BRICs), emerging economies represented in the FSB have only one or two representatives, whilst the G7 all have three. As we discuss in more detail below, poorer and smaller economies are not at all represented.

15. The second caveat relates to the fact that the FSB is now structured not just around a plenary, but also around a Steering Committee and three Standing Committee-for Vulnerabilities Assessment, Supervisory and Regulatory Cooperation, (which also has a Cross-Border Crisis management Group under it), and a Standards Implementation Committee. Whilst this expansion and specialization of the FSB is welcome, as it strengthens its role, it is striking that all the Chairs of these five groups, through very distinguished in the field of financial stability, come from developed countries. This may indicate that, though membership has significantly broadened- which is to be celebrated-, the leadership (via Chairs) of these bodies has not been changed. Greater diversity there would seem desirable in the future. An interesting example that could be followed is provided by the 4 working groups established by the G20 between the Washington November 2008 and London April 2009 G20 summits. Each working group was co-chaired by one developing and one developed country.

[9] Values of gross domestic savings are only available for end-2005; they represent gross domestic savings in US dollars. Source: World Bank World Development Indicators. Based on Griffith-Jones and Young (2009), Policy Brief: Reforming governance of international financial regulation: have the G-20 done enough? www.policydialogue.org

16. Overall, the above described changes amount to a highly significant expansion of representativeness within the global financial regulatory institutions. For the first time, there is a degree of inclusion of developing and emerging countries in the major decision-making bodies of international financial regulation. This is to be greatly welcomed. In terms of the Marlborough House Principles, these reforms increase those bodies' legitimacy and fair representation; hopefully, they will increase their responsiveness, to the interests of developing countries, though lack of representation of smallest and poorest countries, is a source of concern; so is lack of progress on transparency and accountability. Finally, the effectiveness of these bodies in ensuring national and global financial stability should be enhanced by the changes made. But are they enough? Despite the increase of representativeness, broader governance issues remain, which we discuss below, and make proposals for further reform.

Proposals for Improving Governance for the Future; A Possible Role for the Commonwealth Secretariat

17. It is very welcome that there has been a significant increase in the participation of developing countries in the governance of international regulatory bodies. This should enhance their legitimacy and representativeness as financial market regulation is acknowledged as a global public good which requires global stakeholders to design it. It should also improve their effectiveness, as greater diversity of views—reflecting different experiences— should lead to better outcomes. Most importantly, it will allow the concerns of a diversity of developing countries to be better reflected in international regulatory arrangements. Despite these important steps, a number of other improvements could further enhance the legitimacy and effectiveness of the newly reformed institutions. We propose below four further improvements to the system of global financial regulatory governance that should be made:

1) Small and medium countries should have representation in international regulatory bodies

This will firstly, and most importantly, ensure that their concerns (e.g. of simpler regulations, as well as of ensuring greater regulatory power of smaller countries over large international banks, via for example host country regulations) are heard. Secondly, regulation would reflect less exclusively the interests and preferences of large internationally oriented banks, and be more appropriate for regulating smaller banks, that are usually domestically oriented. Whilst keeping the existing membership, additionally small and medium countries should be represented in international regulatory bodies. This could be done on a rotating regional basis, with one (and ideally two) representatives from countries in each of Asia, Africa and Middle East and Latin America and the Caribbean. A precedent for this is the IASB model discussed above in footnote 9.

This is a fairly modest proposal for change, but one that would crucially ensure some voice to smaller and poorer countries, who could sit at the regulatory table. It is consistent with the Marlborough House Principles. It would also have the advantage of increasing the legitimacy and effectiveness of these G-20 bodies, (that are of course far more legitimate than previous G-7 or G-10 bodies) by making them open to the rest of the developing world. It seems urgent to introduce such changes soon, before the new structures become ossified.

It needs to be emphasized that this is a modest proposal for minimum reform to give voice to smaller and poorer countries, that can be easily done. More ambitious ones would suggest introducing a constituency system into regulatory bodies (along the lines of that at the IMF or the GEF, the General Environment Facility), but this would imply a major overhaul of governance that may be more difficult to achieve at present, given the urgency of focusing on major regulatory reforms, that arise from the crisis.

2) Inclusion of representatives from non-financial stakeholders, such as unions, and non-financial corporations in international, as well as national, financial regulatory bodies

This would help ensure that the concerns, needs and perspectives of these groups (focused on sustained growth, employment, access to stable credit and long term financial stability) balanced the interests of a financial services industry often more unilaterally focused on short-term financial profits. For the non financial corporations it would be important to include some representation from both large as well as small and medium enterprises, the latter particularly important in developing countries. Trustees of pension funds could also be represented.

3) Financial regulatory bodies should be made accountable to established forms of political representation.

This may include some system of accountability to national parliaments by national regulators and, reflecting international financial interdependence and globalization, should include accountability of international regulatory bodies to multilateral democratic institutions such as the United Nations.

4) Creating a body for supporting developing countries in their interactions with the international financial services regulatory bodies.

The benefits of the positive move to include developing countries in key international regulatory bodies such as the FSF/B and the BCBS could be strengthened by the creation of a technical secretariat to support developing countries in their interactions with these bodies, both as members and non members This secretariat could prepare or commission studies, provide a forum for debate amongst developing countries and help—where relevant—to define developing country positions on regulatory issues and needs, especially those that require international and/or developed country action. Examples include international regulation of the carry trade which can have very pro-cyclical-and thus negative-effects-on developing countries' exchange rates or regulating unhedged currency mismatches. Both these issues are particularly relevant for developing counties.

There may be a particular role for the Commonwealth Secretariat in supporting this objective, depending on the level of resources that could be devoted to such an initiative. There is scope for the Secretariat to support the membership through research and the dissemination of best practice.

The Commonwealth Secretariat could also offer crucial intangible assets, such as its trusted relationship with its members; its convening power, and its broad membership, that includes both developed and emerging economies, as well as a large number of smaller and poorer countries, the latter being currently excluded from international regulatory bodies.

A first meeting could be organized and hosted in London by the Commonwealth Secretariat and relevant regulatory bodies. This could for example have one or several panels on key regulatory issues of particular relevance for developing countries, such as lessons from the mistakes that led to the global crisis and from current regulatory debates, taking place mainly in developed countries. Possible issues to be discussed would be on how to introduce counter-cyclicality into developing country regulation, how much should the regulatory perimeter be expanded in different categories of developing countries, as well as others. It could also provide a forum for discussing the establishment of a more formal group, that would meet regularly (e.g. once or twice a year), and possibly have some of the characteristics described above.

More broadly, the Commonwealth Secretariat could also organize regional meetings, on these subjects, particularly in regions, where it has an important membership and particularly large convening power. This could for example lead to meetings in the Caribbean region and the Pacific Islands. However, it could be important always to bring relevant regulatory expertise from other countries, both developing and developed. The Commonwealth secretariat network and membership could provide a valuable resource there.

A Commonwealth network of this sort could be a prelude to, or developed in conjunction with a wider forum for supporting developing countries in this area. Developing countries have benefited greatly from the support of the very successful Group of 24 (G-24), which helps them develop their positions in relation to IMF and World Bank matters; a similar body, possibly linked to the G-24, could be created by developing countries for international regulatory issues, to help define developing country positions at the FSF/B, BCBS, and other relevant regulatory bodies. Such a group could ultimately be based in Basel and could help increase both the effectiveness and responsiveness of the new broadened regulatory bodies both to developing country needs and globally.

Overcoming Fragmentation of Regulation; Moving Towards a Global Financial Regulator?

18. International prudential regulation has developed in a relatively fragmented, and weak institutional context. [10] But finance is globally integrated and there is an increasing mismatch between the financial services industry and its accompanying international regulatory structure. The design and creation of a global financial regulator is one of the main institutional challenges that the international community faces after the global financial crisis. The aim should be for the domain of the market to be consistent with the domain of the regulator, and thus avoid regulatory arbitrage between countries and financial centers, it is a highly desirable option to work toward. By pooling and sharing their power internationally regulators would be increasing their joint control over global financial markets, so those can better serve public policy goals. This would help to make costly financial crises less likely in the future.

[10] For a good analysis, see Helleiner and Pagliari, “Crisis and the Reform of International Financial Regulation,” forthcoming, 2009; see also Griffith-Jones and Young, “Institutional Incentives and Geopolitical Representation in Global Financial Governance,” 2009, www.policycydialogue.org

19. In the past implementation of financial regulation and supervision has been mainly located at the national level, with most international financial regulatory agreements simply taking the forms of "best practice" standards, and "principles" which are not legally binding between regulators (Helleiner and Pagliari, op cit). Developing countries however often have to, or feel they have to, follow those standards, either because they are part of IMF or World Bank conditionality, or because "financial markets" pressure them indirectly to do so. This is no longer appropriate.

Criteria for Financial Regulation

20. The purpose of a global financial regulator is to to ensure that the financial sector serves the real economy, and thus the needs of households and enterprises to consume and invest. On the positive side, governments should encourage the financial sector to create financial innovations and instruments that support growth and development in a sustainable way (UN Commission, 2009). But they should also use regulation to avoid systemic risk being generated, thus preventing future crises, which can be so disruptive to the real economy and which tend to be very costly from a fiscal and a development point of view given their impact on lost output and investment. Above all, future crises must be prevented because of their impact on the lives of people, many of whom are poor and have no responsibility for the crisis, especially those living in developing countries.

21. The global financial crisis that started in the summer of 2007 follows many deep and costly financial crises in developing economies over the last 30 years. This more recent crisis, like previous ones, is the result of both inherent flaws in the way financial markets operate-and their inherent tendency towards boom bust behaviour-and insufficient, incomplete and sometimes inappropriate regulation.

22. To reduce the prospect of future crises regulation should be guided by two key principles: *comprehensiveness* and *counter-cyclicality* – which have been backed by most leading recent international and national reports on regulatory reform and rhetorically at least by the leaders of the G20 nations. The key issue is the extent and way in which they will be implemented.[11]

Comprehensiveness

23. With regard to comprehensiveness[12], in order for regulation to be efficient, it is essential that the domain of the regulator is the same as the domain of the market that is being regulated. The crisis has shown that globalized private financial players are supported by increasingly internationalised lender of last resort facilities. Without stronger international financial regulation to complement this, moral hazard will significantly increase once again as financial activity and risk-taking will grow rapidly in areas where international regulatory gaps exist, but there is implicit or explicit coverage by lender-of-last resort facilities. Perhaps more importantly, regulatory arbitrage will take place where regulatory gaps exist.

[11] See again Jane D'Arista and Stephany Griffith–Jones, (op. cit.).

[12] For a fuller discusson see, for example, Jane D'Arista and Stephany Griffith–Jones "Agenda and Criteria for Financial Regulatory Reform;" in Stephany Griffith–Jones, Joseph Stiglitz and Jose Antonio Ocampo (eds), Time for a Visible Hand; Policy lessons from the 2007 Crisis, Oxford University Press 2009.

24. A global regulatory institution seems an essential condition to efficiently implement comprehensive international regulation of institutions and markets that engage in international transactions. This seems particularly desirable from the perspective of developing country interests, as long as developing countries are appropriately and effectively represented in such international regulatory fora.

Counter-cyclicality

25. A key market failure in the financial system is the pro-cyclical behaviour of most financial actors, which leads to excessive risk-taking and financial activity in good times, followed by insufficient risk-taking and financial activity in bad times.

26. Counter-cyclical regulation implies that the traditional microeconomic focus of prudential regulation and supervision be complemented by a macro-prudential perspective, particularly by introducing explicit counter-cyclical features in prudential regulation and supervision that would compensate for the pro-cyclicality of financial markets.

The Functions and Characteristics of a GFR

27. A global financial regulator embodying these characteristics would design standards to be applied by all countries and jurisdictions, and adopt appropriate surveillance mechanisms to guarantee that those standards are adopted. The institutional set up should, however, leave room to adapt regulations to different national conditions, and in this sense as well as in the area of supervision, operate essentially as a network of national regulators with strong international coordination. For example, counter-cyclical regulation criteria could be agreed internationally, but then be implemented nationally depending on the state of the cycle in each country. As the Geneva Report (2009) argued, such national regulation would best be applied by host regulators on local banks and systemic subsidiaries. Also, national financial institutions without global connections – e.g., small national banks — would continue to be regulated nationally.[13]

28. A key question is whether a new institution should be created to fulfil this function. Given the difficulty of achieving consensus for creating new international institutions, it may be desirable to adapt an existing one. It seems that the most appropriate would be the Bank for International Settlements (BIS), given its concern with systemic risk in financial markets and the need for regulating them, the high quality of its analysis, and its close links with central banks and regulatory bodies. However, a pre-condition for the BIS to provide the basis for a global financial authority is that its membership should expand considerably, with the aim of creating a universal body, with developing countries adequately represented on its Board, management, and staff. Some steps have been taken in this direction (see above), but these are clearly insufficient. The accountability of the national representatives of the BIS to Parliaments would also be important. Furthermore, it is clearly central that the Financial Stability Board (FSB), to which the BIS provides a secretariat, should be incorporated into such a global regulator and should play a key part in such an institution.

29. Additionally, there should be close consultation with the IMF on the macroeconomic aspects of risks, both globally and at country level, a subject also studied by the BIS. The IMF, however, is not the appropriate financial institution to take over the task of global

[13] Reddy, Y.V. "Regulation of Financial Sector in Developing Countries: Lessons from the 2008 Financial Crisis" in *Time for a Visible Hand: Lessons from the 2008 World Financial Crisis*, Griffith-Jones, S, Ocampo, J.A. and Stiglitz, J., eds. New York: Oxford University Press, 2009.

regulator,, as it has limited expertise in the design of regulatory standards, a role played by the FSF and the Basle Committee. Furthermore, the IMF has been too closely involved in the recent past to the deregulation of financial markets.

30. An important issue is to ensure that the new global regulator is not just effective and efficient, but also representative. For this reason, it is important that developing countries are adequately represented. It is encouraging that all G-20 members will now be represented in the Financial Stability Board, and as discussed above, the Basel Banking Committee. However, further steps are clearly necessary to ensure broader representation in international regulatory bodies, both of countries and non-financial stakeholders, along the lines out lines above, and in according with the Marlborough House Principles.

31. It is particularly important that a global regulator should have real power to influence the decisions of national regulators, especially in all the major countries whose financial systems have systemic global impact on the rest of the world economy.

32. The design and creation of a global financial regulatory structure is one of the main institutional challenges that the international community faces in the wake of the current financial crisis. It would allow the principles of regulation to be implemented globally, thus avoiding regulatory arbitrage, and helping prevent future crises. This does not eliminate the possibility of segmenting national markets by introducing capital controls that should remain the right of national authorities. The desire to introduce capital controls will increase if regulation is seen as insufficient to curb volatility of capital flows. Therefore those favouring continued globalized finance should become the greatest supporters of increasing effectiveness of financial regulation, including the design of stronger and more representative global financial regulatory structures.

The Case for a Global Financial Regulator (GFR)

33. The international community has taken important and valuable steps toward global coordinated regulation, such as the creation of the Financial Stability Forum and recently its transformation into the Financial Stability Board, which has more powers and staff. The concept of international colleges of supervisors is another step in this direction. However, their efforts are clearly insufficient, given the speed and depth of the globalization of private finance and its often negative spillover effects on innocent bystanders.

34. Indeed, in terms of new institutional arrangements for regulation, it is essential to design an institutional structure consistent with the fact that <u>capital and banking markets have very large parts that operate at a global level.</u> For the domain of the market to be consistent with the domain of the regulator, and to thus avoid regulatory arbitrage between countries and financial centres, <u>a global financial regulator seems very desirable to help provide the regulatory coordination on needed for pursuing the global public good of global financial stability.</u> Both academics[14] and some market actors[15] have long called for such an institution. The recent crisis – and the way contagion has spread throughout the globe to even affect countries with sound financial systems – has made such an institution more necessary and politically more feasible.

[14] See Eatwell, J. & Taylor, L. "Global Finance at Risk: The Case for International Regulation" New York: The New Press, 2000.

[15] See Kaufman,H. "The Principles of Sound Regulation. *Financial Times,* p. 11. 2008.

35. One reason why governments – both in developed and developing countries – may resist calls for a global regulator is their unwillingness to give up perceived national sovereignty in the area of financial regulation – where they see sovereignty to be important. However, this perception is incorrect, given the globalization of private finance.

36. Global financial markets, to the extent that they are unregulated, are profoundly unaccountable and undemocratic. These markets have major and profound effects on economies and on people's lives, many of which are undesirable, due to serious market failures especially pervasive in the financial sector. This is a major factor in undermining national and global financial stability.

37. Such market failures can only be corrected by government actions, such as by regulation. To the extent that financial markets are global, the only option for effective regulation is for sovereignty to be pooled or shared among governments via global arrangements. Therefore, by sharing sovereignty, countries will gain sovereignty, by increasing their joint control over global financial markets so that these can serve public policy goals, such as financial stability, that will contribute to sustained growth. This is clearly a superior option in terms of the exercise of sovereignty compared to individual governments <u>not</u> being able to regulate the international aspects of finance.

38. Developing country governments may feel particularly unwilling to support the creation of a global financial regulator, because they may fear it will be used to impose regulations on them that would reduce their policy space. This was basically true, when finance was mainly controlled by developed countries and actors, and crises happened mainly in developing countries (even though often largely caused by international financial markets). However, the situation has now changed. Much of global savings originates in developing economies, while the current crisis clearly originated in the developed economies; regulatory failures in these developed countries were a major cause of this crisis. Furthermore, developing economies and their people have severely suffered the effects of the crisis through a variety of channels even though they had no responsibility for causing it.

39. Therefore, it is in the interests of developing countries to have a global financial regulator (in which they have appropriate representation), to ensure that global financial markets are adequately regulated. The fact that there is now greater, though still insufficient, developing country representation, than in the past, in the main international regulatory bodies, such as the FSB and the BCBS, makes an international regulator more attractive for developing economies. Its existence would help avoid future crises, especially those originating in developed economies.