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Restructuring Global Governance of the Financial System: a Framework for Preventing Systemic Risk

*'Never let a good crisis go to waste'**

1. Introduction

The *Essay on Financial Crises*, published in The Economist of 12 April 2014, was focused on '*the slumps that shaped modern finance*' considering that finance is not merely prone to crises, rather '*it is shaped by them*'. As some scholars affirm, to understand the present international financial system one should know some history.[1] There is nothing new about financial crises. They have occurred frequently throughout history. The five most devastating crises – starting with America's first crash in 1792 and ending with the biggest (before the latest) in 1929 – highlight the origin of modern finance and the way in which successive reforms have tended to insulate investors from risk. Thus they offer lessons to regulators and policymakers in the aftermath of the current crisis.[2]

* Rahm Emanuel, the former chief of staff of US President Barack Obama.

[1] R. Bukley and D. Arner, 'From Crisis to Crisis: The Global Financial System and Regulatory Failure', *University of Hong Kong Faculty of Law Research Paper*, No. 002/2012.

[2] 'The slumps that shaped modern finance', Essay on Financial Crises, *The Economist*, 12.04.2014, pp. 47–53.

The crisis of 2008 has undermined the previous overwhelming confidence in financial markets. The understanding of the causes of the crisis has focused on the capacity of regulators and regulatory mechanisms to tackle the financial system. Regulators and politicians have struggled to develop new rules, reshape regulatory structures and create new regulators.

There is no doubt that policymakers have recognized the need for a greater surveillance capacity and created new bodies and committees charged with macro-prudential competences, mostly at the EU and global level. However it is worth highlighting that '*regulators failed not just because they did not look hard enough at what was happening in the markets. It was also that their cognitive understandings of the way markets operated, and the way markets and regulation interacted, were flawed*'.[3]

Undoubtedly regulators can witness that any attempt to control risk-taking behaviour of financial institutions prior to the crisis would have been then seen as an intrusion into the management of those institutions and as an action against innovation and competitiveness in the financial markets.

The liberalization of financial markets has been rooted in a deep confidence in their ability to self-regulate[4] and on the approach of traditional neoclassic economics whereby the financial market, like other markets for goods and services, is assumed to allocate financial assets efficiently on the basis of pricing mechanisms.

The recoup of the neoclassic approach to financial markets was also an important ingredient in the collapse of the Bretton Woods system in the early 1970s,[5] as well as the removal of the controls and barriers

[3] J. Black, 'Restructuring Global and EU Financial Regulation: Character, Capacities and Learning' in: *Financial Regulation and Supervision. A Post-Crisis Analysis*, E. Wymeersch, K.J. Hopt and G. Ferrarini (eds.), Oxford 2012, pp. 3–4.

[4] '*Self-regulation by financial market participants […] is somewhat in retreat nowadays in part because of its association with discredited "light touch" approaches, According to Joseph Stiglitz the very idea that markets can self-regulate is an "oxymoron"*', E. Ferran, 'Institutional Design for Financial Market Supervision: The Choice for National Systems', *University of Cambridge Faculty of Law Research Paper*, No. 28/2014, p. 12.

[5] Even if in 1944 the Bretton Wood system was created to regulate economic relationships among States (in particular for exchanging one currency for another), restrictive measures on free movement of capital were also able to assure the monetary stability and, in addition, to maintain national organization of the financial markets. In the 'Introduction' to the book on *Global Governance of Financial Systems*, just a short time before the outbreak of the financial crisis, the authors affirm that '*[m]any experts agree that adequate regulation at the domestic and international level has not accompanied the liberalization of financial markets and, in particular, of short-term capital flows. […] The removal of the extensive system of domestic and international financial*

introduced after the Great Crisis of 1929, i.e. the replacement of structural supervision mechanisms[6] with the prudential supervision system. In a nutshell, prudential supervision focuses on ensuring the safety and soundness of financial institutions through the oversight of their business operations, financial condition, risk management practices and corporate governance.

2. Systemic risk matters: how to handle it?

With respect to financial regulation, it is generally acknowledged that one of the main tasks of regulators is to contain the risk taken by financial institutions to prevent them from spreading systemic damage in the system as a whole. Consequently there have been calls for increased regulation of systemic risk.

Although the issue of systemic risk has been subjected to considerable study, there is a great deal of confusion about what kind of risks are systemic and consequently no widespread agreement on how to define this concept. As often stated, systemic risk is a 'slippery concept' and there are a wide variety of sources offering various definitions. In a recent paper one author lists fourteen different definitions given in the last decade.[7]

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and monetary controls that characterized the post-World War II world before 1971 has resurrected the pre-war origins of crises in microeconomic as well as macroeconomic circumstances. […] Nonetheless, even where crises have microeconomic origins, an important macroeconomic component remains. […] The reason derives from the fact that while commodity markets… involve the pricing of flows of goods and services, financial markets involve the pricing of stocks of financial assets. Moreover, the price of financial asset depends on expectations about its future price […]. Consequently expectations play an extraordinary role in the determination of the prices of financial assets, and shared expectations are a potent source of macroeconomic contagion', K. Alexander, R. Dhumale and J. Eatwell (eds.), *Global Governance of Financial Systems. The International regulation of Systemic Risk*, Oxford 2006, pp. 3–4.

[6] This model was introduced in 1933 by the Glass-Steagal Act and transferred (with innovations) to some EU countries (e.g. Italy, 1936). In the US the Glass-Steagal Act was abolished in 1999 when President Clinton signed the Gramm-Lech-Biley Act.

[7] The definitions are in D. Van Hoose, 'Systemic Risks and Macroprudential Bank Regulation: a Critical Appraisal', *Networks Financial Institute Policy Brief*, No. 2011-PB-04, who also affirms '*whichever of the two traditional views on systemic risk that one chooses as more appealing, there are three key private-market-related factors that potentially contribute to systemic risk. The first of these is fractional reserve banking […]. The second key private-market contributor is the potential for banks to engage in correlated strategies — or what financial market participants and other observers more commonly call herding behaviour […]. The third private-market factor that gives rise to systemic risk is network externalities. In general, an externality exists in a market when*

Even though systemic risk is a form of financial risk, it stands apart and should be differentiated from traditional financial risk. The difference is that '*traditional financial risk focuses on risks within the financial system […]. Conversely, systemic risk focuses on risks to the financial system*'.[8]

In the various definitions a common factor is the idea that systemic risks affect multiple institutions simultaneously, suggesting correlated asset strategies, or 'herding behaviour'. A traditional view of systemic risk is '*the risk that failure of one or a small number of institutions will be transmitted to others due to explicit financial linkages across institutions*.'

Nonetheless it is uncertain to what extent regulators are allowed to contain systemic risk. The question is whether and how the financial crisis has changed the terms of the traditional approach.

No longer is it considered sufficient to concentrate upon the monitoring and supervision of only individual institutions or single countries, but what is fundamental is the functioning of the system as a whole. This reshaping of the relationship between the whole and its parts underlines the shift in the cognitive understanding of what regulation should aim to achieve. These changes in regulation are required '*to strengthen financial stability and the protection of customers so to avoid […] at least a repetition of the extraordinary type of systemic breakdown that we are now witnessing*'.[9]

Drawing some lessons from the crises there is a certain consensus on the idea that financial markets are of macroeconomic relevance. There is less agreement on how to re-design and re-orient regulation and supervision towards the global level as the current crisis revealed that any centripetal pressure for international harmonization was counteracted by centrifugal tendencies[10] pushing back towards 'micro'-regulation, centred on the relevance of individual choices and towards decentralized supervisory measures.

Prior to the crisis the characteristics and conditions of systemic risk had been occasionally questioned but only in the post-crisis

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a characteristic of the market product exerts spill-over effects on individuals or firms not party to transactions in the marketplace' *[emphasis in original]*, at pp. 8–10.

[8] S.L. Schwarcz, 'Systemic Risk', *American Law & Economics Association Annual Meetings Paper*, No. 20/2008, pp. 7 and 19.

[9] The High-level Group on Financial Supervision in the EU, chaired by J. de Larosière, Report, Brussels 2009, p. 13, point 41.

[10] J. Black, 'Restructuring Global and EU Financial Regulation: Character, Capacities and Learning', p. 8.

phase did the issue gain relevance. Debates revealed the need for macro-prudential policies, then led to analysing which institutions or practices are systemically relevant and have ended up by identifying the 'global Systemically Important Financial Institutions' (SIFIs).[11] The assumption that SIFIs represent a key issue in financial market is witnessed by the constant evolution in dealing with this matter by the FSB (Financial Stability Board).

As mentioned above, prudential regulation parameters are built on the leading idea of economic mainstream that risk can always be weighted. Hence, when financial institutions are requested to meet precise requirements (in particular capital requirements), the rise of systemic risk is presumed to be neutralized once and for all. Regulators and policymakers are challenged to change their view on the nature and management of risk in the financial system.[12]

Restructuring controls means to assure the stability of all financial institutions by strengthening the macro-prudential supervision of systemic risks. Focusing on an individual bank and/or financial institution does not allow for assessment of the risks that can be run due to the numerous inter-linking and inter-dependencies between the stability of the macro-economy, individual financial institutions and the 'network effect' of the system as a whole. All in all,

[11] After the crisis the G20 Leaders asked the FSB to develop a policy framework to address the systemic and moral hazard risks associated with systemically important financial institutions (SIFIs); see: Interim report to G20 leaders 'Reducing the moral hazard posed by systemically important financial institutions', 18.06.2010. In Seoul the G20 Leaders endorsed this framework and the timelines and processes for its implementation. Development of the critical policy measures of this framework was completed. Implementation of these measures began in 2012. Full implementation is targeted for 2019. In a document prepared by the FSB, 'Policy measures to address systemically important financial institutions', 4.11.2011, SIFIs are defined as '*financial institutions whose distress or disorderly failure, because of their size, complexity and systemic interconnectedness, would cause significant disruption to the wider financial system and economic activity. To avoid this outcome, authorities too frequently had no choice but to forestall the failure of such institutions through public solvency support. As underscored by this crisis, this has deleterious consequences for private incentives and for public finances*'.

[12] The High-level Group on Financial Supervision in the EU, chaired by J. de Larosière, Report, p. 10, point 23. Furthermore we need to realize that technologies of risk management generally used were inadequate. Also, risk models were found to be flawed. An example can be the Value at Risk models that were recognized to produce pro-cyclical effects. At the same time, the potential pro-cyclical effect of Basel II has also been noted, see: C. Goodhart, 'Financial Regulation, Credit Risk and Financial Stability', *Economic Institute Economic Review*, No. 192/2005, p. 118.

macro-prudential supervision is analogous to oversight of the forest, while micro-prudential supervision is analogous to the oversight of individual trees.[13]

In the aftermath of the crisis the prevailing regulatory responses did not step out of the path of the prudential approach to financial supervision[14] whilst in the international landscape some proposals arose which were aimed at re-introducing more rigorous rules based on the model of structural supervision.

First of all one must mention the so-called ‘Volker rule’ as part of the Dodd-Frank Act which prohibits bank holding companies from engaging in proprietary trading and investing in or sponsoring hedge funds and private equity operations.[15] However, this rule contains numerous significant exemptions and, in addition, is scheduled to come into effect only in July 2015.

Secondly, in UK a cornerstone of the ‘Vickers Report’ was its ‘ring-fencing’ proposal which is maintained in the Banking Reform Act of 2013 although it has been partially watered down.[16]

Similar objectives were included in the mandate conferred to the *High-level Expert Group on reforming the structure of the EU banking sector*, chaired by Liikanen, Governor of the Finnish Central Bank. The Group was required by the EU Commission to pay attention to

[13] As stated in 2009 by the Governor of the Canadian Central Bank. See also: V. Acharya, ‘A Theory of Systemic Risk and Design of Prudential Bank Regulation’, *Journal of Financial Stability*, No. 3/2009, pp. 224–255.

[14] First of all we refer here to the Third Basel Accord, agreed upon by the members of the Basel Committee on Banking Supervision on setting standards on bank capital requirements aimed at internalizing the credit risk, a minimum leverage ratio and two required liquidity ratios.

[15] The objective of the rule is to prevent financial institutions that benefit from government-guarantees and taxpayer-backed deposit insurance from using such guarantees and insurance to raise capital and fund proprietary trading activities, see: E.J. Pan, ‘Understanding Financial Regulation’, *Cardozo Legal Studies Research Paper*, No. 329/April 2011, p. 44.

[16] See: ‘The Vickers Report – Final Report – Recommendations’, 12.09.2011. The proposed structural separation between domestic retail services and global wholesale and investment banking operations represents the most controversial part of the report. According to the report, structural separation should make it easier and less costly to resolve bank failures and should reduce the influence of external financial shocks on national retail banking system. See also: The Independent Commission on Banking, ‘The Vickers Report & the Parliamentary Commission on Banking Standards of 2013’. The Banking Act gives powers, in particular to the HM Treasury and the PRA, to implement the recommendations of the Independent Commission on Banking (ICB) on ring-fencing requirements for the banking sector.

the reforms proposed both in US and in the EU and it launched its proposal in October 2012.[17]

Yet, the idea of going back to a clear-cut split between banking linked to traditional and highly-protected 'narrow banking', and the so-called 'casino finance' has to face numerous and strong criticisms. There is no hope of reaching a globally-binding agreement that is needed to reintroduce structural supervision. In particular, if such severe distinctions were to operate only in some countries but not globally, obvious competitive disadvantages would be produced.[18]

Moreover, the debate launched after the explosion of the financial crisis has not yet resulted in generally-shared structural and operational reforms. There are still contrasting views on understanding the causes of the crisis, as well as on the regulatory responses that can best tackle risk and the measures needed to control it. As clearly affirmed by Julia Black, if regulators and economists '*do not understand how the system works, it is very hard to build in mechanisms either for managing risk or for ensuring the system's resilience when those risks crystallize. Whilst regulators and others realize a new cognitive framework is needed, they are struggling to develop one*'.[19]

On these premises, at least two important questions arise. The first deals with the definition of 'what to regulate', i.e. the 'perimeter' of the supervision. With respect to the institutions, controls should be extended '*beyond the three pillars upon which financial regulation has traditionally rested*' (i.e. banking, securities and insurance) to a broader range of institutions critical to financial stability.[20] But are

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[17] As a follow-up to the Liikanen report, on 29.01.2014, the EU Commission adopted a proposal for a regulation (Proposal for a regulation of the European Parliament and of the Council on structural measures improving the resilience of EU credit institutions – COM(2014) 043 final to stop the biggest banks from engaging in the risky activity of proprietary trading. The new rules would also give supervisors the power to require those banks to separate certain potentially risky trading activities from their deposit-taking business if the pursuit of such activities compromises financial stability.

[18] See: F. Vella, 'Il rischio: questo sconosciuto', *Analisi giuridica dell'economia*, No. 1/2009, p. 174.

[19] J. Black, 'Restructuring Global and EU Financial Regulation: Character, Capacities and Learning', p. 13.

[20] See especially: C.A.E. Goodhart, 'The Regulatory Response to the Financial Crisis', *CESifo Working Paper*, No. 2257/March 2008, p. 13 and R.M. Lastra, 'Regulatory Responses to the Financial Crisis' in: *Financial Crisis Containment and Government Guarantees*, J.R. LaBrosse, R. Olivares-Caminal and D. Singh (eds.), Cheltenham 2013, pp. 76–77 who include in the perimeter '*institutions such as those involved in the "originate to distribute" model of credit intermediation, services providers such as clearing*

these borders to be extended, for instance, to the 'shadow banking system' encompassing a variety of non-bank financial intermediaries engaged in risky activities? Moreover, within the defined perimeter, an important issue is to define what the best indicators of banking and financial soundness are, taking into account that while capital regulation could be an important parameter, it is not the only one.

The second question concerns, on the one hand, the institutional architecture of regulation and supervision, especially for systemic risk control and, on the other hand, the capability of these institutions to implement commonly-shared standards which overcome the dichotomy between national law and global markets. Given the increasing awareness of systemic risk, there is a broad acceptance of the need for an 'international financial architecture' able to reshuffle the governance of the financial system.[21]

This paper focuses on the various problems pertaining to the second question. First of all, it analyses the organizational realignments involving financial institutions and standard-setters at global level. The changes concern not only the structure of the global regulators and the nature of the interdependencies between them, but also the relationships between the global regulators and national regulators and governments. They also concern regulatory capacity, which is a combination of informational and organizational resources, expertise, authority, legitimacy, and accountability. Currently the most important change in the structure of global financial regulation has been the transformation of the FSF into the FSB and its renewed role in global governance as the heads of government in the G20 countries realized that national policy responses would be inadequate to stabilize financial markets.[22]

Secondly, taking into account the main characteristics of the FSB as established in the Charter (agreed to in 2009), the FSB has been provided with a basis for building its own institutional position within

and settlement systems, private pools of capitals such as hedge funds and private equity funds'. For a definition of financial stability, see: G.J. Schinasi, 'Defining Financial Stability', *IMF Working Paper*, No. 04/187, pp. 3–16.

[21] See especially: L. Garicano and R.M. Lastra, 'Towards a New Architecture for Financial Stability: Seven Principles', *Journal of International Economic Law*, No. 3/2010, pp. 599–600.

[22] For more on the role of the G20 and the creation of the FSB, see: D.E. Nolle, 'Who's in Charge of Fixing the World's Financial System? The Un[?]der-Appreciated Lead Role of the G20 and the FSB', *SSRN working papers series*, draft – January 2014, available at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2354395 (last visited 15.05.2014).

the institutional international environment and has received stronger legitimacy as a coordinator.

After a five-year period in its new role, the first issue at stake is whether the FSB is still 'an arm' of the G20 or whether it has become a 'fourth pillar' in the architecture of cooperation established after the Second World War.[23] Moreover, given the need for a renewed global financial architecture, the second point is whether the way forward must entail replacement of the loose network-based structure with a hierarchical institutional system of control where the FSB could become 'head' of the global system in cooperation, at least, with the European Supervisory Authorities as featured in the EU Regulations of 2010.[24]

3. The FSB and its mandate for global financial governance

At their Pittsburgh Summit in September 2009, the G20[25] leaders officially asserted the G20's status as the '*premier forum for international*

[23] As affirmed by Treasury Secretary Tim Geithner at the time of the G20 Pittsburgh Summit.

[24] The Regulations adopted on 24.11.2010 are: Regulation (EU) No 1093/2010 establishing a European Supervisory Authority (European Banking Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/78/EC, OJ 2010 L 331/12; Regulation (EU) No 1094/2010 establishing a European Supervisory Authority (European Insurance and Occupational Pensions Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/79/EC, OJ 2010 L 331/48; Regulation (EU) No 1095/2010 establishing a European Supervisory Authority (European Securities and Markets Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/77/EC, OJ 2010 L 331/84. For more about ESAs see especially: A. Enria and P.G. Texeira, 'A new institutional Framework for Financial Regulation and Supervision' in: *Basel III and Beyond*, F. Cannata and M. Quagliariello (eds.), London 2012, pp. 16–23.

[25] G20 refers commonly to the 19 member countries (Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, Mexico, Russia, Saudi Arabia, South Africa, Republic of Korea, Turkey, UK, US) and the European Union representative. However, from the time of the establishment by the G7 of the Finance Ministers and Central Banks Governors in 1999, the Finance Ministers and Central Banks Governors function as the core group. However, since autumn 2008 the Ministers and Governors requested the direct participation of the heads of state in taking relevant political decisions. Together, G20 member countries accounted for 86% of the world GDP in 2012. The G20 is also dominant in financial markets, where they accounted for 90% of world banking , 81% of global market capitalization, and 94% of global bond markets. See: D.E. Nolle, 'Who's in Charge of Fixing the World's Financial System?', table 1, p. 40.

cooperation on the most important issues of the global economic and financial agenda', thus assuming financial system leadership. At the London Summit in April 2009, the G20 established a new Financial Stability Board (FSB) as a successor to the Financial Stability Forum (FSF) '*with a stronger institutional basis and enhanced capacity*'.[26]

Five years on, it seems that the G20, even without supranational powers, has functioned well, at least in perspective, managing to enforce its agenda through persuasion and peer pressure. The FSB's mandate from G20 leaders included not only coordination of international work on financial system reform, but also the responsibility to '*oversee action needed*' to implement the G20 commitments. FSB member jurisdictions '*will lead by example*', through implementation of the agreed standards, disclosure, and peer reviews.[27]

As observed in many comments on the activity of the predecessor FSF, its role, though unclear and ambiguous but mainly aimed at coordinating the key actors involved in the emerging international standard regime[28], had weakened over time. The FSF had largely failed to realize its potential, as it lacked a clear mandate and allowed large countries, in particular the US, to exercise a veto power.[29]

The relevant change in the governance of international financial standards came with the transformation of the FSF into the FSB.[30]

[26] Declaration on strengthening the Financial System, London Summit, 2 April 2009, quoted in the Charter of the Financial Stability Board (agreed in 2009 and recently amended in June 2012), recital (3).

[27] The main components of the financial regulatory reform concern: bank capital; central clearing and trading of OTC derivatives; regulation of rating agencies and hedge funds; and bank resolution regimes. As observed by K. Lannoo, '*The follow-up to these commitments has been impressive in the G-20 countries, indicating that G-20 process effectively worked. The remaining task now is the monitoring of effective implementation and the exercise of peer pressure*' in: 'The G-20, five years on', *CEPS Essay*, No. 9(3)/March 2014.

[28] Regarding the definition of standards as principles, practices or guidelines in a given area and the reason why standards are important, see: http://www.financialstabilityboard.org/cos/standards.htm (last visited 17.07.2014).

[29] See: A. Baker, 'Mandate, Accountability and decision Making Issues to be Faced by the FSB' in: *The Financial Stability Board: An Effective Fourth Pillar of Global Economic Governance? CIGI Special Report*, S. Griffith-Jones, E. Helleiner and N. Woods (eds.), Waterloo 2010, p. 19; E. Helleiner, 'What role for the New Financial Stability Board? The Politics of International Standards after the Crisis', *Global Policy*, Issue 3/October 2010, p. 283.

[30] A more severe judgement contends there is a substantial contrast between the FSB and the FSF, since the latter was only '*a multilateral "think tank" lacking formal backing from the major financial centre countries for policy development*', D.E. Nolle, 'Who's in Charge of Fixing the World's Financial System?', p. 12.

Significantly the FSB was given a wider membership (G20 countries, Spain and the EU Commission) so that developing countries now have a seat at the rule-makers' table, as well as in some of the standard-setting bodies, such as IOSCO and the Basel Committee on Banking Supervision.[31] According to the FSB's Charter, '*the number of seats in the Plenary assigned to Member jurisdictions reflects the size of the national economy, financial market activity and national financial stability arrangements of the corresponding Member jurisdiction*'.[32]

With respect to the FSB's Charter it is worth noting that it can be, and has been, continuously changed and adapted by the G20, in contrast to a formal treaty which, once drafted, is extremely difficult to amend. Actually the G20 leaders refused to establish the FSB as a formal international organization based on a multilateral treaty. The FSB's Charter remains '*a work in progress*'. It has been changed several times and G20 countries may continue to add new tasks to the list of FSB responsibilities.

The FSB's Charter establishes the FSB as the 'regime manager' for the G-20 and defines the basis whereby FSB builds its own institutional role within the international architecture. It gives the FSB greater legitimacy as coordinator and as standard-setter, at least for the G-20 countries.

The membership of the FSB was a political decision taken in the darkest days of the crisis and it may be said that it was not the result

[31] What is relevant about the membership of the FSB is the diversity of bodies represented, which includes a range of influential non-state actors. The FSB includes three types of members. The first type of membership is the 'member jurisdictions'. The reference to 'jurisdictions' and not 'states' allows the participation of bodies such as the ECB and European Commission in this list. Moreover, it is not strictly the states that are represented, but the relevant authorities responsible for financial stability in that jurisdiction. The second category of member is comprised of the International Financial Institutions: the BIS, IMF, Organization for Economic Co-operation and Development (OECD) and the IBRD. The third type of membership is comprised of International Standard-Setting, Regulatory, Supervisory and Central Bank Bodies. These currently include the International Association of Insurance Supervisors (IAIS), IOSCO, the Basel Committee, Committee on Payment and Settlement Systems (CPSS), Committee on the Global Financial System (CGFS) and the IASB. New members could be included in the future. Article 5(2) of the Charter states that '*the eligibility of Members will be reviewed periodically by the Plenary in the light of the FSB objectives*', implying that members may be excluded or removed from the FSB.

[32] Article 11 and Annex A, Charter of the Financial Stability Board 2009 (June 2012), containing the list of member jurisdictions and the allocation of the seats. The FSB membership extends to the major international financial institutions, including the IMF and the WB, and the international standard setting bodies (SSBs).

of a careful examination of reasonable criteria for membership. As a consequence, not all the countries that are of financial systemic relevance are members of the FSB. Nonetheless, as one of FSB's principal issues is the impact of each jurisdiction on the stability of the global financial system, the FSB is paying increasing attention to the ways of fostering interaction between FSB members and non-members, in particular establishing Regional Consultative Groups and promoting compliance with international standards among non-member countries.

Since its renovation the FSB has become a standard-setter itself and in its first year issued some sets of Principles (for *Cross-border Cooperation on Crisis Management*; *Sound Compensation Practices and its Implementation Standards*). Along with this development of its functions, of greater significance may be the fact that the principles can be seen not only as regulatory tools aimed at affecting behaviour, but they can also have a 'symbolic significance' as they can contribute to define the issuer's role in the regulatory regime. They address not only the market actors in order to regulate their behaviour, but also national regulators in the broadest sense. Lastly, by focusing on implementation they are benchmarks that are being used to assess national regulatory regimes. Consequently, '*the development of the FSB's role as standard-setter is a step towards establishing its position as overall coordinator, manager, and enforcer of the international regulatory regime*'.[33]

As it is well known by regulators, setting principles and/or rules is only the first part of their work. How and to what extent they are complied with is a cornerstone in regulatory procedures. Various mechanisms are already in place for monitoring the implementation of international financial standards and for reviewing their effectiveness.[34]

First of all, the Financial Sector Assessment Program (FSAP) represents an independent assessment of compliance with international financial standards. The origin of this mechanism goes back to the time when FSF was created and the IMF and World Bank established

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[33] J. Black, 'Restructuring Global and EU Financial Regulation', p. 22, and see further: J. Black, 'The Rise, Fall and Fate of Principles Based Regulation' in: *Law Reform and Financial Markets*, K. Alexander and N. Moloney (eds.), Cheltenham 2011.

[34] As mentioned in the FSB 'A Coordination Framework for Monitoring the Implementation of Agreed G20/FSB Financial Reforms', 18.10.2011, such mechanisms include the IMF-World Bank Financial Sector Assessment Program (FSAP) and Reports on the Observance of Standards and Codes (ROSC) assessments; FSB thematic and country peer reviews and progress reports; and monitoring and review processes carried out by SSBs.

the FSAP to evaluate compliance of member countries with the international financial standards (the twelve prioritized standards) that the FSF sought to promote worldwide.

With regard to the FSAP, the distrust of some developing countries towards the international standards regime led to the decision to make this process voluntary and to allow governments to block the publication of results. In a like manner developing countries also requested that participation be voluntary in the preparation of the IMF's Reports on the Observance of Standards and Codes (ROSC). One reason for this wariness towards the international standards regime could have been their low representation in the FSF and in the international standard-setting bodies. Undoubtedly some of these bodies were dominated by advanced industrial countries and the adequacy of the standards for developing countries was often questioned.[35]

Unlike the previous conditions, the FSB imposes an obligation on members to implement the main international financial standards as well as the standards established by the FSB on its own initiative, while FSB members have agreed to undergo an assessment under the FSAP review process every five years and to make the Reports public. Promoting compliance through such an instrument, the focus of the FSB has been on jurisdictions that could pose risks to financial stability because of their position in the financial system and their low compliance with the relevant standards.

The peer review system set up by FSB includes not only the FSAP as a country-based review to ensure the implementation of recommendations in the G20 member jurisdictions, but also reviews on a thematic basis to monitor compliance with the FSB's standards.[36] As stated in a FSB document, '*the added value*' of peer reviews will come '*from the cross-sector, cross-functional, system-wide perspective brought by its members*'. Moreover '*dialogue with peers will be a key benefit*'.[37] In the context of this cooperative dialogue with regulators

[35] E. Helleiner, 'What Role for the New Financial Stability Board?', p. 283 who summarizes the tensions between different sorts of countries and within the standard setting bodies, on the basis of many studies of political scientists quoted in the paper.

[36] See, e.g. Thematic Reviews on Compensation (2010 and 2011); on Risk Governance (2013); on FSB Principles for Reducing reliance on CRA ratings (2013 and 2014).

[37] FSB, 'Framework for Strengthening Adherence to International Standards', 9.01.2010, p. 2. '*The dialogue with jurisdictions has four purposes: – to examine a jurisdiction's compliance against international supervisory and regulatory standards relating to cooperation and information exchange; – to examine the reasons for shortcomings*

and financial supervisors of the countries involved, the role of peer reviews could be considered twofold: providing technical assistance and ensuring compliance. As underlined by many commentators, the FSB's attitude is tending towards the latter.

However the FSB has no direct means to either promote or enforce compliance, and the practical consequences of non-compliance remain unclear and ambiguous. Nonetheless it is developing a 'toolbox' composed, on the one hand, of some 'positive' measures aimed at providing advice and technical assistance and, on the other, in case of insufficient compliance, of 'negative' measures such as signing multilateral Memoranda of Understanding so that standard-setting bodies can assist them in achieving a greater adherence.[38] Hence pressure on non-cooperative jurisdictions has been encouraged by the G20 leaders.

While the priority objective and the ambition of the FSB is to promote worldwide compliance with regulatory and supervisory standards on international cooperation and information exchange, the focus is '*on the adherence of the FSB members and other jurisdictions that rank highly in financial importance*'.[39] In this regard the FSB's

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in adherence; – to discuss the jurisdiction's progress in meeting the relevant recommendations set out in any ROSC; and to make recommendations on steps to improve compliance. The FSB will form an expert team to examine all relevant, existing information, including information provided by the authorities on developments since the latest IMF-World Bank ROSC. The expert team will be composed of specialists in banking, insurance and securities regulation and supervision as appropriate. The expert team will engage in dialogue with the jurisdiction and, if needed, encourage the authorities to request a new assessment of compliance from the IMF/World Bank, either through a Financial Sector Assessment Programme assessment or through stand-alone ROSCs', FSB, 'Promoting Global Adherence to International Cooperation and Information Exchange Standards', 10.03.2010, p. 2.

[38] FSB, 'Promoting Global Adherence to International Cooperation and Information Exchange Standards', pp. 3, 11–12 and Annex D: 'Toolbox of possible measures to promote the implementation of international financial standards'. In November 2011 the FSB published a list, available at: http://www.financialstabilityboard.org/publications/r_111102.pdf (last visited 17.07.2014) of all jurisdictions evaluated to recognise the progress that most jurisdictions evaluated by the FSB under the current initiative have made towards implementing international cooperation and information exchange standards, and to incentivise improvements by those jurisdictions not fully cooperating, see: 'Status update – 2 November 2012'.

[39] '*The FSB prioritised a pool of about 60 jurisdictions for evaluation, including all 24 FSB member jurisdictions together with non-FSB jurisdictions that rank highly based on a combination of economic and financial indicators. (The ranking process is described in more detail in Annex B of the November 2011 statement)*', see: 'Global Adherence to Regulatory and Supervisory Standards on International Cooperation and Information Exchange – Status Update – 18 December 2013', p. 2.

Charter includes provisions for non-member countries to take part in its working groups, standing committees and plenary meetings.[40]

In addition it is affirmed that the FSB should consult widely with non-members '*in the development of the FSB's medium- and long-term strategic plans, principles, standards and guidance*', and that '*[t]his process shall include engaging with the FSB Regional Consultative Groups and include an outreach to countries not included in the Regional Consultative Groups*'.[41]

Regarding the need to develop '*a more ambitious mechanism to provide voice for non-members*', a number of proposals have come up over time. Formerly the 'de Larosière report' suggested, in 2009, that in view of the high role proposed for the FSF ('*promoting the convergence of international financial regulation to the highest level benchmarks*' along with international standard setters), the FSF had to include all systemically important countries and to report to the IMF's International Monetary and Financial Committee (IMFC)[42]. Later it was stated that a reasonable solution would be to make the FSB accountable not to the forum of the G20 leaders but to a more universal body such as the IMF. This proposal followed a previous one aimed at opening the membership of an FSB-like body to all IMF and World Bank members.[43]

At the moment the FSB reports to the G20 leaders. This accountability to the leaders of the most powerful states in the world provides the FSB with greater relevance in global economic governance. However its future relies strictly on the role and the cohesion of the G20 and on its legitimacy *vis-à-vis* non-G20 countries in the long term.

This relationship between the G20 and FSB can be linked to a model of accountability, i.e. horizontal accountability, prevailing in the global system where the legitimacy of transnational regulators can be enhanced when they are able to report to other bodies acting in the same global space. In addition accountability can also be fostered when a wide range of stakeholders are increasingly involved and participate

[40] 'The Chair can extend, after consultation with Members, ad-hoc invitations to representatives of non-FSB Members to attend the whole or part of the Plenary Meetings', FSB Charter, Article 10(3).

[41] FSB Charter, Article 3.

[42] The High-level Group on Financial Supervision in the EU, chaired by J. de Larosière, Report, Recommendation 25, p. 61.

[43] For the first proposal, see: E. Helleiner, 'The Financial Stability Board and International Standards', *CIGI G20 Papers*, No. 1/June 2010, p. 7; and for the second, see: Department of Finance, Government of Canada, International Supervisory and Surveillance Initiative, 1998, as quoted in E. Helleiner.

actively in the procedures and decision-making of transnational institutions.[44]

While FSB needed to increase its legitimacy by providing a wider representation in its deliberations, the Charter allows for consultation '*with other stakeholders including private sector*' as well as non-member authorities. Moreover it notes that '*in the context of specific sessions of the Plenary, the Chair can also invite, after consultation with Members, representatives of the private sector*'.[45]

No doubt global regulators are seeking to enable all the stakeholders acting in the financial system to have their voice heard in 'standard-making' procedures, although at a different level and in different roles. However in this context the FSB needs to develop transparent procedures and to give 'societal interests' a better representation in the international regulatory structure. Otherwise the provisions of the Charter can be criticized on the assumption that FSB can act in favour of the 'private sector', and can run or could have run the risk of being 'captured' by private groups and interests.[46] Having regard to the conditions foreseen by other regulators to reduce the influence of the public sector, the FSB should also minimize the problem of 'revolving doors' and, with regard to consultations, should develop procedures where the private sector can be represented and heard.[47]

[44] It is worth noting that accountability is a concept of a multifaceted and complex nature, and there is also great confusion about its relationship with independence. It has been stated that '*properly-designed accountability mechanisms keep an independent supervisory agency "under control" but do not directly control its policies and practices*'. Thus '*a crucial factor in the global financial crisis was that weak public oversight of financial regulators and supervisors had allowed those guardians to design and maintain policies that favoured the financial sector in the short term but which were ultimately highly destabilizing*', E. Ferran, 'Institutional Design for Financial Market Supervision: The Choice for National Systems', p. 16.

[45] FSB Charter, Articles 3(1) and 10(3).

[46] See, especially: E. Helleiner and T. Porter, 'Making Transnational Networks More Accountable' in: *Re-defining the Global Economy*, S. Burke (ed.), *Friedrich Ebert Stiftung Occasional Paper*, No. 42/2009, p. 14; A. Baker, 'Restraining Regulatory Capture? Crisis Politics and Trajectories of Change in Global Financial Governance', *International Affairs*, Vol. 86(3)/2010, p. 647.

[47] *Macro-prudential regulation requires regulators to take a strong stance against market trends, such as cyclical booms or growing concentration and risk taking within the financial system. If regulators' relationships with private market actors are too cosy, this role cannot be performed well*', E. Helleiner, 'The Financial Stability Board and International Standards', p. 16.

4. What role could the FSB play to ensure stability in the global financial system?

The FSB was established as 'coordinator' of standard-setting bodies and, in a different perspective, as 'network' of regulators.

It is a widely-held opinion that the lack of international coordination in regulation was at the heart of the financial crisis. Hence the idea of strengthening cooperation between national regulators has been seen as part of the policy response, including by means of existing networks responsible for international regulatory standard-setting. In recent decades, 'policy networks'[48] have represented the new form of cooperation and coordination that nationally-based regulatory agencies have used to adapt to the tendencies of the global financial system, including the Basel Committee on Banking Supervision (BCBS), the International Organization of Securities Commissions (IOSCO), the International Accounting Standard Board (IASB), and the International Association of Insurance Supervisors (IAIS). Regulators have tried to achieve convergence on minimum standards by means of 'soft law' and to ensure compliance by sharing information and best practices as well as moral suasion.[49]

In this perspective the FSF, created with a pragmatic approach toward gradually redesigning the international financial architecture, initially played the role of coordinator of rules issued by other bodies. An important FSF initiative was to collect international standards relevant for the stability and correct functioning of financial systems in the *Compendium of Standards*.[50]

The G20 response to the crisis has placed the FSB at the centre of intensified regulatory cooperation. As illustrated in part 2 of this paper, the FSB has played a key role in developing global financial regulation not limited to constantly monitoring the evolution of

[48] For a definition of this term, see, above all: A.M. Slaughter, *A New Global Order*, Princeton 2004.

[49] With respect to the FSB as 'a soft law system', see: D.W. Arner and M.W. Taylor, 'The Global Financial Crisis and the Financial Stability Board: Hardening the Soft Law of International Financial Regulation?', *AIIFL Working Paper*, No. 6/June 2009, p. 14. For a more general discussion on the role of soft law in the financial system, see: Ch. Brummer, *Soft Law and the Global Financial System. Rule Making in the 21st Century*, Cambridge 2012.

[50] The rules collected in the Compendium are partially produced by the bodies that are members of the FSF/FSB, and partially by other organizations. Currently this also represents a tool for coordinating numerous bodies involved in financial governance and for widening the perimeter of the FSB coordination activity.

financial markets and coordinating some other standard setters. Instead, unlike its predecessor, it has promoted, on the one hand, principles and guidelines on its own initiative and assumed the role of standard setter, and on the other hand has improved compliance by means of peer review procedures.

Furthermore it has assumed the role of linking the G20 and the standard-setting bodies, implementing guidance proposed by the former and coordinating the activities of the latter. As for the interaction between the G20 and the FSB, the Board has not only increasingly formulated priorities for the reform of financial regulation but has also extended the perimeter of its own activities by establishing principles and new tools aimed at promoting the implementation of standards in national orders. As for the relationships between the FSB and standard setters, the new mandate foresees periodic reviews aimed at ensuring that these bodies respect the established priorities. The Coordination Framework (2011) makes it clear that the limits of the FBS's role as coordinator of the international regulatory regime are well-defined. Over its early initial years the FSB has been able to reinforce its position as central coordinator, but only within the G20 mandate.[51]

At the heart of this post-crisis reform there is also a renewed cooperation among governments strengthened by the mechanism of the G20 summits and the role of the FSB as an 'umbrella-organisation' responsible for ongoing coordination of governments, national financial regulators, transnational bodies and networks in order to manage macro-prudential oversight and surveillance on systemic risk.[52]

The innovations introduced into the international financial architecture do not provide a radical alternative to the pre-existing structure. All in all, the new architecture of the financial system is only an evolution of the previous one since the most relevant characteristics have been maintained such as the option for soft law and non-binding mechanisms of cooperation and coordination,

[51] '*The motivation for having such a framework is ultimately to ensure that the agreed G20/FSB financial reforms are effectively implemented and have the intended results on global financial stability. Given its mandate and its diverse membership, the FSB is well-positioned to assess the overall coherence and consistency of implementation efforts across its members and to alert relevant bodies of any significant impediments or unintended consequences to implementation*', FSB, 'A Coordination Framework for Monitoring the Implementation of Agreed G20/FSB Financial Reform', 18.10.2011, p. 3.

[52] A. Enria and P.G. Teixeira, 'A new institutional framework for financial regulation and supervision', p. 13.

the traditional balancing between national and international levels, and the lack of supranational powers.

Nonetheless, at the Los Cabos Summit (June 2012) the G20 took the decision to gradually give the FSB more formal autonomy and established the Board '*on an enduring organisation footing, with legal personality, strengthened governance, greater financial autonomy and enhanced capacity to coordinate the development and implementation of financial regulatory policies, while maintaining strong links with the BIS*'[53] (the FSB is still hosted by the BIS in Basel). The FSB has now been established as an association under Article 60 of the Swiss Civil Code. The FSB Plenary approved the Articles of Association in January 2013, although the FSB Charter is still the primary document governing the FSB's activities and decision-making.

This innovation has seen the FSB slowly transformed from a loose and informal network into a more structured organization. However it is uncertain whether the FSB will become an even more permanent and enduring body, since the FSB Articles of Association are binding only under Swiss law. At the international level the Charter remains a non-binding agreement between FSB members. No doubt the FSB's informal structure is in contrast with the other pillars such as the IMF, WB and WTO, which are based on international treaties and enjoy legal personality.

As often recalled, the re-design of the regulatory framework in the wake of the crisis was deeply debated. Following the initial set of reforms, aimed at defining a more strict distinction between micro- and macro-prudential supervision and establishing new bodies such as the European Systemic Risk Board,[54] or redefining pre-existing bodies as in the case of FSB, the debate about reshaping the governance of the financial sector, especially at EU and global levels, hasn't been so widespread and intense, perhaps owing to an assumption that the present financial system could be improved only a little if at all.

However rethinking the organizational structure can lead the discussion to focus on a key question, i.e. what is the most appropriate criterion in the financial sphere for managing a set of regulatory actors, their relationships and their behaviour within a complex and dynamic system?

[53] G20 Leaders declaration, Los Cabos, Mexico, 19.06.2012.

[54] Regulation (EU) No 1092/2010 on European Union macro-prudential oversight of the financial system and establishing a European Systemic Risk Board, OJ 2010 L 331/1.

The future of the architecture of financial stability depends on the choice between two opposite modes of organizing supervision: whether through a hierarchical organization or by promoting coordination in a loose and complex network structure of a multiplicity of different financial bodies and international 'fora'.

In the view of some commentators, given the rise in systemic risks and the characteristics of the current financial system, the way forward must involve '*the substitution of this loose network with a hierarchical structure more akin to the one used in the WTO*', since '*the evolution of the financial system requires the creation of a new multilateral financial body with authority to settle disputes and to impose its decisions*'.[55] This model has been the basis for proposals to add the FSB as a 'fourth pillar' to the architecture of cooperation established after the Second World War.

If the FSB were to move to the WTO model, some new mechanisms would have to be established. Firstly, in the case of non-compliance by member countries, the membership obligations should be enforced by putting in place a more forceful approach similar to the WTO's dispute settlement mechanism. However member countries might not accept such an enhanced power of the FSB and their commitments to international standards, since the new FSB's membership rules remain non-binding in a legal sense, based on the declaration of the FSB Charter that it is '*not intended to create any legal rights or obligations*'.

Secondly, the alternative of a more structured and hierarchical institution would mean that international prudential standards must be harmonized on a worldwide basis, including the rulebooks of national regulators. Achieving harmonization is a highly problematic objective because the FSB's decision-making body, the Plenary, is composed of all the members, and operates on the consensus principle. As long as the priority task for the FSB is to develop appropriate international standards and to create consensus on their content, there is the risk that achieving consensus may become more difficult if there were an increased number of countries in the decision-making bodies.

The problem with decision-making based on consensus is that it provides any member state with a right of veto. The enlargement of FSB membership and the participation in decision making of different types of countries (i.e. developed, developing, systemically significant

[55] L. Garicano and R.M. Lastra, 'Towards a New Architecture for Financial Stability: Seven Principles', *Journal of International Economic Law*, No. 3/2010, p. 619. Instead of proposing a newly revised FSB, the authors suggest that the IMF would be '*the institution best placed to adopt the role of "global sheriff" with regard to international financial stability*'.

and not) could influence the standard-setting process.[56] The FSB may be unable to maintain global financial stability and promote standards harmonization in the G20 member countries, much less able to do so in the non-G20 countries. Extending the perimeter of its influence would mean that the FSB must adjust the basis of its legitimacy and reduce or even eliminate its reliance on the G20 mandate.

As emphasized above, the FSB has sought to expand its base of legitimacy by means of promoting consultation beyond the G20 countries and fostering the role of the Regional Consultative Groups. However, FSB members may fear '*that giving greater autonomy to the FSB would risk the body moving away from its core role of coordination and oversight into a more "regulatory" role*'. Therefore it is hard not to agree with the opinion that '*in the field of financial regulation, there is definitely no desire at present to move towards a body operating in a fashion similar to the other pillars*' such as WTO and IMF.[57]

Undoubtedly such a development would represent, compared to the current institutional structure, a radical change whereby new global supervisors would operate independently of their governments and would gain a superior position *vis-à-vis* networks of national authorities, and in addition be granted their own enforcement and compliance powers. Any reform proposal moving to such a hierarchical authority for the financial system appears highly unlikely inasmuch as states everywhere do not wish to create independent global institutions and to provide them with supranational powers.

Unlike these calls for a more hierarchical architecture for the financial system, there are also numerous opinions recognizing that the choice of a form of 'informal' governance based on intergovernmentalism instead of the formal institutional form represented by the IMF and WTO, follows a trend in global governance towards looser networks and cooperation.[58]

[56] The participation of developing counties in rule-making '*must translate into real influence […]. In this respect it is discouraging that the new steering committee and all three of the new standing committees were chaired initially by officials from developed countries*', E. Helleiner,'What role for the New Financial Stability Board?', p. 287.

[57] J. Wouters and J. Odermatt, 'Comparing the "Four Pillars" of Global Economic Governance: A Critical Analysis of the Institutional design of the FSB, IMF, World Bank and WTO', *Leuven Center for Global Governance Studies Working Paper*, No. 128/ December 2013, p. 14.

[58] '*The "horizontal" approach of intergovernmental co-operation (through the "Gs" and the standard setting bodies) was preferred over an institutional "vertical" approach (involving an international organization such as the IMF to head the process)*' as affirmed by M. Giovanoli, 'The Reform of International Financial Architecture After the Global Crisis', *New York University Journal of International Law and Politics*, No. 81/2009, p. 90.

Although some criticism for the FSB's informality can be heard here and there, it is broadly agreed that the lack of formal decision-making and voting procedures makes it easier to converge on certain issues. Ensuring financial stability is a duty of member authorities and central banks and it may be more efficiently attained by monitoring and supervisory mechanisms, establishing guidelines and exchanging best practices rather than through legal and enforceable measures.

The FSB report to the G20 at the Los Cabos Summit focused on 'flexibility' as one of its strengths and affirmed that '*the FSB should remain a flexible, responsive, member-driven, multi-institutional and multidisciplinary institution*', and that it '*considers a treaty-based inter-governmental organisation not to be an appropriate legal form at this juncture*'.[59]

Furthermore the FSB has no power of implementation and enforcement of binding commitments, but rather resorts to different tools to ensure compliance such as monitoring and peer review. As observed above, the FSB seeks to achieve these tasks with the help of more powerful international bodies such as the IMF and World Bank.

Organizations working in the financial regulatory space have reached a certain degree of supervisory cooperation at the global level and especially in the field of global financial stability are engaged in cooperation like that between the FSB and the IMF for macro-prudential oversight.

As stated in the Charter, the FSB will '*collaborate with IMF to conduct Early Warning Exercises*'[60] that are intended to improve the analysis of systemic risks.[61] In this jointly-carried-out activity, we can see a sort of

In addition, see: J. Wouters and J. Odermatt, 'Comparing the "Four Pillars" of Global Economic Governance', pp. 14, 21; D. Zaring, 'Finding Legal Principles in Global Financial Regulation', *Virginia Journal of International Law*, No. 3/2012, p. 713; E.J. Pan, 'Challenge of International Cooperation and Institutional Design in Financial Supervision: Beyond Transgovernmental Networks', *Chicago Journal of International L*aw, No. 11/2010, p. 243.

[59] FSB, report to the G20 Los Cabos Summit on Strengthening FSB capacity, resources and governance, 18-19.06.2012, points 1 and 11, available at: http://fsbwatch.org/news/146-fsb-reports-to-the-g20-los-cabos-summit (last visited 19.07.2014).

[60] FSB Charter, Article 2(1). See also: A. Enria and P.G. Teixeira, 'A new institutional framework for financial regulation and supervision', p. 14, with regard to the five main layers involving the cooperation between the FSB and the other global financial bodies in the process for achieving regulatory repair and supervisory convergence.

[61] One the G20's first reactions to the crisis was to task the IMF and FSB with establishing a joint Early Warning Exercise (EWE). As the EWE has evolved through multiple iterations, several guiding principles and modalities have evolved: – the key output of the EWE is a confidential presentation of risks and vulnerabilities to the International Monetary and Financial Committee(IMFC); – to facilitate cooperation, the IMF and the FSB take non-exclusive leading roles in their areas of comparative strength.

'division of powers and responsibilities', whereby the IMF is responsible for economic and macro-prudential risk analysis and the FSB has greater responsibility with respect to regulatory and supervisory issues.

The FSB has had a direct role in the formulation of policies concerning cross-border systemic matters. One of the main examples is that of addressing the risks associated with systemically important financial institutions (SIFIs). The FSB promoted the creation of supervisory colleges and developed a policy framework for SIFIs in cooperation with standard setting bodies.[62] Moreover, the FSB has taken into account other pressing issues for the global economy, such as ending the 'Too Big-To-Fail' institutions,[63] reform of OTC derivatives[64] and shortcomingsin the financial system.[65]

The IMF has led the work on macroeconomic and macro-financial vulnerabilities, while the FSB has taken the lead on vulnerabilities and regulatory challenges in the financial sector; – the EWE combines rigorous empirical analysis with surveys of experts and market intelligence. The findings of the EWE are steeped in extensive empirical research, aiming for a thorough quantitative analysis of vulnerabilities by drawing on a large number of empirical tools. The EWE does not aim to predict the timing of crises. Indeed, as the global crisis unfolded, the EWE has increasingly focused on the repercussions of risks that may have already materialized. For a complete description of the EWE's procedures and activities, see: IMF, 'The IMF-FSB Early warning Exercise' Design and Methodological Toolkit, September 2010.

[62] See FSB, FSB Report on Reducing the moral hazard posed by systemically important financial institutions, October 2010; and 'Intensity and Effectiveness of SIFI-Supervision' – Recommendations on enhanced supervision, November 2010, both available at: http://www.financialstabilityboard.org/list/fsb_publications/tid_165/index.htm (last visited 17.07.2014).

[63] See FSB, 'Progress and Next Steps Towards Ending "Too-Big-To-Fail" (TBTF)', Report of the FSB to the G-20, 2.09.2013. '*[The SIFI] framework [endorsed by the G-20 leaders at the Seoul Summit in 2010] addresses the TBTF issue by reducing the probability and impact of SIFIs failing. It comprises requirements for assessing the systemic importance of institutions, for additional loss absorbency, for increased supervisory intensity, for more effective resolution mechanisms, and for stronger financial market infrastructure*'. The G-20 leaders were given advice to renew their commitments to address TBTF especially in six areas: 1) legislative reform; 2) removing obstacles to cross-border resolution; 3) improving the resolvability of firms' structures and operations; 4) considering domestic structural measures that are complementary to en effective SIFI Framework; 5) implementing policy measures for domestic systematically banks (D-SIBs); 6) removing obstacles to supervisory effectiveness.

[64] See the FSB's last document: 'OTC Derivatives Market reforms' Seventh Progress Report on Implementation, 8.04.2014, where it is affirmed that '*Key international policy standards have been finalised in most commitment areas and work on the remaining standards is on track to be finalised by the November 2014 G20 Leaders Summit. Most jurisdictions have completed necessary reforms to legislative frameworks and are developing or bringing into force detailed rules where required*'.

[65] See the Letter of the FSB's Chairman to G20 Finance Ministers and Central Banks Governors, 4.04.2014, on the priorities for completing reforms by the Brisbane Summit.

5. The way forward

Given the important role played by the FSB in global economic governance after the crisis, its informal structure could be considered as no longer adequate to attain the necessary level of influence in the global economy. Nonetheless, it needs to be noted that even in latest point of view of the FSB and its Plenary there is little support for '*moving to a constituency-based membership*' and making '*discussion more rigid*', and it considers '*the current number of 70 members as the upper limit consistent*' with both effectiveness and representativeness. Moreover, it noted that '*members agree to use the flexibility that exists within the FSB's rules to enable relevant authorities within jurisdictions to participate in, or be informed of, the policy work that takes place in the FSB's standing committees and working groups*'.[66]

The FSB emphasizes its role as 'coordinator' and argues that it is not the appropriate body to work with a rigid institutional structure and formal decision making since it was established to coordinate other important actors involved in ensuring financial stability, and not to harmonize or impose international legal rules.[67]

Coordination is a difficult challenge and especially after the crisis possible ways forward, sometimes based on opposite premises, have emerged. Here we can refer to some different approaches.

Firstly, as the G20 has intensified the effort for a stronger international standards regime, some critics have contested the feasibility of the so-called 'one-size-fits-all' global standards model, arguing that a more effective strategy might be to promote core principles and enhance coordination only at the level of broad principles. One further benefit of principle-based *vis-à-vis* rule-based regulatory cooperation is that it might mitigate or thwart the possible increase in financial instability if the rules are of low quality and/or not appropriate.[68]

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[66] Letter of the FSB's Chairman to G20 Finance Ministers and Central Banks Governors, 4.04.2014, on the priorities for completing reforms by the Brisbane Summit, p. 4.

[67] See J. Wouters and J. Odermatt, 'Comparing the "Four Pillars" of Global Economic Governance', p. 22.

[68] Some analysts maintain that detailed harmonized international rules are too inflexible and may increase instability. So they argue that a more principles-based approach might be not only politically realistic but also desirable. For this perspective see, e.g. D. Rodrik, 'A Plan B for Global Finance', *The Economist*, 12.03.2009; Warwick Commission Report, 'The Warwick Commission on International Financial Reform: In Praise of Unlevel Playing Fields', University of Warwick 2009, available at: http://www2.warwick.ac.uk/research/warwickcommission/financialreform/report/ (last

Secondly, some analysts, as illustrated above, have advocated the enhancing of hard law commitments and enforcement and creation of a 'financial WTO' or of a single 'world financial regulator'. But currently such a development at the global level is unlikely politically. In a polycentric regime where there is wide dispersion of authority among numerous financial institutions and regulators, the FSB has to face many challenges if it attempts to gain the position of 'hierarchical leader'. In many respects the FSB is cooperating/competing with some of its own members as standard setter and often as the 'watch-dog' of implementation and it is interacting with national governments that are unwilling to transfer sovereignty to international bodies or to accept common standards or modes of supervision.[69]

Considering, as assumed in part 1 of this paper, that systemic risk focuses on risks to the financial system, the main goal of regulating/preventing systemic risks is to preserve stability of the financial system, since this would prevent a breakdown that could impact on national economic security and generate high social costs.[70] Because of the common element involved in systemic risks, sometimes referred to as 'the domino effect', protecting financial stability calls for fostering macro-prudential oversight by gathering and analysing information, reducing fragmentation of responsibility for macro-prudential analysis, issuing warnings and recommendations, and monitoring compliance.

The question is whether the architecture of the international financial system needs to be revised, and if so, how? After the crisis we are more and more aware that managing global financial markets makes contradictory demands concerning organizational design.

Another question often raised is whether the FSB, in its various roles as coordinator, standard-setter and monitor, is able to prevent systemic risks. First of all, the FSB works within the current soft law framework and lacks legal power to impose implementation upon recalcitrant members. Second, the legitimacy of the FSB is questioned because of its limited membership, which is deemed to undermine its capability to establish rules with global impact. Non-member jurisdictions could always challenge financial standards established to promote global compliance. Third, a further question is whether the FSB is equipped

visited 12.07.2014), and the references in E. Hellneir, 'What Role for the New Financial Stability Board?', pp. 288–289. For a general overview of Principles-Based Regulation and its role prior to and after the crisis, see: J. Black, 'The Rise, Fall and Fate of Principles Based Regulation'.

[69] J. Black, 'Restructuring Global and EU Financial Regulation', p. 45.

[70] S.L. Schwarcz, 'Systemic Risk', pp. 20–22.

with adequate organisational support (the FSB has only a tiny staff and a small Secretariat as compared to the IMF or WTO) to enable it to manage the challenges it faces and to maintain its relevant position in global financial governance. Last but not least, the FSB's position and its role in the financial architecture can be also defined on the basis of its capability to put in place early warning systems and mechanisms to prevent or reduce the impact of any future crisis. In this context the supposed 'regime manager' is seeking to steer the regime, but its role is contested when the other actors try to maintain their own autonomy, and compliance remains uncertain.