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The Development of an Appropriate Regulatory Response to the Global Financial Crisis

Abstract
Recurring financial crises are part of the cyclical nature of a free market economy, though what is remarkable is that people often fail to learn from the previous mistakes that cause these crises. One reason for this could be that there has been a relative calm on Main Street which belies the occasional turbulence on Wall Street. Another reason is that people learn the wrong lessons. Thus reserve banks have tended to concentrate on managing inflation and unemployment levels whilst being relatively complacent about the growing risks engendered by sophisticated and risky derivatives that were hidden within the so-called 'shadow banking system'.

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THE DEVELOPMENT OF AN APPROPRIATE REGULATORY RESPONSE TO THE GLOBAL FINANCIAL CRISIS

JOHN H FARRAR, LOUISE PARSONS AND PIETER I JOUBERT*

Recurring financial crises are part of the cyclical nature of a free market economy, though what is remarkable is that people often fail to learn from the previous mistakes that cause these crises. One reason for this could be that there has been a relative calm on Main Street which belies the occasional turbulence on Wall Street. Another reason is that people learn the wrong lessons.[1] Thus reserve banks have tended to concentrate on managing inflation and unemployment levels whilst being relatively complacent about the growing risks engendered by sophisticated and risky derivatives that were hidden within the so-called 'shadow banking system'.[2]

The size and scope of the present global crisis makes it different in certain respects from earlier crises and highlights major defects in domestic and international regulatory systems. The purpose of this article, written in the midst of the crisis is, first, to survey the nature and causes of the crisis, secondly, to examine the current regulatory systems and their flaws, and finally to outline potential reforms. To attempt this during the crisis means that any proposals must necessarily be tentative since suggesting reform at the moment is akin to shooting at a moving target.

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* This article was conceived in February 2009 to reflect the theme of the special twentieth anniversary edition of the Bond Law Review. Because of the still-unfolding crisis and increasing volume of commentary on the global financial crisis, it was written in difficult circumstances. All three authors contributed to all parts of this article. John Farrar is Emeritus Professor of Law, Bond University, and Professor of Corporate Governance and Joint Director of the New Zealand Governance Centre at the University of Auckland. Louise Parsons is a Senior Teaching Fellow at Bond University and previously held the position of Senior Counsel at the South African Reserve Bank. Pieter Joubert is a Vice-Chancellor's Scholar currently studying a double degree in Law and Commerce at Bond University.

1 See Robert J Barbera, *The Cost of Capitalism* (2009) Chapter 1.

2 See Charles R Morris, *The Two Trillion Dollar Meltdown* (2009) 146 - 147.

The nature and causes of the present crisis[3]

The present crisis can be seen as one of four major financial crises of the last century. We shall compare it with the preceding three crises after first examining the causes of the current one.

The present crisis is the third since the beginning of modern globalisation commencing with the collapse of the USSR. Modern globalisation cast the USA in the role of lead player and this lacked the institutional support that characterised the Bretton Woods Agreement. As a consequence the present crisis started as the American subprime mortgage crisis, which due to globalisation subsequently and rapidly became a global financial crisis.[4] The collective causes of the crisis we are now experiencing have been classified below in an attempt at creating a topical and somewhat chronological overview of why we are now in the midst of such severe and global economic turmoil.

US housing and economic policy[5]

The subprime mortgage crisis was triggered by the collapse of housing prices in the United States and the subsequent losses suffered by investors in residential mortgage-backed securities. Somewhat ironically, the United States government had politically and economically through the course of the 20th century sought to advance both home ownership and affordability.[6] The establishment of the Federal Housing Administration, the Veterans' Administration, the Federal National Mortgage Association ('Fannie Mae'), the Federal Home Loan Mortgage Corporation ('Freddie Mac') and the Government National Mortgage Association ('Ginnie Mae') provided a defined infrastructure through which these policies could be implemented effectively. Accordingly, home ownership in the Unites States increased from approximately 63% in 1965 to an all-time high of 69% in 2005.[7] The increasing provision of subprime mortgages by private mortgage originators also had a significant role to play in this, with subprime mortgage originations comprising only

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3 Ibid. For a detailed discussion of financial crises, see Carmen M Reinhard and Kenneth S Rogoff, 'This Time is Different: A Panoramic View of Eight Centuries of Financial Crises' NBER Working Paper Series, Working Paper 13882.

4 See Morris, above n 3, Chapter 5.

5 Ibid. Chapter 3.

6 Dwight M Jaffee and John M Quigley, 'Housing Policy, Subprime Mortgage Policy, and the Federal Housing Administration' (Paper presented at the NBER Conference on Measuring and Managing Financial Risk, Evanston, Illinois, February 2007).

7 *Housing Vacancies and Homeownership – Historical Tables* (2009) U.S. Census Bureau <http://www.census.gov/hhes/www/housing/hvs/historic/files/histtab14.xls> at 9 May 2009.

7% of all mortgages issued in 2002. By 2006, this figure had risen to 21% of all mortgage originations.[8] As a result of these factors, the US housing market was highly profitable for many investors and more accessible to home buyers through the course of the 1990s and up until 2007.

This rapid growth in the housing market was exacerbated by excessive levels of cheap credit, which became available due to US Federal Reserve lowering interest rates to 1% in mid-2003, with the real, inflation-adjusted federal funds rate actually remaining negative for a period of 31 months.[9] This monetary policy-based response to the Dot-com Bubble has been widely criticised as one of the primary causes of the subprime crisis that began in 2007. It was not the sole driver though, as noted by economist Robert J Shiller, who points out that although low interest rates may have helped contribute to the housing bubble, house prices had been increasing for many years prior to this.[10] However the easy availability of credit and increasingly reckless provision of loans and mortgages did succeed in creating unsustainable growth fuelled by artificial demand, with a staggering example of this being the subprime mortgage market's growth from $160 billion in 2001 to approximately $540 billion in 2004.[11] As former Treasury Secretary John Snow later admitted: 'The Bush administration took a lot of pride that homeownership had reached historic highs, but what we forgot in the process was that it has to be done in the context of people being able to afford their house. We now realise there was a high cost'.[12] The US government did begin to realise this, and raised the federal funds rate from 2.5% at the beginning of 2005 to 5.5% the end of 2006,[13] raising mortgage repayments for many homeowners and interest rates for borrowers in the process. The combination of factors such as rising interest rates and the expiry of the 'honeymoon periods' of adjustable-rate mortgages led to a wave of foreclosures across the United States, in

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8 Jaffee and Quigley, above n 7, 24.

9 Robert J Shiller, *The Subprime Solution: How Today's Global Financial Crisis Happened and What to Do about It* (2008).

10 Ibid.

11 Charles Duhigg, *Pressured to Take More Risk, Fannie Reached Tipping Point* (2008) The New York Times <http://www.nytimes.com/2008/10/05/business/05fannie.html?pagewanted=2> at 7 May 2009.

12 Jo Becker, Sheryl Stolberg and Stephen Labaton, *White House Philosophy Stoked Mortgage Bonfire* (2008) The New York Times <http://www.nytimes.com/2008/12/21/business/21admin.html?pagewanted=1&_r=1> at 8 May 2009.

13 *FRB: Monetary Policy, Open Market Operations* (2008) Federal Reserve <http://www.federalreserve.gov/fomc/fundsrate.htm> at 5 May 2009.

some cases leaving entire neighbourhoods derelict.[14] Owing to the non-recursive nature of their loans, US homeowners could simply walk away from their properties when they could no longer meet the required repayments, leaving the now rapidly devaluing property to the bank or mortgage originator that had so keenly provided the finance for the loan in the first place.

Deregulation

Banks and mortgage originators were not the only ones suffering due to the sudden surge of defaults and decrease in house prices. More than a decade's worth of financial innovation had taken place in order to capitalise on the housing boom, and the use of securitisation and complex new derivatives resulted in millions of investors suffering financially through indirect exposure to the US housing market.

More than three decades of deregulation of the financial sector not only in the United States, but also in other parts of the world, would soon bring about the beginnings of the global financial crisis. The deregulation of the financial world was practically global, meaning that very few countries would be immune. Examples of the steps taken include the repealing of the *Glass-Steagall Act*, implementation of the *Gramm-Leach-Bliley Act* and the passing of the *Riegle-Neal Act* in the United States, whilst Australia scaled back the 'six pillars' policy and Europe introduced the Second Banking Directive. The combined effect of deregulatory measures such as these was the globalisation of financial markets and a lack of any clear distinctions between retail and commercial banks, securities dealers and insurance providers. The consolidation of companies and the convergence of financial products became increasingly common, resulting in fewer, larger financial institutions that offered more diverse and more complicated products. The number of US banks decreased by almost 30% from 1988 to 1997,[15] with a similar trend developing in other countries. With deregulation came a lack of sufficient financial oversight, which in turn increased Wall Street's ability to exploit regulatory gaps in the system. This lack of regulatory oversight was ideological, born of an excessive confidence in free markets to regulate themselves.[16] Added to this was the decline in professional standards

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[14] Thomas Clarke, 'The Causes of the Global Financial Crisis? The Impact of Recurring Crises in Anglo-American Corporate Governance' (Paper presented at the Inaugural Corporate Governance Conference of the New Zealand Governance Centre, University of Auckland, Auckland, 15 August 2008) 10.

[15] Allen N Berger, Rebecca S Demsetz and Philip E Strahan, 'The Consolidation of the Financial Services Industry: Causes, Consequences, and Implications for the Future' (1999) 23(2-4) *Journal of Banking and Finance* 135, 138.

[16] Morris, above n 3, Chapter 7.

amongst the gatekeepers, these being the credit rating agencies, company directors, auditors, corporate lawyers and investment analysts – who, as Oscar Wilde once said, could resist everything except temptation.[17]

In order to try to maintain regulatory oversight of these institutions, measures such as the Basel II Accord were introduced and implemented. However they often relied on a self-regulatory approach to key safety measures such as capital adequacy requirements. Various measures of risk management were explored, with systems such as the Value at Risk model (pioneered by J.P. Morgan) becoming the benchmarks for risk measurement. The key flaw with computer models such as Value at Risk was that they only ever predicted risk based on the historical volatility and a normal distribution. This left open the possibility of a 'Black Swan'[18] event taking place, in which a single shock could potentially have a devastating effect on the system due to the interconnected nature of financial assets and the systemic risk to which they were exposed.

Derivatives and financial innovation

Deregulation also allowed the development of a shadow banking system outside the scope of regulatory bodies. The manipulation of accounting provisions allowed the securitisation, holding and selling of derivatives to take place 'off the balance sheet', allowing firms to leverage their derivative exposures without this leverage being sufficiently disclosed to investors. Less than ten years ago the infamous hedge fund Long Term Capital Management ('LTCM') collapsed for this very reason.[19] LTCM was bailed out by Wall Street institutions in order to prevent their own collapse, as their fates had become inextricably linked to that of LTCM due to highly leveraged exposures. Following on from this came the collapse of companies such as Enron, WorldCom and other major US corporations which exposed fundamental weaknesses of the corporate governance system based on self-regulation and a lack of sufficient penalties.[20]

In recent years, rather than heeding these warnings and approaching derivatives cautiously, investment banks and hedge funds took advantage of cheap credit to

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17 See John C Coffee Jr, *Gatekeepers – The Professions and Corporate Governance* (2006).

18 Nassim Nicholas Taleb, *The Black Swan: The Impact of the Highly Improbable* (2007) New York Times <http://www.nytimes.com/2007/04/22/books/chapters/0422-1st-tale.html?pagewanted=2&_r=1&ei=5070&en=bdae1078f2b4a98c&ex=1178769600> at 9 May 2009.

19 Roger Lowenstein, *When Genius Failed* (2000). See also Thomas Clarke, *International Corporate Governance – A Comparative Approach* (2007) 114.

20 See Bethany McLean and Peter Elkind, *The Smartest Guys in the Room* (2003).

increase their leverage yet again. Gaps in the regulatory system allowed the development of SIVs (structured investment vehicles), which were classified as 'off-balance sheet' entities. SIVs could then securitise pools of mortgages and divide them into various tranches based on expected risk. Some of these tranches were afforded AAA ratings by credit ratings agencies, who faced significant conflicts of interest themselves.[21] The tranches could then be on-sold to investors, with the mortgage originators and the banks receiving a healthy fee income for their efforts. These derivative securities found their way across the globe, placing international investors at the mercy of the American housing market. In order to hedge the risk of these investments, credit default swaps were often entered into, which insured against the risk of the potential default of the underlying mortgages. A modern example of the cumulative effect of this chain can be found in the insurer American International Group ('AIG'). Formerly the world's 18th largest public company,[22] AIG suffered catastrophic losses due to a lack of sufficient collateral on a $526 billion[23] portfolio of credit default swaps held by AIG's Financial Services unit in London. The United States government has since been forced to bail out AIG at a cost of approximately $200 billion. This story was repeated many times over in the case of 'monoline' insurers who, true to their name, would often specialise in insuring against a particular loss.

Contagion and collapse

The collapse of Wall Street itself began in March 2008, when Bear Stearns, one of the oldest investment banks on Wall Street, was forced to provide emergency funding to two of its subsidiary hedge funds, who were heavily exposed to derivative investments. The marking down in value of these funds led to a corresponding decrease in Bear Stearn's share price, based on fears that the investment bank was too highly leveraged (at a ratio of approximately 35:1) and too heavily exposed to derivatives to survive. These fears proved to be correct, as in mid-March 2008, JPMorgan Chase acquired Bear Stearns for $2 per share, where the company had traded at $172 per share two years prior. A contagion effect was felt through Wall Street over the next five months as investors shied away from any company

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[21] See T Hurst, 'The Role of Credit Rating Agencies in the Current Worldwide Financial Crisis' (2009) 30 (2) *Company Lawyer* 61.

[22] *Forbes Global 2000* (2008) Forbes <http://www.forbes.com/lists/2008/18/biz_2000global08_The-Global-2000_Rank.html> at 3 May 2009. For a useful discussion see also E K Moran, 'Wall Street Meets Main Street: Understanding the Financial Crisis' (2009) 13 *North Carolina Banking Institute* 5.

[23] William K Sjostrom, 'The AIG Bailout' (Working Paper, Salmon P Chase College of Law - Northern Kentucky University, 2009).

suspected of derivative exposure or high leverage. Lehman Brothers, a 158 year old institution seen as a pillar of stability on Wall Street, was allowed to file for Chapter 11 bankruptcy in early September by the Federal Reserve. In hindsight, this was seen as the Fed's greatest mistake during the crisis,[24] as the collapse shattered what little confidence investors still had in the system. Paradoxically, Fannie Mae, Freddie Mac and AIG had already been bailed out on the premise of being 'too big to fail'. However the damage had already been done. With Lehman Brothers declaring bankruptcy, banks and lending institutions lost faith in each other and in the regulatory system. Interbank lending dried up almost overnight[25] and the market for short-term credit froze. Consumer and investor confidence immediately collapsed and stock markets around the globe began to plummet as investors withdrew their funds.

Initially governments and institutions faltered, unsure of how to respond to a systemic shock of this nature. There were then rhetorical calls for a new Bretton Woods, with an eventual rallying of governments and regulators, mainly through the activities of the Group of Twenty ('G-20'). While the USA is still a leading player on the global stage, it has had to abandon its pretensions of world leadership to adopt more of a team approach. Governments and central banks have had to assume new and increasingly interventionalist roles. It is a massive reversal of the orthodox policies of the last twenty years. The IMF, the World Bank and the OECD have seemed somewhat unsure of their roles, whilst the International Organisation of Securities Commissions ('IOSCO'), after a slow start, seems to have shown some initiative and enlarged its role. Likewise, the Financial Stability Forum has been strengthened and tasked with greater responsibility in light of the current crisis.

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[24] Michael McKee and Vivien Lou Chen, *Yellen Signals Letting Lehman Collapse Was a Mistake* (2009) Bloomberg <http://www.bloomberg.com/apps/news?pid=20601087&sid=aycrixRelVc0&refer=home> at 9 May 2009.

[25] Carrick Mollenkamp, Mark Whitehouse, Jon Hilsenrath and Ianthe Jeanne Dugan, *Lehman's Demise Triggered Cash Crunch Around Globe* (2008) Wall Street Journal <http://online.wsj.com/article/SB122266132599384845.html> at 9 May 2009. See Moran, above n 23, 23-24.

Brief comparisons with earlier major financial crises

The present recession can be distinguished from earlier recessions because it is centred in the financial system.[26] However it is still useful to briefly compare the current financial crisis with earlier financial crises.

The Wall Street Crash of 1929[27]

The 1929 stock market crash heralded the Great Depression. It arose due to a decline in real estate values after a period of speculation and excess on Wall Street during the Roaring Twenties. The stock market became severely unstable and the crash was a massive correction.

Economists and historians disagree as to the causes of, and the causal link to, the Great Depression. Milton Friedman argued that ultimately it was the collapse of the banking system which made the contraction so severe.[28] This shows obvious similarities to the present crisis – a decline in real estate values, a stock market crash, a failure of the banking system and a resulting recession or depression. However, the current crisis is distinguished because of the presence of significant lender of last resort assistance, and also the negative impact of the globalisation of financial markets due to derivatives trading.

The 1987 Crash[29]

The 1987 Crash has been described as a 'Black Swan' event as it challenged prevailing economic wisdom. It has been argued that the main causes were overregulation, program trading and market psychology. These collectively reflect the influence of cyclicality, the effect of automated systems (which linked the stock market to the futures market for the first time), and behavioural finance. The present crisis is inherently more complex due to the multiple causes and other complicating factors such as globalisation.

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[26] See Sir John Gieve, 'Economic prospects and the policy challenge' (Speech delivered at the Cityco Breakfast Meeting, Manchester, 16 January 2009).

[27] See J K Galbraith, *The Great Crash 1929* (1954).

[28] M Friedman and A Schwartz, *A Monetary History of the United States 1867-1960* (1963).

[29] See '1987: Shares plunge after Wall Street crash' (2008) BBC <http://news.bbc.co.uk/onthisday/hi/dates/stories/october/19/newsid_3959000/3959713.stm> at 14 May 2009. For a detailed analysis see *Report of the Presidential Task Force on Market Mechanisms*, (N F Brady Chairman), US Government Printing Office (1988).

The Asian Financial Crisis[30]

The Asian Financial Crisis began as a regional crisis centred on the collapse of various Asian currencies and subsequently became more widespread. The causes again are disputed. Some argue it was caused by a bubble fuelled by hot money and crony capitalism which led to distorted banking practices. Others argue that it was caused by massive currency speculation. Whatever the causes, there was controversial action taken by the IMF both before and after the crisis that possibly exacerbated the problems that ultimately led to a recession.[31]

The similarities with the present crisis are the speed with which it affected the international economy and the contagious way in which it spread to banks and the stock market.

The Dot-com Bubble of 2000[32]

The Dot-com Bubble was caused by irrational exuberance about the technology revolution taking place in the 1990s, where vast sums were invested by venture capitalists and the public in overvalued high technology companies. The market subsequently went through a drastic correction.

The distinctive features of this were the specialist nature of the companies and the lack of adequate due diligence. It had a relatively mild effect on the economy and the recession was correspondingly brief.

Overview of the present national and international regulatory systems and their weaknesses

A complete analysis of the financial crisis and markets involves consideration not only of legal rules and institutions, but also of economic, accounting and political factors. To attempt this is beyond the scope of the present paper.

While law remains central to governance of global financial institutions and markets, the relevant laws are a complex web of national laws and regulations of many countries; bilateral, regional and multilateral agreements and softer commitments, as well as the rules, decision(s) and recommendations of several key international bodies.

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30 See G G Kaufman, T H Krueger, W C Hunter, *The Asian Financial Crisis: Origins, Implications and Solutions* (1999).

31 For a defence see *The IMF's Response to the Asian Crisis Fact sheet* January 1999 (2005) IMF < http://www.imf.org/external/np/exr/facts/asia.HTM> at 14 May 2009.

32 See J Cassidy, *Dot.Con – The Real Story of Why the Internet Bubble Burst* (2002).

There are often many alternative ways of achieving the same regulatory objective, such as host country regulation, national treatment and the extraterritorial application of law; mutual recognition of home country regulation; harmonisation of national laws; and supranational regulatory bodies. The need for a comprehensive understanding and analysis provides a challenge to establish a consistent and coherent system of global governance. In particular, how the many different layers and types of legal rule fit together, and the divergent interests of states can be reconciled.

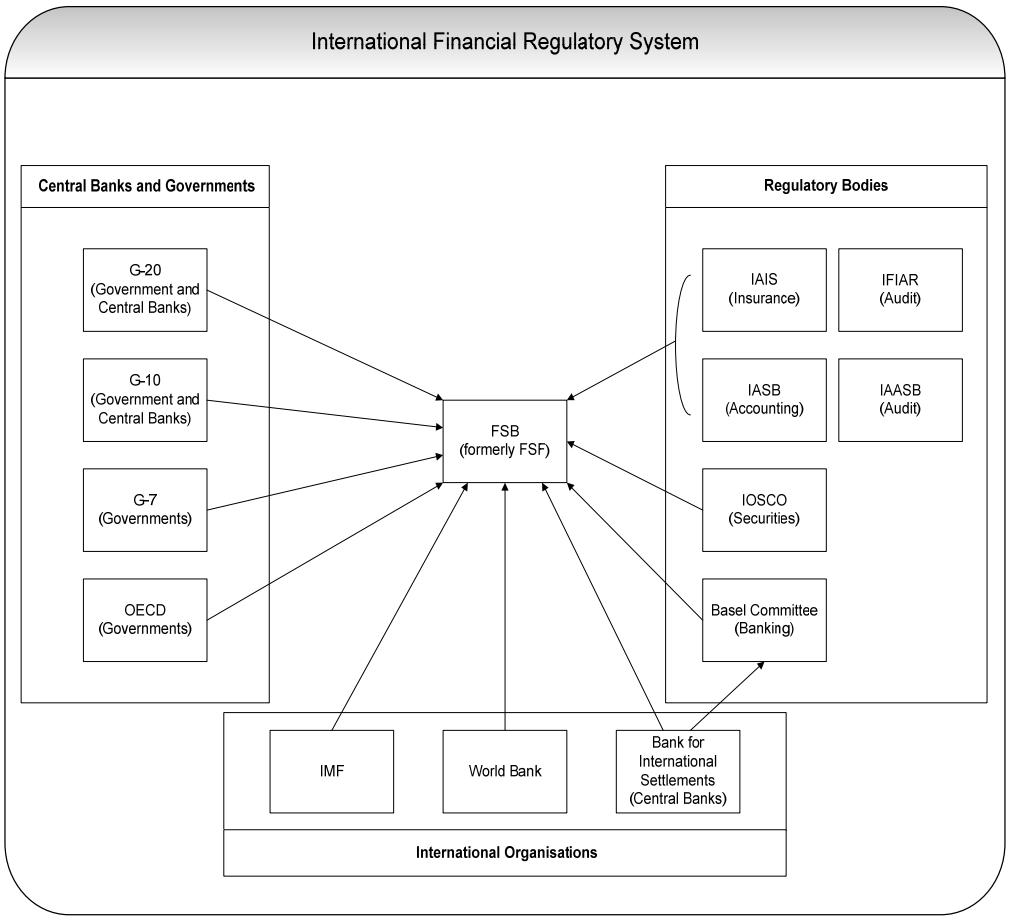
- A wide range of national laws and regulations are relevant: securities regulation; banking regulation; exchange controls; accounting standards; corporate governance; taxation law; bankruptcy law and laws that address money laundering and other illegal financial activities;
- There are a number of, generally bilateral, enforcement cooperation agreements relevant to securities law. More general enforcement cooperation regimes are also relevant, such as mutual legal assistance treaties and the Hague Convention;
- Several international organisations are relevant, in particular the IMF, Bank for International Settlements; GATS; World Bank; the OECD; International Organization of Securities Commissions; International Association of Insurance Supervisors; and International Accounting Standards Board; and
- Some of the issues dealt with by international organisations are also dealt with under bilateral and regional trade and investment agreements or intergovernmental groups like the G-8 and G-20 and by trade associations, such as the Bond Market Association, International Swaps and Derivatives Association, International Securities Market Association, International Primary Market Association, and the International Capital Market Association.

The current system is characterised by complexity and ineffectiveness due to there being too many organisations and committees. The system is built on three silos: banking, securities and insurance, and no longer reflects reality.[33] It is not suited to the urgency of dealing with the crisis in today's capital markets. It has not kept pace

[33] Members of the Research, Monetary and Capital Markets, and Strategy, Policy and Review Departments of the IMF argue that the fragmentation of expertise into silos will have to be overcome. Research, Monetary and Capital Markets, and Strategy, Policy and Review Departments IMF, approved by O Blanchard, J Caruana and R Moghadam *Initial Lessons of the Crisis* 6 February 2009, IMF <http://www.imf.org/external/np/pp/eng/2009/020609.pdf> at 9 March 2009.

with the growth in cross border activity, the increased use of derivatives without adequate risk management and the changing patterns of intermediation.[34]

The present regulatory structure is shown on the diagram below:[35]



[34] This discussion is based on an unpublished draft document produced by John Farrar, Susan Watson and Chris Noonan of the Department of Commercial Law, University of Auckland 'Governance of Global Financial Institutions and Markets: Consequences and Strategies for New Zealand.' See generally 'A regulatory response to the global banking crisis' (Discussion Paper 09/2, FSA, 2009) <http://www.fsa.gov.uk/pages/Library/Policy/DP/2009/09_02.shtm> at 14 May 2009.

[35] See also H Davies and D Green, *Global Financial Regulation – The Essential Guide* (2008), 33. The diagram in this book is derived from Sloan and Fitzpatrick, *Financial Markets and Exchanges Law* (2007), Chapter 13.

This shows a complex matrix with the banking, securities, insurance and accounting regulatory systems coming together in bodies such as the Financial Stability Forum ('FSF').

Domestic responses – central banks and governments

Domestic responses are generally the first responses to a financial crisis. We will now consider the roles of central banks and governments (the State).

The role of central banks

Central banks traditionally respond to financial crises with actions to reintroduce stability into the domestic financial system, reduce systemic risk and prevent systemic failure, and regain the confidence of the markets. A central bank is typically a creature of statute, from which it derives its powers and duties. There is a great deal of convergence between the nature, stature, powers and functions of different domestic central banks worldwide.

International cooperation between central banks

Whilst central banks traditionally focus on domestic financial systems and economies, the global financial crisis placed them in a position where they had to consider increasingly the globalised financial system as well as their domestic financial systems. Central banks in some countries at times even synchronised and coordinated their decisions and actions with those of central banks in other jurisdictions.[36] October 2008 saw unprecedented coordination between central bank actions when a number of central banks lowered interest rates[37] (six of the major central banks, including the Federal Reserve, the Bank of England and the European Central Bank all lowered their overnight fund rates within the first two weeks of October 2008).[38] These acts are significant for two reasons. First, central banks

[36] Sir John Gieve pointed out that '[t]his is not easy. In particular emergencies there are often different national interests at stake and the sheer pressure of events can limit cross-border consultation'. Sir John Gieve, 'Learning from the Financial Crisis' (Speech delivered at the European Business School London 2008 Europe in the World Lecture Panel Discussion, London, 19 November 2008).

[37] *Central banks cut interest rates* (2008) BBC News <http://news.bbc.uk/2/hi/business/7658958.stm> at 14 May 2009.

[38] Ben S Bernanke refers to 'unprecedented international policy coordination, within Europe but also globally', and states that 'central bankers have been working closely together throughout [the] period of financial turmoil.' Ben S Bernanke, 'Policy Coordination Among Central Banks' (Speech delivered at the Fifth European Central Banking Conference, The Euro at Ten: Lessons and Challenges, Frankfurt, Germany, 14 November 2008).

traditionally have a domestic focus, and domestic needs drive monetary policy. In the global financial crisis, domestic interests were clearly inseparable from international interests, and conceivably even subservient to international interests which would ultimately affect the domestic situation. Second, central banking is premised on the central bank's independence in the setting of monetary policy. In the global financial crisis some of the notions of central bank independence became strained as collaborative actions between central banks clearly pointed to political, or political-economic, objectives.

Coordination between central banks in different countries also mirrored coordination between different finance ministries – for instance, deposit insurance was provided or increased in numerous countries, and economic stimulation and bailout packages were announced in many jurisdictions. Central banks and governments acted in tandem. The lines between economic and political issues became blurred and may be redrawn completely in future, and the concept of central bank independence and the relationship between central banks and governments will surely be the focus of future study and debate. The public cooperation for instance between the Federal Reserve Bank and the Treasury in the USA to the extent that the Chairman of the Federal Reserve and the Treasury Secretary jointly lobbied Congress, emphasises the close connection between the government and the central bank, and highlights that both central bank and government actions may involve the use of taxpayer (i.e. public) money.

The lender of last resort function

The role of a central bank as the lender of last resort when the collapse of a financial institution with temporary liquidity problems threatens to create systemic risk is well established, and Bagehot's dictum for central banks to 'lend freely against good collateral at a high rate of interest' is widely accepted.[39] Lender of last resort facilities are essentially granted as a loan, subject to certain conditions.

Traditionally, central banks only lend to certain institutions – those that have access to central bank liquidity. In the global financial crisis liquidity had to be provided across a broader range of institutions to ensure that it would indeed flow through the system. Investment banks did not have access to the lender of last resort facilities of the central bank and Morgan Stanley and Goldman Sachs, for instance, were required to be registered as bank holding companies to receive that assistance. These

[39] Glenn Stevens, 'Liquidity and the Lender of Last Resort' (Speech delivered at The Seventh Annual Sir Leslie Melville Lecture ANU-Toyota Public Lecture Series 2008, Canberra, 15 April 2008).

requirements may no longer be commensurate with the modern financial system where not only banks (or bank-like financial institutions) are capable of causing systemic risk. The failure of investment banks such as Lehman Brothers, as well as the risks created by the difficulties of mortgage giants Fannie Mae and Freddie Mac, and the problems encountered by AIG, an insurer, are testimony of the need to reconsider the notion of 'systemic risk' *per se*. In the global financial crisis non-banks have emerged to be significant threats to financial stability. Furthermore, institutions such as investment banks, banks, and insurers were so interconnected that contagion was an almost immediate and unavoidable consequence of the failure of any one of them.

In light of the above, the statutory and internally imposed rules for central banks may have to be revisited, as well as the specific statutory powers of central banks to provide emergency liquidity assistance in a financial crisis. It is important for a government to create an appropriate legal framework within which the central bank will have flexibility to respond adequately to financial crises. The measure of discretion of central banks not only in the amount or conditions of assistance to be provided is important, but also the circumstances under which the lender of last resort powers can be used, need to be broadly and flexibly defined. Central banks need a wide discretion, but it is not proposed, because of the ensuing moral hazard issues, that lender of last resort facilities should be provided to financial or other systemically important institutions in difficulty as a matter of right.

Transparency when providing lender of last resort assistance (or a 'bailout'), which will ultimately put public funds at risk, is important from a governance point of view, and will likely have to be reconsidered. Competing interests are at play – in the UK it appears that the announcement of the provision of emergency liquidity assistance to Northern Rock as required under EC rules, may have contributed to the demise of the bank.[40] In the US, the use to which bailout funds were put for instance by AIG, caused great controversy – the public demanded answers, and President Barack Obama ordered that 'every single legal avenue' be used to block AIG traders from receiving bonuses in light of the financial assistance provided to AIG.[41] Loans by the Federal Reserve to financial institutions not only came under criticism for the lack of transparency, but an action under the US *Freedom of Information Act* was

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[40] See Steven R Blau, 'The Federal Reserve and European Central Bank as Lenders-of-last-resort: Different needles in their compasses' (2008) 21 (2) *New York International Law Review* 39.

[41] *Obama tries to stop AIG bonuses: 'How do they justify this outrage?* 16 March 2009, CNN, <http://edition.cnn.com/2009/POLITICS/03/16/AIG.bonuses/index.html> at 19 May 2009.

brought by Bloomberg.[42] By 19 April 2009 the Federal Reserve had lent some $2 trillion (ultimately tax-payers' money) to financial institutions without disclosing the names of the borrowers, the amounts of the loans, or the assets that have been given as collateral for those loans. It is important to note that unlike the funds approved by Congress to be used for the US Troubled Asset Relief Program ('TARP'), there are no oversight requirements or compensation limits on funds granted by the Federal Reserve.[43]

Furthermore, it became evident in the global financial crisis that the point of departure of a central bank when providing liquidity assistance may have to be revisited. Traditionally a central bank will only provide cash in exchange for assets of a certain quality (as these assets will be transferred to the books of the central bank). Also, only a limited number of institutions are eligible for this type of assistance. Central banks may in future have to respond by accepting a wider range of assets or by dealing with a wider range of institutions, or even intervene directly in the market where the problem has arisen.[44] An additional challenge that will have to be overcome is created by financial institutions holding instruments in foreign currencies on their balance sheets. Merely 'injecting euros or sterling into national

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[42] *Bloomberg LP v. Federal Reserve*, U S District Court, Southern District of New York (Manhattan). Bloomberg News requested information about the securities the Federal Reserve Bank accepted as part of its loans to different banks. Mark Pittman, *Bloomberg Sues Fed to Force Disclosure of Collateral (Update1)* (2008) Bloomberg <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aKr.oY2YKc2g> at 14 May 2009.

[43] Mark Pittman, *Fed Shrouding $2 Trillion in Bank Loans in 'Secrecy', Suit Says* (2008) Bloomberg <http://www.bloomberg.com/apps/news?pid=20670001&sid-aS89AaGjOplw> at 19 April 2009. Further information was also demanded on the use of the approved 'bailout funds'. One can argue that there are good reasons not to release that information – some of the reasons given by the Federal Reserve were that it could lead to short-selling and drops in stock prices. It is also possible that such information could threaten systemic stability and create a run on banks. The Chairman of the Federal Reserve Bank, Ben Bernanke, has however countered this criticism by pointing out that the Federal Reserve has provided sufficient information on how the programs work on its website but that specific names have of course not been provided.

[44] Glenn Stevens refers to proposals that have been made by some writers, such as Willem Buiter and Anne Sibert that central banks should even consider transacting in collateralised debt obligations, but this specific suggestion does not seem to have found much favour with central banks. It is clear however that important questions about what would be eligible assets for central bank transactions will have to be raised and considered in the near future. Stevens, above, n 40.

money markets may not be sufficient to restore market function in these economies when funding shortages are in dollars'.[45]

Easing of monetary policy and the fundamental role of central banks

Monetary policy was used extensively to combat the global financial crisis and central banks in many countries lowered interest rates. Many critics argue that interest rates should not be used as a tool to mop up the effects of asset bubbles, and that the use of interest rate adjustments should be limited to 'leaning against the wind' in boom times. Others argue that in the global financial crisis the easing of monetary policy did stabilise the economy – evidence of this effect may however only be visible later. The role of monetary policy may be reconsidered in the aftermath of the global financial crisis – should central banks use monetary policy to 'lean against the wind' with restrictive monetary policy to prevent a crisis, or to rather 'mop up' after a crisis has occurred?[46]

The role of government

As indicated above, the role of governments and central banks cannot be viewed completely separately.

The modern role of governments in connection with markets has been to:

- Decide what individual goods should be provided for free or below cost;
- Regulate markets;
- Tax;[47] and
- Redistribute wealth by welfare programmes.[48]

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45 Bernanke, above, n 39.

46 See P Tucker, 'The Structure of Regulation: Lessons from the Crisis of 2007' (Speech delivered at the LSE's Financial Markets Group Conference, London, 3 March 2008). See also C Bean, 'Some Lessons for Monetary Policy from the Recent Financial Turmoil' (Speech delivered at the Conference on Globalisation, Inflation and Monetary Policy, Istanbul, 22 November 2008).

47 Timothy Besley highlights the power of the State to tax in 'On The Global Economic Crisis: Meeting the Challenge' (Speech delivered at the London School of Economics, London, 17 February 2009.). He states that '[a] remarkable feature of the current episode is how the very considerable fiscal resources available to the state are being marshalled to solve the problems of private banking and capital markets. This is a reminder of the very important market supporting role that fiscal capacity - developed over years of crises and wars – plays in modern economics'.

48 See Hugh Stretton, *Economics A New Introduction* (1999) 234.

All of this presupposes the prior existence of markets which exist in some shape or form from the dawn of history even before the growth of social order. When the operations of the market threaten its very existence, government has the difficult task of deciding whether to leave this to market adjustment or to intervene. Government intervention can sometimes make matters worse.

In the global financial crisis governments exhibited high levels of diplomacy. Different governments made consistent calls for 'global cooperation', emphatically cautioned against protectionism, emphasised the international nature of the crisis, and called for 'international' or 'global' responses. In response to the global financial crisis many governments entered what is perhaps an unprecedented era of the recognition of internationalisation, as well as fiscal expansion and economic intervention.[49] Governments, through the Treasuries, Ministries of Finance or Finance Departments, provided financial assistance to multiple institutions and in some instances virtually nationalised formerly private institutions. Governments, just like central banks, have concerns of moral hazard, and also have to deal with criticism from tax-payers in view of the reality that government budget deficits will be made up by taxation in future. Governments were also criticised for providing large amounts of government resources to assist primarily the financial industry, and not other industries suffering as well.[50] At the height of the crisis, Henry Paulson, former Treasury Secretary of the USA, stated that raw capitalism is dead.[51] It has been widely questioned whether the interventions by governments all over the world have been contrary to the basic principles of capitalism and the free market system, and also whether pure capitalism has been abandoned or should be abandoned. The global financial crisis has forced policy-makers in government to reconsider the basic

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[49] The Governor of the South African Reserve Bank, a member of the G-20, described the position succinctly: 'We are living through the most severe economic crisis in our living memory. In response, many governments and central banks have taken extraordinary measures to protect their banking systems and their economies. However the past few months have shown that increased global economic and financial integration has resulted in an increasingly independent world.' Tito Mboweni, 'An Annus Horribilis?' (Speech delivered at the Annual Dinner in Honour of the Ambassadors and High Commissioners accredited to the Republic of South Africa, Pretoria, 27 November 2008).

[50] For a scathing critique of government actions, that argues that governments had worsened the matters by misdiagnosing problems and acted in an ad hoc manner, see John B Taylor *The Financial Crisis and the Policy Responses: An Empirical Analysis of What Went Wrong* (2008) Stanford University <http://www.stanford.edu/~johntayl/FCPR.pdf> at 18 May 2009.

[51] See Andy Serwer and Allan Sloan, *How Financial Madness Overtook Wall Street* (2008) Time <http://www.time.com/.time/printout/0,8816,1842123,00.html> at 15 May 2009.

building blocks and philosophical underpinnings of the current global financial system.[52]

Different governments responded to the global financial crisis in different ways. For example, deposit guarantees were introduced or improved, loans were provided to different institutions, some institutions were nationalised, some banks were recapitalised, fiscal stimulus packages were announced, and legislation was passed on an emergency basis to deal with the crisis – for instance to curb short-selling. Regulators, who are specific governmental bodies and do not have the same independence from government that central banks have, now have a longer-term goal to consider how regulation may have failed, and how the focus of regulation, which was traditionally on banks, and not the 'shadow banking system' and 'non-banking entities', may have contributed to the global financial crisis.

The cooperation between different governments of different states in the global financial crisis – whether informally or through the auspices of bodies such as the G-20 – has been remarkable, and evidence of globalisation and the increasing acceptance of the effects of internationalisation.[53] This globalised crisis has perhaps given new life to some of the arguments against globalisation because of a measure of abdication of sovereignty by domestic governments. Conversely, it might have strengthened arguments for global governance.

International responses

International Monetary Fund ('IMF')

Of all the international institutions the IMF has probably been most criticised - mostly for failing to effectively warn of the impending financial crisis. Initially it seemed as though the IMF was too remote from the global financial crisis – this position led to the questioning of the relevance of the IMF as an institution. IMF Managing Director Dominique Strauss-Kahn however believes that notwithstanding the changes in the world financial system since 1944, when the IMF was created at the Bretton Woods Conference, that the IMF is 'as central as ever. But it took the

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52 See Ben S Bernanke, 'The Crisis and the Policy Response' (Speech delivered at the Stamp Lecture, London School of Economics, London, 13 January 2009).

53 For instance, prior to the G-20 London Summit, there was considerable media attention focused on the actions of the leaders of different countries that seemed to evidence cooperation and solidarity. See eg Jeff Zeleny and David E Sanger *Obama and Brown Pledge Cooperation* (3 March 2009) New York Times <http://www.nytimes.com/2009/.03/04/us/politics/04prexy.htm> at 13 May 2009.

worst financial crisis since the Great Depression for this to be made manifest'.[54] Perhaps somewhat surprisingly, many critics of the IMF do not call for its abolishment or replacement, but rather for an enhancement of its role, and an extension and improvement of its operations.[55] There seems to be a need for a strong, international and independent voice representing the world economy.[56] At its London Summit in April 2009 the G-20 expressed support for the IMF and reiterated that the IMF played and should continue to play an essential role in the global financial system, but also called for significant reforms.[57]

Even before the onset of the global financial crisis the IMF struggled with its own crisis – one of credibility and legitimacy.[58] In this regard it should be recognised that the actual (current) and official (historical) purposes of the IMF are no longer completely aligned - the purpose and functions of the IMF have changed since its formation. Any criticism of the IMF should be evaluated against its official mandate and purpose. The official purposes of the IMF as expressed in Article I of the Articles of Agreement of the International Monetary Fund appear not to have been amended since inception. The IMF was created to:

- promote international cooperation;
- facilitate the growth of trade and economic advancement;

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54 Dominque Strauss-Kahn 'Multilateralism and the Role of the International Monetary Fund in the Global Financial Crisis' (Speech delivered at the School of Advanced International Studies, Washington DC, 23 April 2009).

55 For instance, Governor Tito Mboweni from the South African Reserve Bank expressed the view that whilst countries should take action in their own rights in a financial crisis, there is a need for the IMF to act on a higher level and provide 'overarching advice' on how the global economy is to be stabilised, 'as a public good'. Tito T Mboweni, 'Lessons to be drawn from the financial crisis for multilateralism and global financial co-operation' (Speech delivered at a charity gala dinner organised by the University of Pretoria, Pretoria, 15 October 2008). Also, Dominique Strauss-Kahn is of the view that the IMF is uniquely poised to give guidance on matters such as macro-financial linkages and spill-overs across national borders. Dominique Strauss-Kahn, 'A Mandate for Action' (Speech delivered at the National Press Club,Washington DC, 16 April 2009).

56 'Ex-chief economist of IMF to advise PM', *The Times of India* (New Delhi) 4 November 2008 <http://timesofindia.indiatimes.com/Ex-chief_economist_of_IMF_to_advise_PM/rssarticleshow/3670254.cms> at 14 May 2009.

57 *Global plan for recovery and reform: the Communique from the London Summit*, (2009) The London Summit <http://www.londonsummit.gov.uk/en/summit-aims/summit-communique/> at 18 May 2009.

58 Dominique Strauss-Kahn stated that at the end of 2007, the IMF was facing 'a progressive loss in its relevance and its legitimacy'. Strauss-Kahn, above n 55.

- promote exchange stability;
- assist in establishing a multilateral system of payments;
- provide loans to members; and
- assist members with balance of payment problems.[59]

Commenting on the current focus of the IMF, Dominique Strauss-Kahn however emphasised the importance of protecting the poorest and most vulnerable from the fall-out of the global financial crisis.[60] The IMF has in recent years been predominantly involved in assisting developing countries. Dominique Strauss-Kahn summarised the functions of the IMF under three broad categories. These are:

- providing assistance to members;
- giving policy advice; and
- alerting members to possible crises and problems.[61]

The activities portrayed as the IMF's key responsibilities on its website are similar – surveillance, lending and technical assistance.[62] These activities are broadly related to Article I of the IMF Article of Agreement but are not identical to the original purposes, and a formal change may be beneficial.

Although many of the problems for which the IMF was formed - its 'raison d'être' - such as balance of payment issues and exchange rate fluctuations, have largely disappeared,[63] the IMF still remains relevant, and will be important in the ongoing global response to the global financial crisis. On 18 December 2008 the International Monetary and Financial Committee ('IMFC') and the G-20 emphasised the central role of the IMF as crisis responder and developer of ideas - two very distinct roles

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59 *Purposes of the IMF, Articles of Agreement of the International Monetary Fund*, Article 1, (2005) IMF <http://www.imf.org/external/pubs/ft/aa/index.htm> at 24 April 2009.

60 *IMF Key to Crisis Policy Response, Strauss-Kahn Says IMF Survey online 24 April 2009* (2009) IMF <http://www.imf.org/external/pubs/ft/survey/50/2009/NEW042409A.htm> at 27 April 2009.

61 Ibid.

62 *The IMF at a Glance, A factsheet – April 2009* (2009) IMF <http://www.imf.org/external/np/exr/facts/glance.htm> at 27 April 2009.

63 See James R Vreeland, *The International Monetary Fund, Politics of Conditional Lending* (2007) 8.

that should be reflected in the official purpose statement of the IMF.[64] It is however also important to note that the role of the IMF will in future be supplemented significantly by the Financial Stability Board, and its very nature may be fundamentally adjusted.[65]

The first function of the IMF as outlined by Dominique Strauss-Kahn is to provide assistance to member countries. Recently the IMF has not only provided emergency assistance to a number of countries,[66] but it has also changed some of its approaches to be more responsive to the prevailing circumstances. An institution such as the IMF should be able to respond, and respond flexibly, to a particular economic situation and should therefore have the authority and mechanisms to do so. Although the much–criticised IMF conditional loans[67] have not been abandoned, and will likely be continued, the IMF recently introduced concessional loans and flexible credit lines that were provided to countries that had in the past exhibited good performance. It also increased its lending capacity under existing and new facilities.[68] In its response to the global financial crisis the IMF has demonstrated a certain measure of flexibility.

The criticism of the IMF's previous conditional loans however remains relevant as it is argued that significant foreign reserves were built up by some countries (predominantly Asian countries following the Asian financial crisis) to avoid making use of conditional IMF loans. On a more fundamental level, the very nature of IMF loans may have to be revisited and restructured as some countries are unwilling to take up loans because of the signals that will be sent to the rest of the world if it is known that IMF support was utilised.

The most incisive and severe criticism of the IMF is for its perceived failure effectively to warn participants in the global financial system of the possible

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64 'IMF to Focus on Crisis Response, Policy Recommendations, and New Financial Architecture' IMF Press Release No. 08/308 18 December 2008, IMF, <http://www.imf.org/external/np/sec/pr/2008/pr08308.htm> at 14 May 2009.

65 Some suggestions have been made about other roles that the IMF could for instance play, such as that of asset manager, or a more active manager of currency reserves and the global savings pool. See H James 'The Making of a Mess – Who Broke Global Finance, and Who Should Pay for It?' (2009) 88 (1) *Foreign Affairs* 166.

66 The IMF has assisted, among others, Hungary, Iceland, Pakistan and Ukraine.

67 See Ross P Buckley, 'Re-envisioning Economic Sovereignty: Developing Countries and the International Monetary Fund' (2007) 24 *UNSWLR* 6 <http://www.austlii.edu.au/au/journals/UNSWLRS/2007/24.html> at 13 October 2008.

68 'Communiqué of the International Monetary and Financial Committee of the Board of Governors of the International Monetary Fund' (Press Release No. 09/139, 25 April 2009) <http://www.imf.org/external/np/sec/pr/2009/pr09139.htm> at 27 April 2009.

impending crisis.[69] It appears that the IMF underestimated the importance of potential cross-border systemic risk issues. One of the possible reasons for this failure was that the IMF did not pay sufficient attention to excessive use of leverage, credit booms, and asset prices.[70] All of these factors would have an impact on systemic risk - an issue that was not sufficiently assessed by the IMF.

The IMF maintains that it did issue warnings, but acknowledges that such warnings were ineffectively communicated,[71] pointing possibly to the fact that the IMF did not have the level of credibility that it should have enjoyed. Its messages seem to have been largely disregarded.

Calling for a change in focus by the IMF essentially requires that the IMF be more responsive to current market conditions. One example of responsive and self-adjusting actions by the IMF would be to expand its surveillance to not only surveyed countries, but also private capital flows, as these private players can have an important impact on the markets.[72] Another example of more responsive action, and adjustment to changes in the world economy would be to expand the role of the IMF.[73]

The decline in the IMF's credibility and legitimacy

In a recent speech, Dominique Strauss-Kahn recently acknowledged that over the period of 18 months from October 2007 the IMF faced 'a progressive loss in its relevance and legitimacy'.[74]

The reasons for the decline in credibility should therefore be examined. First, the terms of conditional loans granted by the IMF often reflected norms associated predominantly with Western developed economies. In some cases, compliance by other countries with these conditions has led to financial and other problems,

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69 Some also blame the major member countries of the IMF for the failure to anticipate the crisis and to commence preventative actions. See F C Bergsten *Stopping a Global Meltdown, Op-ed in the Washington Post*, 12 November 2008, Washington Post <http://www.iie.com/publications/opeds/oped.cfm?ResearchID=1044> at 5 February 2009.

70 Strauss-Kahn, above n 55.

71 Ibid. See also Domique Strauss-Kahn 'A Mandate for Action' (Speech delivered at the National Press Club, Washington DC, 16 April 2009).

72 Michael Bordo and Harold James, *The IMF as Reserve Manager* (2008) VOX <http://www.voxeu.org/index.php?q=node/1241> at 14 May 2009.

73 Ibid. It has for example also been suggested that the IMF should fulfil the role of a manager of a global savings pool.

74 Strauss-Kahn, above n 55.

prompting the subsequent avoidance of IMF assistance.[75] Second, the IMF's governance structures currently do not allow large and/or economically and financially important nations such as China and India to have meaningful influence in the organisation – changes to the governance structures have recently been reviewed and a number of recommendations have been made.[76] The chairmanship will likely also be revisited. Historically the chairmanship is held by a representative from a European country (just as the chairmanship of the World Bank is traditionally held by a representative of the USA). The executive board of the IMF is dominated by the West and because of historical reasons, Europeans are over-represented, and emerging and Asian countries are under-represented.[77] Both quotas and voting rights should be changed – the IMF is already committed to reviewing these.[78] Current voting rights give the 25 nations of the European Union 32% of the vote, whilst the voting shares of China, India, Brazil and Mexico together comprise of little more than 10%.[79] The US influence at the IMF is also considerable and needs to be reduced – not only does the US have just over 17% of the votes, it also has indirect influence over other countries who may be beneficiaries of USA relief programmes and may be reluctant to vote against the USA. The US can also veto the appointment of the Managing Director.[80] Third, the IMF staff needs to be diversified to be more representative. It is important to note that global legitimacy can only be achieved if the IMF is seen to be truly representative of its members (and of course the important participants in the global financial system).

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75 S Grenville, 'Increase IMF capacity, replace its useless bosses' *The Australian Financial Review*,(Melbourne) 23 February 2009, 20.

76 Trevor A Manuel to Dominique Strauss-Kahn 24 March 2009 (2009) IMF <http://www.imf.org/external/np/omd/2009/govref/032409n.pdf> at 24 April 2009.

77 C Fred Bergsten, 'Stopping a Global Meltdown' *The Washington Post*, Washington 12 November 2008, A19, < http://www.washingtonpost.com/wp-dyn/content/article/2008/11/11/AR2008111102256.html > at 18 May 2009.

78 Communiqué of the International Monetary and Financial Committee of the Board of Governors of the International Monetary Fund, above n 69. See also *Report of the Managing Director to the International Monetary and Finance Committee on Reform of Quota and Voice in the International Monetary Fund* (2008) IMF <http://www.imf.org/external/np/pp/eng/2008/040708.pdf> at 18 May 2009. A useful analysis is provided in Mark Weisbrot *IMF Voting Shares No Plans for Significant Changes* (6 May 2009) Center for Economic and Policy Research, <http://www.commondreams.org/newswire/2009/05/06-8> at 18 May 2009.

79 See Weisbrot above n 79.

80 See eg Vreeland, above n 64.

A lack of reliability and accuracy also detract from the credibility of the IMF as it is judged by its intellectual output. The IMF has been much criticised for its view in December 2007, just as the crisis was unfolding, that there was no deep crisis in the markets. Furthermore in April 2008 the IMF predicted that the losses following the crisis would be $1 trillion (less than half of what it will likely be).[81] The IMF needs to regain its intellectual credibility.[82]

Credibility and legitimacy are also furthered by responsiveness. The IMF should continue to acknowledge that it is learning from the situation and adapting and adjusting its practices accordingly.[83] The IMF has, during the global financial crisis and in response to it, already developed new programmes, such as the new Flexible Credit Lines and the High Access Precautionary Arrangements. Revitalising the role of the IMF will contribute to meeting the objectives of the G-20 of enhancing regulation in the financial system, increasing transparency and improving international cooperation.[84]

It seems to be time to review the policies and points of departure of the IMF. The IMF may have to re-examine its predominant 'market' philosophy, according to Joseph Stiglitz, who is highly critical of the IMF.[85] He points out that the IMF bases its policies on the 'market' philosophy, in the belief that the 'market theory' is the best – but then the IMF is itself a non-market solution to the problems of the markets. Stiglitz points out that the IMF exists because markets fail, yet paradoxically the IMF believes in the market as the basis for sound economic policy. Traditionally, the IMF required in its conditional loans that countries reduce government spending, when the biggest economies have used fiscal stimulation to improve a dire financial situation. The IMF has however changed its views in this regard and the stimulus

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81 It appears that this amount was later adjusted upward to $1.5 trillion, an amount representing loan losses for global financial institutions. See R C Altman, 'The Great Crash, 2008, A Geopolitical Setback for the West' (2009) 88 (1) *Foreign Affairs* 7.

82 Dominique Strauss-Kahn points out that legitimacy is about more than quota and voice reform, and that the IMF needs to do a better job at a number of things. See Strauss-Kahn, above n 55.

83 Dominique Strauss-Kahn admitted that some of the criticism against the IMF, namely that it was 'sleeping at the wheel', is justified. The IMF was 'lulled by the experience of strong growth and low and stable inflation' and also did not sufficiently consider factors such as excess leverage, systemic risk, credit booms and asset prices'. See Strauss-Kahn, above n 55. Evidence that the IMF is learning lessons can be found in the IMF's doubling of all loan access limits and the granting of upfront financing.

84 Communiqué of the International Monetary and Financial Committee of the Board of Governors of the International Monetary Fund, above n 69.

85 Vreeland, above n 64, 114.

package by the USA in October 2008 was endorsed by the IMF. The market philosophy is likely to be scrutinised and adjusted. Alan Greenspan, the former Federal Reserve Chairman, admitted that economists were shocked to find that the self-interest of the markets was insufficient protection against a global collapse.[86]

Cooperation between financial institutions, both domestic and international, needs to be nurtured, and possibly increased. The IMF has a long history of cooperation with the World Bank and continued cooperation is envisaged and supported. The relationship between the G-20 and the IMF has however recently gained prominence and the influence of G-20 decisions and recommendations (not only on the IMF, but also in general) have perhaps been unexpected. The G-20 endorsed the role of the IMF,[87] and the IMF seems to have accepted the G-20's recommendations,[88] and started to implement the decisions and recommendations of the G-20. This was not only true of the London Summit of the G-20 in April 2009 but also of the Washington Action Plan outlined by the G-20 in 2008. Some of the priorities set by the G-20 for the IMF included structural and functional restructuring, and also cooperation with the reforms of the former Financial Stability Forum ('FSF'), now to be known as the Financial Stability Board ('FSB'). The IMF and the FSB have started to undertake joint semi-annual 'Early Warning Exercises' with a view to identifying emerging risks and suggesting pre-emptive policy actions.[89]

World Bank

The World Bank is, like the IMF, a creature of the Bretton Woods Conference. The World Bank is a vital source of financial and technical assistance to developing

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86 In his testimony to the Committee of Government Oversight and Reform, Alan Greenspan said: 'I made a mistake in presuming that the self-interest of organizations, specifically banks and others, was such that they were best capable of protecting their own shareholders and the equity.' US Congress – Committee on Oversight and Government Reform, (2008) <http://oversight.house.gov/documents/20081023100438.pdf> at 13 May 2009.

87 This endorsement was given in November 2008 at the G-20's Washington Summit in November 2008. The G-20 at that stage already announced that it would support the IMF's capacity to assist with the resolution of the global financial crisis. *World Leaders Launch Action Plan to Combat Financial Crisis, IMF Survey online 15 November 2008*, (2008) IMF <http://www.imf.org/external/pubs/ft/survey/so/2008/new111508a.htm> at 15 March 2009.

88 The IMF may be the 'big winner' in the G-20 summit with 'huge increases planned in its resources and new roles'. S Shifferes, *G20 leaders seal $1tn global deal* (2009) BBC News <http://news.bbc.co.uk/1/hi/business/7979484.stm> at 18 May 2009.

89 *World Finance Chiefs Back Moves to Support Recovery from Crisis IMF Survey online*, (2009) IMF <http://www.imf.org/externalpubs/ft/survey/50/2009/P0L042609A.htm> at 27 April 2009.

countries - with a strong emphasis on assistance to the world's poorest people and countries. It operates through two development institutions owned by 185 member countries - the International Bank for Reconstruction and Development and the International Development Association. The World Bank provides low-interest loans, interest-free credits and grants to developing countries for different purposes including investments in education, health, public administration, infrastructure, financial and private sector development, agriculture, and environmental and natural resource management.[90] The original purpose of the creation of the World Bank was to rebuild Europe, but although reconstruction has remained an important theme of the work of the World Bank, it has largely focused on poverty reduction. It has also been involved in financial sector reform, predominantly within the banking sector.[91]

Whilst the World Bank is assisting with the global financial crisis, it has maintained its focus primarily on poverty reduction for millions of people who have been affected by the crisis[92] - typically in poor countries - and have also proposed the creation of a vulnerability fund to be funded by wealthier countries.[93] The role of the World Bank has been fairly uncontroversial in the global financial crisis, but it has of course been of the utmost importance.

Group of Twenty ('G-20')

The G-20 was established in 1999 to bring together the finance ministers and central bank governors of a group of 20 countries in a forum to discuss the global economy. The G-20 is not institutionalised in the same manner as the IMF or World Bank, but is a more informal forum, with no permanent staff and a rotating chair and temporary secretariats. It is therefore quite remarkable how powerful, compared to other

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90 *About Us*, (2009) World Bank <http://web.worldbank.org/WBSITE/EXTERNAL/EXTABOUTUS/0,,pagePK:50004410~piPK:36602~theSitePK:29708,00.html> at 11 May 2009.

91 *The World Bank and financial sector reform* (2009) Bretton Woods Project, <http://www.brettonwoodsproject.org/art-557193> at 27 April 2009.

92 A recent World Bank publication provides a useful and comprehensive exposition of the position of developing countries in the wake of the global financial crisis and suggests policy responses that would provide protection to these countries. *Weathering the Storm: Economic Policy Responses to the Financial Crisis* (2008) World Bank, <http://siteresources.worldbank.org/NEWS/Resources/weatheringstorm.pdf > at 14 May 2009.

93 For more information about the initiatives of the World Bank in the global financial crisis, see <http://www.worldbank.org/html/extdr/financialcrisis/bankinitiatives.htm> at 18 May 2009. The World Bank focuses on infrastructure development projects and it has also been involved with bank recapitalisation in poorer countries.

institutions and forums, this group has become in the global financial crisis as evidenced by the general acceptance and implementation of their recommendations made at the recent London Summit. The aim of the G-20 is to promote open and constructive discussion between industrial and emerging-market countries on key issues related to global economic stability.[94] The G-20 contributes to the strengthening of the international financial architecture and helps support growth and development world-wide.[95]

Perhaps it is the current membership of the G-20 that provides it with greater impact and possibly more credibility than that enjoyed by the G-7. The G-20 has the finance ministers and central bank governors of 19 countries, representing the major economies as well as prominent developing markets, as well as the European Union, as members. The members are responsible for about 90% of global gross national product and 80% of world trade. Moreover, there is direct interaction with the IMF and the World Bank, as well as the International Monetary and Financial Committee ('IMFC') and the Development Committee of the IMF and the World Bank, as these institutions and committees participate in the G-20 meetings on an *ex officio* basis.[96]

The London Summit of the G-20 in April 2009 issued a Declaration, 'Strengthening the Financial System', which is quoted below. They agreed:

- to establish a new Financial Stability Board (FSB) with a strengthened mandate, as a successor to the Financial Stability Forum (FSF), including all G20 countries, FSF members, Spain, and the European Commission;
- that the FSB should collaborate with the IMF to provide early warning of macroeconomic and financial risks and the actions needed to address them;
- to reshape our regulatory systems so that our authorities are able to identify and take account of macro-prudential risks;
- to extend regulation and oversight to all systemically important financial institutions, instruments and markets. This will include, for the first time, systemically important hedge funds;
- to endorse and implement the FSF's tough new principles on pay and compensation and to support sustainable compensation schemes and the corporate social responsibility of all firms;

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94 *About G-20* (2009) G-20 <http://www.g20.org/about_what_is_g20.aspx> at 11 May 2009.
95 Ibid.
96 Ibid.

- to take action, once recovery is assured, to improve the quality, quantity, and international consistency of capital in the banking system. In future, regulation must prevent excessive leverage and require buffers of resources to be built up in good times;
- to take action against non-cooperative jurisdictions, including tax havens. We stand ready to deploy sanctions to protect our public finances and financial systems. The era of banking secrecy is over. …;
- to call on the accounting standard setters to work urgently with supervisors and regulators to improve standards on valuation and provisioning and achieve a single set of high-quality global accounting standards; and
- to extend regulatory oversight and registration to Credit Rating Agencies to ensure they meet the international code of good practice, particularly to prevent unacceptable conflicts of interest.[97]

Organisation for Economic Cooperation and Development ('OECD')

The role of the OECD in responding to the global financial crisis has not received much main-stream publicity, but it should not be disregarded as its overarching goal is the support of economic development. The OECD was formed in 1961 with a view *inter alia* to supporting economic growth, maintaining financial stability, assisting the economic development of other countries and contributing to world trade. With 30 member countries, its membership is fairly representative of the important players in the world economy but it does not have all the members of the G-20 as members - something that may influence its legitimacy and credibility.

The OECD has been instrumental in developing a global response to the global financial crisis in that it has volunteered to co-ordinate a project to develop a 'Global Charter' or 'Legal Standard' for the manner in which 5 of the world's most influential and important organisations, namely the IMF, World Bank, International Labour Organisation ('ILO'), World Trade Organisation ('WTO') and the OECD could cooperate to respond to the global financial crisis. These institutions have conducted an audit of the range of international policy tools available to them with a view to making the world economy stronger, cleaner, and fairer.[98] The aim of the audit is also

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97 *G-20 London Summit Leaders' Statement* (2 April 2009) G-20 <http://www.g20.org/Documents/g20_communique_020409.pdf> at 14 May 2009

98 *OECD Tackling the crisis – a strategic* response (2009) OECD <http://www.oecd.org/document/27/0,3343,en_2649_201185_41973851_1_1_1_1,00.html> at 24 April 2009, and *OECD, A global standard for a stronger, cleaner, fairer economy?* (2009) OECD

to identify gaps and strengths. These efforts highlight the need for cooperation between international institutions in this field. Cooperation at this level is on a meta-level – a level structurally higher than cooperation between different sovereign nations. Cooperation between sovereign nations can take place directly through diplomacy, or it could take place in a specific forum at international institutions or international groups. Promoting and facilitating cooperation at this meta-level could be one of the most fundamental contributions to a global response to the global financial crisis.[99]

Financial Stability Forum ('FSF')

The FSF was created in April 1999 to improve international financial stability. This forum was established after the Asian Financial Crisis, as none of the international bodies in existence at that stage predicted or foresaw the impending crisis and its effect.[100] It was envisaged that information would be exchanged at the FSF and that this forum would improve international cooperation with regard to the surveillance and supervision of the financial system. The objective of the FSF was to identify vulnerabilities in the international financial system and to then propose steps or actions to be taken. The FSF also had to improve the exchange of information between the different responsible supervising and regulatory authorities.[101] A lack of focus by the IMF and World Bank on weaknesses in financial regulation seemed to have been at the heart of the Asian Financial Crisis.[102]

The FSF has played a central role in the global financial architecture as it promotes contact between the following institutions: central banks, regulators, supervisors and

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<http://www.oecd.org/document/10/0,3343,en_2649_201185_42393354_1_1_1_1,00.html> at 24 April 2009.

99 The Global Charter is at time of writing a work in progress and at the stage where available instruments have been listed by the various contributors. At this early stage it has already been identified that updates of some of the instruments would be required and that there are gaps to be filled. See *OECD A 'Global Charter' / 'Legal Standard' An Inventory of Possible Policy Instruments (Preliminary, as of 19th March 2009) A joint stock-taking exercise coordinated by the Organisation for Economic Co-operation and Development* (2009) OECD <http://.oecd.org/dataoecd/35/63/42393042.pdf> at 24 April 2009.

100 Davies and Green, above n 36, 110.

101 IMF, Lessons of the Financial Crisis for Future Regulation of Financial Institutions and Markets and for Liquidity Management (prepared by the Monetary and Capital Markets Department and approved by Jaime Caruana) 4 February 2009 (2009) IMF <http://www.imf.org/external/np/pp/eng/2009/020409.pdf> at 19 May 2009.

102 Davies and Green, above n 36, 111.

the finance ministries of the G-7 countries and more (the G-7 plus five[103]), the European Central Bank, the IMF, the World Bank, the OECD, the Bank for International Settlements ('BIS'); and international regulatory and supervisory standard-setting bodies (and committees of central bank experts). It is important to note that the FSF combines, in one forum, domestic and international bodies, governmental and private institutions, and international bodies or institutions with different memberships. As of March 2009 all members of the G-20 as well as Spain and the European Commission are members of the FSF.[104]

The G-20 at its London Summit not only endorsed the role of the FSF but proposed that it should be increased – and the 'Forum' was renamed a 'Board', probably indicative of the greater powers of the body, and hinting at a more institutional character. The FSF has already proposed in April 2008 that it should cooperate more closely with the IMF with regard to international financial stability.[105] Considering the large range of issues that the FSF/FSB is currently considering, it is evident that this body will and should play a central role in the resolution of the global financial crisis. Through different work streams, the FSF is considering a wide range of important issues such as pro-cyclicality (and the role of valuation and leverage in pro-cyclicality), the use of judgment in accounting standards, and the capital regime of financial institutions.[106]

International Organisation of Securities Commissions ('IOSCO')

The IOSCO is the international body which brings together securities commissions and futures markets. It works with the Basel Committee on Banking Supervision ('BCBS') and the International Association of Insurance Supervisors ('IAIS') as part of the matrix which we have shown above.

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[103] The countries who are involved are: Australia, Canada, France, Germany, Hong Kong SAR, Italy, Japan, Netherlands, Singapore, Switzerland, United Kingdom and United States of America.

[104] Communiqué of the International Monetary and Financial Committee of the Board of Governors of the International Monetary Fund, above n 69.

[105] Strauss-Kahn, above n 55.

[106] IMF, Lessons of the Financial Crisis for Future Regulation of Financial Institutions and Markets and for Liquidity Management, above n 102. See also Financial Stability Forum Issues Recommendations and Principles to Strengthen Financial Systems, FSF Press Release, Financial Stability Board (2009) <http://www.financialstabilityboard.org/index.htm> at 18 May 2009

It was set up in 1974 as the 'Inter-American Conference of Securities Commissions' but was expanded in 1983 and acquired its present name.[107] Its membership comprises more than 100 jurisdictions and is divided into three categories - ordinary, associate and affiliate. Ordinary members are the primary regulators in a jurisdiction. Associate members are other regulators and affiliates are stock exchanges and self-regulatory organisations.

IOSCO has a secretariat based in Madrid. Jane Diplock, an Australian who is chair of the New Zealand Securities Commission, is Chair of the Executive Committee and Greg Tanzer, another Australian, is the current Secretary-General.

IOSCO functions through a Presidents' Committee, an Executive Committee, a Technical Committee and an Emerging Markets Committee.[108]

IOSCO is the recognised standard-setter for securities markets.[109] Its role is to assist members to cooperate with each other in order to promote high standards of regulation to maintain just, efficient and sound markets. They also encourage members to exchange information in order to promote the development of domestic markets as well as to unite their efforts in establishing standards and effective surveillance of international securities transactions.[110]

IOSCO's main work recently has been preparing regulatory principles for auditor independence, financial disclosure,[111] and for financial analysts. Additional important contributions have been the development of a code of conduct for credit rating agencies,[112] a set of 'core' principles for securities regulation and a multilateral Memorandum of Understanding.

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[107] *IOSCO Historical background* (2009) IOSCO <http://www.iosco.org/about/index.cfm?section=history> at 14 May 2009.

[108] *Structure of the organization* (2009) IOSCO <http://www.iosco.org/about/index.cfm?section=structure> at 14 May 2009.

[109] IOSCO Historical background, above n 108.

[110] *General Information on IOSCO The International Organization of Securities Commissions*, (2009) IOSCO <http://www.iosco.org/about/> at 18 May 2009.

[111] For a discussion of accounting issues, see Stephen G Ryan 'Accounting in and for the Subprime Crisis' March 2008 *Social Science Research Network* (2008) <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1115323&rec=1&srcabs=999710> at 18 May 2009. Also see Christian Laux and Christian Leuz, 'The Crisis of Fair Value Accounting: Making Sense of the Recent Debate' (Working Paper No 33, Initiative on Global Markets, The University of Chicago, Booth School of Business, 21 April 2009) <http://ssrn.com/abstract=1392645> at 18 May 2009.

[112] For a useful discussion of conflicts of interest problems regarding credit rating agencies, see Timothy E Lynch, 'Deeply and Persistently Conflicted: Credit Rating Agencies in the

The Technical Committee of IOSCO produced a useful Final Report on the Subprime Crisis in May 2008. This deals with the connection between innovations in the financial market and the crisis and highlighted poor underwriting practices and problems of disclosure and investor due diligence. These raised issues of inadequate risk modelling, over reliance on credit ratings, inadequate balance sheet liquidity and the use of off-balance sheet entities.

In IOSCO's letter of 12 November 2008 to the Heads of State of the G-20, IOSCO argued:

> In the face of the crisis, it has become evident that regulatory gaps, such as those posed by certain unregulated or under-regulated products, must be closed. It also is becoming increasingly clear that, while financial regulatory structures may remain national, consistent global solutions are desired by many.[113]

Regulators around the world have been criticised for alleged supervisory lapses. Professor John Coffee Jr, a panellist at the IOSCO Conference to be held in Israel in 2009, stated: '[I]n the wake of the 2008 crisis, regulators will inevitably face a new and vastly expanded mission. It will no longer be enough to assure full disclosure and transparency; rather regulators must come to grips with the problems of systemic risk and impose a degree of prudential financial oversight over institutions that are indeed 'too big to fail.'[114]

Actions relating to short sales

In a recent statement IOSCO said that it noted that short-selling played an important role in the market for a number of reasons. These include providing more efficient price discovery, mitigating market bubbles, increasing market liquidity, facilitating

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Current Regulatory Environment' (Research Paper No 133, Indiana University Maurer School of Law – Bloomington Legal Studies Research Paper Series, 2009) <http://ssrn.com/abstract=1374907> at 18 May 2009.

113 Letter from (jointly) IOSCO Executive Committee, IOSCO Technical Committee, and IOSCO Emerging Markets Committee to Heads of State of the G-20, (12 November 2008) <http://www.iasplus.com/iosco/0811ioscog20.pdf> at 18 May 2009.

114 Matthew Krieger, IOSCO to outline new role of regulators at conference (13 April 2009) *The Jerusalem Post* <http://www.jpost.com/servlet/Satellite?cid=1239618129529&pagename=JPost%2FJPArticle%2FShowFull> at 13 May 2009.

hedging and other risk management activities and importantly, limiting upward market manipulations.[115]

IOSCO did note that short-selling may create problems when abused in the midst of a loss of market confidence. In some circumstances this can result in an unfair impact on stock prices which in turn may mislead investors. In order to minimise the abuse of short-selling as an investment tool, IOSCO members have taken steps to reconfirm or implement different measures including:

- confirming or imposing new bans on naked short sales by requiring market participants to either borrow or make arrangements to borrow securities before conducting short sales transactions (in some jurisdictions this outcome was achieved with the cooperation of regulated or licensed exchanges), while ensuring bans on naked short sales do not negatively impact critical market functions such as securities lending or hedging;
- requiring reporting by certain investors of short sales or net short sales positions to regulators, self-regulatory bodies, or the public;
- conducting heightened surveillance of trading to detect abusive short selling; and
- agreeing to share surveillance information among members to address abusive short selling.[116]

Credit rating agencies

IOSCO produced a Code of Conduct for credit rating agencies which it has updated in June 2008. This deals with conflicts of interest, obligations of investors, quality and integrity of the rating process and treatment of non-public information. It is developing modules to assist regulators in dealing with the Code.[117] IOSCO has voiced its support for the development of 'robust, internationally accepted, and consistently applied financial reporting standards through appropriate consultation and an accountable standard setting process'.[118] It has also urged legislators to consider the IOSCO Code of Conduct for Credit Rating Agencies (of which a revised

[115] Letter from (jointly) Jane Diplock, Christopher Cox, Guillermo Larraine (on behalf of IOSCO), 'Regarding Efforts to Enhance Investor Confidence During the Credit Crisis' 12 November 2008, <http://www.fsa.go.jp/inter/ios/20081113/04.pdf> at 18 May 2009.

[116] Ibid.

[117] 'IOSCO update on credit rating agency oversight, (Media release, 12 March 2009) <http://www.fsa.go.jp/inter/ios/20090318-2/02.pdf> at 18 May 2009.

[118] Ibid.

edition was published in June 2008) when proposing legislation, as the IOSCO Code of Conduct represents significant regulatory consensus, and a fragmented legislative approach in different countries could result in renewed problems.[119]

Transparency in accounting

IOSCO has established a Monitoring Board to interact with the International Accounting Standards Foundation. The latter is the public interest overseer of the International Accounting Standards Board.[120]

Cooperation in enforcement

IOSCO members have agreed to improve their international enforcement cooperation efforts. These increased efforts are a necessary response to cross-border challenges that have emerged. Financial regulators accordingly have to strengthen their cooperation with their foreign counterparts and, where possible, coordinate responses to common problems. Some of these problems include novel types of cross-border market manipulation and other fraud, inappropriate uses of exotic financial products, and extreme market conditions that exacerbate the impact of regulatory non-compliance by market participants.[121]

This confirms what Jane Diplock has previously said, in that 'IOSCO has shifted from being a purely standards-setting organisation to a much more operational organisation'.[122] This is reflected in the global Memorandum of Understanding. The recent crisis has galvanised the political will of the G-20 leaders to implement the necessary changes.

IOSCO itself will no doubt be organised along the lines of 'form follows function'. It is possible that its headquarters might shift to Basel which will then become the hub

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119 Ibid.

120 IOSCO 'IOSCO Update on progress made in addressing G-20 concerns' (Media statement, 3 April 2009). <http://www.iosco.org/library/statements/pdf/statements-5.pdf> at 20 May 2009.

121 IOSCO – Statement by the International Organization of Securities Commission Regarding Efforts to Enhance Investor Confidence during the Credit Crisis, attachment to the letter from – (jointly) Jane Diplock, Christopher Cox, Guillermo Larraine (on behalf of IOSCO), 'Regarding Efforts to Enhance Investor Confidence During the Credit Crisis' 12 November 2008, <http://www.fsa.go.jp/inter/ios/20081113/04.pdf> at 18 May 2009.

122 See the useful interview by M Fahrer 'Casting a Wide Net' (2009) 123 inFinance 10, 12.

of global financial regulation, with the newly constituted Financial Stability Board at its centre.[123]

The International Association of Insurance Supervisors ('IAIS')

The IAIS was established in 1994 and its objectives are to:

- cooperate to contribute to improved supervision of the insurance industry on a domestic as well as on an international level in order to maintain efficient, fair, safe and stable insurance markets for the benefit and protection of policyholders;
- promote the development of well-regulated insurance markets; and
- contribute to global financial stability.124

The IAIS has issued two progress reports to the G-20 and FSF. These reports respond to the recommendations made in 2008 by the G-20 and the FSF to enhance sound regulation, strengthen transparency and reinforce international cooperation. They address specific actions the IAIS has recently taken, including:

- Charting a new focus for the IAIS on the supervision of internationally active insurance groups;
- Working with the International Organization of Securities Commissions and the Basel Committee on Banking Supervision to identify important regulatory gaps and areas of enhanced supervision; and
- Providing guidance on the use of supervisory colleges in group-wide supervision.[125]

The IAIS has identified several issues facing insurers and insurance supervisors, such as:

- unregulated entities within a group, posing risks and liquidity demands for the overall group;
- the complexities of supervising cross-border groups due to varying legal environments and coordination challenges among supervisors; and

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[123] Interview with Jane Diplock by J H Farrar, (Wellington, 15 April 2009).

[124] *International Association of Insurance Supervisors* IAIS, <http://www.iaisweb.org/> at 7 April 2009.

[125] IAIS, 'IAIS takes action on G20 and FSF recommendations' (Press Release,16 February 2009) <http://www.iaisweb.org/__temp/IAIS_follow-up_response_to_FSF__February_2009.pdf> at 18 May 2009.

- regulatory arbitrage by taking advantage of difference in regulatory requirements.[126]

The IAIS is of the view that '[t]he financial crisis has served to emphasise the importance of supervisors taking both a solo and group-wide approach to supervision'.[127] This is discussed further in a new paper elaborates on challenges from a group-wide perspective, including:

- intra-group transactions and gearing of capital;
- fungibility of capital and transferability of assets;
- complexity of group structures, including non regulated entities;
- diversity of legal and regulatory frameworks and regulatory arbitrage; and
- measurement of risk dependencies and aggregations of risks.[128]

As discussed previously, the collapse of the American insurer AIG has highlighted some of the dangers that insurance companies have faced in light of the current crisis.[129] **The role of the IAIS will be impacted by the regulatory gaps exposed by the AIG collapse, and future reform in the insurance industry may be required as a result.**

The Basel Committee on Banking Supervision

The Basel Committee on Banking Supervision is a forum for international cooperation on matters relating to banking supervision with 12 member countries. Its stated objective is to 'enhance understanding of key supervisory issues and improve the quality of banking supervision worldwide'.[130] The first steps in attempting to achieve these goals were the introduction of the Basel I and Basel II Capital Accords. These capital adequacy standards were adopted by the member countries in order to try and prevent bank collapses as a result of undercapitalisation. The Basel Accords

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126 Ibid.

127 IAIS, 'IAIS moves forward on group-wide solvency assessment and supervision' (Press release, 9 March 2009) <http://www.iaisweb.org/__temp/9_March_2009__IAIS_moves_forward_on_group-wide_solvency_assessment_and_supervision.pdf> at 18 May 2009.

128 Ibid.

129 For a further discussion, see W K Sjostrom Jr, 'The AIG Bailout' 10 March 2009 Social Science Research Network (2009) <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1346552> at 18 May 2009.

130 *About the Basel Committee* (2009) Bank for International Settlements <http://www.bis.org/bcbs/> at 14 May 2009.

have been widely adopted and have been successful at creating regulatory harmonisation.[131] Other issues that the Committee attends to include bank supervision and supervisory rules. As a result of the success of the Basel Capital Accords, and because the IMF is too politicised, it has been suggested that the Basel Committee should be the senior financial regulator in the world, and to provide more unified control.[132] The G-20 did not however enlarge the role of the Basel Committee, but has called generally for the strengthening of financial supervision and regulation. In particular it was agreed that the members of the G-20 would:

> Establish the much greater consistency and systemic cooperation between countries, and the framework of internationally agreed high standards, that a global financial system requires. Strengthened regulation and supervision must promote propriety, integrity and transparency; guard against risk across the financial system; dampen rather than amplify the financial and economic cycle; reduce reliance on inappropriately risky sources of financing; and discourage excessive risk-taking. Regulators and supervisors must protect consumers and investors, support market discipline, avoid adverse impacts on other countries, reduce the scope for regulatory arbitrage, support competition and dynamism, and keep pace with innovation in the marketplace.[133]

However, Basel II has received criticism due to the self-regulatory nature of the capital adequacy requirements under the Accord. Some of its alleged failures relate to inadequately addressing liquidity risk and reputation risk, and not including protocols for the prevention of the insolvency of financial institutions. It has been suggested that a Basel III may be justified.[134]

Policy issues and reforms

The main lessons we can learn from the present crisis are:[135]

- no two crises are exactly alike;
- the first step is to ensure stability of the system;

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[131] R Bollen, 'The Slow Journey Towards A Global Regulator' 5 *MqJBL*, 261.

[132] See C Felsenfeld, and G Bilali, 'The role of the Bank for International Settlements in Shaping the World' (2004) 25 U. Pa. J. *Int'l Econ.L.*945.

[133] *London Summit Leaders' Statement*, (2009) G-20 <http://www.g20.org/Documents/g20_communique_020409.pdf> at 18 May 2009.

[134] See generally 'The 2007 Meltdown in Structured Securitization, Searching for Lessons, Not Scapegoats' (Policy Research Working Paper 4756, The World Bank, 2008).

[135] Cf Sir John Gieve, 'Seven Lessons from the Last Three Years' (Speech delivered at the London School of Economics, London, 19 February 2009).

- regulators must be flexible to respond to an emerging crisis while recognising that they cannot manage it;
- regulators need to develop a global early warning system to identify asset bubbles and excesses in domestic markets and the systemic risk implications;
- there needs to be improved cross-border data sharing and cooperation;
- regulators must take into account the global nature of the present system and its complications;
- regulatory reform must not overreact or be overambitious;
- derivatives need special attention in terms of regulation, disclosure and risk management;
- credit rating agencies need supervision; and
- the Financial Stability Forum in its new form as the Financial Stability Board as the place where all the regulators meet needs strengthening as an international coordinating body and it would be useful to have all the key bodies based in Basel.

These lessons lead to the need for new institutions, or new functions for existing institutions, and a new approach to regulation.

The idea of a new Bretton Woods Agreement has not been pursued.[136] Instead there has been a strengthening of existing institutions, notably the FSF (now the FSB) and IOSCO.

The main themes of a new approach to regulation are to be:

- a greater focus on macro-prudential risks across the financial system which takes account of banks, shadow banks and private capital;
- greater emphasis on shared information on financial markets;
- a campaign to reduce regulatory arbitrage;
- some greater regulation of hedge funds;
- standardisation of credit derivatives markets and central clearing systems;
- agreed action against uncooperative tax havens;
- improved standards for valuation of financial instruments; and

[136] See Altman above n 92. See also James, above n 66.

- more effective oversight of credit rating agencies.

The particular changes made with respect to the FSF and IOSCO are briefly examined below.

The new role of the FSF – now the Financial Stability Board ('FSB') and IOSCO

The G-20 recently released a declaration pertaining to the revised structure of the FSF. It was agreed that the FSF should be expanded, given a broader mandate to promote financial stability, and re-established with a stronger institutional basis and enhanced capacity as the FSB. The FSB's role will be to:

- assess vulnerabilities affecting the financial system, identify and oversee action needed to address them;
- promote co-ordination and information exchange among authorities responsible for financial stability;
- monitor and advise on market developments and their implications for regulatory policy;
- advise on and monitor best practice in meeting regulatory standards;
- undertake joint strategic reviews of the policy development work of the international Standard Setting Bodies to ensure their work is timely, coordinated, focused on priorities, and addressing gaps;
- set guidelines for, and support the establishment, functioning of, and participation in, supervisory colleges, including through ongoing identification of the most systemically important cross-border firms; and
- collaborate with the IMF to conduct Early Warning Exercises to identify and report to the IMFC and the G20 Finance Ministers and Central Bank Governors on the build up of macroeconomic and financial risks and the actions needed to address them.[137]

As discussed previously, it can be seen that the role of IOSCO has also changed, in that it has shifted to a more operational focussed approach. Jane Diplock has emphasised the role of the IOSCO MOU and concluded that IOSCO will become much more involved with policy makers and with industry in different jurisdictions. This hands-on regulatory approach is likely to be implemented in the following areas:

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[137] *Declaration on Strengthening the Financial System – London, 2 April 2009*, (2009) G-20 <http://www.g20.org/Documents/Fin_Deps_Fin_Reg_Annex_020409_-_1615_final.pdf> at 18 May 2009.

- short selling;
- unregulated financial markets and products; and
- unregulated financial entities.[138]

Regulatory change or paradigm shift?

The increased roles and responsibilities of the FSF and IOSCO come as no great surprise. What is surprising is the size of capital injections into financial institutions and the broader economy by national governments. This is leading to new forms of nationalisation of financial institutions and a changing role of the state. It is also leading to continuing demands for more global governance, the nature of which is still evolving.[139] It is too late to resurrect or replace Bretton Woods. A new system must reflect the changing reality of globalisation and a more closely integrated world. It must recognise the role of the major emerging economies and the private sector. The old dichotomies of domestic/international and public/private need to be adjusted to accommodate the new reality and environment both of which are changing continuously and quickly. Whether these changes amount to a paradigm shift[140] in capitalism is debatable.[141] Whether the new arrangements will provide strong enough institutions, and whether the new regulatory approach will be adequate, remains to be seen. Global governance in any event is not world governance. The new system is a continuation of the system of disaggregated sovereignty with modest modifications. Even the term 'global governance' is better avoided since what is more important is that we provide the practical means by which collective interests on a global scale are articulated and problems of financial risk are managed in a spirit of cooperation. We have all received a series of nasty shocks recently but it is important that we do not lose our nerve. Regulation is a tool to help us achieve a solution and will not in itself provide the solution. This can only come from the markets themselves adjusting to the new environment.[142] The problem

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138 Interview with Jane Diplock by J.H. Farrar, (Wellington, 15 April 2009).

139 See D Nayyar (ed), Governing Globalization – Issues and Institutions (2002) 3

140 See Thomas Kuhn, Structure of Scientific Revolutions (1970).

141 See 'When Fortune Frowned' *The Economist* (London), 2 October 2008 3.

142 Carmen M Reinhard and Kenneth S Rogoff, 'Is the 2007 Sub-Prime Financial Crisis So Different? An International Historical Comparison' 5 February 2008, Harvard University <http://www.economics.harvard.edu/files/faculty/51_Is_The_US_Subprime_Crisis_So_Different.pdf> at 19 May 2009. For a critique of the new financial architecture, see James Crotty, 'Structural Causes of the Global Financial Crisis: A Critical Assessment of the 'New Financial Architecture' (Working Paper Series Number 180, Political Economy Research Institute University of Massachusetts Amherst, 2008). See also Rhys Bollen, 'The

with paradigm shifts is that when you are in the middle of one, you do not know when it has shifted. In any event, a paradigm is only an intellectual construct, which is simply a way of interpreting the real world.

International Financial System and Future Global Regulation' (2008) 23(9) *Journal for International Banking Law and Regulation*.