

## **Three key elements of a new global financial architecture**

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At the G-20 Summit in Washington, it was agreed that global growth will require sound new global regulation of financial markets. But what would it take to achieve such regulation? The Summit offered few concrete answers. We argue that a new global architecture for the regulation of banking and finance is required to ensure success, comprising three elements: better representation in the rule-making process, a new robust system of monitoring, and systematic enforcement.

First, a better and more impartially-informed process for setting the rules is required. The existing rules were written by the Basel Committee on Banking Regulation which comprises officials from Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Spain, Sweden, Switzerland, the United Kingdom and the United States. They were wrongly persuaded by banks that complex derivative instruments could improve risk management and distribution as well as enhance market efficiency and resilience. Indeed, the financial sector argues its case extremely effectively. Recall how quickly and effectively their July 2008 report argued against any new or further regulation by detailing instead “best practice reforms” for the industry. Regulators who have resisted the finance industry’s well-honed case have been accused of stupidity, incompetence, and over-zealousness by those whose profits and personal gains are at risk by new rules.

Effective new regulation thus requires participation by a broader range of countries and stakeholders in rule-making, to ensure that different stakes, interests and risks are taken into account. The recent crisis shows that the costs of poor regulation fall on a wide range of countries, and not just those with the largest and most open financial sectors. Their voices would add a different and balancing set of stakes into rule-making.

Equally important is the range of agencies involved in rule-making. The Basel Committee is dominated by central banks (many of whom have bank supervisory duties). They do not represent the broad range of interests likely to be affected by bank failure. They are not politically accountable; most are independent. And for their own operational reasons, many have a culture of discretion and secrecy, rather than of transparency and openness to public scrutiny.

The new global regulation will require more politically accountable and more transparent engagement. One possible route is to transform the Financial Stability Forum which represents Central Banks, Finance Ministries, and regulators, widening the countries represented in the forum and vesting it with formal authority to make rules.

A second requirement of a new architecture is robust monitoring of regulators and those they regulate. New global rules – once agreed upon – need to be implemented and obeyed in the face of well-organized and richly-resourced firms and groups who try to avoid this. Robust monitoring requires “watching the watchdog” bodies such as have emerged in environmental regulation, sometimes financed by public grants or compulsory fees paid by firms. Voluntary private contributions to such a system are not inconceivable. Indeed, the current crisis has shown that some healthy and responsibly-run banks have lost out as a confidence crisis engulfed the entire industry. These banks will want to rebuild reputation and legitimacy, including by demonstrating they are distinct from their less-reputable peers. A few large financial services firms have already announced that they support the establishment of an effective new regulatory system to level the playing field with competitors in other jurisdictions. Such “watching the watchdog” bodies at the national level must be complemented by global supervisory agencies.

Enhanced global supervision was proposed during the G-20 Washington summit where leaders proposed establishing international ‘supervisory colleges for all major cross-border financial institutions’ (where financial regulators can compare market notes across countries, better co-operation between nations on regulations, the eventual standardization of accounting rules governing how companies can value assets, and new attention to credit-rating agencies). This is a step in the right direction. Global institutions need to monitor and report on national regulators, pressuring them to apply regulatory standards – countervailing the pressures from the financial services sector to “lighten up”.

One obvious contender for this role is the International Monetary Fund which already has a Financial Sector Assessment Programme seeking to monitor the health and resilience of a country’s financial sector. At present these assessments are entirely voluntary: the United States, for example, refused to participate until July 2008. The assessments need to be made compulsory and focused on whether or not regulators are implementing globally agreed standards. Furthermore, the results need to be published.

A third essential element of the new architecture is the creation of a special-function international judicial institution charged with assisting the enforcement of the new rules in banking and finance, adjudicating disputes, and offering uniform authoritative interpretations of the rules. Such institution would be made up of independent experts whose decisions would be subject to public scrutiny. This judicial body would be open to lawsuits by any affected individuals (much in the same way as the American chapter nine bankruptcy provisions permit filings by “parties in interest”) – without governments acting as gatekeepers. The problem here may be that affected individuals are willing but not able to sue for lack of resources. They thus will need public or private support. One model is the Advisory Centre on WTO law. Major trading countries including Canada, Denmark, Finland, Ireland, Italy, the Netherlands, Norway, Sweden, Switzerland and the United Kingdom have funded the Advisory Centre which gives advice to developing countries on WTO law and assists them in bringing dispute settlement proceedings (including against those countries funding the centre).

We should also consider permitting cases from non-state (including private) actors. The historical record on this is interesting: international courts with compulsory jurisdiction and non-state actor access hear more cases. In part this is because governments are reluctant to sue each other. Letting non-state actors bring cases would further widen the pressures and incentives on national regulators to ensure rules are applied.

Sceptics may deem such proposal impracticable, undesirable, and excessive – a pipedream. But do not forget that since 1990, states have established nineteen new international judicial institutions – most in the area of trade. This is almost three times the number of international courts that existed prior to 1990. Old and new international courts have issued since then over 24,000 rulings and opinions - that is 75 percent of total judicial output by international public courts. Governments have created these institutions because they help to spur global commerce.

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