Cambridge University Press
978-1-107-12863-7 — Soft Law and the Global Financial System
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Introduction

The Perils of Global Finance

Although financial crises have never been pleasant for people who have to live through them, they now seem to be more common and devastating than at any time in living memory. Large-scale financial crises sparked by loose lending and asset bubbles have occurred on average nearly once every three years since the 1990s – and in countries as diverse as Mexico, Thailand, and, of course most recently, the United States. Moreover, their impact has grown as ever more financial institutions from all over the world have become more central and indispensible to international capital markets. These developments have helped ensure that when financial crises occur, the global economy shrinks, companies go out of business, and countless jobs are lost, often in different countries and continents.

Perhaps, then, it is not surprising that people are now more interested than ever before in the issue of international financial market regulation. Whether it be on the pages of the *New York Times*, the *Frankfurter Allgemeine*, or *Le Monde*, scarcely a week has gone by since 2007 without a front page story on the machinations of the "G-20," "IOSCO," the "Basel Committee," or other seemingly arcane international institutions that are crafting key regulatory policies for the world's financial markets.

In some part, popular interest is due to the now widespread acknowledgment of financial regulation as a basic matter of economic prudence – and survival. Financial markets, when left to their own devices, have proven fertile grounds for disastrously bad behavior and poor decision making.[1] Banks take on extreme leverage to fuel speculative and often foolhardy bets involving poorly understood investments; conflicts of interests can skew incentives such that analysts insufficiently assess and report risk; con men can develop

1 Robert Kuttner, *Financial Regulation After the Fall* 3 (Demos Effective Regulation for the 21st Century Report Series, 2009), *available at* www.demos.org/pubs/reg fall.pdf.

fraudulent schemes to cheat investors out of their savings; and executives are empowered to act in their own short-term interest instead of the interests of the firms for which they work and shareholders. Ultimately, when gambles go awry, and animal spirits wane, financial institutions can fail – from commercial banks and investment banks to insurance conglomerates and money market funds – and in the process stifle lending and other financial activities necessary for running a modern economy. Indeed, the bankruptcy of just one institution can create panic in the marketplace, strangle the provision of credit in an entire financial system, and cause investors to pull hundreds of billions of dollars from an economy overnight. When severe enough, crises of confidence can even require national governments to intervene and participate in the markets that they would otherwise oversee, and in the process transform financial market crises into sovereign debt fiascos where the very creditworthiness of even the largest leading economies is questioned, a fact illustrated by both the ongoing Eurozone crisis and Standard & Poor's historic downgrade of the US credit rating.

Concerns about financial market regulation have also intensified as the world has become increasingly aware of the transmission belt of risk that can effectively export financial risks across borders. Over the last twenty years, failures in even marginal or peripheral economies have upended major financial institutions halfway around the globe that had large exposures to failing foreign companies and financial conglomerates and markets. And the locales generating risk have seemingly multiplied. No longer do commentators argue or assume that financial shenanigans and crises were primarily a problem of developing countries. Instead, the last financial crisis has showed with painful clarity that even the United States – from its unregulated credit default swaps to toxic subprime securities to the Bernie Madoff scandal – can suffer momentous lapses in regulatory oversight, and accordingly generate consequences for the global economy far greater than those once imagined with emerging markets.

Nevertheless, even the most fastidious observers of financial markets tend to have little familiarity with the specifics of international financial regulation. They may have heard of the Basel Committee or the G-20, especially in the wake of the financial crisis, but little else. And even the media may have only a limited understanding of how standards are set within the international system and, more generally, of how and under what circumstances international financial law – the diverse set of regulatory rules, standards, and best practices governing capital markets – actually "works." Instead, players in the international regulatory system are routinely referred to in shorthand as "a global body" or "group of regulators" without much attention paid to the means by which rules are propagated, or for that matter, what it even means to have "rules."

The contributions of academic writers to the study of international financial law have been similarly mixed. Understanding the supervision and oversight of the international financial system involves many disciplines, including international law, political science, and "corporate law" (which depending on one's views can itself entail a variety of fields like finance, securities, insurance, and banking). This complexity makes international financial law tough both to teach and to write about and often leads to a variety of disciplinary biases. Academic contributions have, as a result, ranged from the parochial to the profound.

Legal scholars, perhaps surprisingly, have been least likely to tackle the emerging field head-on. Business law scholars have tended to focus on domestic corporate, banking, and securities regulations since most international accords are dependent on national governments for their implementation. Similarly, legal philosophers, especially of the positivist bent, have argued that international financial law does not qualify as "law," given the absence of a centralized, coercive authority – a world government in effect – to implement its dictates. Even international lawyers have had little enthusiasm for international financial law, due in no small measure to its lack of traditional signposts of legitimacy and solemnity. In contrast to most other areas of international economic law (like trade, tax and, to a lesser extent, monetary law), international financial agreements do not take the form of legally binding treaties. Instead, global rules and standards are promulgated as informal, non-binding "soft law" agreements, often between regulatory agencies – and by international institutions with amorphous legal identities. International financial law has, as a result, occupied a backseat when compared to other areas of international law with more obvious features cognizable under traditional international legal theory.

By comparison, international relations scholars have arguably presented more compelling studies of international financial law. More sensitive to the competitive pressures unleashed by global financial markets, scholars in the field have, with increasing sophistication, examined the rise (and in some cases, fall) of many international economic institutions and their increasing prominence as standard setters in the area of international financial rule making. International relations scholars have also emphasized the distributional consequences inherent in international financial rule making. In the process, they have identified various means by which states pursue their national interests while also illuminating both the coordination challenges preventing cross-border regulation and the tactics needed to secure cooperation.

Yet even international relations theorists rarely examine international law as a category distinct from international politics. Political scientists tend not to talk about the prospect of international financial regulation *as law*.[2] Instead, they view law as the product of power relations between countries. Consequently, international financial law is almost always cast as a dependent variable or a signpost of power positions, as opposed to an independent variable informing the behavior of a host of regulatory and financial actors. Realist narratives of sovereign power fail to explain, however, why international financial law should exist at all in a world of deep distributional challenges. Assuming that countries indeed follow their own national interest, international codes, best practices and standards – especially the nonbinding ones like the ones shaping the global financial system – should provide minimal credibility or comfort to those relying on them. Compliance with particular standards often begins to resemble a zero-sum game. Once a regulatory choice is no longer beneficial to a party, there are, at least according to standard understandings of soft law, few (if any) incentives for that party to act on its commitments. Backtracking on promises should be costless. Existing models are, as a result, ill-equipped to explain the puzzle of why soft law is so heavily negotiated and bargained over, much less *ever* relied on to communicate commitments in international financial regulation.

The tendency to overlook international financial law reflects an incomplete understanding of soft law – both of its impact on financial markets and of the unique institutional ecosystem in which it operates. As to the first point, existing theories of international financial regulation routinely underemphasize the role of market participants and international organizations in promulgating and backing global financial standards. Theorists, instead, routinely view markets and firms as a means by which state policy is exerted and rarely study them as independent variables that can affect the strength and pull of international financial standards. And though some scholars have identified a few of the key institutions governing international finance, few have comprehensively inspected how disparate organizations interact with one another as part of an international regulatory architecture. Consequently, theorists have failed to pinpoint the design features that can bolster, as well as reduce, the effectiveness of the global regulatory system. Instead, scholars generally rely on the theoretical models developed in other areas of international law, like the burgeoning "network" literature of global governance, that speak to the institutional specificities of international financial

[2] Jack L. Goldsmith & Eric A. Posner, The Limits of International Law 83 (2005).

regulation. In doing so, they fail to explain the existing soft law system and often overlook alternative routes to regulatory reform.

This book engages these and other issues in an effort to stake out a more nuanced understanding of international financial law. It argues that in order to understand how soft law works in the global financial system, we need to examine the broader institutional environment in which it operates. To do so, the book builds, on the one hand, on long-standing insights from international law that soft law can have important advantages as a coordinating mechanism. But it breaks, on the other hand, with pervasive views that assume soft law to be necessarily "nonbinding." Instead, it argues that the degree to which an instrument is coercive or "binding" is less a matter of obligation than enforcement. Where standards and best practices – even if informal – are backed by mechanisms that enforce compliance, they can be viewed from a functional standpoint as species of international law, albeit promulgated by means other than traditional treaty-making processes. And here, the book argues, international financial regulation, though not emanating from traditional authoritative sources, is indeed bolstered by a range of often complex enforcement technologies that render it more coercive than traditional theories of international law predict.

At the same time, the book notes that key features of the international regulatory system – including its considerable substantive and qualitative blind spots – help to explain general questions that have long interested students of international relations, such as when or why states fail to comply with or to implement international rules. The book predicts that the effectiveness of international financial law will depend, in part, on the benefits (or costs) of conforming to a standard as measured against the benefits (or costs) generated by reputational, institutional, and market disciplines. This analytical framing yields, in turn, important insights into reform. Efforts at reform have typically focused on whether the existing soft law architecture should be replaced with more "hard law" commitments and formal international organizations. This book shows, however, that the toolbox of options available to regulators is both broader and deeper than is commonly assumed, and that many of the most important choices are not necessarily between hard and soft law as such, but between different institutional arrangements.

To the extent to which international financial law intrudes more deeply into the fabric of domestic regulatory supervision, and as more national regulatory agencies are either tasked with or commit to implementing international standards and best practices, it makes sense to ask whether global mechanisms and forums properly represent and reflect the interests of both national and international stakeholders and constituents. Though operating at an "international" level, "international" financial law is not always "global" to the extent that some countries participate more than others and play more important roles in the promulgation of international standards. It also evades key domestic processes like treaty ratification and adopts more administrative modes of rule making. In light thereof, this book provides the conceptual tools with which we can begin to systematically think through the implications of such structural and procedural features embedded in the global financial system, and proposes a framework for addressing potential democratic deficits, legitimacy and accountability.

In doing so, this book provides the theoretical building blocks for studying international financial law as a coherent discipline. Because international financial codes, best practices and standards do not resemble other more traditional areas of public international law, international financial law is not generally understood as comprising a body or pattern of common principles, strategies, or instruments. This book challenges this tendency, and sets forth a holistic framework for understanding the qualitative features of the global financial system. At the same time, the book shows that any broad attempt to posit international financial law as "law" outright, or to deny it altogether, would be far too sweeping.[3] To be sure, many areas of international financial law exhibit key attributes of efficacy, legitimacy, and obligation – perhaps the three most common signposts of legality – whereas in other situations it does not. Context is thus very important. That said, there are important general principles that illuminate the operation and implications of international standard setting and the kinds of institutional features that can affect any of the common attributes of legality.

WHAT IS FINANCIAL REGULATION?

Although international financial law is still an emerging field when compared to international human rights or more traditional economic areas like trade, the demand for financial market regulation is not in itself new. The roots of its modern incarnation can be traced to the regulatory responses to the excesses of the 1920s, an otherwise golden era for the US economy, though one plagued by unbridled and often highly leveraged capital markets speculation. Investors – ranging from individuals to leading investment banks, commercial banks, and insurance companies – jockeyed to make quick winnings in companies connected with the new technologies of radio, air flight, utilities,

[3] Joshua Kleinfeld, *Skeptical Internationalism: A Study of Whether International Law Is Law*, 78 Fordham L. Rev. 2451 (2010).

and automobiles. Many of these investments were made with borrowed money and with little understanding of the companies concerned. Financial services professionals often misrepresented the economic prospects of the investments that they sold, and thousands of fraudulent companies were formed for the purpose of duping investors into parting with their savings. The value vested in the exchanges soared as money poured into stocks and bonds.

On October 24, 1929, as it is famously recounted, the market ultimately "crashed" from the weight of bets gone bad, losing 9 percent of its value. In the month following the crash, one of the most dramatic in history, the capitalization of companies trading on the exchange fell from $80 billion to $50 billion, wreaking havoc on the US economy. By 1932, stocks had lost nearly 90 percent of their value. Millions of retail investors lost their life savings, leading to deep declines in consumer confidence and spending. Highly leveraged financial institutions had insufficient cash on their books to cover the bets that they had made. In the banking crisis that followed, nearly four thousand banks could not even honor withdrawal demands by customers, just as insurance companies scattered around the country could not honor claims by policyholders. These difficulties sparked bank runs across the country as depositors panicked over the security of their savings, setting off a worldwide run on gold deposits and causing other banks to fail through the mass withdrawals. With distrust of financial institutions rampant, lending between financial institutions halted, choking off credit and liquidity to the broader economy, ushering in a deflationary cycle marked by a decade of still-record 25 percent unemployment in the United States.

In response to these failings and the events leading up them, the federal and state governments in the United States, as well as various capitalist governments observing from afar, undertook regulatory reforms to help prevent financial crises from arising again and sapping the health of national economies. Key to these efforts was the regulation of capital – with a sectoral focus on banks, via banking regulation; on securities transactions, via securities regulation; and on insurance companies, via insurance regulation. This focus was due, in part, to the role of so many institutions as "culprits" in the financial crisis leading up to the Great Depression. After all, these institutions lay at the heart of a modern financial system – that is, the myriad economic and financial institutions and mechanisms whereby funds are channeled from savers to borrowers, enabling those with productive investment opportunities to avail themselves of much-needed capital.

Each regulatory sector had its own areas of emphasis. Bank regulation largely concerned commercial banks – the institutions that receive deposits of money from the general public and that lend out those deposits to other banks, institutions, and individuals. Historically, commercial banks have been regarded as the most critical pillar of a nation's economy. They act as the generative and backup source of liquidity for all other financial institutions and are the means by which monetary policy, usually through interest rates, is exercised. Consequently, banks are important channels for moving and directing capital in the national and international economy. Their failure, especially in large numbers, can rapidly deprive society of liquidity and increase the costs of credit. The focus of bank regulation is not to protect bank customers – though national banking authorities or governments generally guarantee deposits. Instead, the purpose of banking laws is to ensure that banks are prudently run, with adequate capital and liquidity, and are involved in safe, delimited commercial activities that do not unduly jeopardize the bank's health.

Similarly, insurance laws focus on the permissible investments of insurance companies to ensure their financial solvency and soundness, thereby enabling them to honor their long-term obligations to policyholders. Given that insurance companies market their services, insurance regulation aims to guarantee the fair treatment of current and prospective policyholders and beneficiaries by both insurers and the people who sell their policies. Like banks, insurance companies are required to meet and maintain certain financial requirements in order to conduct business and must abide by fair trade practices with regard to their terms of business with consumers.

Securities regulation governs the issuance, sale, and subsequent trading of securities instruments like stocks and bonds as well as, potentially, more exotic instruments like derivatives. Securities regulations involve three basic subfields. First, securities laws try to make available for investors useful, high-quality information regarding firms and potential investments. They prescribe the kind of disclosure that companies are required to make to the public when selling securities – a process that, among other things, involves the drafting of a prospectus containing financial statements detailing the economic condition of the firm. Second, securities regulation dictates how securities are traded and touches upon the procedures and constraints imposed during the trading process. Third, securities regulation governs stock exchanges and other venues for the sale of securities, as well as brokers and dealers – that is, those financial players (often housed as subsidiaries of investment banks) that either trade securities on their own behalf or for others (together, "broker-dealers").

Despite the seemingly disparate concerns, all sectors of financial regulation share two important points of focus. They all seek to reduce information asymmetries that increase the risks to which the institutions are exposed.

Banking, by its nature, involves the credit risk that borrowers may fail to repay their loans to banks. One significant element of this risk is that banks are less knowledgeable about a borrower's revenue streams, market conditions, and organizational integrity than the borrower itself. Similarly, a significant element of an insurance company's risk (over and above spates of insurance claims) involves potential customers of insurance claims being more knowledgeable about their propensities to generate insurance claims than their issuers. Even securities transactions involve considerable risk insofar as investors and traders of securities are likely to have significantly less information about a firm's prospects for future success than the issuers of the securities. As a result, despite the myriad supervisory and prudential regulations in place, virtually all financial institutions are subject to various disclosure and capital reserve requirements in case investments go bad.

Financial regulations are also largely focused on the systemic risk generated by financial institutions. When a firm can no longer internalize the risks associated with its financial activity, it may collapse. With most firms, such collapses create losses for the firm's shareholders and creditors. However, with financial institutions, a collapse can have serious repercussions on other market participants and also the wider economy. Depositors may withdraw their money from a failing bank, precipitating a general perception that other banks are equally troubled and generating a run on banks by depositors en masse. In a rush to secure their asset bases and reduce the risks among themselves, banks may call in loans previously made to one another, compounding the systemic distress. Suspensions of both interbank lending and lending to corporate clients can slow economic growth and exacerbate wide-scale financial distress.

The failure of an insurance company can result in financial losses for clients with outstanding claims – which, depending on the severity of loss and their dependence on insurance coverage, may affect their ability to continue operations. Likewise, the collapse of a securities firm can severely disrupt international capital markets. When a major financial conglomerate files bankruptcy, some of the outstanding obligations to other firms go unmet, potentially imperiling the financial stability of borrowers and counterparties that depend on the firm's performance. Additionally, because a large securities firm can hold vast quantities of securities both to serve as collateral for loans and to maintain orderly markets, any major financial stress that it experiences could force it to sell off large swaths of its inventory to meet collateral calls – which can cause the stock market to decline as securities flood the market. The capital bases of other firms can then plummet in concert with the stock market's decline, forcing them to sell off their inventory and exacerbating the extent of decline. Interfirm lending can dry up altogether, creating a credit crunch for financial institutions. In light of these risks, international financial regulation has worked increasingly to establish best practices and oversight for these activities to ensure the stability of the global financial system.

THE RISE OF CROSS-BORDER CAPITAL

For much of the postwar period and up through the late 1980s, the objects of financial regulation – banks, the buyers and sellers of securities, and insurance companies – were primarily domestic actors. Banks tended to take deposits from local actors and lend to nearby businesses. Investors would invest in businesses that they knew, usually on nearby exchanges. And local insurance companies would provide products and services to their respective local constituencies. But as international trade linkages have deepened with globalization, so has finance, to the point that it now flows even more freely than the trade of goods.

Three dynamics have helped the rise in cross-border capital flows: deregulation, technology, and financial innovation. The first development, deregulation, involves the easing of governmental regulations over both capital and financial products. Throughout the 1990s, most countries sought to increase inward foreign investment. To do so, many countries introduced a range of measures that allowed "sophisticated" investors, among them foreign financial institutions, to raise capital or engage in complex financial transactions with light governmental supervision. More permissive institutional rules were also introduced, especially in the United States, which allowed greater affiliation between commercial banks and securities firms, and in the process generated greater incentives for traditional depositary institutions to seek higher-yielding returns in overseas ventures. Meanwhile, rules on currency convertibility were eased, facilitating the ability of foreign investors to repatriate capital and thus reduce the risk of investment. And thousands of investment treaties were entered into between countries in which governments, hungry for foreign capital, promised to compensate firms should their investments be seized or expropriated. Advances in information technology have also spurred cross-border, outward investment. Innovations in information technology have enabled the transmission of virtually real-time information over the Internet concerning securities traded on foreign capital markets. Earnings reports, government filings, and market developments can be disseminated via the Web pages of issuers, financial advisers, the government, and online news services – along with near-instantaneous quotations on most publicly traded securities. Equally important, "the digitalization of