# Chapter 2

# Global Financial Governance and Banking Regulation:

# Redesigning regulation to promote stakeholder interests

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## I. Introduction

The global financial crisis of 2007-08 demonstrated serious weaknesses in global financial governance and has led to comprehensive reforms of international financial regulation. The G20 and the Financial Stability Board have taken the lead post-crisis with efforts to make international financial standard setting more accountable and legitimate by involving more countries in the standard setting process and by making deliberations more transparent and reflecting the views of a broader number of stakeholders. Moreover, the G20 initiated at the Heads of State Summit in September 2009 an extensive reform of international financial regulation with the overall aim 'to generate strong, sustainable and balanced global growth'. An important feature of the international regulatory reforms has been the G20's stated objective to make financial regulation more 'macro-prudential', that is, to address risks and vulnerabilities across the financial system and broader economy that might threaten the stability of the financial system – and hence imperil the stability and sustainability of the economy. The crisis demonstrates the need to adopt a more holistic approach to financial regulation and supervision that involves linking micro-prudential supervision of individual institutions with broader oversight of the financial system and to macroeconomic policy. This chapter makes the novel contention that the crisis was the result not only of inadequate

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international regulatory standards (eg., Basel II) but that it resulted also from flawed international decision-making structures that failed to incorporate the views and perspectives of most countries and many non-state actors that represent societal stakeholders whose interests were not taking into account in the international financial standard setting process.

As is highlighted throughout this book, the process of spreading and implementing effective regulation represents a central challenge in the governance of today's global financial system.[1] This chapter contributes to the overall theme of this volume by attempting to shed more light on the decision-making processes in international financial standard setting bodies such as the Basel Committee on Banking Supervision and to analyse critically whether or not the views and interests of other countries and stakeholder groups outside the Basel Committee are adequately taken into account in the development of international banking supervisory standards. Other chapters in this volume analyse the extent to which stakeholder groups contribute to, and have a voice in, international decisionmaking and standard setting in important areas of global public policy. After critiquing pre-crisis international financial standard setting, the chapter discusses how post-crisis international regulatory reforms have increased the number of countries involved in international standard setting from the small number of advanced industrialised countries pre-crisis to a much broader grouping that includes large emerging market and developing countries and representatives from regional trading blocs. This chapter submits that although significant progress has been made in increasing the number of countries involved international financial decisionmaking, these bodies still do not meaningfully involve other countries (outside of the G20) in decision-making, nor do they adequately involve non-state actors representing a large number of societal stakeholder groups in such decision-making.  This is particularly the case with international financial bodies, such as the Basel Committee, which still do not adequately

[1] See chapter X (conclusion) 4.

consult nor involve societal stakeholder groups, such as environmental and social governance representatives, in their decision-making processes and institutional structures.

This chapter suggests that the inclusion of more countries and societal stakeholder groups in global financial governance will enhance the efficacy, accountability and legitimacy of international financial regulatory norms. This is because stakeholder engagement is driven most often by enlightened self-interest, in which the effectiveness of decision-making depends crucially on the expertise and resources of societal stakeholders, who as strategic actors are in a position to influence more effective governance and because of their incentives, expertise and resources are able more effectively to diffuse policies globally.[2]

The chapter first considers how decision-making has evolved in the most important international financial sector bodies, namely, the Group of 10 (G10) central banks with particular focus on how they have influenced the development of international standards of banking supervision. Second, the chapter considers the case of the Basel Committee on Banking Supervision and its role pre-crisis in setting international banking supervisory standards for all countries with market-based banking systems, but without the involvement or participation of countries who were not members of the Basel Committee or of non-governmental organisations that represent societal stakeholder groups affected by the standards. The crisis of 2007-08 demonstrated how the Basel Committee's supervisory standards failed to estimate and manage the risks that toppled the global banking system. The section suggests that had decision-making been more accountable and legitimate in involving more countries and stakeholder groups from outside the G10 advanced economies then the harshest aspects of the crisis could have been mitigated. Third, the chapter discusses how the post-crisis international regulatory reforms have expanded the number of countries involved in international standard setting, particularly the Basel Committee which now has close to

[2] Ibid.

thirty members in contrast to thirteen pre-crisis. Although international financial committees are now consulting a broader number of countries, stakeholder groups that represent broader economic and societal interests are under-represented and often not consulted in international financial standard setting activities, particularly regarding environmental and social sustainability concerns.

Also, section IV discusses the emergence of informal bodies of standard setters consisting of representatives from the financial sector, regulatory community, and stakeholder groups, which act outside of international financial standard setting bodies. These new international bodies are beginning to influence the content of international norms in environmental and social governance. These initiatives, however, are limited and suggest that more should be done to integrate a broader array of international bodies and stakeholder groups into international financial standard setting processes.

## II. Global Financial Governance and the Rise of G10 Committees

In international finance, the globalization of financial services has necessitated that central banks and financial regulators develop cooperative relations to facilitate their oversight and regulation of banking and financial services. Beginning in 1962, the central banks of the ten leading industrialized nations began to meet regularly at the Bank for International Settlements[3] and other venues to coordinate central bank policy and to organize lending to each other through the General Arrangements to Borrow.[4] From the 1960s until 1990s, the G10 central bank governors represented the world's most advanced industrialised countries and were responsible for setting the agenda of other G10 financial standard setting committees.

[3] The Bank for International Settlement (BIS) is an international organization created under the Hague Agreements of 1930 and the Constituent Charter of the Bank for International Settlements of 1930. See James C Baker, *History of the Bank for International Settlements* (Cambridge University Press 2002) 32. .

[4] See Kern Alexander, 'The Fund's Role in Sovereign Liquidity Crises' in International Monetary Fund (ed), *Current Issues in Monetary and Financial Law,Volume 5* (International Monetary Fund 2008) 131-190, 140-146.

In the early 1970s, the IMF fixed exchange rate regime collapsed, leading many countries to de-link the value of their own currencies to the value of the US dollar, thereby resulting in increased volatility in foreign exchange rates and considerable instability in global banking and financial markets. The ensuing volatility resulted in a clear and present threat to financial stability when the German bank Herstatt Bankhaus of Cologne Germany collapsed into insolvency in 1974 because of mismanaged foreign exchange exposures and the collapse of the Franklin National Bank of New York – a systemically important US bank – because of mismanaged foreign exchange exposures. This led G10 central bank governors to create the Basel Committee on Banking Regulation and Supervisory Practices (Basel Committee) in December 1974 to address cross-border coordination issues and to enhance cooperation between central banks and bank supervisors in overseeing cross-border banking activity.[5]

Since the 1970s, the three main G10 (or BIS) committees – the Basel Committee, the Committee on Payment and Market Infrastructure, and the Committee on the Global Financial System – have become the most influential international financial standard setting bodies by exercising either direct or indirect influence over the development of banking, currency and market operations, and payment system law and regulation for all developed countries and most developing countries. The Committees have examined many important central banking and financial regulatory issues, as well as attempted to elaborate and promulgate best practices in supervision and regulation, the functioning of payment and settlement systems, and the overall operation of financial markets. They are usually chaired by senior officials of member central banks and are composed of experts from central banks, regulatory authorities, and finance ministries. In the case of the Basel Committee, members also include non-central bank supervisory authorities and other regulatory and economic policy experts. Members of the Committees have voting power and decision-making authority, while non-G10 country

[5] Charles A E Goodhart, *A History of the Basel Committee on Banking Supervision* (Cambridge University Press 2011) chapter 14.

representatives were often consulted for their views on a variety of regulatory and economic issues. Frequently, special initiatives are undertaken to share experience with, and invite the opinions of, those not directly involved in the work of the Committees.

In promoting cooperation in their respective areas, the Committees determine their own agenda and, within their mandate, operate independently from their host organization, the BIS, which only provides its good offices for meetings as well as administrative and research support. Significantly, these Committees have resolved not to adopt legally binding international standards in a public international law sense, but rather to influence domestic regulatory practices and standards by adopting what has become known as 'international soft law'.[6] Adopting international standards as soft law rather than in a legally binding form can also be observed in global health standard setting, where soft law is used as a tool to achieve compliance with global standards.[7]

Although international soft law standards have been praised as allowing international standard setters to respond flexibly to rapidly changing developments in financial markets and to diffuse standards to a wider number of countries,[8] they began to attract much criticism in the early 2000s after the Basel Committee proposed amendments to the 1988 Capital Accord known as Basel II that was intended to apply not only to the G10 countries but also to all countries that are members of the International Monetary Fund and World Bank. This attracted significant critical comment – especially later after the crisis began in 2007 when Basel II's standards had failed to protect the banking system - and brought its work under close scrutiny by leading policymakers and regulators.

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[6] See Kern Alexander, Rahul Dhumale, and John Eatwell, *Global Governance of Financial Systems: The International Regulation of Systemic Risk* (Oxford University Press 2006) chapter 3, discussing international soft law.

[7] See chapter X (conclusion), 15-16.

[8] George Alexander Walker, *International Banking Regulation: Law, Policy, and Practice* (Kluwer 2001) preface, xxiii.; see chapter X (conclusion) 4, 24.

## III. The Basel Committee on Banking Supervision – A Case Study of Inadequate Stakeholder Participation

The Basel Committee has been the most influential of the G10 committees with respect to its impact on developing legally nonbinding international financial norms of banking regulation, especially through the adoption of the *Capital Accord, the Concordat,* and *the Core Principles for Effective Banking Supervision (revised 2012)* and their impact on domestic regulatory and supervisory practices. The Basel Committee's most famous international standards agreement was the 1988 Capital Accord. The Capital Accord established a minimum eight percent capital adequacy requirement on internationally active banks within G10 country jurisdictions, which later was applied to most countries internationally.[9] Between 1999 and 2004, the Committee engaged in a lengthy and radical revision of the Accord known as 'Basel II.' Basel II was concluded in 2004 and the final text was published in June 2004.

Although the revision of the Accord involved non-members of the Basel Committee offering their views on the new capital framework, final decision-making and deliberation was controlled by the G10 countries (13 countries as of 2004) and decisions were taken in opaquely operated committees consisting of G10 members without consultation or involvement of countries outside the G10 or of civil society groups who represent societal stakeholder interests affected by the Committee's decisionmaking. The flawed decision-making structure of the Basel Committee not only produced inadequate regulatory standards for the countries that had adopted them (because the bank supervisors were under tremendous influence by the global banking interest groups) but also produced particularly pernicious

[9] 'International Convergence of Capital Measurement and Capital Standards' and it applied based on the principle of home country control to banks based in G10 countries with international operations (Basel 1988).

standards for the many countries of the world not on the Basel Committee but who were subject to its standards, particularly developing and emerging market countries.

The financial crisis of 2007-08 revealed that banks were exposed to significant liquidity risks, especially in their off-balance sheet exposures, and that they should have been holding more loss-absorbent capital. The flawed decision-making structure of the Basel Committee contributed to the final agreement (Basel II) failing to address the liquidity risks to which banks are exposed and also requiring inadequate levels of loss-absorbent capital. Another major flaw in Basel II was that it relied excessively on risk-weightings of bank assets to calculate regulatory capital, resulting in procyclicality, which meant that banks were holding too little capital during market upturns and too much capital during downturns.[10] The procyclicality of Basel II also had pernicious effects on economies that were more prone to volatility and booms and busts – specifically, developing and emerging market economies. Basel II also favoured large banks with sophisticated data management systems over small banks (mainly in developing and emerging economies) with less data in that it allowed banks with large amounts of credit default and loss data to input that data into their regulatory capital calculation models, while banks without the data (mainly smaller banks and most banks from developing countries) had to hold higher capital amounts based on the regulator's standardised model. The imbalance in how regulatory requirements apply between developed economies and smaller developing and emerging economies unfortunately persists in other areas of international financial regulation and in other areas of global governance outside of finance, which is repeatedly reflected in other chapters of this book.[11]

[10] Kern Alexander, John Eatwell, Avinash Persaud, and Robert Reoch, 'Financial Supervision and Crisis Management in the EU' (Commissioned Report for the EU Parliament Committee on Economic and Monetary Affairs, EU Parliament 2007).
<http://www-cfap.jbs.cam.ac.uk/publications/downloads/2007_alexander_eatwell_persaud_reoch_financial.pdf> accessed 24 April 2015.
[11] See chapter X (conclusion), 15-16.

As discussed above, the Basel Committee and other international standard-setting bodies have been characterized as 'networks' of international technical experts, which are not concerned with broader public policy or international political economy issues. Rather, they are at the 'coal face' of technical and regulatory standard setting. They form a type of epistemic community that is concerned with the stable and efficient operation of the global financial system and share common views and philosophies regarding the role of regulation and central banks in overseeing the operations of the banking and financial system.[12] The goal of these regulatory technicians in international bodies is to coordinate and cooperate with each other regarding the cross-border operations of banks and financial conglomerates with operations across financial sectors. These networks are composed of national regulators and supervisors—mainly from developed countries—who have established several international bodies to coordinate communication and the exchange of ideas among regulators on common issues of concern. These regulatory networks play an important role in disseminating information among regulators across financial sectors in different jurisdictions and, as is the case with other global standard setting bodies, serve as the principal diffusion mechanism of global standards.[13]

Before the 2007-8 crisis, non-state actors that constituted industry lobbying bodies (ie., the Institute of International Finance) for the banking and financial services sector played a role in international financial standard setting by sending representatives to participate in the deliberations of the Financial Stability Forum (FSF) and other international financial bodies, such as the Joint Forum on Financial Conglomerates, which consisted of representatives of the Basel Committee, the International Organisation of Securities Commissions, and the International Association of Insurance Supervisors. Crucially, the FSF and the Joint Forum involved representatives of the banking and financial services industry in its deliberations and

[12] See e.g. chapter X (conlusion) 22-25.
[13] See chapter X (conclusion) 6.

it is commonly known that the major global banks were recruiting regulators who were involved in the Basel II deliberations to come to work for the banks after the Basel II agreement was concluded. The major banks were the only representatives from so-called stakeholder groups who were permitted to participate in international financial standard setting on the grounds that the deliberations were addressing merely technical issues of risk management and bank corporate governance and therefore were not the concern of other societal groups that were not directly involved in the financial services industry. Despite the criticism of involvement by industry funded stakeholder bodies in international standard setting because of their parochial interests that do not reflect broader societal concerns, it is submitted that their involvement can be seen as a positive development in enhancing stakeholder participation as long as it based transparent decision-making structures and sound accountability mechanisms that involve other non-state stakeholder groups on an equal basis.[14]

### A. Decision-making and legitimacy of international financial standard setting

The international financial bodies lack the requisite attributes of an international organization, namely, they are not subject to international law, and do not have international personality, the capacity to conclude treaties, or international legal immunities. Insofar as these organizations are neither composed of States nor founded upon an international treaty, they also do not meet the traditional legal definition of an international organization and therefore are not subject to minimum rules of transparency regarding, for example, the keeping of meeting minutes and other records concerning decision-making and deliberations. It is argued in some quarters that this lack of accountability in decision-making and operational processes can potentially undermine the effectiveness and legitimacy of the IFIs.

[14] See chapter X (conclusion), 11, 24.

Achieving legitimacy is another theme that resonates throughout this book and is an essential criticism of international financial bodies as well as standard setters in other fields.[15]

On the other hand, other commentators suggest that precisely because these international standard-setting bodies are devoid of legal personality and excluded from the potential discipline of international law, they gain in flexibility and enhanced coordination benefits, by not being subject to formalistic rules of decision-making process and consultation, and therefore are in a position to devise international norms that turn out to be more effective in influencing state practice than traditional methods and procedures of public international law-making.[16] This flexibility offers the benefit of enhancing effectiveness and accelerating the process of influencing the creation of law, but simultaneously risks drawing criticism, since this process lacks accountability and traditional control mechanisms.[17] For the exact reasons outlined above, the worldwide financial crisis called the efficacy of this flexible and unstructured decision-making framework into question and in particular has raised concerns regarding the accountability, effectiveness and legitimacy of the IFI standard setting processes.

The case of the Basel Committee and its adoption of Basel II is a case in point about how limited input from stakeholder groups – including the great majority of countries who were expected and pressured to comply with Basel II by the IMF and World Bank – can result in flawed and detrimental standards of regulation. To improve standard setting, it must be based on the principles of accountability and legitimacy. In assessing whether the Basel Committee's standard setting process complies with the principle of legitimacy, a closer look at the Basel Committee's deliberation and decision-making process is necessary.

[15] See chapter X (conclusion) 19.
[16] See Alexander and others (n 7) 136-139.
[17] See chapter X (conclusion) 24.

The Basel Committee addresses issues that are of global concern to regulators and supervisors through a set of committees established to address particular issues of concern to bank regulators. After committees deliberate they issue recommendations to the Basel Committee Secretary General and Deputy Secretary General who are in position to table recommendations or issues of concern (including reports by external bodies) to Committee. The Basel Committee's decision-making operates on a consensus basis. Although the Committee's decision-making has traditionally been secretive and substantially relied on personal contacts, it has become more formalized in recent years because of the considerable attention given to the deliberations over Basel II.[18] The Committee's decision-making places a great deal of emphasis on decentralized implementation and informal monitoring of member compliance. The Committee has sought to extend its informal network with banking regulators outside the G10 through various consultation groups. For example, the Core Principles Liaison Group remains the most important forum for dialogue between the Committee and systemically-relevant non-G10 countries. Most recently, it has conducted seminars and conferences with many countries outside of the G20 through the BIS Financial Stability Institute that addresses implementation issues concerning international financial standards.

As mentioned above, monitoring noncompliance has generally been a decentralized task that is the responsibility of Member States themselves, not international organizations, such as the BIS, or other international bodies. Nonetheless, the Committee monitors and reviews the Basel framework with a view to achieving greater uniformity in its implementation and convergence in substantive standards. To ensure that its standards are adopted, the Committee expects the IMF and World Bank to play a surveillance role in

[18] For instance, during the Basel II negotiations, the Committee put a number of issues for consultation on its website and engaged in a public dialogue on its website through the publication of its quantitative impact studies which measured the impact of Basel II on a hypothetical basis based on the reports of a number of banks in both G10 and non-G10 countries.

overseeing Member State adherence through its various conditionality and economic restructuring programs. This extended application of the Basel Committee's standards to non-G10 countries has raised questions regarding the accountability of its decision-making structure and its suitability for application in developing and emerging market economies. In addition, because most G10 countries are members of the European Union, they are required by EU law to implement the Capital Accord into domestic law.[19]

### B. Ineffective standard setting

Although the flexible and secretive manner in which the Basel Committee conducted its deliberations and standard setting was generally considered a strength in the effectiveness of its governance structures and decision-making processes, it also had the unfortunate result of insulating the Committee from outside public scrutiny that could have legitimately been carried out by a wider array of non-state actors representing stakeholder interests concerned with the development of banking and other financial regulatory standards. Indeed, the risk of regulatory capture and conflict of interests resulted from an opaque decision-making process in which only a few stakeholder groups (banks and their lobbying organisations) were allowed to influence Basel Committee standard setting. This is the main danger that exists in non-state actor participation in international standard setting. The pressure by special interest groups, as it occurred in the context of Basel II, was the manifestation of these risks that arose because of the asymmetric involvement of a few stakeholder groups (in this case the banking industry) in the decision-making process in the absence of any involvement of broader

[19] See Capital Requirements Directive (CRD) IV which consists of the Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, and Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 [2013] OJ L176/1.

societal stakeholder groups while decision-making itself lacked transparency and was not adequately scrutinised by the public.[20]

The implications for global financial governance of the international financial standards produced by the Basel Committee and other international financial bodies discussed above have raised important questions regarding the accountability, and legitimacy of global financial governance. The growing importance of international financial standards and their acceptance by most countries for their domestic regulatory systems demonstrates the influence of international financial standard setting in its current guise. Nevertheless international financial standard setting and related global governance structures failed in part to produce effective regulations and supervisory standards because the countries and the banking industry that developed the standards did not consult countries outside of the G10 industrial countries and did not (with the exception of the financial services industry) consult non-state actor organisations that represent broader stakeholder groups directly affected by international financial decision-making. Unfortunately, the exclusion of countries that were not members of the Basel Committee and neglecting the interests of other stakeholders is indicative of a more general trend in stakeholder participation and integration in the creation and implementation of international standards that, despite some improvement, that still persists. Other chapters of this book reflect this.[21]

## III. Post-crisis international institutional reforms

The global financial crisis of 2007-08 resulted in the largest global economic slowdown since the 1930s and demonstrated serious weaknesses in global financial governance. The post-crisis international regulatory reforms have been centred around the international policy initiatives of the G20 and the implementation efforts led by the Financial Stability Board.

[20] See chapter X (conclusion) 23.
[21] See chapter X (conclusion) 4.

## A. The G20 Response

The financial crisis has triggered intense efforts internationally, regionally and nationally to enhance the monitoring of systemic stability and to strengthen the links between macro- and micro-prudential oversight, supervision and regulation. One such response is the widening of the international forum in which world-wide economic and financial policy issues are discussed from G8, the group of eight leading industrialized countries, to G20 in 2008. The transition from G8 to G20/Financial Stability Board (FSB) is of great importance because at all G20 meetings of 2008 to 2010, notably those in London (2009), Pittsburgh (2009) and Seoul (2010), the financial crisis and the international response to it were the dominant topics. And it were indeed decisions taken by the assembled 20 heads of state which kick-started many of the national and regional responses to the crisis that are discussed in this section .For instance, in motivating the steps it has taken to avoid a repetition of the crisis or at least to mitigate the negative effects that a new financial crisis might have, the EU authorities regularly referred to commitments made at G20 meetings.

Since the crisis, the philosophy of prudential financial regulation has shifted away from a primary focus on micro-prudential regulation and supervision - the regulation of individual banks and financial firms - to a broader focus on the whole financial system and how it relates with the broader economy. This is called macro-prudential regulation. The redesign of international financial regulation – and the main objective of global financial governance – is regulatory challenge posed by the financial crisis will be how regulators and central bankers can strike the right balance between micro-prudential regulation and supervision with macro-prudential controls on the broader financial system and economy. The overriding theme of the international financial reform initiatives (eg. the G20, the Financial Stability Board and Basel Committee) that began with the G20 Summits in Washington DC in November 2008 and London in April 2009 has been how to devise effective regulatory frameworks that durably link micro-prudential supervision with broader macro-prudential systemic risk concerns.

### B. The Financial Stability Board

The Financial Stability Board is the international body that has been given the responsibility by the G20 Heads of State to develop international financial standards that control systemic risk and provide more effective oversight of the global financial system.[22] The FSB was created at the G20 London Summit in April 2009 and was later established with legal personality by the G20 in the Cannes 2010 Summit Communique that stated that the Financial Stability Board will have 'legal personality', which could potentially change the present system of legally non-binding international financial soft law standards. The Cannes Communique also provided for enhanced G20's/FSB's coordination with the International Monetary Fund on macro-prudential financial regulation and oversight of the global financial system. This raises important issues regarding the reach of FSB/G20/IMF decision-making and standard setting to countries outside the FSB and G20 and their impact on the broader economy, environment and society. The G20 has addressed this concern partially by expanding the membership of the FSB and other international standard setting bodies such as the Basel Committee to include twenty six member countries, the European Central Bank and International Monetary Fund. This expansion mirrors the more general tendency of incorporating emerging economies into international financial committees, which this book expands on in other chapters.[23]

The FSB has adopted twelve key standards for sound financial systems, all of which are legally non-binding soft law but nevertheless are expected to be incorporated into the

[22] See G20, 'London Statement' (2 April 2009) para. 15.
[23] See chapter X (conclusion) 15. The same trend of including emerging economies can be seen, inter alia, in organisations such as the BIS, BCBS, FATF, IMF, and the World Bank.

national regulatory regimes of all countries.[24] Since its establishment, the FSB has been addressing a diverse range of regulatory issues. For example, it adopted key ‘attributes’ or principles governing effective bank resolution regimes in 2009 that allow banks experiencing financial distress to fail without causing a systemic crisis. Also, banks were required under Basel III to ‘move expeditiously’ to raise the level and quality of capital, but in a manner that ‘promotes stability of national banking systems’.

It has taken some of the work of the Financial Stability Forum forward by overseeing reviews of the system of supervisory colleges to monitor each of the largest international financial services firms.[25] It has developed guidance notes and draft bank recovery and resolution plans to assist with its advice to national authorities for implementing the FSB *Principles for Cross-Border Cooperation on Crisis Management*.[26] It has established *Principles for Sound Compensation Practices*,[27] and has coordinated with other international financial bodies such as IOSCO to develop a consistent regulatory framework for the oversight of hedge funds.[28] It is also overseeing the emergence of national and regional frameworks for the registration, regulation and oversight of credit rating agencies and encouraging countries to engage in bilateral dialogues to resolve home-host country issues,

[24] Financial Stability Board, ‘Key Standards’ <http://www.financialstabilityboard.org/cos/key_standards.htm> accessed 18 June 2018.
[25] See G-20/FSB protocol to establish colleges of supervisors for all major cross-border financial institutions. Reports of the Financial Stability Board to G20 Finance Ministers and Governors, *Overview of Progress in Implementing the London Summit Recommendations for Strengthening Financial Stability* (FSB September Report 2009) 2-3 and Financial Stability Board, ‘Report to G20 Finance Ministers and Governors: Guidance to Assess the Systemic Importance of Financial Institutions, Markets and Instruments: Initial Considerations’ (Report to G20 Finance Ministers and Governors, International Monetary Fund, Bank for International Settlements, Financial Stability Board, November 2009),13. Other FSB initiatives include the Financial Stability Board, ‘Principles for Cross-Border Cooperation on Crisis Management’ (Financial Stability Forum, 2 April 2009) <http://www.financialstabilityboard.org/2009/04/principles-for-cross-border-cooperation-on-crisis%2Dmanagement/>accessed 15 January 2015.
[26] FSB November 2009 Report (n 41).
[27] Financial Stability Board, ‘Principles for Sound Compensation Practices: Implementation Standards’ (25 September 2009) 14, <http://www.financialstabilityboard.org/wp-content/uploads/r_090925c.pdf?page_moved=1>accessed 15 January 2015.
[28] FSB November 2009 Report (n 25) 11-12.

involving inconsistencies and disagreements that may arise because of different regulatory approaches.

To enhance the legitimacy of the FSB standard setting, the G20 and FSB increased their membership to include 12 additional member countries compared to the previous membership of the Financial Stability Forum and the G10 standard setting committees. The additional membership includes large developing and emerging market countries, such as China, South Africa, India and Brazil.

### C. Consequences of Global Financial Governance Reform

As discussed above, the G20 and the Financial Stability Board have adopted the overall objective of reconstructing financial regulation to address broader system-wide macroprudential economic and financial risks. This requires not only stricter capital and liquidity requirements for individual institutions, but also monitoring risk exposures across the financial system and the inter-connections with the broader economy. For example, the G20/FSB objective of requiring systemically significant financial instruments (ie., OTC derivatives) to be traded on exchanges and centrally cleared with central counterparties is an important regulatory innovation to control systemic risk in wholesale securities markets. Also, systemically important financial institutions will be subjected to more intensive prudential regulatory requirements, including higher capital requirements and more scrutiny of their cross-border operations.

## V. The Role of Non-State Actor Stakeholder Groups

The global financial standard setting bodies discussed above have failed to interact with and coordinate their standard-setting activities with other relevant non-state actors that represent stakeholder interests on the international stage. An important question arises whether international financial regulation adequately addresses environmental and social risks

– for example, the economic risks associated with the financial sector's exposure to high carbon assets and other environmental and social sustainability challenges.[29] Recent research suggests that international financial standard setting bodies are not being used to their full capacity to address systemic environmental and social risks and that such risks are in the 'collective blind spot of bank supervisors.'[30] Despite the fact that history demonstrates direct and indirect links between systemic environmental risks and financial sector stability and that evidence suggests this trend will continue to become more pronounced and complex as environmental sustainability risks grow for the global economy, For example, the Basel Committee has yet to take explicit account of, and therefore only marginally addresses, the environmental and social risks that could threaten banking sector stability. Nevertheless, some international standard setting groups are taking the lead in addressing environmental and social risks in the banking and other financial sectors. There have been a number of initiatives undertaken by industry groups consisting of financial institutions and investment firms to improve their management of environmental and social risks. For instance, the largest banks, financial institutions and other multinational firms involved in largescale infrastructure development have adopted the Equator Principles which apply to risk management "for determining, assessing and managing environmental and social risk in projects". The Equator Principles are primarily intended to provide minimum standards for due diligence and monitoring to support responsible risk management decision-making regarding lending and investing in largescale infrastructure projects. They apply globally to all industry sectors and specifically pertain to four financial products: 1) Project Finance Advisory Services, 2) Project Finance, 3) Project-Related Corporate Loans, and 4) Bridge Loans. Different stakeholder groups provide guidance to financial institutions and other multinational

[29] The challenge of addressing environmental systemic risks was first introduced in the literature by an empirical report authored by Kern Alexander entitled 'Stability and Sustainability in Banking Reform: Are Environmental Risks Missing in Basel III?' (UNEP/Cambridge University, September 2014).
[30] Kern Alexander, 'Stability and Sustainability in Banking Reform: Are Environmental Risks Missing in Basel III?', (University of Cambridge and UNEP, 2014), 2.

enterprises that have signed up to the Equator Principles (EPFIs) on issues such as biodiversity and ecosystem services, climate change and social risks.

Similarly, the Global Sustainable Investment Alliance (GSIA) is a collaboration of the seven largest sustainable investment organizations in the world.[31] The GSIA's mission is to deepen the impact and visibility of sustainable investment organizations at the global level. The GSIA aims to influence investment firms, insurance and asset management companies to "integrate into financial systems and the investment chain" in order to "represent and advance the sustainable investment community".

The Global Reporting Initiative (GRI) is another important non-state actor representing stakeholder interests affected by disclosure and reporting of the risk associated with unsustainable economic activity. The GRI helps businesses and governments worldwide to understand and communicate their impact on critical sustainability issues such as climate change, human rights, governance and social well-being. The GRI Sustainability Reporting Standards are developed with multi-stakeholder contributions and rooted in the public interest.[32] The GRI mission aims '[t]o empower decisions that create social, environmental and economic benefits for everyone".[33] It focuses in the areas of creating standards and guidance to advance sustainable development; provide the market with leadership on consistent sustainability disclosures, including engaging with stakeholders on emerging sustainability issues. The GRI also attempts to promote efficient and effective sustainability reporting by improving the quality of disclosures made using the GRI Standards, reducing reporting burdens and exploring reporting processes that aid decision making. It also liaises

[31] See Global Sustainability Alliance, http://www.gsi-alliance.org/aboutus/ These organisations are: Association for Sustainable & Responsible Investment in Asia (ASrIA), European Sustainable Investment Forum (Eurosif), Responsible Investment Association Australasia (RIAA), Responsible Investment Association (RIA) in Canada, UK Sustainable Investment and Finance Association (UKSIF), US Forum for Sustainable and Responsible Investment (US SIF), and Vereniging van Beleggers voor Duurzame Ontwikkeling (VBDO) in the Netherlands.

[32] *See* https://www.globalreporting.org/information/about-gri/Pages/default.aspx [15.1.2019].

[33] *See* https://www.globalreporting.org/information/about-gri/Pages/default.aspx [15.1.2019].

with policymakers, stock exchanges, regulators and investors to promote transparency and enable effective reporting of sustainability risks. The GRI produces the Sustainable Reporting Standards, which represent global best practice for reporting on economic, environmental and social risks and challenges. In addition, GRI advises governments, stock exchanges market regulators in their policy development to help create a more conducive environment for sustainability reporting.[34]

And of relevance as a non-state international actor in global financial policy is the International Institute for Sustainable Development (IISD). IISD is a research institute based in Canada that influences the development of standards and understanding of sustainability issues. This independent and research-focused institute analyses many different kinds of sustainable development issues. The IISD's work is organized around 5 programs: Economic Law and policy; Energy; Resilience of communities and ecosystems; Water; Sustainable Development Governance knowledge. It produces reports that inform policymakers on areas of economic and financial policy essential to sustainable development, including investment, trade, public procurement and infrastructure finance and sustainability standards. It also conducts research on the effect of financial regulation on the economy and has argued for the reform of the financial regulatory system in order to improve transparency of climate-related financial risks.

Other important stakeholder groups that consist of both state and non-state actors include the Sustainability Banking Network (SBN) of the International Finance Corporation – consisting of bank regulators of developing and emerging market countries, China, Brazil and Peru, and a number of large banking groups and financial institutions and other stakeholder groups – have adopted standards of bank corporate governance that incorporate environmental and social risk controls into the institution's risk governance strategy. The SBN consults not

[34] *See* https://www.globalreporting.org/information/about-gri/Pages/default.aspx [15.1.2019].

only a wide number of countries that normally are involved in international financial standard-setting, but also involves other non-governmental stakeholder bodies in their deliberations and outreach.

Under the SBN guidelines, bank supervisors in participating jurisdictions have engaged in a variety of innovative regulatory and market practices to control environmental systemic risks and to adopt practices that mitigate the banking sector's exposure to environmentally unsustainable activity and related social risks. A defining feature of the SBN is that its membership largely consists of regulatory officials and financial institution representatives from developing and emerging market countries and that none of their members are from central banks or other regulatory authorities of the G10 advanced industrial countries. This has allowed the SBN to define itself in a unique way by emphasising innovative and forward-looking regulatory approaches that address in many instances broader stakeholder interests related to the environmental and social drivers of risk in the financial sector and the relationship with financial stability and sustainability.

SBN regulatory members – including Brazil, China and India – have been concerned with how prudential bank regulation affects the green economy and inequality in society. Their regulatory initiatives have been based on existing regulatory mandates in Basel III to promote financial stability by identifying, monitoring and managing banking risks both at the transaction specific level and at the broader portfolio level. What is significant about these various country and market practices is that the regulatory approaches used to enhance the bank's risk assessment fall into two areas: 1) Greater interaction between the regulator and the bank in assessing wider portfolio level financial, social and political risks, and 2) banks' enhanced disclosure to the market regarding their exposures to systemic environmental risks. These innovative regulatory approaches and market practices are the result of pro-active policymakers and regulators adjusting to a changing world. Other international bodies, such as the United Nations Finance Initiative, have sought to promote further dialogue between practitioners and regulators on environmental sustainability issues and to encourage a better understanding of these issues by financial regulators.[35]Although the Basel Committee has formed a committee to address certain areas of social risks, such as financial inclusion, it (and other international financial bodies) has not addressed broader environmental and social risk governance concerns. In 2017, a study[36] commissioned by the United Nations Environment Programme suggested that international financial standard setting could be made more effective and legitimate by recognising some of the synergies that could be achieved by linking up the financial regulatory reform agenda with international reforms undertaken in the area of sustainable development, particularly regarding climate and environmental protection, financial inclusion and related cultural sustainability issues. The UN report, however, stressed that none of the international financial standards it reviewed has an explicit reference to sustainable development. It is argued that integrating sustainable development into the global financial governance agenda is crucial for ensuring a more robust, efficient and sustainable financial system. Despite some efforts to this end, approaches are still uncoordinated and fragmented.

Accordingly, the UNEP report proposes to consider five pillars or ‘entry points’ that might enhance the consideration and incorporation of sustainable development into international financial standard setting. The five pillars are: Systemic Risk, Transparency, Governance, Materiality and Culture.[37] Some countries have already begun to link financial regulatory objectives to sustainable development policies and practices. Acting under the

[35] See United Nations Environment Programme Finance Initiative, ‘Inquiry into the Design of a Sustainable Financial System’ (23 January 2014)<http://www.unep.org/inquiry/portals/50215/Inquiry_expanded.pdf> accessed 15 January 2015.

[36]See Toby A A Heaps and Danyelle Guyatt, ‘A Review of International Financial Standards as they Relate to Sustainable Development’ (United Nations Environment Programme: Inquiry into the Design of a Sustainable Financial System, February 2017) <http://unepinquiry.org/wp-content/uploads/2017/02/A_Review_of_International_Financial_Standards_as_They_Relate_to_Sustainable_Development.pdf>.

[37]Ibid, 5-6.

guidance of the SBN, China, Brazil and non-governmental actors, such as the GSIA, GRI and IISD, have embarked on innovative risk assessment programmes to assess financial stability risks associated with environmental and social sustainability concerns. These international initiatives that are being spearheaded by important emerging market countries and non-governmental actors are beginning to influence state practice internationally and should be linked to and coordinated with the work of the traditional international financial standard setting bodies, such as the Basel Committee.

## Conclusion

The global financial crisis of 2007-08 has called into question the efficacy of the traditional global financial governance model's flexible and unstructured decision-making framework and in particular has raised concerns regarding the accountability and legitimacy of the IFI standard setting processes. The discussion of the international financial standard setting bodies' efforts in this area and the need for them to be more inclusive in their membership and to include more non-governmental stakeholder groups suggests that global financial governance should be more inclusive in whom they involve in their decision-making processes. This point is also emphasised as one of the core conclusions of this book.[38] The case of the Basel Committee's adoption of the flawed Basel II agreement based on a loosely organised decision-making framework, which did not adequately incorporate the perspectives of non-G10 countries or of the relevant non-governmental civil society groups, demonstrated the failure of global financial governance prior to the crisis to address the risks that had imperilled the international financial system.

Although after the crisis the number of countries involved in standard setting has increased under the aegis of the G20, there remains inadequate involvement in the Financial Stability Board and other international financial bodies by non-G20 countries. Moreover, non-state stakeholder groups should be consulted more and involved in international financial standard setting. For example, the international bodies concerned with sustainability issues should be expressly included in international standard setting. This would enhance the quality of the standards adopted by international bodies by providing the opportunity to address the broader economic and societal risks – particularly, environmental and social risks - that can have a significant effect on financial stability thereby contributing to more sustainable economic growth and financial development for all countries and stakeholder groups. The

[38] See chapter X (conclusion) 25.

overall message – welcomed in many reform circles - is that economic policymakers should consider building institutional mechanisms that transcend national borders which establish solidarity between the financial sector and all parts of society that are affected by financial risk-taking.