BASEL COMMITTEE ON BANKING SUPERVISION: A POST-CRISIS ANALYSIS OF GOVERNANCE AND LEGITIMACY

by

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A THESIS SUBMITTED IN PARTIAL FULFILLMENT OF
THE REQUIREMENTS FOR THE DEGREE OF

DOCTOR OF PHILOSOPHY

in

THE FACULTY OF GRADUATE AND POSTDOCTORAL STUDIES

(Law)

THE UNIVERSITY OF BRITISH COLUMBIA

(Vancouver)

December 2014

Abstract

The Basel Committee on Banking Supervision (BCBS) was established in 1974 as an informal group of central bankers and bank supervisors with the mandate to formulate supervisory standards and guidelines. Although the Committee does not have any formal supranational authority, it is the de facto global banking regulator and its recommendations have been widely implemented by member and non-member states. This thesis investigates the BCBS's governance, operation, and policy outcomes to determine the extent to which it is and has been legitimate. The point of departure for my analysis is the literature on legitimacy in law, political science, and international relations. In particular, I draw upon Global Administrative Law theory (GAL) to examine the BCBS's legitimacy against three principles: reasoned decision making, transparency, and accountability. My analysis is guided by five overarching questions: 1) Does the BCBS give reasons for its decisions? 2) Are the Committee's governance and decision-making procedures transparent? 3) How and by what means does the BCBS consult the public in its policy-making process? 4) How and by whom is the Committee's performance monitored? 5) Has the BCBS taken adequate measures to corrective measures to address the regulatory failures that contributed to the Global Financial Crisis (GFC)? I argue that the BCBS has gradually become a more legitimate institution but there still exists significant room for improvement. Inadequate disclosure on the BCBS's deliberations, inadequacy and dilution of the post-crisis regulatory reforms, the underrepresentation of those constituencies without business interest or insufficient financial resources in BCBS consultations, and the absence of meaningful oversight of the BCBS's policies, are among the areas I highlight for reform. I set out policy prescriptions to enhance the BCBS's legitimacy, including the establishment of a new framework for transparency; creation of a proxy advocate to participate on behalf of underrepresented constituencies in the BCBS's policy making; and the establishment of a new body to exercise active oversight of the BCBS's operations.

Preface

This thesis is original, independent work by the author, M. Peihani.

Some parts of Chapter 1 have been published in Maziar Peihani, "The Global Financial Crisis of 2008: An Analysis of Contributing Trends, Policies and Failures" (2012) 27(3) BFLR 465; Maziar Peihani, "Systemically Important Financial Institutions: An Analysis of Current Regulatory Developments" 2013 29 (1) Banking and Finance Law Review.

A concise version of Chapters 5 and 6 will be published in Maziar Peihani, "The Basel Committee on Banking Supervision: An Analysis of the Post-crisis Governance and Accountability" (2014) Canadian Foreign Policy Journal (Forthcoming).

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List of Abbreviations

AEG	Accounting Experts Group
AFC	Asian Financial Crisis
AIG	American International Group
ASF	Available Stable Funding
BCBS	Basel Committee on Banking Supervision
BCG	Basel Consultative Group
BIS	Bank for International Settlements
CRR	Capital Requirements Regulation
CCF	Credit Conversion Factor
CCP	Central Clearing Counterparty
CDO	Collateralized Debt Obligation
CDS	Credit Default Swaps
COCO	Contingent Convertible Capital
CSE	Consolidated Supervised Entity
CPSS	Committee on Payments and Settlement Systems
CRA	Credit Rating Agencies
CRR	Capital Requirements Regulation
DNB	De Nederlandsche Bank
D-SIB	Domestic Systemically Important Banks
EBF	European Banking Federation
EEC	European Economic Community
EU	European Union
EBA	European Banking Authority
FSI	Financial Stability Institute
FSA	Financial Services Authority
FSAP	Financial Sector Assessment Program
FSB	Financial Stability Board
FSF	Financial Stability Forum

GAL	Global Administrative Law
GATT	General Agreement on Tariff and Trade
GFC	Global Financial Crisis
GHOS	Governors and Heads of Supervision
G-SIB	Global Systemically Important Bank
HPE	Hypothetical Portfolio Exercise
IAIS	Association of Insurance Supervisors
IBRD	Bank for Reconstruction and Development
ICJ	International Court of Justice
IDA	International Development Association
IEG	Independent Evaluation Group
IFA	International Financial Architecture
IFAC	International Federation of Accountants
IFIAR	International Forum of Independent Audit Regulators
IFRS	International Financial Reporting Standards
IFS	International Financial Standards
ILA	International Law Association
IMF	International Monetary Fund
IOSCO	International Organization of Securities Commissions
IPE	International Political Economy
IRB	Internal Rating Based
ISAB	International Accounting Standards Board
LCR	Liquidity Coverage Ratio
MAG	Macroeconomic Assessment Group
MBS	Mortgage-backed Security
MDB	Multilateral Development Banks
MES	Marginal Expected Shortfall
MPG	Macroprudential Supervision Group
NSFR	Net Stable Funding Ratio
OBC	Off-balance Sheet Commitments

OGBS	Offshore Group of Banking Supervisors
OSFI	Office of the Superintendent of Financial Institutions
OTC	Over the Counter
PD	Probability of Default
PDG	Policy Development Group
PI Group	Public Interest Group
QIS	Quantitative Impact Study
RCAP	Regulatory Consistency Assessment Program
REIT	Real Estate Investment Trust
RSF	Required Stable Funding
RWA	Risk-weighted Asset
SEC	Securities and Exchange Commission
SIB	Systemically Important Banks
SIFIs	Systemically Important Financial Institutions
SIG	Supervision and Implementation Group
SSBs	Standard-setting Bodies
SSRN	Social Science Research Network
TARP	Troubled Asset Relief Program
EC Treaty	Treaty Establishing the European Community
TRN	Transnational Regulatory Networks
VAR	Value at Risk
VFCR	Voluntary Foreign Credit Restraint Program
WTO	World Trade Organization

Acknowledgments

I am offering my gratitude to everyone whose support and assistance contributed to the successful completion of this work. First and foremost, I would like to thank the outstanding scholars on my committee with whom I have been privileged to work: Janis Sarra, Ronald Davis, and Ralph Winter. I owe particular thanks to Janis Sarra for her guidance, patience, and encouragement and to Ralph Winter for his critical engagement with my research and constant enthusiasm and support.

I would like to acknowledge the financial support that made this research possible, including generous funding from the UBC Law and the Law Foundation. I would also like to thank the UBC Law Graduate Program, and particularly Douglas Harris, Ljiljana Biuković, and Joanne Chunge for their cooperation and support throughout these years. I would also like to thank the UBC Law Library Staff who created a warm and welcoming studying space for me and my fellow graduate students and went out of their ways to help me with my research on a daily basis.

I owe my most sincere gratitude to Bruce MacDougall and Benjamin Richardson for their amazing mentorship and support over the many years. I feel truly honored to have worked with them and my experience at UBC would have not been the same without their comforting and encouraging presence.

Appreciation and many thanks go to my friends and colleagues. Amir Tangestani, Jill Teasley, and Rezvane Norouzi have been an incredible and continual source of support, energy and humor. I could have never made it without their friendship. David Cotterall has been an exceedingly insightful reader of my work. He has expanded my horizons in crucial ways by pointing out many new ideas and perspectives. Our conversations at the law Library were among the most exciting and rewarding moments in my years of graduate studies. Robert Diab has been a great friend and mentor since my arrival at UBC. He has helped me with my doctoral program and professional development in countless ways. I am deeply indebted to him for his trust, confidence and support throughout this entire project.

This thesis represents a milestone in more than a decade of my university education. Neither it nor the journey that led me to this point would have been possible without the unwavering love, cheering, and support of my wonderful parents and brother: Javad, Malihe, and Mehdi. I am forever indebted.

To Javad, Malihe, and Mehdi

Chapter 1: Introduction

1.1 Introduction

The global financial crisis (GFC) of 2008 was the most destructive economic event since the Great Depression. Many of us who lived through the crisis will easily remember the shocking events that took place: stock prices went down dramatically; investors lost their confidence in the market and pulled their money out; large and famous financial institutions failed or teetered on the brink of bankruptcy; the global credit markets ceased to function and liquidity vanished from the system; governments were scrambling to prevent the collapse of the whole system with massive taxpayer-funded bailouts.[1] According to the US Treasury, the crisis cost US households $19.2 trillion in wealth and 8.8 million jobs.[2] During the crisis, member states of the European Union (EU) committed to aid banks in the amount of approximately 30% of the EU GDP and

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[1] The turmoil originated with the credit contraction in the interbank markets beginning 9 August 2007. The interbank credit froze after BNP Paribas suspended payments on three investment funds. The German Sachsen Landesbank was sold to the Landesbank Baden-Wuerttenberg on 28 August 2007 and IKB lost $1 billion in subprime loans. Shares in Northern Rock, a British bank that had invested heavily in sub-prime mortgages, fell on 14 and 15 September 2007, following the announcement of its request for liquidity support from the Bank of England. In the United States, the collapse of the housing bubble and the abrupt shutdown of subprime lending had led to substantial losses for many financial institutions. On 17 March 2008, the Federal Reserve, using its authority under s. 13(3) of the Federal Reserve Act, announced $29.97 billion to enable JP Morgan to purchase Bear Sterns for $2 per share. The crisis then reached a critical stage in September 2008 with the failure of Lehman Brothers and the near collapse of the American International Group (AIG). The lack of transparency of the balance sheets of the major financial institutions, which were "too big to fail", and had a high level of interconnections, caused the credit market to seize up. In the five days between Monday, 15 September and Friday, 19 September, the global financial system was teetering on collapse. Even after the US government announced a $700 billion bailout plan, namely the Troubled Asset Relief Program (TARP), the US markets slightly stabilized. In Europe the EU leaders could not agree on a collective response. This failure then forced the British government to take the lead in announcing a comprehensive rescue package totaling £ 500 billion of loans and guaranties. See George A Walker, "Credit contraction, Financial Collapse and Global Recession: pt 1", (2009) 1 JIBFL 5; A Cohen, "Global Financial Crisis — Timeline" (2009) 1 JIBFL 10.

[2] US Department of Treasury, "The Financial Crisis Response In Charts" (2012) at 1, online: US Treasury http://www.treasury.gov/resource-center/data-chart-center/Documents/20120413_FinancialCrisisResponse.pdf.

paid out amounts equivalent to 13% of EU GDP.[3] The economic costs of the GFC in terms of output losses and increases in public debt was much larger than all crises occurring in the previous thirty years in advanced and emerging economies combined. The median output loss (computed as deviations of actual output from its trend) during the GFC (from 2007 to 2009) was 25% of GDP compared to a historical median of 20%, while the median increase in public debt is 24% of GDP compared to a historical median of 16%.[4]

There has been enormous debate about the causes of the GFC.[5] However, one common narrative is that the crisis was an *incident* that took everyone, particularly regulators, by surprise.[6] Under this narrative, the years preceding the crisis witnessed a major saving glut, which led to large

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[3] Herman V Rompuy, "Reshaping Europe's Economy— The Role of the Financial Sector" (2011) at 3, online: European Union http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/119231.pdf.

[4] Luc Laeven & Fabian Valencia, "Resolution of Banking Crises: The Good, the Bad, and the Ugly" (IMF Working Paper, WP/10/146, June 2010) at 4.

[5] See, e.g., Howard Davis, *The Financial Crisis: Who is to Blame* (Cambridge: Polity Press, 2010); Marc Jarsulic, *Anatomy of a Financial Crisis: A Real Estate Bubble, Runaway Credit Markets, and Regulatory Failure* (New York: Palgrave, 2010); Robert Kolb, ed., *Lessons from the Financial Crisis: Causes, Consequences, and Our Economic Future* (New Jersey: Wiley, 2010); Joseph Stiglitz et al, *The Stiglitz Report: Reforming the International Monetary and Financial Systems In the Wake of the Global Crisis* (New York: The New Press, 2010); John B Taylor, *Getting Off Track: How Government Actions and Interventions Caused, Prolonged, and Worsened the Financial Crisis* (California: Hoover Institution Press, 2009); Mathias Dewatripont et al, *Balancing the Banks: Global Lessons from the Financial Crisis* (Princeton: Princeton University Press, 2010); Hershey H Friedman & Linda W Friedman, "The Global Financial Crisis of 2008: What Went Wrong?" (March 9, 2009) online: Social Sciences and research Network: http://dx.doi.org/10.2139/ssrn.1356193; Sher Verick & Iyanatul Islam, "The Great Recession of 2008-2009: Causes, Consequences and Policy Responses", IZA Discussion Paper No. 4934 (2009) online: Social Sciences and research Network http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1631069; Douglas W Arner, "The Global Credit Crisis of 2008: Causes and Consequences", AIIFL Working Paper No. 3 (2009) online: Social Sciences and research Network http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1330744.

[6] See, James R Barth, Gerard Caprio Jr. & Ross Levine, *Guardians of Finance: Making Regulators Work for Us* (Cambridge, MA: MIT Press, 2012) at 1-4. The authors provide an eloquent explanation of the incident narrative.

flows of capital into several major economies. These flows in turn triggered lower interest rates, investors' turn to high-yield risky structured products, and explosion of credit.[7]
Together, these factors brought about a crisis that Alan Greenspan has likened to a "hundred-year flood" unforeseen by all.[8] Inadequate legal authority, an incomplete toolkit to combat the financial market's fragility, and insurmountable regulatory gaps are among the themes commonly referred to by those who subscribe to the view that the GFC was a complex and severe crisis. [9] As Timothy Geithner said after the AIG bailout, "If we could have done it differently, we would have done it differently. Instead, we had no other choice. That is the basic lesson of this great recession."[10]

There is some merit to the incident narrative. When the Crisis exploded, panics, runs, and massive failures appeared inevitable and policy makers needed to take immediate action to thwart financial contagion and assuage the impact of the Crisis. However, the incident narrative, is at the same time, a woefully incomplete account of the crisis. The housing boom, the surge of

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[7] Timothy F Geithner, "Reducing Systemic Risk in a Dynamic Financial System" (Remarks at the Economic Club of New York, New York City, 9 June 2008) online: Federal Reserve Bank of New York http://www.newyorkfed.org/newsevents/speeches/2008/tfg080609.html.

[8] Alan Greenspan, "The Crisis" in David Homer & Justin Wolfers, eds, *Brookings Papers on Economic Activity* (Brookings Instituion Press, 2010) 201 at 216.

[9] On inadequate legal authority, see, e.g., Christopher Cox, Address (Speech delivered at the Security Traders 12th Annual Washington Conference, 7 May 2008) online: US Securities and Exchange Commission http://www.sec.gov/news/speech/2008/spch050708cc.htm; On incomplete toolkit to manage financial crises, see Timothy F Geithner, (Written Testimony House Financial Services Committee Hearing, 24 march 2009), online: US Department of Treasury http://www.treasury.gov/press-center/press-releases/Pages/tg67.aspx; On regulatory gaps, see Timothy F Geithner, Address (Remarks Remarks before the American Enterprise Institute on Financial Reform, 22 March 2010) online: US Department of Treasury http://www.treasury.gov/press-center/press-releases/Pages/tg600.aspx; Christopher Cox, "The State of the United States Economy and Financial Markets" (Testimony Before the U.S. Senate Committee on Banking, Housing and Urban Affairs, 14 February 2008) online: US Securities and Exchange Commission http://www.sec.gov/news/testimony/2008/ts021408cc.htm.

[10] Timothy F Geithner, Address (Secretary Written Testimony before the House Committee on Oversight and Government Reform, 27 January 2010) online: US Department of Treasury http://www.treasury.gov/press-center/press-releases/Pages/tg514.aspx.

subprime mortgages, the massive leverage, and the proliferation of complex structured products were trends closely watched by regulators and policy makers.[11] It is even more troubling to

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[11] From 1997 until the middle of 2006, house prices began to rise much more rapidly than building costs or general price levels in the US. While nominal house prices increased at annual rate of 9.3%, building costs only increased at an annual rate of 2.9% and consumer price index at an annual rate of 2.5%. Between 1953 and 1997 (a period of 45 years) housing prices remained basically unchanged. It was, therefore, a historical anomaly when housing prices increased 85% between 1997 and 2006. The Federal Reserve had knowledge of this irregularity and continued appreciation of housing prices. However, Alan Greenspan, its former Chairman, told audiences "that we were facing not a bubble but froth — lots of small local bubbles that never grew to a scale that could threaten the health of the overall economy." See, Alan Greenspan, *The Age of Turbulence: Adventures in a New World* (New York: Penguin Press, 2007) at 231; Jarsulic, *supra* note 5 at 12-13; Karl E Case & Robert Shiller, "Is There a Bubble in the Housing Market?" (Brookings Paper on Economic Activity, No. 2, 2003): Brookings Institution http://www.brookings.edu/~/media/Files/Programs/ES/BPEA/2003_2_bpea_papers/2003b_bpea_caseshiller.pdf.
From 2001 through 2003, the value of subprime loans almost doubled to $310 billion. The volume of subprime mortgages then increased from 8% of mortgage originations in 2003 to 20% in 2005. Regulators were aware of the dangers of the subprime market but chose not to curb its expansion. Greenspan considered it undesirable to rein in subprime lending. In his view, subprime products and practices were not necessarily improper. On the contrary, they could facilitate "the national policy of making home- ownership more broadly available". His successor, Ben Bernanke, also believed that the impact of the subprime market turmoil on the financial markets and the broader economy "seem[ed] likely to be contained". The Office of Federal Housing Enterprise Oversight (OFHEO), which was in charge of overseeing the operations of Fannie Mae and Freddie Mac, knew about the purchase of subprime mortgages-backed securities by these firms. In its 2004 examination, however, it mentioned that such mortgages were not a "significant supervisory concern" and satisfactory credit risk management was in place. See, The Financial Crisis Inquiry Commission, "Final Report of the Na tional Commission on the Causes of the Financial and economic Crisis in the United States" (January 2011) at 93-94, 123, online: FCIC http://cybercemetery.unt.edu/archive/fcic/20110310173545/http://c0182732.cdn1.cloudfiles.rackspacecloud.com/fcic_final_report_full.pdf; Ben Bernanke, "The Economic Outlook" (Testimony before the Joint Economic Committee, U.S. Congress, 28 March 2007) online: http://www.federalreserve.gov/newsevents/testimony/bernanke20070328a.htm.
From 2002 to 2007 financial markets observed a staggering growth in securitization. In the aggregate, securitization worldwide went from $767 billion at the end of 2001 to $1.4 trillion in 2004 and $2.7 trillion in December of 2006. Regulators, however, did not seem concerned with this development. The common belief was still that securitization transactions could help distribute the risk and make financial markets safer. In a speech delivered in June 2006, Ben Bernanke said:

consider that the Crisis occurred despite the existence of a comprehensive body of international financial standards (IFS) that had been developed over the previous 35 years. [12] At the time of Crisis, the IFS covered 12 areas of financial activity including banking, securities, corporate governance, and accounting.[13] In spite of their scope and sophistication, not only did the IFS not prevent the Crisis but also contributed to it in significant ways. The failure of the IFS is most evident in the context of international capital adequacy standards, commonly known as the Basel Accords.[14] The Basel Accords encompass prudential standards. These standards depart from the premise that banks occupy a special position in the financial system given banks' central role in the payment and credit network and their vulnerability to loss of confidence.[15] A bank run is not

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> To an important degree, banks can be more active in their management of credit risks and other portfolio risks because of the increased availability of financial instruments and activities such as loan syndications, loan trading, credit derivatives, and securitization . . . Asset-backed securitization has also provided a vehicle for decreasing concentrations and credit risk in bank portfolios by permitting the sale of loans in the capital markets, particularly loans on homes and commercial real estate.

Similarly, the IMF's Global Financial Stability Report of April, 2006 stated: "The dispersion of credit risk by banks to a broader and more diverse set of investors, rather than warehousing such risk on their balance sheets, has helped make the banking and overall financial system more resilient". It noted that this dispersion would help to "mitigate and absorb shocks to the financial system". See, Viral V Acharya & Matthew Richardson, "Causes of the Financial Crisis" (2009) at 7-8, online: SSRN http://ssrn.com/abstract=1514984; Arnold Kling, "Not What They Had in Mind: A History of Policies that Produced the Financial Crisis of 2008" (15 September 2009) at 27-28, online: SSRN http://ssrn.com/abstract=3D1474430; Ben Bernanke, "Modern Risk Management and Banking Supervision" (12 June 2006), online: Federal Reserve http://www.federalreserve.gov/newsevents/speech/Bernanke20060612a.htm; IMF, "Global Financial Stability Report—April 2006", at 51, online: IMF http://www.imf.org/External/Pubs/FT/GFSR/2006/01/pdf/chp2.pdf.

[12] FSB, "Compendium of Standards" (Accessed on 1 July 2013) http://www.financialstabilityboard.org/cos/index.htm.

[13] FSB, "Key Standards for Sound Financial Systems" (Accessed on 21 May 2014) online: FSB http://www.financialstabilityboard.org/cos/key_standards.htm.

[14] BCBS, "The Basel Committee's Work" (Accessed on 21 May 2014) online: BIS http://www.bis.org/bcbs/bcbs_work.htm.

[15] Charles E Goodhart et al, *Financial Regulation: Why, How and Where Now* (London: Routledge, 1998) at 10-12; Peter Brierley, "The UK Special Resolution Regime for Failing Banks in an International Context" (2009) at 5,

only a threat to the bank itself but can pose risks to the entire financial system and broader economy. To rule out externalities arising from bank runs, authorities establish safety net mechanisms such as deposit insurance and lender of last resort. [16] These mechanisms, however, impose costs on taxpayers and, more importantly, could exacerbate moral hazard by encouraging banks to take excessive risk. [17] To address these problems regulators go beyond disclosure requirements and market discipline and subject banks to prudential regulation.[18]

However, as it will be fully explained later, Basel Accords failed to achieve their intended objectives, namely ensuring the stability and soundness of the banking system. The Accords proved to be inadequate, pro-cyclical, and excessively reliant on internal risk modeling and credit ratings. There were also no minimum standards that could protect the system against the liquidity risk. The failure of Basel Accords raises important questions about the body out of which they are conceived, namely the Basel Committee on banking Supervision (BCBS), which is the principal agent investigated in this research. Similar to many other international regimes, the BCBS is a problem-driven institution. The primary purpose for its establishment was to tackle risks arising from the operations of internationally active banks. The Committee's authority is therefore often justified based on the utilities delivered, namely a safer and sounder international banking system. However, such perception of *output legitimacy* is challenged by the failure of the most important policy outcome of the BCBS, namely, capital adequacy standards.

Although the GFC has been associated with systemic regulatory failures, the question of how to make regulators more accountable has been largely overlooked. A glance at recent initiatives in

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online: Bank of England http://www.bankofengland.co.uk/publications/fsr/fs_paper05.pdf.

[16] Howard Davies & David Green, *Global Financial Regulation—The Essential Guide* (Cambridge: Polity, 2008) at 16-17.

[17] *Ibid* at 18.

[18] *Ibid* at 19-20.

the areas of prudential regulation, corporate governance, derivatives and consumer protection indicates that the post-crisis reform agenda mainly seeks to promote responsible behaviour by market participants. Undoubtedly, the Crisis revealed significant market failures. In order to address these failures, regulators should incentivize market participants to act more responsibly and avoid the type of risk taking that can lead to externalities for all of society. However, when it is acknowledged that the role of regulatory failures in the Crisis was as important—if not more so—than that of market failures, the issue of regulator accountability gains equal significance.

Inadequate research of regulatory governance and accountability is apparent with respect to international institutions, particularly the BCBS, which has been central to the global governance regime of banking. The Committee is the oldest and best-known global regulatory forum, and the primary global prudential standard setter. The Committee's standards, guidelines and sound practices have been widely implemented and countries look to the Committee's leadership with respect to regulatory and supervisory issues. However, as the following literature review will demonstrate, the BCBS's governance and policy making has been subject to little research— a research gap that motivated this thesis. As this chapter explains, my primary thesis is that there are considerable steps that the BCBS must take in order to become a more accountable global standard setter.

1.2 Overview of the Literature on the BCBS

To date, the BCBS has been subject to three comprehensive studies. The first study was "The Basel Committee on Banking Supervision: A History of the Early Years, 1974-1997" by Charles Goodhart. An important feature of this book is that the author was the first to be given access to the BCBS's papers and archives, including the records of the 83 meetings that occurred in the period covered by the book.[19]

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[19] Charles A E Goodhart, *The Basel Committee on Banking Supervision: A History of the Early Years, 1974-1997* (Cambridge, UK; New York : Cambridge University Press, 2011) at xi-xii.

The book provides an in-depth and comprehensive narrative of the BCBS's history. Goodhart's main aim is to tell the story of the BCBS's evolution as the Committee itself saw it. In other words, the book chiefly seeks to produce a quasi-official public record of the BCBS, with a lot of "cut and paste" of original documents which can be useful for future historians.[20] The bulk of the book is about the BCBS's work in the covered period, including Concordat, the First Capital Accord, and the Core Principles of Banking Supervision. It also provides short commentaries on issues such as the BCBS's legal position, and its international relations with its counterparts.[21]

Professor Goodhart's book is a significant contribution to the literature on the history of financial regulation in general and the BCBS in particular. My thesis particularly benefited from the book's research on how and why the BCBS was created and its evolution during its first two decades. However, it needs to be kept in mind that the book's history ends with 1997, a year when the BCBS started to think about new stages of capital adequacy regulation. Consequently, the Basel II exercise, which became the focus of the BCBS in subsequent years, is excluded from the book. The reason that Goodhart offers for such exclusion is that the Basel II initiative is "too recent and for the time being too contentious to become subject of a historical study such as this."[22] Be that as it may, the book also does not provide an account of the current status of the BCBS and major changes it has undergone in more recent years.

The second important study is "International Banking Regulation: Law, Policy, and Practice" by George Walker.[23] The book's purpose is to consider the structure and content of regulation that apply to banks at the international level. Similar to Goodhart's book, this manuscript begins by explaining the circumstances surrounding the establishment the Basel Committee following the collapse of the Bretton Woods System of managed exchanged rates and the subsequent closures of Franklin National and Banhus Herstatt.[24] The book then turns to explain the structure and

[20] *Ibid* at xii.

[21] *Ibid* at 96-371, 542-571.

[22] *Ibid* at 7.

[23] George A Walker, *International Banking Regulation: Law, Policy, and Practice* (London, UK, Kluwer, 2001).

[24] *Ibid* at 17-34.

operation of the BCBS and assesses its contribution to international bank regulation and supervision. In addition to drawing upon publicly available sources of information, the book benefits from personal interviews with Central bankers and supervisors who were closely involved in the BCBS's agenda setting and policy making in its early years, such as Peter Cooke, the former BCBS Chairman,.[25]

The book pays particular attention to cross-sector and cross-border regulatory issues that arise from the increasingly integrated activities of complex banking and financial groups.[26] Walker considers the background context for the rise of financial conglomerates and provides a detailed assessment of the international response to their risks.[27] Another important contribution of the book is its careful consideration of the nature and content of capital adequacy standards at the time. While the book was written at a point when the Committee's work on Basel II was at a very early stage, the book considers the BCBS's preliminary proposals and their impact on the banking regulatory regime.[28]

From the perspective of this thesis, an important contribution of this book is the explanation of the nature of modern regulatory requirements and the relationship between law and regulation. Walker notes that banking regulation does not fit with any of the traditional definitions or classifications of national or international law to the extent that it is not imposed in the form of primary or secondary legislation and is not backed by any formal court processes.[29] He acknowledges, however, that many, if not all, of the obligations imposed on banks operate within a large legal framework. Compliance with regulatory requirements is not secured through court adjudication and formal enforcement but through a range of formal and informal devices and

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[25] *Ibid* at xix.

[26] *Ibid*, Part II Financial Conglomerates.

[27] *Ibid*.

[28] *Ibid*, Part V Postscript.

[29] *Ibid* at xxii.

controls. Thus, bank regulations have the equivalent significance of a legal obligation without falling within category of law as such. [30]

The third important study on the BCBS is "Governing Global Banking: the Basel Committee and the Politics of Financial Globalization".[31] Adopting a largely historical approach, Duncan Wood traces the evolution of the Basel Committee from its origin in the 1970s to its early years in the 21st century. The author's hypothesis is that the evolution of the BCBS has been driven by the need for banking authorities in the major economies to respond to challenges in the changing market place. In other words, it was the serious risks posed by profit-seeking practices of financial institutions that necessitated increasing cooperation among the banking supervisors from the world's major financial institutions.

Wood argues that the BCBS has continued to respond effectively to new problems and crises in the post-Bretton Woods era. Although the Committee has not eliminated crises from national or international banking systems, its existence and work has greatly contributed to the stability and soundness of the international financial system. According to Wood, the BCBS's limited success can be explained by reference to three factors: the will of powerful states to create an agenda for cooperation; the influence of private actors in national policy processes; and the capacity of the Committee to avoid or overcome conflict between its members.[32] Power, leadership, the influence of private sectors, and the dynamic relationship between regulators and markets are among the key themes of the book. The book's contribution is thus best understood from a political economy perspective. Wood's inquiry builds upon earlier contributions of political economists such as Ethan Kapstein, Tony Porter and Beth Simmons who have

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[30] *Ibid*.

[31] Duncan Wood, *Governing Global Banking: the Basel Committee and the Politics of Financial Globalization* (Aldershot, Hants, England; Ashgate, 2005).

[32] *Ibid* at 4-5.

highlighted the importance of elements of power and coercion in the area of international banking cooperation.[33]

The most important insight that this thesis takes away from Wood's analysis is that politics is essential and central to an adequate understanding of the BCBS. Though the Committee has been frequently idealized as purely technical - an epistemic community of specialists engaging in technocratic deliberations - Wood's book indicates that politics has marked every step of the BCBS's work and evolution.[34] The centrality of politics is conspicuous in the Basel II process, which was characterized by the emergence of ideological divisions between the Anglo-Saxon states on the one hand and the Continental European states on the other hand.[35] The book also provides important empirical evidence regarding the influence of the banking sector in the notice and comment process, which this thesis discusses in addressing the narrative of regulatory capture.

1.3 Contribution of Thesis

The existing books on the BCBS make important contributions to the understanding of BCBS's history, governance, and policies. However, they are written in reference to a state of affairs that appears quite out of date. There can be little doubt, if any, that the recent Crisis has transformed the governance and regulation of international banking. For instance, the BCBS is no longer a standing Committee of G10 but a reporting Committee to G20, which has in recent years become

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[33] See for instance, Ethan B Kapstein, Resolving the Regulator's Dilemma: International Coordination of Banking Regulations", (2009) 53:2 *International Organization* 323; Ethan B Kapstein, Supervising International Banks: Origins and Implications of the Basle Accord (Princeton, NJ: Princeton university, 1991); Ethan B Kapstein, *Governing the Global Economy: International Finance and the State* (Cambridge, MA: Harvard University, 1994); Tony Porter, *States, Markets and Regimes In Global Finance* (New York: St. Martin's Press, 1993); Beth A Simmons, "The International Politics of Harmonization: the Case of Capital Markets Regulation", (2001) 55:3 *International Organization* 589.

[34] Wood, *supra* note 31 at 163-164.

[35] *Ibid* at 123-148.

the primary forum for global economic cooperation.[36] The Committee's membership has been expanded twice to include emerging markets and developing economies.[37] The basis for the BCBS's operations is no longer an informal press statement,[38] but a new *Charter* which sets out its structure, mandate and function in some detail.[39] The BCBS's operations have been subjected to oversight of a higher body, designated as the Group of Governors and Heads of Supervision.[40] Last but not the least, the Committee has adopted any array of new policies in response to the recent crisis. Basel III is the most important of such policies, the implementation of which is now monitored by the BCBS.[41]

The current literature on the BCBS does not engage with these new developments. Nor do they engage with questions of legitimacy and accountability, which warrant immediate attention in the face of massive regulatory failures. My research seeks to make a positive contribution towards filling these gaps. It investigates the BCBS's governance, operation, and policy outcomes to determine the extent to which it is and has been legitimate. The point of departure for my analysis is the literature on legitimacy in law, political science, and international relations. In particular, I draw upon Global Administrative Law (GAL) theory to examine the BCBS's legitimacy against three principles of reasoned decision making, transparency, and accountability. I argue that the BCBS has gradually become a more legitimate institution but that significant room still exists for improvement. Inadequate disclosure on the BCBS's deliberations,

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[36] See, e.g., G20, "Monitoring Adoption of Basel III Standards and Reports to the G20" (Accessed on 1 June 2014) online: BIS http://www.bis.org/bcbs/implementation/bprl1.htm.

[37] BCBS. "Basel Committee broadens its membership" (2009) online: BIS http://www.bis.org/press/p090610.htm; BCBS, "Expansion of Membership Announced by the Basel Committee" (2009) online: BIS http://www.bis.org/press/p090313.htm.

[38] See, "Note on the BIS Governors' Activities vis-à-vis the Euro-currency Market" (12 February 1975), reprinted in Goodhart, *supra* note 19 at 50.

[39] BCBS, "Basel Committee on Banking Supervision (BCBS) Charter" (January 2013) online: BIS http://www.bis.org/bcbs/charter.htm [*Charter*].

[40] *Charter, ibid*, s 6.

[41] BCBS, "International Regulatory Framework for Banks (Basel III)" (Accessed on 1 May 2014) online: BIS http://www.bis.org/bcbs/basel3.htm.

underrepresentation of constituencies without business interest or insufficient financial resources in BCBS consultations, and absence of meaningful oversight of the BCBS's policies, are among the areas that I highlight for reform. I set out policy prescriptions to enhance the BCBS's legitimacy, including the establishment of a new framework for transparency; creation of a proxy advocate to participate on behalf of underrepresented constituencies in the BCBS's policy making; and the establishment of a new body, which I designate as the Independent Evaluation Committee, to exercise active oversight of the BCBS's operations.

1.4 Overview of Thesis

The inquiry begins by taking a closer look at what legitimacy means and how it can be assessed for the global governance of banking. A taxonomy of legitimacy is developed, drawing upon four established bases for the acceptance of a governing authority: 1) majority will and representation, 2) dialogue and deliberation, 3) stability and coherence of rules, and 4) expertise and competence to generate material benefits. The discussion illustrates the contested nature of legitimacy and the insights that can be drawn from different theories for assessing legitimacy at the supranational level. I argue that while institutions of global governance often lack direct mechanisms of democracy, such as elections, nurturing other accepted bases for legitimacy can further legitimize them. In particular, I will draw upon GAL to argue that the BCBS can become more legitimate by meeting adequate standards of reasoned decision making, transparency, consultation, and oversight.

Chapter 3 explores the BCBS's history and current position in the global regulatory sphere. It aims to establish a general understanding of the BCBS's evolution and current governance and serve as a background for the analyses in subsequent chapters. The chapter traces the origins of the BCBS to the drastic changes that took place in the system of international banking in 1960s and 1970s and illustrates how the BCBS grew from a forum merely for informal education and exchange of information on banking supervision to a primary global standard setter for prudential regulation of banks. Particular attention is paid to the post-crisis governance and operation of the BCBS and its current position in the international financial architecture. The Chapter posits that the BCBS can be best understood as a transnational regulatory network that has dispensed with traditional formalities associated with formal international organizations. The networked governance of the BCBS represents both opportunities and challenges with respect to its legitimacy. For instance, strong peer-to-peer ties among bank supervisors, twinned with institutional flexibility and consensus-based decision making can be viewed as enhancing the deliberative quality of the BCBS's policy making. On the other hand, closed operation of the BCBS and its exclusive membership of officials from central banks and supervisory authorities, who have similar education and career backgrounds, expose the Committee to groupthink problems and the risk of adopting inferior policies.

Chapter 4 assesses the BCBS's legitimacy and accountability based on the criteria identified in the theoretical framework (Chapter 2). Four crucial questions drive this chapter's assessment: 1) Does the BCBS give reasons for its decisions? 2) Are the Committee's governance and decision-making procedures transparent? 3) How and by what means does the BCBS consult the public in its policy-making process? 4) How and by who is the Committee's performance monitored? Since the BCBS has produced a massive body of standards over the years, my assessment of reasoned decision making focuses on the Basel III process which has produced one of the most important post-crisis regulatory reforms. The analysis of the BCBS's transparency is conducted around three focal points: internal governance, decision-making procedures, and implementation of standards. In regard to consultation, I consider both the sources of input for the BCBS's policy making and the notice and comment process, which is used to consult the public on the BCBS's major policy proposals. In addition to examining the origin of the notice and comment, I investigate its operation in the Basel II and Basel III processes. I am particularly concerned with the question of 'who' participates in the process and engage with the political economy literature on regulatory capture as it applies to the BCBS's interaction with private interests. Finally, Chapter 4 assesses the oversight arrangements for the BCBS's policy making at the international level. In particular, it focuses on two supranational bodies that currently exercise oversight over the BCBS: the Group of Governors and Heads of Supervision (GHOS) and the G20. The GHOS has been expressly designated as the BCBS oversight body in the *Charter* and appears to have been in operation since 2009.[42] The G20 does not have any formal authority over the BCBS but it seems noteworthy for the purpose of this analysis given the influence that it exercises over the post-crisis financial reform.

The findings of my assessment indicate that the BCBS does not score equally on all criteria. The best score seems to be achieved on reasoned decision making given the sound administrative procedures that the BCBS followed during the Basel III process, such as public invitation for comments, clear articulation of reforms' objectives, and timely costs and benefits analyses. Considerable progress can be also observed on the transparency front. The adoption of the notice and comment, the online disclosure of policy documents and the newly-adopted *Charter* has made the Committee's work more visible to the public. Important information gaps, however, remain regarding the BCBS's internal governance and decision making, especially the BCBS's deliberations which are subject to little and selective disclosure.

The assessment of the BCBS's consultation indicates greater legitimacy gaps and room for improvement based on the previous two criteria (reasoned decision making and transparency). The real benefits of notice and comment cannot be overstated given that it has been mostly used as a lobbying tool by banks rather than as a mechanism for conveying the demands and concerns of a broad set of stakeholders. Moreover, notice and comment cannot always facilitate timely input given that it is only used for completed draft proposals. The lowest score seems to be achieved on oversight, given that neither GHOS nor G20 exercise meaningful oversight over the BCBS. The technical nature of the BCBS's work and lack of independence on the part of oversight bodies are among the factors that can explain this weak oversight.

Chapter 5 explores the theme of correction in the work of the BCBS. It demonstrates the shortcomings of the Basel Accords that surfaced with the outbreak of the GFC, and seeks to examine the corrective measures that the BCBS has adopted in response to the crisis. The key question that guides the analysis of post-crisis reforms is whether such reforms have made the

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[42] *Charter*, *supra* note 38, s 6.

international banking system more resilient, or if there still remain vulnerabilities in the system that pose threats to financial stability. This question has important implications not only for BCBS's accountability, but also for its *performance-based legitimacy*. The BCBS is perceived as more legitimate if its post-crisis policies help reduce the likelihood of financial crises and increase the prospect of financial stability.

One important question that this chapter examines with respect to banking standards prior to the crisis is whether Basel II should be removed as a contributing factor given its delayed implementation in some jurisdictions. This question is of particular significance given that the criticism of Basel II has been contested by the Basel Committee's supporters who argue that Basel II had not been implemented extensively at the beginning of the crisis in US and, as such, it is difficult to blame it. I argue that while this argument may have some merit with respect to Basel II, it can hardly answer the broader role that capital adequacy regulations played in the crisis. In fact, some important criticisms of Basel II, such as procylicality, are equally relevant in the context of Basel I. More importantly, while the implementation of Basel II was delayed with respect to US commercial banks, since 2004, it was applied to the US's largest investment banks.

The remainder of the chapter is devoted to the analysis of the post-crisis regulatory reforms, particularly Basel III from an accountability perspective. My analysis focuses on three key areas of post-crisis reforms: minimum capital requirements, liquidity standards, and leverage ratio. I argue that BCBS has not met the test of correction for two primary reasons. First, the Committee failed to remedy the flaws and weaknesses that surfaced in the recent Crisis, including insufficiency of capital buffers and the use of internal models to manipulate and distort the intentions of the capital adequacy rules. Second, some of the key reforms that the BCBS adopted, such as the liquidity standards and the leverage ratio, have been so heavily diluted and fall far short of their objectives. Additionally, I argue that the failure and dilution of the reforms reflect important accountability problems, particularly with respect to the BCBS's transparency and consultative practices. It is such accountability deficits that the recommendations outlined in the next chapter seek to remedy.

Chapter 6 contains the concluding remarks. It posits that legitimacy appears to be a matter of degree. An institution is not simply legitimate or illegitimate but rather more legitimate or less legitimate, depending on how it scores on legitimacy criteria. Institutional change and direction must also be considered when evaluating legitimacy; an institution whose legitimacy is deteriorating is more questionable than that of an institution that is improving. Applying the above criteria to the issue at hand, the BCBS has indeed become incrementally more legitimate since its inception. It clearly articulates the rationale for its policies and discloses more information on its operations and policies. It attempts to engage with the public through notice and comment. Lastly, its performance and policies are also subject to some form of oversight by a superior body. Nevertheless, as this thesis's assessments show, there is considerable room for BCBS to become more legitimate. Thus Chapter 6 outlines some recommendations for improved BCBS legitimacy. These recommendations have been grouped around five major categories: enhancing reasoned decision making and transparency; creating new consultation mechanisms; enhancing the BCBS accountability at the national and international level; and making the BCBS a more inclusive global standard setter. The policy recommendations are subject to two important caveats. First, they are by nature preliminary, as they represent the first attempt in the literature to make the BCBS more legitimate. Second, the institutional supply of such reforms as enhanced transparency and consultation must be met by strong societal demand for public interest banking regulation to emerge.

Chapter 2: An Exploration of Legitimacy: What Does It Mean for the Global Governance of Banking and How Can It Be Assessed?

2.1 Legitimacy: An Elusive Concept

The term "legitimacy" can be traced back to the Latin word *legitmus*, which was used in Roman and medieval jurisprudence to characterize a state of affairs that was in accordance with law, justice and customs.[1] Beginning in the middle ages, the concept came to represent legal succession to a throne according to the principle of primogeniture. Legitimacy then became a key political term in post-colonial Europe when the sovereignty of rulers (legitimacy as primogeniture) and the sovereignty of people (legitimacy as self-determination) became two competing concepts.[2]

At its most basic, the idea of legitimacy refers to rightfulness and acceptability of political authority. However, what makes political authority acceptable and what criteria should be used to measure legitimacy are contested questions; many commentators have used the democratic theory to answer it.[3] However, as will be illustrated below, the conception or model of democracy used in an analysis could result in different outcomes. The question also becomes more challenging when the locus of analysis is global governance institutions that, in nature and operation, are not confined to any nation state. It must also be noted that democracy is not the only premise for such an analysis; the order or stability and the performance of an institution are among other important bases of legitimacy. In the following sections, I trace through four established foundations of governing authority: 1) majority will and representation; 2) dialogue

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[1] Achim Hurrelmann, Steffen Schneider & Jens Steffek, “Introduction: Legitimacy in an Age of Global Politics” in Achim Hurrelmann, Steffen Schneider & Jens Steffek, ed, *Legitimacy in an age of global politics* (New York: Palgrave Macmillan, 2007) at 3-4.

[2] *Ibid.*

[3] See, e.g., Fritz W Scharpf, *Governing In Europe: Effective and Democratic?* (Oxford: Oxford University Press, 1999); David Held, *Democracy and the Global Order: Form the Modern States to Cosmopolitan Governance* (Polity Press: Cambridge, 1995); Jan A Scholte: Towards Greater Legitimacy in Global Governance (2011) 18:1 Review of International Political Economy 110 [Scholte, “Towards Greater Legitimacy”].

and deliberation; 3) stability and coherence of rules; and 4) expertise and competence to generate material benefits. In addition to discussing their salient features, I will briefly comment on the application of these principles to global governance, as well as broader insights that can be drawn from their application. My central argument is that while institutions of global governance often lack direct mechanisms of democracy, such as elections, nurturing other accepted bases for legitimacy can further legitimize them. In particular, I will draw upon Global Administrative Law theory to argue that the BCBS can become more legitimate by meeting adequate standards of reasoned decision making, transparency, consultation, and oversight.

As an initial step, it is important to note that legitimacy can be seen from two perspectives: normative and empirical. In the former, a researcher defines and defends a set of criteria for legitimacy and then applies them to institutions or orders. This approach assesses particular regimes and produces statements of a *normative* or *diagnostic* nature. In the second case, by contrast, the researcher is particularly concerned with the conception of legitimacy held by real world actors. For instance, the researcher examines how citizens or certain elites see and evaluate legitimacy of existing institutions. This approach results in statements with an important *empirical* dimension given that the identified criteria are described as being used more or less widely and certain institutions as being more or less accepted.[4] It is important to note that even in such situation the real world actor's perception of legitimacy can be indeed normative. However, since the social scientist makes assertions based on cumulative evidence, his or her statements have empirical significance. What follows next is primarily concerned with a normative perspective of legitimacy. That is, it examines what different theorists identify as an appropriate basis for legitimacy, and what criteria they define and defend for their normative evaluations. However, one must be cautious not to see the distinction between normative and empirical legitimacy as too rigid, as a theorist is not only an observer but also a real-world actor.

[4] Hurrelmann, Schneider & Steffek, *supra* note 1 at 3-4.

2.1.1 Representative Legitimacy

From the classical era to the 17th century, democracy was largely associated with a gathering of citizens in assemblies or public meetings.[5] However, in the early 19th century, democracy began to be thought of as the right of citizens take part in the determination of collective will through the election of representatives.[6] The idea of representative democracy was grounded in the work of liberal philosophers, such as James Madison and Jeremy Bentham, who were critics of direct democracy but argued for citizen empowerment to appoint their own rulers. With universal suffrage, liberal representative democracy took on its distinctive form, encompassing a cluster of rights and institutions such as elected government, free elections, and freedom of conscience, expression and information.[7]

Central to representative democracy is the idea that consent, expressed through the medium of election, legitimizes political power. In other words, the government's decisions and actions are legitimate if they represent the consent of the majority of the *demos*. To be sure, most modern representative democracies allow the elected representatives to delegate some of their powers to others, such as administrative agencies. However, the chain of authority that derives from democratic mechanisms—namely, election—imbues delegates with legitimacy as well.[8]

While the theory of representative democracy can fairly easily legitimize national governments, its application causes challenges at the supranational level. Indeed, supranational governance regimes might be regarded as illegitimate when they are seen through the lens of representative democracy. Absence of election and extensive chains of delegation are important reasons that

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[5] Held, *supra* note 3 at 9-12.

[6] *Ibid.*

[7] *Ibid*.

[8] *Ibid*; Ilter Turan, "Democracy, Types of" in Bertrand Badie, Dirk Berg-Schlosser & Leonardo Morlino, eds, *International Encyclopaedia of Political Science* (Thousand Oaks, Cal: Sage Publications, 2011) at 592.

representative democracy advocates make an argument for the unfeasibility of democracy at the international level.[9]

It must be conceded that direct election of international officials is unlikely in the near future. However, this unlikelihood need not end the discussion of legitimacy or legitimization at the global level. Indeed, emphasis on election or majority voting as the central institution of democracy has been regarded as misplaced. As Barker puts it:

> If democracy as a feature of government entails that policies, or rulers, reflect the wishes of the people or majority of them, then it could be achieved by responsive despotism or by authoritarian government informed by market research. It is paradoxically, such an account of democracy on which rational choice theory has concentrated while at the same time insisting on its impossibility**.** [10]

In short, it does not seem that majority voting or direct electoral underpinnings are essential prerequisites of legitimate governance. Decision-making procedures of international institutions could be designed so that they connect citizens to policymakers and engage them in a dialogue that establishes some degree of democratic legitimacy. The next section will present such a topic.

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[9] Diversity of interests and values at the global scale, lack of interest or knowledge of many citizens to involve in international issues are also reasons that have been mentioned in this his regard. See Robert A Dahl, "Can International Organizations be Democratic? A Skeptic's View" in Ian Shapiro & Casiano Hacker-Cordón, eds, Democracy's edges (New York: Cambridge University Press, 1999).

[10] Rodney Barker, "Democratic Legitimation: What Is It, Who Wants It, and Why?" in Achim Hurrelmann, Steffen Schneider & Jens Steffek, ed, *Legitimacy in an age of global politics* (New York: Palgrave Macmillan, 2007) 19 at 24.

2.1.2 Deliberative Legitimacy

In an early and very influential paper, Bernard Manin observes that, similar to liberalism, modern democratic thought is based on principles of individualism.[11] While there are differences between liberal and democratic points of view, both arrive at the same consideration of unanimity as the true source of legitimacy.[12] Basing political legitimacy on unanimity derives from the principles of modern individualism. By nature, individuals are free and equal to one another. There is no essential difference or natural hierarchy among individuals that can justify the domination of some over others. Since political power and the rules it promulgates bear on and constrain all members of society, they are legitimate as long as they arise from and represent the will of all.[13] At the same time, however, most democratic theories are not only concerned with legitimacy but also with efficiency. Such theories therefore bring into play the majority principle, which is a more realistic mechanism for decision making.[14] As a result, the question arises how 'unanimity' - as the principle of legitimacy - can be reconciled with 'majority' - the principle of decision making.

The work of Emmanuel Sieyès, the French political theorist, is remarkably illustrative of how liberal philosophers contemplated this question.[15] Sieyès posits that humans are free by nature; when they form a society or association, "only relations based on the free act of will of each individual can be established among them." [16] In his view, the laws of a society are legitimate only if they represent the achievement of unanimous will of all of its individuals.[17]

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[11] Bernard Manin, "On Legitimacy and Political Deliberation" (1987) 15:3 Political Theory 338 at 341.

[12] *Ibid* at 341.

[13] *Ibid* at 340.

[14] *Ibid.*

[15] Emmanuel Sieyes, Vuessur les moyensd'exécutiondont les représentants de la France pourront disposer en 1979 (Pans, 1789), 15, cited in Manin, *ibid*, at 365.

[16] *Ibid*.

[17] *Ibid*.

Sieyès acknowledges "unanimity being a very difficult objective to attain even among a rather small group of people," thus making it "impossible in a society of several million individuals."[18] With good reason then, majority becomes a substitute for unanimity. However, due to the centrality of unanimity as the true source of legitimacy in Sieyès's theory, he cannot dispose of it. Instead, he tries to transubstantiate majority into unanimity, asserting that one must resolve to find all the attributes of the former in the latter. [19] Sieyès' attempt is, of course, unsuccessful, as the will of the majority and the will of *all* are by no means equivalent. The word "majority" itself implies a degree of exclusion. However, it successfully illustrates the extreme difficulty that democratic theories face in reconciling unanimity—as the main source of legitimacy—with the practical realities of modern life.[20]

It should be noted that under the liberal democratic theories discussed above, the will of individuals that make collective decision making legitimate is predetermined. In other words, such theories assume that an individual already knows what he or she wants when he or she comes to a public assembly, along with others, to assert a decision. Based on this assumption, deliberation becomes unnecessary, or even undesirable, because individuals have already made up their mind and any act of persuasion attempted by others could taint or oppress their will. Jean-Jacques Rousseau's *Social Contract* clearly makes such a point:

> Whenever men who have gathered together, consider themselves as one single body, they will have only one will, dedicated to the preservation of the community, and the general well-being. <u>Then all the actions of the state would be vigorous and simple, its maxims clear and luminous. There will be no tangled, contradictory interests, the public good would be evident everywhere, and would only need</u>

[18] *Ibid.*

[19] *Ibid.*

[20] Manin, *supra* note 11 at 342.

> common sense to be apprehended. Peace, unity, and equality are the enemies of political subtleties. [21] [Emphasis added]

Rousseau assumes that deliberation is unnecessary because citizens can independently make their own choices and the common good of a society is obvious. It is this assumption, however, that deliberative theorists characterize as the chief shortcoming of modern democratic thought. As Manin notes, the complexity of social life does not allow individuals to avail themselves of complete information. It is unreasonable to assume that individuals are already informed and have a complete set of preferences regarding a multitude of issues. They may only have incomplete and fragmentary knowledge of a problem or a solution. Deliberation could therefore be characterized as a procedure of becoming informed, allowing individuals to confront various points of view, clarify their information, and sharpen their preferences.[22] The significance of this procedure explains why the deliberative account argues for radical alteration of a perspective common to both liberal theories and democratic thought: legitimacy's source is not the predetermined will of individuals but the process of its formation—namely, deliberation.

Cohen observes that "the notion of deliberative democracy is rooted in the intuitive ideal of a democratic association in which the justification of terms and conditions of association proceeds through a public argument and reasoning among equal citizens."[23] In such an order, citizens commit to the resolution of collective problems through public reasoning and consider their institutions legitimate insofar as they establish a framework for public deliberation.[24]

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[21] Jean-Jacques Rousseau, *Du Contrat Social*, Book IV, chap. 1, 437, cited in Manin, *supra* note 11 at 346-347.

[22] *Ibid* at 352.

[23] Joshua Cohen, "Deliberation and Democratic Legitimacy" in James Bohman& William Rehg, *Deliberative Democracy: Essays on Reason and Politics* (MIT Press, 1997) 67 at 72.

[24] *Ibid*.

Central to the deliberative account of democracy are *reasoning* and *publicity*. In a deliberative account, reasons, rather than preference, constitute the main input into the democratic decision-making process. Reasons might be directed on policy proposals (what needs to be done) on the one hand, and the empirical claims and hypotheses on which proposals rest on the other. In most cases, participants in the deliberation do not agree on the reasons. Indeed, disagreement about the reasons for and against a course of action and evaluation of the conflicting reasons is the *raison d'être* of the deliberative process. The second dimension (publicity) requires deliberation participants to justify the reasons for which they prefer a particular course of action. Such justification is then scrutinized by other discussants. Indeed, as Fabienne Peter argues publicity is not only about the forum in which reasoning takes place, public deliberation vis-à-vis private deliberation, but also refers to the types of reasons given. A reason is public when it has the potential to be accepted by those who do not share the same point of view. [25]

The deliberative process is brought to an end by a choice. The proposal that wins the greatest support among participants will be adopted. However, the final decision is not legitimate simply because it carries the approval of the greatest number. Instead, it is legitimate because it is the outcome of a deliberative process where participants had the opportunity to voice their views and choose or refute a solution.[26]

Theories of deliberative democracy offer insights that prove useful when looking at the legitimacy of supranational governance arrangements. Arguably, a global governance regime carries greater legitimacy when its decision-making procedures are accompanied by an established framework for deliberation among different perspectives. Affected constituencies are more likely to grant an institution the right to rule when the institution gives reasons for its decisions and welcomes a public debate on the merit of such reasons. It is even arguable that an appropriate deliberative mechanism could substitute for

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[25] Fabienne Peter, *Democratic legitimacy* (New York: Routledge, 2009) at 31-33.

[26] Manin, *supra* note 11 at 359-360.

democratic mechanisms, such as election, that are absent internationally. When designing a deliberative framework, attention must be given to the efficiency dimension of international policymaking. Deliberation should not unreasonably slow down or impose excessive costs on the decision-making process.

2.1.3 Rules-based Legitimacy

In his seminal volume, *The Morality of Law*, Lon Fuller exposes his view on the normative characteristics of a legal system.[27] Through the parable of *Rex* (the imaginary king and lawmaker), Fuller demonstrates several ways a legal regime may flounder, including failure to publicize rules, abusive use of retroactive rules, failure to make rules understandable, enactment of contradictory rules, rules impossible to implement, frequent changes to the rules so that action in accordance with them cannot be oriented, and failure of the rules to correspond to their interpretation or implementation. According to Fuller, the entire legal system may cease to be characterized as a legal system if it fails too extensively in any of these particularities.[28]

Interaction between rules and legitimacy at the international level has also been studied by legal scholars, including Thomas Franck. In his book, *Power of Legitimacy Among Nations*[29], Franck rejects the view that an international norm or rule is legitimate when a coercive authority backs it. Instead, he argues that a rule is legitimate when those it addresses perceive the rule to be legitimate. [30] That is, they perceive the rule to have come into being and that it operates according to the right process. A full discussion of what Franck considers to be the right process is beyond the purview of this thesis; it suffices to say that the two main components of the right process of relevance to this contribution are determinacy and coherence.

A rule is determinate when its content can be ascertained with relative ease and certainty. Logically, rules that have a high degree of determinacy are more likely to be successful in

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[27] Lon L Fuller, *The Morality of Law* (New Haven: Yale University Press, 1964).

[28] *Ibid* at 33-94; Perry Meyer, Book Review of *Morality of Law* by Lon L Fuller, (1964) 10 McGill L J 380 at 381.

[29] Thomas M Franck, *The power of legitimacy among nations* (New York: Oxford University Press, 1990).

[30] *Ibid* at 16.

regulating conduct than those that are less determinate because those to whose conduct the rules are directed can understand what is expected of them. This understanding is the first essential step toward compliance. In contrast, the more indeterminate a rule, the easier it is to justify non-compliance.[31] Franck recognizes that some degree of complexity and vagueness might be necessary for some rules.[32] An example, he offers *pacta sunt servanda,* which essentially means that treaties are binding. While this rule communicates a very clear message, its application may lead to problems. For instance, what if the subject matter of a treaty ceases to exist? What if the conditions in which a treaty operates change so dramatically that the application becomes irrational? Insistence on the implementation of the treaty in such circumstances produces absurd outcomes. International law therefore imposes the *clausula rebus sic stantibus,* which permits a treaty to be voided upon a profound change of circumstances.[33] Although *clausula rebus sic stantibus* reduces the clarity of *pacta sunt servanda*, it also prevents it from creating absurd outcomes. Franck, however, stresses that rules such as *clausula rebus sic stantibus* should not give states the license to do whatever they wish. Instead, there should be a legitimate interpretative process that allows for the case-by-case application of such rules. [34]

Another important way that rules can contribute to legitimacy is by coherence. Franck's conception of coherence is very similar to, and in fact draws upon, Ronald Dworkin's theory of integrity. Dworkin contends that integrity is helpful in understanding why rules are treated as compelling. He uses the term in two different, but related, fashions: *moral integrity,* which requires a rule to be principally related to the other rules of the same system, and *adjudicative integrity,* which means that all like cases will be treated alike in the application of a rule.[35] Using the same mode of analysis, Franck introduces two concepts of *coherence* and *consistency*. Similar to adjudicative integrity, consistency simply means treating likes alike. Coherence,

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[31] *Ibid* at 50-52, 64-66.

[32] *Ibid* at 84.

[33] *Ibid* at 84-85.

[34] *Ibid*.

[35] Ronald Dworkin, *Law's Empire* (Cambridge, Mass.: Belknap Press of Harvard University Press, 1986) at 176-224; Franck, *supra* note 29 at 143.

however, which is of more significance, means that a rule is based on principles that are widely accepted (or at least not unacceptable) in the international community. Coherence legitimates a rule by providing a connection between the rule or its application on one hand, and its own principled purpose plus a web of other principles, including those previously used in similar cases, on the other hand.[36]

This brief introduction to some rule theories by jurisprudence scholars suggests that the legitimacy of any governance system, be it national or supranational, derives at least partially from having decision-making procedures and rules that are publicized, intelligible and coherent. The order and stability established by rules significantly contributes to good governance by preventing chaos and promoting collective action. In addition, Fuller's observation holds true in any context of governance in that one cannot be legitimately expected to comply with a rule when the rule is kept secret, cannot be understood, is contradicted by another rule, demands the impossible, or changes too often.

2.1.4 Outcome-based Legitimacy

Legitimacy may derive from the technical expertise of the governing institution and its ability to deliver socially beneficial outcomes. Theories of output legitimacy usually focus on the performance and accomplishment of an institution, rather than on its institutional characteristics. In other words, it is the institution's success in producing desirable outcomes that legitimizes its authority.[37] For instance, Bressman observes that "an institution derives legitimacy from its ability to solve problems that could not be addressed by other means."[38] Buchanan and Keohane similarly note that "the legitimacy of an institution is called into question if there is an institutional alternative, providing significantly greater benefits, that is feasible, accessible

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[36] Franck, *supra* note 29 at 143-149.

[37] Chris Brummer, *Soft law and the Global Financial System: Rule Making in the 21st Century* (New York: Cambridge University Press, 2012) at 180.

[38] *Ibid*.

without excessive transition costs, and meets the minimal moral acceptability criterion."[39] Legitimacy based on outcomes has also been considered by Max Weber. Weber valued bureaucratic governance mainly because it allows delegation to experts whose knowledge, neutrality and insulation from politics promise delivery of superior policy outcomes.[40] Outcomes undoubtedly contribute to legitimacy; constituencies are more likely to recognize the authority of an institution when it delivers material objectives. For instance, the Basel Committee is perceived to be more legitimate to the extent that its policies help reduce the likelihood of financial crises and increase financial stability. It is also true that expertise is an essential condition for desirable institutional performance and a key reason for national governments to delegate authority to international institutions.

Two notes of caution are warranted here. First, technical performance is only one source of legitimacy, and while it is important, it does not eliminate the need for other substantive foundations of legitimacy. Indeed, some authors have argued that technical performance on its own cannot secure legitimacy. For instance, Jan Art Scholte observes that many constituencies have not treated the G8 as a legitimate institution, despite the material benefits that flow from its initiatives, including enhancing financial stability, combating climate change and broadening digital access.[41] Such perception is largely due to the fact that the G8 has extremely poor democratic credentials for a global authority, a problem that the shift to the G20 seeks to address. Similarly, the Group of Thirty may have significant expertise in economic and financial policy analysis, but because it lacks any constitutional or democratic grounds, few constituencies accord

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[39] Allen Buchanan & Robert O Keohane, "The legitimacy of global governance institutions" (2006) 20:4 Ethics and International Affairs 405 at 405.

[40] Max Weber, *Economy and Society: An Outline of Interpretive Society* (Berkley: University of Californian Press, 1978) at 216-227; Daniel C Esty, "Good Governance at the Supranational Scale: Globalizing Administrative Law" (2006) 115 Yale Law Journal 1490 at 1517.

[41] Jan A Scholte, "Global Governance, Accountability, and Civil Society" in Jan A Scholte, ed, *Building Global Democracy: Civil Society and Accountable Global Governance* (New York: Cambridge University Press, 2011) 8 at 114-115 [Scholte, "Global Governance and Accountability"].

it with the right to rule.[42] Thus, global governance institutions must acquire legitimacy through a combination of grounds. Technocratic efficiency on its own does not generate sufficient support from the stakeholders[43] to sustain a regime.

Second, outcomes cannot be considered in isolation from the institution delivering them. The previous sections explained how appropriate deliberative mechanisms and sound rulemaking can contribute to greater legitimacy. Such mechanisms can also positively affect the outcomes institutions produce. Giving voice to different perspectives and critically evaluating them helps institutions produce better policies. Likewise, institutions that operate based on a clear, stable rule system are more likely to find success, in contrast to a regime that operates based on incoherent and ambiguous rules.

2.2 Global Governance of Banking from the Lens of Global Administrative Law

The previous section developed the taxonomy of legitimacy, drawing upon four established bases for the acceptance of a governing authority: 1) majority will and representation, 2) dialogue and deliberation, 3) stability and coherence of rules, and 4) expertise and competence to generate material benefits. It illustrated that institutions of global governance often lack direct mechanisms of democracy, such as elections, at the national level. It was, however, argued that the regimes of global governance could be further legitimized by nurturing other accepted bases of legitimacy, such as appropriate deliberation mechanisms or governance through sound and stable rules. Against such a background, this section will elaborate further on the approach and principles of my thesis upon evaluation of the legitimacy of the global governance of banking. Global administrative law (GAL) is the basic theoretical framework used in my thesis. GAL is an emerging field that refers to “mechanisms, principles, practices, and supporting social understandings that promote or otherwise affect the accountability of global administrative bodies, in particular by ensuring they meet adequate standards of transparency, participation,

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[42] *Ibid.*

[43] For the definition of stakeholders see the discussion of accountability (2.3.4) below.

reasoned decision, and legality, and by providing effective review of the rules and decisions they make."[44]

As noted by Benedict Kingsbury, Nico Krisch, and Richard Stewart, underlying GAL's emergence is the vast increase in the types and reach of transnational regulation and administration. Today, global interdependencies in such fields as security, development, environmental protection, banking, intellectual property and trade give rise to pressing issues that cannot be addressed by isolated national measures. As a result, various transnational systems of regulation and cooperation have been established that take on many important regulatory functions of national regimes. In light of this, GAL offers two important insights. First, much of what is termed "global governance" can be accurately characterized as administrative action.[45] Many institutions and regimes that engage in global governance perform functions that have a genuine administrative character. That is to say, they operate below the level of treaty making but still manage and regulate vast aspects of social and economic life through specific decisions and rules. This is particularly the case with regard to transnational regulatory networks (TRN) such as the Basel Committee. From a legal point of view, the TRN's function can be distinguished from both legislation in the form of treaty making and adjudication in the form of dispute settlement (between states or other disputing parties). Second, administrative action performed by various governance regimes could be regulated by administrative law-type principles, rules and mechanisms.[46] The case for such regulation arises because these institutions, unlike their national counterparts, are not subject to direct control by national governments or domestic legal systems. This situation creates an accountability deficit that GAL seeks to address.[47]

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[44] Benedict Kingsbury, Nico Krisch & Richard B Stewart, "The Emergence of Global Administrative Law" (2005) 68:15 Law & Contemp Probs 15 at 17.

[45] *Ibid.*

[46] *Ibid.*

[47] *Ibid* at 16-18.

It is important to note that GAL's principles and standards are broad enough to be applied to a multitude of global governance regimes, including formal governmental regulatory bodies, informal intergovernmental regulatory networks, and hybrid public–private or private transnational bodies. There are, of course, important differences among these regimes. Some of them merely provide a framework for state action, whereas others establish guidelines that directly address domestic administrative agencies. Some regulatory regimes have their own enforcement mechanisms, while others may simply rely on national authorities to implement the rules. Nevertheless, such differences do not constitute a barrier to GAL's application given that GAL does not focus on specificities of the substantive rules generated by these institutions, but on the existence and operation of a minimum set of good governance principles that are intended to ensure legality, transparency and accountability.[48]

2.2.1 Sources of Global Administrative Law

An important question that arises asks where the norms and principles of GAL come from. As the following paragraphs will demonstrate, there is no definitive answer to this question. GAL is a new field whose principles, domain and sources are still under development. The written instruments concerning its norms are scattered and the practices of global administrative bodies are fragmented. Disagreement seems inevitable about whose practices to rely on for rules and how much consistency in practice is needed to generate adhesion.

However, such issues may seem less challenging in light of the fact that a legal commonality could be imposed on diverse norms and practices that GAL builds upon. As Benedict Kingsbury notes:

> … the various mechanisms for accountability, for participation, and for the strengthening … legitimacy in these different governance structures are evolving not simply in parallel but in increasingly interconnected ways that represent an emerging global administrative

[48] *Ibid* at 17, 20-23.

law.[49]

The following sections will consider GAL's sources under two broad categories: national and transnational.

2.2.2 National Sources

The primary function of administrative law in domestic legal systems is control of public power. Administrative law subjects administrative agencies to the rule of law and prescribes behaviours within their organization. As the authors of a leading administrative law text write:

> Administrative law is the law relating to the control of governmental power. This, at any rate, is the heart of the subject as viewed by most lawyers….The primary purpose of administrative law is therefore to keep the powers of government within their legal bounds, so as to protect the citizen against their abuse. The powerful engines of authority must be prevented from running amok.[50]

This characterization reflects the fact that the main systems of administrative law established themselves in the context of constitutions that placed great emphasis on the separation of powers. *Marbury v. Madison*[51] in United States and *Prince Napleon*[52] in France were early precedents that established judicial control over acts previously considered governmental or apolitical. In other words, these cases illustrate the role that administrative law played in the struggle for limited government.[53]

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[49] Benedict Kingsbury, "The Administrative Law Frontier in Global Governance" (2005) 99 Am Soc'y Int'l L Proc 143 at 148.

[50] William Wade & Christopher Forsyth, *Administrative Law*, 10th ed (New York: Oxford University Press, 2009) at 4.

[51] *Marbury v Madison*, 1 Cranch 137, 2 L Ed 60 (1803).

[52] Conseild'Etat, 19 Feb. 1875, Prince Napoléon, Rec. 155, concl. David.

[53] Carol Harlow, "Global Administrative Law: The Quest for Principles and Values" (2006) 17:1 EJIL 182 at 191.

In most systems, administrative law has evolved mainly as a system of principles with significant procedural characteristics. Administrative law requires the government to stay within the boundaries of legality or, in the parlance of US administrative law, not to overstep their power as delegates. Out of such boundaries originates the principle of legality central to all administrative law systems, known as *ultra vires* in Common Law and *excès de pouvoir* in civil law France.[54] Legality requires the administration to act within its powers and observe the principles of due process.

As Shapiro puts it, administrative law contains "a set of rules prescribing the proper rule-making behaviour for administrative agencies; that is, administrative law is a key set of procedures."[55] Common examples of such procedural rules include public notification of proposed rules and inviting interested parties to comment, providing opportunities for public participation, giving reasons for decisions, and providing mechanisms for review and correction.[56] These procedural rules are arguably associated with broader principles such as openness, rationality and accountability, all of which promote the ideal of good governance according to law.[57] This chapter will return to that topic in a later section.

2.2.3 Transnational Sources

GAL's formal transnational sources are classic sources of public international law, namely treaties, custom and general principles. It is, however, important to note that such sources do not always account for GAL's origins and the authority of normative practice that already exists in the field. For instance, treaties may rarely address issues of administrative law, and when they do they are addressed to states and not to international organizations or transnational networks.

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[54] *Ibid.*

[55] Martin Shapiro, "The Institutionalization of European Administrative Space" in Alec S Sweet, Wayne Sandholtz, & Neil Fligstein, eds, *The Institutionalisation of Europe* (New York: Oxford University Press, 2001) 94 at 94.

[56] Kingsbury, *supra* note 49 at 146.

[57] Mark I Aronson, Bruce Douglas Dyer & Matthew Groves, *Judicial Review of Administrative Action*, 3rd ed (Pyrmont, NSW: Lawbook Co, 2004) at 1.

Similarly, international customary law has been mainly forged by state action and does not incorporate practices of non-state actors. The acceptance of general principles in international law has also been low and limited to norms that are subject to a high degree of worldwide convergence. It therefore seems unlikely that general principles will be extended to the diverse and fragmented context of global administration.[58]

Accordingly, the limitations of formal transnational sources suggest that while GAL is influenced by treaties and international customary law, it goes beyond such sources and, in some cases, may even move away from them. What is important is that GAL builds on the existing and emerging normative practices of global institutions, regardless of whether or not their governance or administrative functions originate from classic sources of international law. Mapping and exploring all such practices is beyond the scope of this contribution. By way of example, however, this chapter will review the practices of three institutions central to the global governance of security, trade and finance.

2.2.3.1 UN Security Council Delisting Procedures

Under Chapter VII of the United Nations Charter, the Security Council can take measures to maintain or restore international peace and security.[59] Such measures can include acting directly on individuals through targeted sanctions and the associated listing of persons deemed to pose threats to international peace. Such targeted sanctions can involve freezing of assets or blocking of financial transactions.[60] In 2006, the Security Council adopted Resolution 1730, which sought

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[58] Kingsbury, Krisch & Stewart, *supra* note 44 at 29.

[59] Under the UN Charter, the Security Council has primary responsibility for the maintenance of international peace and security. It has 15 members, and each member has one vote. Under the Charter, all state members must comply with Council decisions. See UN, "The Security Council" (Accessed on 1 May 2014) online: UN http://www.un.org/en/sc/.

[60] UNSC, "Security Council Sanctions Committees: An Overview" (accessed August 1, 2013) online: UN http://www.un.org/sc/committees/.

to review delisting requests from targeted persons.[61] In 2009, Resolution 1904 allowed "individuals, groups, undertakings or entities seeking to be removed from the Security Council's Al-Qaida Sanctions Committee List" to submit their request for delisting to "an independent and impartial ombudsperson" appointed by the Secretary-General.[62] The delisting procedure was adopted, in part, in response to domestic court reviews of listing decisions.[63] While it may seem limited in nature, it incorporates some elements of reasoned decision making and review into the work of Security Council. Thus, it illustrates GAL's insight that an internal accountability mechanism can help enhance the legitimacy of an institution.[64]

2.2.3.2 World Bank Inspection Panel

The Inspection Panel was established by the International Bank for Reconstruction and Development (IBRD) and the International Development Association (IDA) in September 1993.[65] The establishing resolution allows the panel jurisdiction over operations supported by the IBRID and IDA. The Inspection Panel provides a forum for people who have been adversely affected by bank-financed operations, to bring their concerns to the World Bank.[66] The Panel determines whether the World Bank is complying with its own policies and procedures that are intended to ensure that bank-financed operations provide benefits for communities and avoid social and environmental harm. The Panel consists of three members who are selected based on

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[61] UNSC, "Focal Point for De-listing established pursuant to Security Council resolution 1730" (2006) online: UN http://www.un.org/sc/committees/dfp.shtml.

[62] Office of the Ombudsperson, "An independent and Impartial Ombudsperson, Who Reviews Requests From Individuals, Groups, undertakings or Entities Seeking to be Removed from the Al-Qaida Sanctions List of the Security Council's Al-Qaida Sanctions Committee" (2013) online: UN http://www.un.org/en/sc/ombudsperson/ [Ombudsperson, "Delisting Requests"].

[63] Peter Gutherie, "Security Council Sanctions and the Protection of Individual Rights" (2004) 60 NYU ANN SURV AM L 491 at 512-14.

[64] Kingsbury, Krisch& Stewart, *supra* note 44 at 34.

[65] Inspection Panel, "Panel Resolution and Mandate" (2013) online: World Bank http://web.worldbank.org/WBSITE/EXTERNAL/EXTINSPECTIONPANEL/0,,contentMDK:20173262~menuPK:64129254~pagePK:64129751~piPK:64128378~theSitePK:380794,00.html.

[66] *Ibid.*

"their ability to deal thoroughly and fairly with the requests brought to them, their integrity and independence from Bank Management, and their exposure to developmental issues and living conditions in developing countries."[67]

What made the Panel unique at the time of its establishment, was that it allowed a group of two or more individuals to trigger the procedure and thereby established the first legally relevant relationship between individuals and an international institution.[68] In this respect, the Panel was the first international accountability mechanism of its kind and was fairly quickly emulated by other Multilateral Development Banks (MDBs).[69] As noted by some scholars, the structure and institution of the Panel suffers from shortcomings, such as limited jurisdiction and inadequate authority.[70] Nevertheless, the standards and practices generated by the panel have been an important source of normative contribution toward enhancing the legitimacy and accountability of international institutions.

2.2.3.3 World Trade Organization

Article X of the 1947 General Agreement on Tariff and Trade (GATT) has been considered as the "oldest transparency and good governance obligation of the WTO."[71] This article imposes

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[67] Inspection Panel, "About Us" (2013) online: World Bank: http://web.worldbank.org/WBSITE/EXTERNAL/EXTINSPECTIONPANEL/0,,menuPK:64129249~pagePK:64132081~piPK:64132052~theSitePK:380794,00.html.

[68] Ellen Hey, "The World Bank Inspection Panel: Towards the Recognition of a New Legally Relevant Relationship in International Law" (1997) 2 Hofstra L & Pol'y Symp 61.

[69] See for more information, Daniel D Bradlow & Andria N Fourie, "Independent Accountability Mechanisms at International and Regional Development Banks" in Thomase Hale & David Held, eds, *Handbook of Innovations in Transnational Governance* (Cambridge: Polity Press, 2011) 122.

[70] See, e.g., Stephanie R Roos, "The World Bank Inspection Panel in Its Seventh Year: An Analysis of Its Process, Mandate, and Desirability with Special Reference to the China (Tibet) Case" (2001) 5 *Max Planck Yearbook of United Nations Law* 473; Korinna Horta, "Rhetoric and Reality: Human Rights and the World Bank" (2002) 15 Harv Hum Rts J 227.

[71] Padideh Ala'i, "From the Periphery to the Center? The Evolving WTO Jurisprudence on Transparency and Good Governance" (2008) 11:4 J Int'l Econ L 779 at 779.

broad publication and due process requirements on the administration of trade measures, including the following:

Laws, regulations, judicial decisions and administrative rulings related to trade issues (such as customs, duties and method of payment) must be "published promptly in such manner as to enable governments and traders to become acquainted with them."[72]Such laws, regulations and decisions must be administered "in a uniform, impartial and reasonable manner."[73] Members should establish judicial, arbitral or administrative tribunals or procedures for the purpose of review and correction of administrative actions related to custom matters. Such tribunals or procedures must be independent from agencies entrusted with administrative enforcement.[74]

An interesting analysis of Article X can be found in *United States – Restrictions on Imports of Cotton and Man-Made Fiber Underwear (United States – Underwear)*[75] where the WTO Appellate Body states:

> Article X: 2 . . . may be seen to embody a principle of fundamental importance—that of *promoting full disclosure of governmental acts affecting Members and private persons and enterprises, whether of domestic or foreign nationality.* The relevant policy principle is widely known as the principle of transparency and has obvious due process dimensions. The essential implication is that Members and other persons affected, or likely to be affected, by governmental measures imposing restraints, requirements, and other burdens,

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[72] *General Agreement on Tariffs and Trade*, 30 October 1947, 58 NTS 187, Can TS 1947 No 27, art x [GATT]. Please note that the language of Article X remains unchanged in GATT 1994. See WTO, "Legal texts: the WTO agreements" (2013) online: WTO http://www.wto.org/english/docs_e/legal_e/ursum_e.htm#General.

[73] GATT, *ibid*, art x.

[74] *Ibid*.

[75] *United States – Restrictions on Imports of Cotton and Man-Made Fibre Underwear (United States – Underwear)* (1997) WTO/DS24/AB/R (Appellate Body Report) online: WTO http://www.wto.org/english/tratop_e/dispu_e/ab_reports_e.htm.

> should have a reasonable opportunity to acquire authentic information about such measures and accordingly to protect and adjust their activities or alternatively to seek modification of such measures . . .[emphasis added][76]

The importance of Article X was underscored again in *Import Prohibition of Certain Shrimp and Shrimp Products (US – Shrimp).*[77] At issue was whether the US import ban of shrimp and shrimp products could be justified under the General Exceptions in Article XX of GATT. The Appellate Body stated that Article X:3 could be an aid interpretation of Article XX because it "establishes certain minimum standards for transparency and procedural fairness in the administration of trade regulations." [78] It was held that the ban would not qualify as an exception because the US government denied basic fairness and due process" to foreign governments applying for certification under the US shrimp–turtle regulation.[79]

This brief discussion of Article X and its surrounding jurisprudence suggests that transparency has become a central principle in the WTO regime. In addition to its importance as a benchmark for the review of domestic adminstartive decisions by WTO tribunals, the principle of transparency channels and disciplines the global trade regulation. Taken together, the three examples considered here demonstrate how a global regulatory regime can be held accountable to norms of administrative law character.

2.3 Criteria for Assessment of Legitimacy

The assessment my thesis makes on the legitimacy of the global governance of banking will be guided by three overarching principles: reasoning, transparency and accountability. These principles have been the subject of rich debate in legal scholarship, and in GAL in particular.

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[76] *Ibid* at 21.

[77] *United States – Measures Relating to Shrimp from Thailand* (2008) WT/DS343/R (Appellate Body Report) online: WTO http://www.wto.org/english/tratop_e/dispu_e/ab_reports_e.htm.

[78] *Ibid* at para183.

[79] *Ibid* at para 181.

Drawing upon such debate, the following paragraphs elaborate on the three principles and illustrate how they affect and operate in domestic and international settings. Yet, it is crucial to note that the reach and significance of these principles transcend any given doctrine, be it in jurisprudence, political science, or any other discipline. Most scholars who are concerned with normative legitimacy seem to agree that a system of governance cannot be legitimate unless it operates transparently, provides reasons for its decisions, and remains accountable to those it affects. For example, reference can be made to "Global Governance and Legitimacy" where Robert Keohane identifies transparency as a crucial criterion in the evaluation of legitimacy. Keohane argues that the ability of the ruled to control the ruler depends on their access to information about the ruler's behaviour.[80] Keohane also considers accountability as another important standard of legitimacy. In his view, accountability provides the ruled with power over the ruler, and is comprised of three important elements: 1) standards that are expected to be met by those who are held accountable; 2) information that is made available to accountability holders, enabling them to apply the standards in question to those who are held accountable; and 3) the ability of the accountability holders to impose sanctions when there is a failure in meeting the standards.[81]

Reference can be also made to Jens Steffek's scholarship, which is illustrative of the significance of reason giving.[82] Drawing upon Max Weber's idea of rational legal domination and on Jürgen Habermas's idea of legitimation through justificatory discourse, Steffek argues that the legitimacy of an international governance regime hinges upon its success in justifying its goals, principles and procedures.[83] He notes that whereas in pre-modern times legitimacy was mainly

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[80] Robert O Keohane "Global Governance and Legitimacy" (2011) 18:1 Review of International Political Economy 99 at 101 [Keohane, "Global Governance and Legitimacy"].

[81] *Ibid* at 102.

[82] Jens Steffek, "Legitimation of International Governance: A Discourse Approach" (2003) 9 European Journal of International Relations 249.

[83] *Ibid.*

derived from divine authority, modern legitimacy is derived from authority of reason. Reason giving is the communicative process that legitimates governance.[84]

One must keep in mind that the principles discussed here are interrelated and the boundaries among them maybe considerably blurred. For instance, as will be explained further below, transparency can be considered a pre-condition of accountability. Similarly, an institution cannot be perceived as legitimate when it does not even provide reasons for its actions. It is, therefore, plausible to consider these principles under different frameworks or classifications.

Finally, the principles that will be discussed below are chosen for their importance with regard to the global regime of banking, as well as for the broad agreement of their desirability. However, they are not by any means exhaustive of the criteria for legitimacy. Inclusiveness, fairness, impartiality, minimal moral acceptability, epistemic quality and legality are some of the criteria used by scholars in their analysis of the legitimacy of global governance.[85]While the differences among these criteria are sometimes primarily about the terminology used, they can also be used to denote substantively different concepts. This theoretical question, however, falls outside the purview of this thesis.

2.3.1 Reasoning

Max Weber argues that bureaucracy is an efficient form of organization due to its rationality.[86] Bureaucratic decisions are not arbitrary manifestations of personal will. Instead, they are the outcome of reasoning. Weber says that "the only decisive point for us is that in principle a system of rationally debatable reasons stand behind every act of bureaucratic administration,

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[84] *Ibid* at 263.

[85] For discussion and application of such criteria, see Keohane, "Global governance and legitimacy", *supra* note 80 at 101-108; Scholte, "Towards Greater Legitimacy", *supra* note 3 at 110-120; William D Coleman & Tony Porter "International Institutions, Globalisation and Democracy: Assessing the Challenges" (2000) 14:3 Global Society 377; Esty, *supra* note 40 at 1515-1523.

[86] Weber, *supra* note 40 at 979.

namely either assumption under norms, or a weighing of ends and means."[87] Thus, bureaucratic authorities should give rational reasons for their actions and decisions.[88]

However, rational decision making cannot be based exclusively on reasons. Reasons must also be rationally debatable. The idea of rational debate implies that the decision maker and the stakeholders can meaningfully engage in a discussion about the reasons on which the decisions are based. As Steffek points out, communicability of reason "is the mechanism that enables individuals to exchange their views and communicatively to agree on strategies of action."[89] Rational justification is an important source of legitimacy. An international institution can enhance its legitimacy by engaging in a rational dialogue with its stakeholders. Such a dialogue can help the institution justify its existence or, alternately, to partially or entirely reform its governance.

The importance of reasons as the basis for the legitimate exercise of power stands at the heart of administrative law. Here are a few examples of the duty of reason-giving in different legal systems:

- The *US Administrative Procedure Act*[90] requires administrative agencies to "incorporate in the rules adopted a concise general statement of their basis and purpose."[91]
- Under the *Netherlands' General Administrative Law Act,* administrative decisions must be based on valid reasons stated at the time a decision is disclosed.[92]

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[87] *Ibid*.

[88] Steffek, *supra* note 82 at 261.

[89] *Ibid* at 262.

[90] *Administrative Procedure Act*, 5 USC § 553(c) (2000) [USAPC].

[91] USAPC, *ibid,* § 556(e).

[92] *General Administrative Law Code* (Algemene wet bestuursecht, AWB), Act of June 1992 in force on January 1994, Official Journal (Staatsblad) 1994, nr. A, arts 3:46- 3:47 as cited in René Seerden & Frits Stroink, "Administrative Law in the Netherlands" in René Seerden & Frits Stroink (eds) *Administrative Law of the European*

- Art. 39 (1) of the *German Administrative Procedure Act* (1976) provides that “An administrative act ... shall be accompanied by a statement of grounds. This statement of grounds must contain the chief material and legal grounds that led the authority to take its decision. The grounds given in connection with discretionary decisions shall also contain the points of view which the authority considered while exercising its powers of discretion.”[93]
- Article 3(1) of the Italian *Administrative Procedure Act* (1990) provides that “Save in the situations provided for under subsection (2), every administrative measure, including those regarding administrative organisation, personnel and the conduct of public competitive examinations, must include a statement of reasons. The statement of reasons must set out the factual premises and the points of law that determined the authority’s decision, as these emerge from the preliminary fact-finding activities.”[94]

From a legal perspective, the duty to give reasons seems to serve its purpose in three important ways. First, it enables the affected parties to know why a decision is adopted and on what factual and legal basis it is founded. Second, an obligation to state reasons motivates decisionmakers to diligently think through the rationale of their actions. As Craig notes, “having to explain oneself, and defend the rationality of one’s choice, is always a salutary exercise.”[95] Third, the existence of reasons facilitates oversight—particularly judicial review—to determine if a decision was irrational or disproportionate.[96]

Union, Its Member States and the United States: A Comparative Analysis (Cambridge, UK: Intersentia, 2002) 145 at 147.

[93] Unofficial translation published by the Federal Ministry of the Interior. See, Giacinto della Cananea, 'The Giving Reasons Requirement: A Global Standard for Public Authorities” in Giacinto Della Cananea & Aldo Sandulli, *Global Standards for Public Authorities* (Editoriale Scientifica, 2012) at 14.

[94] Unofficial translation available in the issue n. 2/2010 of the *Italian Journal of Public Law* (*www.ijpl.eu*). See for further detail, Della Cananea, *ibid*, at 14.

[95] Paul P Craig, *EU Administrative Law* (New York: Oxford University Press, 2006) at 382.

[96] *Ibid* at 382.

The principle to give reasons has been also extended from domestic law into some regional and global institutions. Article 253 of the Treaty Establishing the European Community (EC Treaty) provides the following:

> Regulations, directives and decisions adopted jointly by the European Parliament and the Council, and such acts adopted by the Council or the Commission, shall state the reasons on which they are based and shall refer to any proposals or opinions, which were required to be obtained pursuant to this Treaty.[97]

Similarly, The UN Security Council Sanction Committee is required to give reasons for placing individuals or entities on the sanctions list and provide a narrative summary of the case on its website. The summary should include the basis for listing according to relevant Security Council resolutions, as well as specific information demonstrating that the individual or entity meets the criteria for listing set out in the resolutions.[98] These examples show that reason giving is an important standard for public authorities and a requirement prevalent in many areas of global governance practice.

2.3.2 Transparency

In broad terms, transparency refers to the degree to which information is available to constituencies of a governance regime, enabling them to understand and assess the decisions made and have an informed voice in decision making.[99] Those who are affected must be able to

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[97] *Treaty Establishing the European Community (Nice consolidated version)*, 24 December 2002, Official Journal C 325, 24/12/2002 P. 0135 – 0135, online: EU http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:12002E253:EN:HTML [EC Treaty].

[98] Security Council Committee Pursuant to Resolutions 1267 (1999) and 1989 (2011) Concerning Al-Qaida and Associated Individuals and Entities, "Guidelines of the Committee for the Conduct of Its Work" (2013) at 12, online: UN http://www.un.org/sc/committees/1267/pdf/1267_guidelines.pdf.

[99] Ann Florini, "The Battle over Transparency" in Ann Florini, ed, *The Right to Know: Transparency for an Open World* (New York: Columbia University Press, 2007) 1 at 5.

discover what and when decisions are taken, by whom, and under what procedures. Without such information, constituencies are left ignorant and cannot effectively scrutinize the actor.[100]

Transparency contributes to good governance in at least three ways. First, transparency makes accountability possible. Without free access to information, people have little chance of knowing, let alone having a say, in decisions that affect their lives. Second, transparency can address, or at least disclose, a host of principal-agency issues by shining light on decision makers' actions and deterring such decision makers from turning public service into a means of private gain. Finally, transparency is a key component of effective policymaking. Even the most competent decisionmakers need feedback on how the policies they have adopted are working in actual practice.[101]

Transparency has been the focus of administrative law in many jurisdictions. For instance the *US Administrative Procedure Act* requires administrative agencies to publish a notice of the proposed rulemaking in the Federal Registrar. The notice should include a statement of the time, place, and nature of the rulemaking,the legal authority under which the rule is proposed, and a description of the substance of the rule and the issues involved.[102]Administrative agencies are also required to make the following information available to public:

- A description of the organization and the methods whereby the public may obtain information, make submissions or requests, or obtain decisions;
- A statement of the general course and method by which its functions are channeled and determined, including the nature and requirements of its formal and informal procedures;
- A statement of general values and policies.[103]

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[100] Scholte, "Global Governance and Accountability", *supra* note 41 at 16.

[101] Florini, *supra* note 99 at 1-5.

[102] UPAC § 553.

[103] *Ibid*; *Freedom of Information Act* 5 USC § 552 (1966).

Transnationally, transparency is deemed to be an important value. For instance, the Treaty on the European Union (EC Treaty) requires the Union's institutions and bodies to "conduct their work as openly as possible."[104] This requirement is intended to promote good governance and ensure the participation of civil society. The right to access EU documents has been also protected by the *EU Charter of Fundamental Rights*,[105] which asserts:

> Any citizen of the Union, and any natural or legal person residing or having its registered office in a Member State, has a right of access to European Parliament, Council and Commission documents.[106]

Transparency has been enacted to the fullest extent in the founding documents and internal procedures of the WTO. Article X of GATT requires all WTO members to "publish [regulations] promptly in such a manner as to enable governments and traders to become acquainted with them".[107] The WTO uses web-based tools to give the public access to a variety of documents. In terms of notification of domestic regulation, the *Marrakesh Decision on Notification Procedures* affirmed pre-existing obligations and established a central registry for notification managed by the Secretariat.[108] In 2002, the WTO General Council's historic "transparency decision" established the rule that "all WTO official documents shall be unrestricted."[109] Practically speaking, this means that all decisions, meeting minutes, accession protocols, laws and

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[104] EC Treaty, *supra* note 97, art 15.

[105] *Charter of Fundamental Rights of the European Union*, 18 December 2000, (2000/C 364/01) online: EU http://www.europarl.europa.eu/charter/default_en.htm [*EU Charter*].

[106] *EU Charter*, *ibid*, art 42.

[107] GATT, *supra* note 72, art x.

[108] WTO, *Reports of the Subsidiary Bodies to the General Council for Trade in Goods* (1996) Vol. II, Annex 1 at 16-18, online: WTO http://www.wto.org/english/thewto_e/minist_e/min96_e/w46-2.pdf.

[109] WTO, *Procedures for the Circulation and De-restriction of WTO Documents* (2002) T/L/452, online: WTO http://members.wto.org/WTO_resources/documentation/derestriction_e.htm.

regulations and Secretariat decisions are translated to the WTO's three official languages and then made public on the WTO website.

With respect to dispute settlement, document availability to the public depends on a specific stage of the process. The WTO promptly posts updates on the status of disputes and maintains a registry of all cases. When a member state makes a request for consultation,[110] the WTO issues a summary of the request, including a description of the contested measure, as well as the legal basis for the complaint. Actual consultations are held in camera but are not otherwise documented or released to the public. Should the consultation prove fruitless, a member can request the establishment of a panel to settle the dispute and the content of the request is published on the WTO website. Panel and Appellate body decisions are also available to the public after their adoption.[111]

2.3.3 Accountability

Accountability is an essential condition for the establishment and maintenance of legitimate and effective global governance. In the absence of accountability, there are major deficits in the provision of global public goods, such as ecological integrity, financial stability, and disease control. Across the diverse and contrasting conceptions that exist with regard to accountability, "there is general agreement that accountability is a condition and process whereby an actor answers for its conduct to those whom it affects".[112] This statement could be illustrated by a simple example. If A takes an action that affects B, then under the principle of accountability A must answer to B for that action and its consequences. Accountability is therefore linked to

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[110] Consultation is the first stage of a formal dispute settlement. It gives the parties the opportunity to discuss the matter and find a satisfactory solution without resorting to litigation. See WTO, "The Process — Stages in a Typical WTO Dispute Settlement Case" online: WTO http://www.wto.org/english/tratop_e/dispu_e/disp_settlement_cbt_e/c6s2p1_e.htm.

[111] Gabrielle Marceau & Mikella Hurley, "Transparency and Public Participation in the WTO: A Report Card on WTO Transparency Mechanisms" (2012) 4:1 TRADE L & DEV 19 at 25-26.

[112] Scholte, "Global Governance and Accountability", *supra* note 41 at 16.

power: if A has the power to affect B, it has also a duty to account for the exercising of its power.[113] Determining to whom accountability should be made available is a challenging task, but as the definition used here suggests, the key test seems to be "affected interest".[114] Accordingly, a global governing institution is accountable to those whose lives and affairs it influences. Those people affected by an institution's actions collectively form that institution's constituency.[115] With regard to global banking governance, this means that constituencies comprise not only domestic regulators but also countries, and especially in the sense of countries' citizens. Citizens ultimately bear the weighty consequences of banking crises that regulations fail to prevent, in terms of losing jobs, homes, and funding bailouts.

Accountability can be understood to have prospective and retrospective aspects. Prospective aspects of accountability are transparency and consultation. Transparency, which requires an actor to be visible to affected constituencies, was discussed to some length in the preceding section. With respect to consultation, accountability requires a decision maker to explain its actions to affected constituencies and incorporate those constituencies in deliberation and allow them to shape outcomes.[116]

Retrospective elements of accountability broadly fall into two categories: evaluation and correction. With respect to evaluation, accountability requires the actor's action, and its impact on affected parties, to be subject to independent oversight and assessment. With respect to correction, accountability requires that affected constituencies be provided with redress in cases where the affecting actor has made wrong decisions with harmful consequences.[117]

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[113] International Law Association, *Accountability of International Organizations* (2004) at 5, online: ILA http://www.ila-hq.org/download.cfm/docid/6B708C25-4D6D-42E2-8385DADA752815E8 [ILA].

[114] Erika D Wet, "Holding International Institutions Accountable: The Complementary Role of Non-Judicial Oversight Mechanisms and Judicial Review" in Armin V Bogdandy et al, eds, *The Exercise of Public Authority by International Institutions: Advancing International Institutional Law* (New York: Springer, 2010) 855 at 858.

[115] Scholte, "Global Governance and Accountability", *supra* note 41 at 21.

[116] *Ibid* at 16-17.

[117] *Ibid* at 41.

The different dimensions of accountability alluded to above can be found in various forms, and to varying degrees, at the domestic level. Many legislatures have promulgated rules requiring administrative bodies (particularly regulatory agencies) to provide information allowing legislatures to monitor and assess their actions, policies and procedures. Regulators are often required to publish reports that explain the basis of their decision making and to inform the public on rules they intend to pass or implement. On some occasions, public hearings are required or third party observers are allowed to attend meetings.[118] Finally, administrative decisions are subject to judicial review. If an administrative agency renders its decision in bad faith or exceeds the jurisdiction granted, the court will deem the decision to have no effect. The court will also nullify a decision that is improper with regard to the policy objectives established by the agency (decision made for *improper purposes*), or one that is based on irrelevant considerations (decisions *in abuse of power*).[119]

As a general rule, direct instruments of accountability that operate on the domestic level are absent at the supranational level. As previously stated, there is no global legislative assembly that can provide a direct link between the governed and the governors. Global governance also lacks judicial proceedings through which affected parties can seek evaluation and correction of flawed regulatory policies. While courts with global jurisdiction do exist—such as the International Court of Justice (ICJ)—they do not adjudicate on the conduct of TRN.[120]

Nevertheless, the absence of a domestic mechanism of accountability does not remove potential for a suitably accountable global regulatory regime. Some useful insights in this respect could be derived from the three-layered model of accountability provided by the International Law Association (ILA).[121] The first level of accountability in this model concerns the extent to which

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[118] Brummer, *supra* note 37 at 185-186.

[119] Gerald L Gall, *The Canadian legal system*, 5th ed (Ont.:Carswell, 2004) at 549-550.

[120] *Statute of the International Court of Justice*, art 36, online: ICJ http://www.icj-cij.org/documents/index.php?p1=4&p2=2&p3=0.

[121] ILA, *supra* note 113 at 5.

an international institution, in fulfillment of its functions, is subject to forms of scrutiny and monitoring, regardless of potential and subsequent liability in a legal sense.[122] The second level of accountability is concerned with tortious liability for injurious consequences of acts and omissions that do not involve a breach in any rule of international law. A good example of this type of liability is environmental damage arising out of lawful nuclear or space activity. The third level of liability arises out of acts or omissions that constitute a breach of international or institutional law. Examples of the third level include violations of human rights, gross negligence and breach of contract, or as far as institutional law is concerned, acts of organs that are *ultra vires* or violate the law of employment relations.[123]

Whereas the second and third levels of accountability correspond to classic legal notions of state responsibility as well as responsibility of international organizations, the first level, which is of greater significance to this thesis, is considerably broader. It encompasses a range of non-judicial procedures for scrutinizing the behaviour of international institutions. Further, it is applicable to both formal and informal international institutions, including TRN.[124]

Current practices of transnational institutions reflect the increasing significance of general oversight mechanisms. A common phenomenon is vertical oversight where the parent organization exercises formal supervision over a subsidiary organ. The oversight is characterized as vertical as there is a hierarchical relationship between the respective organs.[125] The parent has the right to question the subsidiary's exercising of power and impose sanctions with varying intensity. For instance, with regard to OECD Guidelines on Multinational Enterprises, the OECD’s Investment Committee could issue abstract clarification on the guidelines in instances

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[122] *Ibid* at 8.

[123] *Ibid* at 38-39.

[124] Wet, *supra* note 114 at 859-60.

[125] *Ibid* at 866.

where National Contact Points did not interpret the guidelines correctly.[126]

It is also possible for oversight to be exercised by an independent institution that does not have a hierarchical relationship with the supervised body. In this situation, oversight takes place in a hierarchy because the supervising body acts on the authority of the higher body and reports to it.[127] The Independent Evaluation Group (IEG) at the World Bank exemplifies this type of oversight. The group is institutionally separate from other departments at the Bank and reports directly to the board of executive directors. It rates the Bank's operation programs in accordance with four standards driven from the Bank's own standards: namely, outcome sustainability, institutional impact, and Bank and borrower performance.[128]

Centralized non-judicial complaint procedures, which take place within the institutions themselves, constitute another distinct form of oversight. The most extreme example is that of the Al-Qaeda/Taliban Sanctions Committee's proceedings which allows affected individuals to submit a request for delisting through the United Nations Focal Point.[129] The World Bank also operates the Inspection Panel, which is composed of independent experts and hears complaints from stakeholders adversely affected by the Bank's financed projects.[130]

In sum, in the absence of a national-type mechanism of accountability such as parliamentary oversight or judicial review, general oversight mechanisms could prove helpful in advancing accountability at the supranational level. Current practices of international organizations further illustrate the potential of such mechanisms. At the same time, it is important to realize that the

[126] Gefion Schuler, "Effective Governance through Decentralized Soft Implementation: The OECD Guidelines for Multinational Enterprises" in Armin V Bogdandy et al, eds, *The Exercise of Public Authority by International Institutions: Advancing International Institutional Law*(New York: Springer, 2010) 197 at 220-221.

[127] Wet, *supra* note 114 at 867.

[128] Philipp Dann, "Accountability in Development Aid Law: The World Bank, UNDP and Emerging Structures of Transnational Oversight" (2006) 44 Archiv des Völkerrechts 381 at 392, online: SSRN http://ssrn.com/abstract=1799290; IEG, "About IEG: Improving World Bank Group Development Results Through Excellence in Evaluation" (2013) online: IEG http://ieg.worldbankgroup.org/about-us.

[129] See the UN Security Council Delisting Procedures, above, for more information.

[130] See the World Bank Inspection Panel, above, for more information.

quality of an oversight mechanism depends greatly on the degree to which it shows authority, independence and fairness. The OECD's Investment Committee discussed earlier would barely pass the authority test as it does not have the right to make determinations in regard to specific multinationals, nor reverse the decision of the National Contact Points.[131]

In regard to independence, particular challenges arise from the overlapping of the supervisory body and the supervised body. This is particularly noticeable in the case of the Council for Trade on Services and its subsidiary organ, the Committee on Trade and Financial Services. The fact that the Council for Trade in Services is a plenary body means that the membership of the parent and subsidiary overlaps. This overlapping membership, combined with the technical nature of the Committee's work, makes it unlikely that the Council will conduct a strict review or reach a different conclusion than the Committee. In fact, when reporting to the WTO General Council, the Council for Trade in Services merely refers to the work of the Committee, which is annexed to the report without any further comment.[132]

Finally, the value of an oversight mechanism is greatly affected by the degree of its fairness. Particularly problematic in terms of fairness is the Al-Qaeda/Taliban Sanctions Committee proceedings. While affected individuals can submit a request for delisting through the United Nations Focal Points, they have no right to demand that the Committee consider their requests, nor do they have the right to be heard before the Committee.[133] In contrast, the World Bank

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[131] In other words, the Investment Committee is precluded from acting as a judicial or quasi-judicial body. It cannot reinvestigate the facts of a specific instance or reach conclusions of its own on the conduct of an enterprise. See, Schuler, *supra* note 126 at 221.

[132] Joseph Windsor, "The WTO Committee on Trade in Financial Services: The Exercise of Public Authority within an Informational Forum" in V Bogdandy et al, eds, *The Exercise of Public Authority by International Institutions: Advancing International Institutional Law* (New York: Springer, 2010) 405 at 428-429.

[133] Clemens A Feinäugle, "The UN Security Council Al-Qaida and Taliban Sanctions Committee: Emerging Principles of International Institutional Law for the Protection of Individuals?" in Bogdandy et al, eds, *The Exercise of Public Authority by International Institutions: Advancing International Institutional Law* (New York: Springer, 2010) 101 at 121-122.

Inspection Panel seems to score higher with regard to fairness.[134] The Panel's experts are selected based on their integrity and autonomy from the Bank's management as well as their ability to deal with requests thoroughly and fairly. The proceedings give people and communities, whose interests have been affected, greater input into projects sponsored by the Bank and can facilitate redress when warranted.[135]

2.4 Conclusion

Legitimacy is a concept whose meaning and sources are often contested. This chapter was not intended to settle disagreements on this elusive concept in academic literature. Rather, it was an attempt to show that common threads run though different theories and that legitimacy can be nurtured on multiple bases that are not necessarily mutually exclusive. This point seems to particularly be the case with respect to two sources of legitimacy: deliberation and technical performance. Undoubtedly, global banking standards must be set by policy makers who have essential expertise in financial regulation. At the same time, rational discourse with a broader set of stakeholders, such as academics and civil society organizations, can have equally significant benefits. First, such discourse will increase public confidence in the policy making process. Second, it will help policy makers test the assumptions underlying the policies and will make policy makers more successful in detecting systemic risks.

The chapter drew upon global administrative law (GAL) as a helpful legal theory in assessing the legitimacy of the global governance of banking. I chose to use GAL due to the strengths that I

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[134] As Sarra notes, "at heart, fairness is the capacity to take the perspective of another and to adjust our conduct and decisions to take account of others' perspective in order to achieve more equitable outcomes." When one considers the perspective of those whose liberty and property have been targeted by listing decisions, it seems that they are entitled to have their request heard before the Sanctions Committee. See, Janis Sarra, "Embedding Fairness as a Fundamental Norm in Financial Markets", in Janis Sarra, ed, *An Exploration of Fairness: Interdisciplinary Inquiries in Law, Science and the Humanities* (Carswell: Canada, 2013) 194 at 194.

[135] Word Bank Groups, "The Inspection Panel" (2013) online: World Bank http://web.worldbank.org/WBSITE/EXTERNAL/EXTINSPECTIONPANEL/0,,menuPK:64129249~pagePK:64132081~piPK:64132052~theSitePK:380794,00.html.

believe it possesses. First, GAL acknowledges that there are significant benefits to international policy making and that collective action is the only way to address issues caused by today's global interdependencies. Second, GAL offers a sound legal understanding of the functions and traits of global governance related to financial regulation. As previously stated, standard setting by transnational regulatory networks shows considerable resemblance to rule making by regulatory agencies, an administrative function distinct from both legislation and adjudication. Third, and most importantly, GAL pays particular attention to procedural safeguards and the contribution they can make to the legitimacy of governance regimes. The GAL sources that were reviewed in this chapter (domestic administrative law systems as well as current and emerging practices of international institutions) can be used to design appropriate rules and procedures to govern conflict of interest, disclosure, consultation, oversight and redress. However, my thesis will not draw solely on GAL. As previous discussion suggested, the thesis will continue to benefit from other theories of political science, jurisprudence and international relations that apply to global financial governance.

After an introduction to the Basel Committee on Banking Supervision as the main research subject, my thesis will conduct an assessment of the Committee's legitimacy based on the perspectives and criteria identified in this chapter. The locus of analysis will be the Committee's governance and policy outcomes after the global financial crisis of 2008.The Committee will be considered legitimate to the extent that it meets the requirements of transparency, reasoning and accountability. In regard to accountability, my analysis will be guided by three questions: 1) How and by what means does the BCBS consult the public in its policy making process? 2) How and by whom is the Committee's performance monitored? 3) To what extent has the Committee taken corrective measures to make the banking system more resilient to crises? The thesis will then identify gaps in BCBS legitimacy and will propose policy prescriptions to address those gaps.

I will conclude this chapter with two general points. First, the legitimacy criteria identified here are not intended to be a set of rigid principles. Indeed, there may be legitimate reasons for trade-offs among these principles, or exceptions to them. For instance, while transparency is an important principle, it should give way to confidentiality when justified by banking regulation necessities. However, one must bear in mind that exceptions must not become so large, either in number or in scope, that they undermine the underlying principle. I will elaborate further on this subject in my thesis. Second, legitimacy is better considered as a matter of degree. A governance institution, including the BCBS, is not simply legitimate or illegitimate, but rather *more* legitimate or *less* legitimate, depending on how it scores on legitimacy criteria. Institutional change and direction are also factors that need to be taken into account when evaluating legitimacy; an institution whose legitimacy is deteriorating is more questionable than that of an institution that is improving.

Chapter 3: A Primer on the BCBS History, Governance and Status in the International Financial Architecture

3.1 Introduction

The Basel Committee was founded in 1974 at a time when the health of the international financial system was poor and the prospect for international cooperation weak.[1] Financial markets were reeling under the strain of oil price shock and debacles such as the collapse of Bankhaus Herstatt in Germany, which led to a curb in the foreign exchange markets.[2] The BCBS was initially established to deal with the immediate problems caused by the international financial crises, by providing a forum for education and exchange of information on bank supervision.[3] However, as will be demonstrated below, the Committee's power and influence have gradually grown far beyond its founding mandate.

This chapter seeks to investigate the BCBS's history and current position in the global regulatory sphere. It aims to establish a general understanding of the BCBS's evolution and current governance and serve as a background for the analyses in subsequent chapters. The chapter starts with an overview of the historical context within which the BCBS was established. It seeks to identify and explain the driving forces behind the establishment of the BCBS, including the rapid expansion of international banking, concerns over the influx of petrodollars into the Eurocurrency markets, the curb in the foreign exchange markets, and collapse of individual banking institutions. The first section also looks at some of the important issues that preoccupied the BCBS founders at the time of its establishment, such as its make-up and function.

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[1] BCBS, "History of the Basel Committee" (Accessed on 1 June 2014) online: BIS http://www.bis.org/bcbs/history.htm [BCBS, "History"].

[2] Charles A E Goodhart, *The Basel Committee on Banking Supervision: A History of the Early Years, 1974-1997* (Cambridge, UK; New York: Cambridge University Press, 2011)

[3] BCBS, "History", *supra* note 1.

The chapter then turns to key aspects of the BCBS's governance, including membership, mandate, legal position, internal structure and operation, and policy outcomes. In addition to considering important historical factors, the chapter draws upon new sources of information, such as the recently-adopted *Charter* to explain how the Committee today is organized and conducts its affairs.

The third section takes a step back to consider the BCBS's position in the larger international regulatory regime. It investigates the evolution of the International Financial Architecture (IFA) since the Asian Financial Crisis and attempts to locate the BCBS among the highly-fragmented instuitions that are involved in global financial regulation.

Finally, the chapter revisits the BCBS as a transnational regulatory network. It draws upon the relevant literature in international relations and international law, to explain the recent rise of the disaggregated state – a phenomenon marking the shift of power from formal international organizations to informal, loosely-structured networks. The section then proceeds to take a closer look at the networked governance of the BCBS, examining the ways the BCBS has dispensed with traditional formalities associated with formal international organizations.

3.2 The Historical Context for the BCBS's Establishment

3.2.1 The Emergence of the Eurocurrency Market

As Robert Johnston notes in "The Economics of the Euro-Market: History, Theory and Policy", following the Second World War, the foreign currency business of banks consisted mainly of traditional services such as payments abroad and the financing of national and foreign trade.[4] Sterling continued as an important, if not the main, currency for international trade and London remained the centre for trade finance.[5] With the postwar reconstruction of Europe and large US

[4] Robert B Johnston, *The Economics of the Euro-Market: History, Theory and Policy* (London: McMillan Press, 1983) at 9.

[5] *Ibid*.

trade surpluses, the demand for the dollar increased and some countries placed restrictions on the import of goods as a means of conserving scarce dollar reserves.[6]

In the late 1950s, two important developments changed the organization of international financial flows. First, following a series of foreign exchange crises between 1955 and 1957, the British authorities restricted the use of sterling in foreign transactions.[7] In particular, use of the sterling to finance non-UK trade was prohibited and the sterling refinancing of trade credits was limited. Second, there was a turnaround in the US's balance of payments. Toward the end of 1950, the US trade surplus gradually vanished. The US government compensated for the decline in surplus by increasing foreign holdings of dollar and capital flows into the US. The abundance of dollars in Europe greatly enhanced its role as the predominant international reserve currency and its use in the financing and invoicing of international trade. [8]

Due to the implemented restriction on sterling use in foreign transactions, British banks began to more actively seek dollar deposits for use in their external obligations.[9] When they were met with a readily available supply of dollar, banks became better positioned to offer customers and correspondent banks dollar facilities instead of sterling credits.[10] By 1958, a European market in dollar deposits and loans was established. There were a number of reasons why investors were inclined to hold their dollar balances in Europe rather than the US. One common view is that some Eastern European banks were afraid that their dollar balances in the US might be confiscated due to cold war political tensions.[11] However, this factor by itself could not have lead to the growth of an active European market in the dollar, had it not been for a number of favourable economic and regulatory factors. [12]

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[6] *Ibid*.

[7] *Ibid*.

[8] *Ibid*.

[9] *Ibid*.

[10] *Ibid*.

[11] *Ibid*.

[12] *Ibid* at 10.

The external currency market began to broaden its scope and deepen by the early 1960s, and became known as the Eurodollar, Eurocurrency market and Euromarket. As the market widened, banks from Italy, France, Canada, Japan, Britain, West Germany, as well as foreign branches of US banks, became important participants in the Eurocurrency market. These banks were ready to accept deposits and provide credit in a number of foreign currencies such as pound sterling, Deutsche Mark, and Swiss Francs.[13]

3.2.2 The Rapid Expansion of International Banking

Throughout the 1960s and 1970s, the Eurodollar market continued growing at a remarkable pace. In September 1963— the earliest date for which systemic data of European Banks' foreign currency activities is available—the total short-term foreign currency assets of commercial banks of nine countries reporting to the BIS were $12.4 billion (of which 9.3 billion was in USD).[14] By the end of 1960s, this figure had grown over 500% to 63.4 billion (of which $53 billion was in USD). The 1970s witnessed a structural change in the world's banking system. National banks began establishing a network of subsidiaries and branches aboard to operate in foreign money and Eurocurrency markets.[15]

Brimmer and Dahl document the rapid expansion of foreign branches of US banks in the 1960s-1970s.[16] At the end of 1964, there were only 11 US banks with foreign branches abroad. In combination, these 11 banks operated 181 branches. By the end of 1974, however, there were 129 banks with a total of 737 foreign branches.[17] The total resources of foreign branches of US banks had climbed from $27.1 billion in 1969 to $148.1 billion in 1974.[18]

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[13] *Ibid* at 11.

[14] *Ibid*.

[15] *Ibid*.

[16] *Ibid*.

[17] Andrew F Brimmer & Fredrick R Dahl, "Growth of American International Banking: Implications for Public Policy" (1975) 30: 2 Journal of Finance 341 at 346.

[18] *Ibid* at 349.

The growth of the Eurodollar market was significantly driven by national regulations introduced in the 1960s and early 1970s to restrict international capital flows. "These controls shifted the locus of international transactions to the Euro-currency markets and away from national banking systems."[19] A good example of such regulations was the Voluntary Foreign Credit Restraint Program (VFCR), introduced in the US in 1965, which severely limited the ability of US banks to lend directly to foreigners.[20] Under the VFCR, banks in the US were required to keep loans to foreigners and other foreign assets within a certain limit.[21] However, since the program was only applicable to banks located in the US and not their foreign branches, it shifted international finance activities to their foreign branches, which were highly active in the Eurocurrency market.

Another monetary regulation that favoured the development of the Eurocurrency market was Regulation Q.[22] This regulation imposed ceilings on interest rates that banks were permitted to pay on deposits in the US but was not applicable to deposits held by foreign branches. Tight credit conditions in the US and the increase of actual interest rates above Regulation Q ceilings gave banks in the Eurodollar market a competitive advantage in attracting dollar deposits.[23] Johnston notes that the impact of these ceilings on the growth of the Eurodollar market was particularly evident in 1968 and 1969 as interest rates rose during a period of credit restraint. In order to offset large losses of time deposits— which were moving to the banks in the Euromarket that were willing to pay higher interest rates— US banks turned to the Euromarket and their

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[19] Johnston, *supra* note 4 at 14.

[20] *Ibid*.

[21] *Ibid*.

[22] Regulation Q was Title 12, part 217 of the United States Code of Federal Regulations. In 2011, the Federal Reserve Board approved a final rule to repeal the regulation Q. The final rule implemented Section 627 of the *Dodd-Frank Wall Street Reform and Consumer Protection Act*, which repealed Section 19(i) of the *Federal Reserve Act* in its entirety. See for more information, Federal Reserve Board of Governors of the Federal Reserve System, Press Release (14 July 2011) online: Federal Reserve http://www.federalreserve.gov/newsevents/press/bcreg/20110714a.htm.

[23] Johnston, *supra* note 4 at14.

branches abroad as a source of funding. From the end of 1964 to the end of 1969 the Eurodollar claims of European reporting banks on US residents rose from $3 billion to $18 billion.[24]

Corporations in Western Europe used the Eurodollar market as a funding source when domestic credit became tight. In the face of strict monetary controls, West German companies met one-third of their financing needs in 1970 from abroad. UK firms also borrowed heavily in the Eurodollar market during 1960-1970, a period marked by tight domestic credit conditions. Importantly, unlike banks in West Germany and the US, banks in the Eurocurrency market were free from holding reserve balances against deposits. Consequently, these banks were able to offer higher interest rates. Short-term interest rates were 0.5 percent higher in the Eurocurrency market than in the US domestic markets.

3.2.3 Increasing Cooperation among Central Banks and the Establishment of the Basel Committee

As suggested above, the Eurocurrency market was developed primarily as a means to escape and exploit domestic controls. It was, therefore, of little surprise that monetary authorities were suspicious of its development. This suspicion was particularly evident in the US where domestic regulations had effectively been neutered by the Eurodollar market, and also in West Germany where the Eurocurrency market made it much harder for the Bundesbank (German central bank) to adhere to the pegged exchange rate and other strict monetary policies.[25]

The world, however, turned upside down with the outbreak of the Arab-Israeli war in October 1973. The war led to a cutback in oil production by the Arab Gulf States and quadruple increase in the price of oil. These events shifted the focus of attention about the Eurodollar market from whether it was exploitative or expansionary to whether it could successfully recycle the petrodollar from oil exporting countries to oil importers.

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[24] *Ibid*.

[25] Goodhart, *supra* note 2 at 29; Brimmer & Dahl, *supra* note 17 at 9-10.

This concern garnered greater urgency by the subsequent collapse of the Bankhaus Herstatt in June 1974.[26] Although not a major player, the bank had taken large speculative positions on foreign exchange. When Herstatt became insolvent, the German authorities shut the bank and appointed a receiver. It occurred after the German market was closed but before the closure of the US markets. The receiver insisted that all inward payments to the bank be made but refused to make outward payments until the bankruptcy procedures were completed.[27] Consequently, the banks that had sold Deutsche Mark to Herstatt and expected dollar in return, did not receive anything in return.[28] This badly rattled the foreign exchange market which closed for several days.

The Herstatt debacle was related mainly to the structure of the foreign exchange market and not to the systems of the Euromarket and international capital transfers. The debacle, however, was a reminder of the inherent fragility of the systems on which the global economy had become heavily reliant.[29] On 3 August 1974, the *Economist* raised the question whether there might be "a world banking crisis?" It articulated three interconnected dimensions of the problem as follows:

> The three big international banking problems of the moment are the dangerous curb in foreign exchange markets, the uncertainty about how oil money will move in the two usual crisis months of August and September, and the way in which fears of crashes are causing money to be withdrawn from small banks all around the world. [30]

Central banks governors then came under significant pressure, particularly from leading politicians, to devise mechanisms and procedures to enhance the stability of the international

[26] Goodhart, *ibid*, at 29.

[27] *Ibid*.

[28] *Ibid*.

[29] *Ibid* at 32.

[30] "A World Banking Crisis", *The Economist* 6832 (3 August 1974) 55 at 55.

financial system.[31] However, when the central bank governors met in June 1974 for one of their regular meetings in Basel at the Bank for International Settlements (BIS), vociferous disagreements were expressed around the table.[32] Whereas the US argued that the central banks should make a collective statement expressing their readiness to provide liquidity support to banks operating in the Eurocurrency market, the Germans refused to send such an explicit signal to the markets.[33] They had three important reasons for their refusal. First the Bundesbank did not have a mandate to act as a lender of last resort for foreign banks.[34] Second, the Germans believed that if a bank was in danger of collapse because of managerial incompetence, it should be left to fail. Third, they argued that any blanket assurance would create moral hazard. Thus, the meeting of June 1974 ended without any agreement. [35]

Central banks, were not, however, let off the hook by their domestic banks. Kapstein notes, "as word spread of the disagreement, small banks started to be shut out of the interbank markets, leading them to place strong political pressure on their financial supervisors." [36] Pressured by domestic actors and politicians, central bank governors returned to Basel for another meeting in September 1974. This time, however, the views seemed to converge and the governors were ready to issue a statement. The press communiqué of the meeting read as follows:

> At their regular meeting in Basel on 9th September, the Central-Bank Governors from the Countries of the Group of Ten and Switzerland discussed the working of the international banking system. They took stock of the existing mechanisms for supervision and regulation and

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[31] Ethan B Kapstein, "Architects of Stability? International Cooperation among Financial Supervisors" (Paper prepared for the Bank for International Settlements 75th Anniversary Conference Basel, Switzerland, June 2005) at 6.

[32] *Ibid*.

[33] *Ibid*.

[34] *Ibid*.

[35] *Ibid*.

[36] *Ibid*.

> noted recent improvements made in these fields in a major number of countries. They agreed to intensify the exchange of information between central banks on the activities of banks operating in international markets and, where appropriate, to tighten further the regulations governing foreign exchange positions. The governors also had an exchange of views on the problem of the lender of last resort in the Euro-markets. They recognized that it would not be practical to lay down in advance detailed rules and procedures for the provision of temporary liquidity. But they were satisfied that means are available for that purpose and will be used if and when necessary. [37]

The last paragraph of the communiqué attracted much attention from the market participants. Although it was intentionally opaque, there was a signal, for the first time, that the central banks were ready to take on the role of lender of last resort in the Euromarket. Having given this assurance, the central banks were concerned about the inadequate regulation of the Euromarket. Consequently, when returning home, they began to conceptualize the formation of a new G10 subcommittee for bank supervision.[38]

The focus of this new committee was systemic stability, with particular emphasis on the structure and operation of institutions. The nature of its work was to be micro-oriented, particularly in comparison to the *macro*-approach of the existing G10 Eurocurrency Standing Committee.[39] This micro-oriented approach required a different set of expertise than bank supervisors seemed to possess. It should be borne in mind that an authority other than the central bank was in charge of banking supervision in many G10 countries, including Belgium, Canada, Japan, Sweden, Switzerland, and to a degree, France, Germany, and the US.[40] At the same time, central bank

[37] G10 Press Communiqué (September 1974), reprinted in Harold James, *Making the European Monetary Union* (United States: Bank for International Settlement, 2012) at 114.

[38] Kapstein, *supra* note 31 at 6.

[39] *Ibid*.

[40] Goodhart, *supra* note 2 at 4.

officials were needed on the new committee as they had essential expertise on foreign exchange markets. As previously explained, the Herstatt failure caused massive losses in the foreign exchange markets, indicating that banking crises might well be accompanied with instability in the currency markets. An agreement was therefore made that each country have two representatives on the new committee: one from the prudential authority and one from the central bank. [41] Luxembourg was an exception to this rule, as it did not have a central bank. The new committee was named by the G10 as the Standing Committee on Banking Regulations and Supervisory Practices and George Blunden from the Bank of England was appointed as its first Chairman.[42] The following paragraphs will look in more detail at the governance and operation of this new committee.

3.3 BCBS Governance

3.3.1 Designation and Membership

The BCBS did not carry the same name throughout its history. At its inception, it was named the Standing Committee on Banking Regulations and Supervisory Practices. It was however a rather mouthful title, without a catchy acronym. So the Committee came to be known by other shorter names. In early years, the Committee was usually known by the name of its Chairman, first the Blunden Committee (1975-1977) and then the Cooke Committee (1978-1988). It however became a matter of concern to some countries as it would challenge the independence of the Committee or lesson the contribution of countries other than the country of origin of the Chairman. In 1985, the Committee discussed, but took no action on, a note proposing its name be shortened to the Basel Supervisors' Committee. Then in 1989, the BIS Secretariat put forward a note to the Committee proposing alternative names. The Basel Committee on Banking Supervision (BCBS) then emerged as the generally agreed choice.[43]

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[41] *Ibid* at 41-42.

[42] BCBS, "History", *supra* note 1; BCBS, "Chairmen of the Basel Committee" (Accessed on 1 June 2014) online: BIS http://www.bis.org/bcbs/chairmen.htm.

[43] Goodhart, *supra* note 2 at 7, George A Walker, *International Banking Regulation: Law, Policy, and Practice* (London, UK: Kluwer, 2001) at 40-41.

As previously said, the BCBS was established as a standing committee of the G10. The G10 countries therefore became members as of right. Luxembourg was also granted membership mainly because of its significance as a major Euromarket centre and the influence of Albert Dondelinger, commissiaire au Controle des Banques, in supervisory cooperation among European countries. [44] The British argued that membership of the committee should be expanded to include all European Economic Community (EEC) countries, so that all cross-border international issues could be discussed in the forum. The G10 governors were, however, unwilling to dilute committee membership beyond an extra seat for Luxembourg. Thus, Ireland, Denmark, and subsequent entrants to the EU were excluded from the Basel Committee.[45] The limited membership of the BCBS was justified on the basis of the need to facilitate discussion and decision-making, which would be obstructed in a larger grouping. Moreover, 90 percent of the global banking business was then carried on in the G10 jurisdictions and Luxembourg.[46]

At the time, the G10 was the most-established and well-organized international grouping with respect to financial markets. The Group was informally established in 1974 with the support of the IMF, OECD and the BIS by the finance ministers of Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, the UK and the US for the primary purpose of intergovernmental discussion regarding the implementation calls upon the lines of credit extended to the IMF. The scope of discussion, however, was broadened over the years. Subsequently, Switzerland became a member of the group, making the 'G10' designation a misnomer. The G10 operated through the finance ministers at the highest level but also through a

[44] Goodhart, *supra* note 2 at 42.

[45] *Ibid* at 44-45; George Blunden, "Control and Supervision of the Foreign Operations of Banks" in John Edvin Wadsworth et al, eds, *The Development of financial institutions in Europe 1956-1976* (Leyden: Sijthoff, 1977) at 195 [Blunden, "Control and Supervision"].

[46] Walker, *supra* note 43 at 44.

committee of central bank governors on banking issues. It was the decision of the G10 central bank governors that led to the establishment of the BCBS in 1974.[47]

With the near collapse of the financial systems of major developed economies in 2008-2009, the need to abandon the BCBS exclusive membership to include new economic players became more evident. Thus, following the G20's call in November 2008 to examine participation in standard-setting bodies (SSBs), the BCBS expanded its membership to include Australia, Brazil, China, India, Mexico, South Korea, and Russia. [48] The BCBS was expanded for a second time, following the G20's Summit in London, to include the entire G20 along with Hong Kong and Singapore. [49]As previously mentioned, representatives on the BCBS come from central banks and prudential authorities and the number of representatives does not normally exceed two, with the exception of the United States, which has four representatives.[50]

A number of regional and international bodies are also observers on the Committee: The European Commission, The European Central Bank, The European Banking Authority, The International Monetary Fund, and The Financial Stability Institute. The BCBS also engages in dialogue with bank supervisors from non-member countries through it subcommittee, the Basel Consultative Group (BCG). The BCG brings together senior representatives from various

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[47] Joseph J Norton, "The Work of the Basle Supervisors Committee on Bank Capital Adequacy and the July 1988 Report on "International Convergence of Capital Measurement and Capital Standards"" (1989) 23 Int'l L. 245 at 248.

[48] BCBS, "Expansion of Membership Announced by the Basel Committee" (2009) online: BIS http://www.bis.org/press/p090313.htm.

[49] BCBS, "Basel Committee broadens its membership" (2009) online: BIS http://www.bis.org/press/p090610.htm.

[50] This is mainly because the US regulatory system is highly fragmented. Representatives come from the Board of Governors of the Federal Reserve System, Federal Reserve Bank of New York, Office of the Comptroller of the Currency, and Federal Deposit Insurance Corporation. See the BCBS, "Basel Committee membership" (Accessed on 1 January 2014) online: BIS http://www.bis.org/bcbs/membership.htm.

countries, international institutions and regional groups of banking supervisors that are not members of the Committee.[51]

3.3.2 Legal Position and Mandate

The question of the BCBS's legal position may seem quite simple: the Committee does not have a legal position. Peter Cooke, the BCBS's second Chairman, once said, "the committee does not undertake a formal supranational supervisory role; its conclusions do not have, and were never intended to have, legal force."[52] A similar statement can now be found on the BCBS's own website:

> The Committee's decisions have no legal force. Rather, the Committee formulates supervisory standards and guidelines and recommends statements of best practice in the expectation that individual national authorities will implement them. In this way, the Committee encourages convergence towards common standards and monitors their implementation, but without attempting detailed harmonisation of member countries' supervisory approaches.[53]

In spite of such disclaimers, the BCBS's policies have important legal implications for national jurisdictions. This issue will be considered in some detail below in discussing the *soft law* characteristics of BCBS's policy outcomes.

As a standing committee of the G10, the BCBS derived its mandate and authority to act from the terms of its appointment. [54] It is important to note that that the BCBS was established as a

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[51] BCBS, "Main Expert Sub-Committees" (Accessed on 1 January 2014) online: BIS http://www.bis.org/bcbs/mesc.htm [BCBS, "Sub-Committees"].

[52] Peter Cooke, "Discussion of the Role of the Committee" (Committee document for external distribution, 21 June 1984), cited in Norton, *supra* note 47 at 249.

[53] BCBS, "History", *supra* note 1.

[54] Walker, *supra* note 43 at 51.

permanent standing committee. In other words, it was not set up as an *ad hoc* committee to perform a particular task within a fixed time limit. Rather, it was intended to meet periodically throughout the year to discuss the issues of current importance in the field of banking supervision.[55] The G10 governors encouraged the BCBS members to be frank in expressing doubts, criticisms, and raising questions about the adequacy of the supervisory arrangements in countries. It was also the wish of the governors that members solely concern themselves with problems affecting international markets. Matters of purely domestic nature and techniques for dealing with them were not of direct relevance to the Committee. [56]

The BCBS's original objective was relatively modest. Following the decision to set up the Committee, Dr. Zijlstra, then president of the Nederlandsche Bank and the Chairman of the G10, stated that its objective should not be to make far-fetched attempts to harmonize supervisory systems in member countries. Rather, it would attempt "to enable its members to learn from each other and to apply the knowledge so acquired to improving their own systems of supervision, so indirectly enhancing the likelihood of overall stability in the international banking system".[57] While issues of liquidity support were to be considered by the G10 central bank governors, regulatory and supervisory issues were to be considered by the new standing committee.[58]

A striking change in the BCBS's activity, however, started with the capital adequacy harmonization in the second half of the 1980s. The extension of the BCBS's activities to substantive supervisory rules was mainly prompted by the pressure exerted by some BCBS members concerned about the declining capitalization of their banks and the risk of a race to bottom in prudential supervision. US authorities in particular were deeply concerned about the

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[55] *Ibid*; Blunden, "Control and Supervision", *supra* note 45 at 195.

[56] George Blunden, "Opening Remarks Draft for the BCBS First Meeting" (24 January 1974), cited in Goodhart, *supra* note 2 at 45-47 [Blunden, "Opening Remarks"].

[57] Blunden, "Control and Supervision", *supra* note 45 at 195.

[58] Walker, *supra* note 43 at 51.

sound capitalization of American banking intermediaries in the wake of the 1980s debt crisis.[59] A move towards greater capital ratios could endanger the competiveness of US banks, particularly in contrast to the Japanese banks.[60] As a result, the first Capital Accord was based on two important considerations. First, the framework would “serve to strengthen the soundness and stability of the international banking system”. Second, it was intended to be “fair and consistent in its application to international banks in different countries so as to diminish one important source of competitive inequality”.[61] The harmonization of capital standards stands in sharp contrast to the low-key collaboration that distinguished the BCBS’s earlier policy initiatives, such as the 1975 Concordat.[62] Whereas the Concordat merely endorsed the generally accepted principles that guide coordination among home and host authorities, Basel I dealt specifically with capital adequacy rules.[63] Such rules were then significantly expanded in scope and detail by subsequent amendments, including Basel II and Basel III.

The BCBS’s current mandate is set out in its new *Charter*, which was endorsed in January 2013 by the Group of Governors and Heads of Supervision (GHOS), the BCBS's oversight body. The first thing to note about the *Charter* is that it does not change the formal position of the BCBS.[64] Neither the *Charter* nor the Committee has formal legal status under international law. The *Charter* sets the BCBS’s objectives and operating modalities and is intended to enhance

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[59] Duncan Wood, *Governing Global Banking: The Basel Committee and the Politics of Financial Globalization* (Aldershot, Hants, England: Ashgate, 2005) at 70-72.

[60] *Ibid* at 75.

[61] BCBS, “Outcome of the Consultative Process on Proposals for International Convergence of Capital Measurement and Capital Standards” (July 1988) at para 3, online: BIS http://www.bis.org/publ/bcbs04b.pdf.

[62] BCBS, Report *on the Supervision of Banks' Foreign Establishments - Concordat* (September 1975) online: BIS http://www.bis.org/publ/bcbs00a.htm ; Enrico L Camilli, “Basel–Brussels One Way? The EU in the Legalization Process of Basel Soft Law” in Edoardo Chiti & Bernardo G Mattarella, eds, *Global Administrative Law and EU Administrative Law: Relationships, Legal Issues and Comparison* (Berlin: Springer, 2011) 324 at 334-335.

[63] *Ibid*.

[64] BCBS, “Group of Governors and Heads of Supervision Endorses Revised Liquidity Standard for Banks” (2013) online: BIS http://www.bis.org/press/p130106.htm.

understanding of the Committee's activities and decision-making processes.[65] It considers the BCBS "the primary global standard-setter for the prudential regulation of banks", and "a forum for cooperation on banking supervisory matters."[66] The BCBS's mandate is to strengthen the regulation, supervision and practices of banks worldwide with the purpose of enhancing financial stability."[67] Such a mandate is achieved through an array of activities, including: exchange of information on recent developments in the banking sector and financial markets; sharing supervisory issues and techniques to promote common understanding and cross-border cooperation; establishing and promoting standards, guidelines, and sound practices for bank regulation; addressing gaps that pose threats to financial stability; monitoring the implementation of the BCBS's standards; consulting with central banks and supervisory authorities of non-member countries; and coordination and cooperation with other financial sector standard-setters and international bodies.[68]

Thus, the BCBS's mandate is now considerably broader than its original purpose, namely providing a medium for education and exchange of information about bank supervision. As indicated by its *Charter*, the BCBS is "the primary global standard-setter for the prudential regulation of banks". In fact, the BCBS's post-crisis mandate goes beyond setting standards to include the surveillance of their implementation in member countries and beyond. This issue will be considered in more detail in subsequent chapters.

3.3.3 Internal Structure and Operation

Historically, the nature and operation of the BCBS have been noted for their legal and procedural informality. Due to the highly secretive nature of its operation, a large amount of uncertainty has always surrounded the Committee's operation. Once the decision was made by the G10 to establish the new standing committee in December 1974, no separate directions were provided

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[65] *Ibid*.

[66] *Basel Committee on Banking Supervision (BCBS) Charter,* January 2013, s 1, online: BIS http://www.bis.org/bcbs/charter.htm [*Charter*].

[67] *Charter*, *ibid*, s 1.

[68] *Charter*, *ibid*, s 2.

with respect to the structure and method of its operation.[69] The early operations of the Committee were left to its first Chairman, George Blunden. In an interview with George Walker, Blunden said that he had to arrange a number of meetings with the Committee's first secretary, Michael Daltry to discuss various preparatory issues prior to the first meeting in February 1975.[70] The focus of such meetings was, however, what was to be achieved by the Committee rather than operational or structural issues. As a result, the nature and character of the BCBS's meetings and operations were developed naturally, or perhaps accidentally, over time.[71] Although still nominally informal, the Committee now seems to operate in a carefully structured and organized manner, which is consistent with its growing stature and its extended mandate. The most up-to-date source of information on the current organizational structure and operation of the BCBS is its *Charter*. Under s. 7, the BCBS's internal structure comprises four bodies: 1) the Committee; 2) Groups, Working Groups and Task Forces; 3) the Chairman; and 4) the Secretariat.[72]

The Committee is the ultimate decision-making body of the BCBS, ensuring that the BCBS's mandate is achieved.[73] It normally meets four times per year but the Chairman can hold additional meetings, if necessary.[74] There has never been a formal voting system within the BCBS and all decisions are decided by consensus.[75]

BCBS members and observers are entitled to appoint one representative to attend the "committee" meetings. These representatives should be senior officials of their institutions such as head of banking supervision, head of banking policy/regulation, central bank deputy governor,

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[69] Walker, *supra* note 43 at 39.

[70] *Ibid*.

[71] *Ibid* at 40.

[72] *Charter*, *supra* note 66, s 7.

[73] *Charter*, *ibid*, s 8.

[74] *Charter*, *ibid*, s 8.2.

[75] *Charter*, *ibid*, s 8.4; Goodhart, *supra* note 2 at 547.

head of financial stability department or the equivalent. More importantly, the representatives should have the authority to commit their institutions. [76]
The main responsibilities of the Committee include: developing and monitoring the BCBS's work program with general guidance provided by the GHOS; establishing and promoting the BCBS's standards, guidelines and best practices; establishing and disbanding groups, working groups and task forces; deciding on organizational regulations governing its activities; recommending amendments to the BCBS's *Charter* to the GHOS. [77]

The Committee's work is organized around Groups, Working Groups, and Task Forces.[78] Groups are subcommittees that report directly to the Committee. They are composed of senior staff who undertake major areas of the Committee's work.[79] At present, the BCBS has five major Groups:

1. The Supervision and Implementation Group (SIG) serves two primary objectives: fostering timely, consistent, and effective implementation of the Basel Committee's standards and guidelines; and advancing improvements in banking supervision, particularly in member countries. That SIG has a number of Working Groups and Task Forces that work on specific issues such as the *Working Group on Operational Risk*, *Working Group on Supervisory Colleges*, and *Working Group on Systemically Important Banks Supervision*.[80]
2. The Policy Development Group (PDG) assists the Committee by developing policies which promote a sound banking system and high supervisory standards. The PDG special Working Groups include *Woking Group on Capital*, *Trading Book Working Group*, *Securitisation Working Group*, *Working Group on Liquidity*, and *Working Group on Disclosure*.

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[76] *Charter, ibid*, s 8.4.
[77] *Charter, ibid*, s 8.1.
[78] *Charter, ibid*, s 9.
[79] *Charter, ibid*, s 9.1.
[80] BCBS, "Sub-Committees", *supra* note 51.

3. The Macroprudential Supervision Group (MPG) monitors and reports to the Committee on systemic risk and developments related to the macroprudential oversight and systemically important banks (SIB). It also provides guidance to the work of other groups and develops policy proposals which may be needed to address gaps and inconsistencies in the overall framework of macroprudential/SIB supervision. [81]
4. The Accounting Experts Group (AEG) works to ensure that international accounting and auditing standards promote sound risk management, market discipline, and safety and soundness of the banking system. It provides guidance on prudential reporting and takes an active role in the development of accounting and auditing standards.
5. The BCG, which as mentioned earlier, provides a forum to facilitate the Committee's engagement with supervisors around the world. In particular, it fosters dialogue between the Committee and prudential authorities of non-member jurisdictions.[82]

The Chairman is appointed by the GHOS for a term of three years, which can be renewed once.[83] The Chairman convenes and chairs meetings and directs the work of the Committee in accordance with its mandate.[84] In addition, the Chairman represents the BCBS externally and is the main spokesperson for the BCBS.[85]

The BCBS Secretariat is provided by the BIS. The secretariat is primarily comprised of professional staff who are usually on temporary secondment from BCBS members.[86] Some of the important responsibilities of the Secretariat are: providing support and assistance to the Committee, Chairman, and Groups; ensuring timely and effective flow of information to the

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[81] *Ibid*.

[82] *Ibid*.

[83] *Charter*, *supra* note 66, s 10.1.

[84] *Charter*, *ibid*, ss 10, 10.2.

[85] *Charter*, *ibid*, s 10.2.

[86] *Charter*, *ibid*, s 11.

BCBS members and facilitating contact between the BCBS members and non-members; and maintaining and administering the BCBS records and website.[87]

The GHOS is the oversight body of the BCBS. The BCBS reports to the GHOS and seeks its endorsement for its major decisions. In addition the GHOS has the responsibility for approving amendments to the BCBS *Charter*, proving general directions for the BCBS's work program and appointing the BCBS's Chairman from among its members. [88]

3.3.4 Policy Outcomes

The BCBS's policy outcomes can be considered under three main categories. The first category is the *standards* for prudential regulation and supervision of banks.[89] These standards primarily apply to internationally active banks, although they might be applied more broadly. It is important to remember that the BCBS's standards constitute the *minimum* prudential requirements. Countries may, therefore, decide to go beyond them.[90] The second group of policies are *guidelines,* designed to elaborate upon and provide additional guidance for implementation of standards.[91] The Committee has also issued guidance for a wider range of issues including corporate governance, liquidity risk management, operational risk, stress testing, and supervisory colleges.[92] Finally, the BCBS issues sound practices. These documents describe

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[87] *Charter*, *ibid*, s 11.1.

[88] *Charter*, *ibid*, s 6.

[89] *Charter*, *ibid*, s 12.

[90] For examples of standards see, BCBS, "Core Principles for Effective Banking Supervision" (2012) http://www.bis.org/publ/bcbs230.htm; BCBS, "Liquidity Coverage Ratio Disclosure Standards - Consultative Document" (2013) online: BIS http://www.bis.org/publ/bcbs259.htm; BCBS, "Capital Requirements for Bank Exposures to Central Counterparties" (2012) online: BIS http://www.bis.org/publ/bcbs227.htm.

[91] *Charter*, *supra* note 66, s 13.

[92] For examples of guidelines, see BCBS, "Guidance for National Authorities Operating the Countercyclical Capital Buffer" (2010) online: BIS http://www.bis.org/publ/bcbs187.htm; BCBS, "Operational Risk - Supervisory Guidelines for the Advanced Measurement Approaches - Final Document" (2011) online: BIS http://www.bis.org/publ/bcbs196.htm; BCBS, "Supervisory Guidance for Managing Risks Associated with the Settlement of Foreign Exchange Transactions" (2013) online: BIS http://www.bis.org/publ/bcbs241.htm.

actual observed practices, with the goal of promoting common understanding and improving supervisory and banking practices.[93] Members and banks are encouraged to compare these practices with those applied in their own jurisdictions so that they may identify areas for improvement. Stress testing, asset securitization, resolution and remuneration are among the recent themes of sound practices.[94]

The most important policy outcomes of the BCBS - which will be also the focus of this thesis - are standards. While the BCBS members are *encouraged to adopt best practices*, they are *expected to implement standards* in full.[95] The key standards are capital and liquidity requirements for internationally active banks. These requirements are set in the Basel Accords, which have been revised at different stages. The most recent Accord is Basel III, which includes the reforms adopted after the GFC.

The BCBS's policy outcomes, particularly the standards, are considered *soft law*. Soft law refers to rules that are not legally binding but in practice are adhered to by those addressed or by others for various reasons such as moral suasion or fear of adverse action.[96] The term *soft law* is usually used in contrast to *hard law*. While hard law is characterized by formality, soft law is characterized by informality. Moreover, hard law is binding in a coercive and externally-imposed fashion, but soft law is obeyed in a voluntary and self-imposed manner. Enforcement is, therefore, the key distinction between soft law and hard law. As Giovanoli puts it, "from the legal point of view, no remedies are available if the rules are not followed. This does not, of

[93] *Charter*, *supra* note 66, s 14.

[94] See, e.g., BCBS, "Report and Recommendations of the Cross-border Bank Resolution Group - Final Paper" (2010) online: BIS http://www.bis.org/publ/bcbs169.htm; BCBS, "Sound Practices for Backtesting Counterparty Credit Risk Models - Final Document" (2010) online: BIS http://www.bis.org/publ/bcbs185.htm; BCBS, "Principles for Enhancing Corporate Governance - Final Document" (2010) online: BIS: http://www.bis.org/publ/bcbs176.htm; BCBS, "Good Practice Principles on Supervisory Colleges - Final Document" (2010) online: BIS http://www.bis.org/publ/bcbs177.htm.

[95] *Charter*, *supra* note 66, s 5(e).

[96] Roy Goode, *Commercial Law*, 2d ed (London: Penguin, 1995) at 20-21.

course, preclude the existence of factual sanctions, either from the market or from other bodies, which can be very effective."[97]

The soft-law nature of BCBS's decisions can help with understanding why the Basel Capital Accords have been widely implemented. Basel I was recognized as one of the most successful international regulatory initiatives. In addition to its promulgation by the BCBS members, more than 100 countries implemented the accord in their national systems.[98] The implementation of Basel II was associated with a number of complications that will be considered at some length in the last chapter. Here it suffices to note that Basel II came into force in 2006 and by 2008, when the globe was fully emerged in a financial crisis, 57 countries were in the process of implementing all or parts of the Basel II framework.[99] Finally, with respect to Basel III, which came into force in January 2013, 25 BCBS members (out of 27) issued the final rules by August 2013.[100] The remaining two member jurisdictions have issued draft rules. [101]

Since the early days of the BCBS, its members had established the unwritten rule that once the proposals were agreed upon within the committee and endorsed by the governors, members were honor-bound to implement them.[102] Non-member countries also had important incentives to comply with BCBS's policies. If they did not implement the standards, the BCBS members might deny them access to their financial markets. Additionally, the Financial Sector Assessment Program (FSAP), a joint IMF-World Bank surveillance initiative, introduced in 1999, indirectly

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[97] Mario Giovanoli, "A New Architecture for the Global Financial Market: Legal Aspects of International Financial Standard Setting" in Mario Giovanoli, ed, *International Monetary Law, Issues for the New Millennium* (Oxford: Oxford University Press, 2000) 3 at 35.

[98] Anupam Prakash, "Evolution of the Basel Framework on Bank Capital Regulation" (Reserve Bank of India Occasional Papers Vol. 29, No. 2, Monsoon, 2008) at 85.

[99] *Ibid* at 102.

[100] BCBS, "Report to G20 Leaders on Monitoring Implementation of Basel III Regulatory Reforms (August 2013) at 3, online: BIS http://www.bis.org/publ/bcbs260.pdf.

[101] *Ibid*.

[102] Goodhart, *supra* note 2 at 554-5.

enforced the BCBS's standards.[103] An important component of the FSAP was Reports on Observance of Standards and Codes (ROSCs), which summarised the extent to which countries observed internationally recognized standards, including those adopted by the BCBS.[104] These evaluations, therefore, provided the non-G10 countries with an important incentive to observe the BCBS's standards.[105] The FSAP will be discussed in greater detail in the next section. With the backing of the G20, the BCBS has recently established a more active program to monitor the implementation of its standards, particularly Basel III, including through publishing periodic reports on the progress made in implementation of standards, and producing detailed assessments of national regulations against the agreed international standards.[106] The BCBS surveillance program will be considered in more detail in the next chapter.

3.4 The BCBS and the International Financial Architecture

The International Financial Architecture (IFA) includes various institutions that produce international financial standards (IFS). Broadly speaking, the IFS refers to a wide range of principles, practices and guidelines that establish the rules of the game in the global financial markets and provide the framework within which financial institutions operate and financial policies are devised and implemented.[107] The development of IFS started in earnest after the Asian Financial Crisis (AFC).[108] Following the crisis, Robert Rubin, the Secretary of the United States Treasury gave a lecture at the Brookline institution, stressing the need to strengthen the

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[103] IMF, "Financial Sector Assessment Program (FSAP)" (10 June 2014) online: IMF http://www.imf.org/external/NP/fsap/fssa.aspx.

[104] World Bank, "RSOC— Reports on Observance of Standards and Codes" (Accessed on 16 August 2014) online: World Bank http://www.worldbank.org/ifa/rosc_more.html.

[105] Goodhart, *supra* note 2 at 554-5.

[106] BCBS, "The Basel Committee's Work" (Accessed on 22 June 2014) online: BIS http://www.bis.org/bcbs/bcbs_work.htm.

[107] Mario Giovanoli, "The Reform of the International Financial Architecture after the Global Crisis" (2009) 42 International Law and Politics 81 at 84 [Giovanoli, "Reform of the IFA"].

[108] Peter B Kenen, *The International Financial Architecture: What's New? What's Missing?* (Washington: Institute for International Economics, 2001) at 1.

International Financial Architecture. This was the first time the term IFA was used and the lecture was considered to open a new chapter in the regulation of international finance.[109]

It was then understood that the Asian Financial Crisis happened largely due to inadequate regulation and supervision of financial institutions, particularly in crisis-stricken countries. There was therefore a strong need to upgrade the regulatory frameworks to the requirements of global finance and to safeguard the stability of the international system against future crisis.[110] International financial institutions in Washington, particularly the IMF, then started to push for "sequencing thesis", meaning that before liberalizing their capital accounts, countries should upgrade their regulatory regime.[111] Washington institutions called for greater transparency and a set of detailed standards to ensure financial safety and to reduce the excessive risk of financial integration. Standard-setting bodies such as the BCBS, Financial Stability Forum (which was subsequently re-founded as the Financial Stability Board), International Organization of Securities Commissions (IOSCO) and International Accounting Standards Board (ISAB), were assigned to develop standards and codes of best practices.[112] These standards covered 12 areas that could be grouped under three main categories:

1. **Policy transparency**, including data transparency, fiscal transparency, monetary and fiscal policy transparency;
2. **Financial Sector Regulation and Supervision**, including standards in the areas of banking, securities, insurance, payment systems and anti-money laundering and combating the financing of terrorism; and
3. **Market integrity**, including three areas of corporate governance, accounting, auditing

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[109] *Ibid*.

[110] *Ibid* at 10; Jakob Vestergard, *Discipline in Global Economy: International Finance and End of Liberalism* (New York: Routledge, 2009) at 123.

[111] IMF, "Financial Sector Assessment: A Handbook" (29 September 2005) at 317-320, online: IMF http://www.imf.org/external/pubs/ft/fsa/eng/.

[112] G7, "Declaration of G7 Finance Ministers and Central Bank Governors" (30 October 1998) online: IMF http://www.imf.org/external/np/g7/103098dc.htm.

and insolvency and credit rights.[113]

The coordination of these efforts was assigned to the IMF and the World Bank. The IMF primarily coordinated the efforts in the first two areas (policy transparency and Financial Sector Regulation and Supervision), while the World Bank held responsibility for the third area of standards.

The system of standards went hand in hand with a system of surveillance. In their declaration on 3 October 1998, the G7 called upon all countries "to comply with internationally agreed codes and standards". More importantly, they asked the IMF "to monitor the implementation of these codes and standards" and "to publish in a timely and systematic way the results of its surveillance of the degree to which each of its member countries" was successful in compliance with the standards.[114] The surveillance that was established for this purpose was the Financial Sector Assessment Program (FSAP), which will be considered in more detail later.

In spite of their scope and sophistication, IFS were unable to prevent or mitigate the GFC. Some key standards played an enabling role in the crisis, contributing to the emergence, aggravation and dissemination of the crisis.[115] Consequently, it became evident that both the IFA and the IFS had to be reformed. The political support for these reform initiatives was provided by the G20, an informal forum that "promotes open and constructive discussion between industrial and emerging-market countries on key issues related to global economic stability". [116] G20 was more or less inactive since its inception in 1999 until 2008 when it was revived as the main forum for reforming international financial architecture.[117] To prevent future crises, G20 leaders committed

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[113] FSB, "Compendium of Standards" (accessed on 18 February 2010) online: FSB http://www.financialstabilityboard.org/cos/index.htm.

[114] G7, *supra* note 112.

[115] Giovanoli, "Reform of the IFA", *supra* note 107 at 87.

[116] Global Partnership for Financial Inclusion, "About the G20" online: Global Partnership for Financial Inclusion http://gpfi.org/about-gpfi/about-the-g20.

[117] Giovanoli, "Reform of the IFA", *supra* note 107 at 90.

to repairing the financial system, strengthening financial supervision and regulation, and reforming global financial institutions.[118] International standard-setting bodies (SSBs) were required to reform their existing standards and develop new ones. The Financial Stability Forum was reinvented as the Financial Stability Board (FSB) to coordinate the activities of the SSBs and to develop and promote the implementation of effective regulatory and supervisory policies.[119]

The new international financial architecture bears significant resemblance to the old regime. It consists of highly fragmented institutions that perform three sets of activities related to international financial regulation: setting agendas, developing standards, and monitoring compliance. The first activity is mainly associated with the G20, and in particular its technocratic extension, the FSB. These bodies operate at the core of the IFA, determining the objectives that need to be achieved and issues that need to be addressed through regulation. Some of the recent agenda includes strengthening macroprudential oversight, [120] improving the transparency and regulation of over-the-counter (OTC) derivatives, [121] and intensifying regulation and supervision of Systemically Important Financial Institutions (SIFIs).[122] The second activity, namely devising guidance for market participants, is largely undertaken by the SSBs, which set standards for various financial sectors. The categorization and areas of standards remains the same as the

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[118] G20, "Global Plan for Recovery and Reform" (April 2009) online: G20 Information Centre http://www.g20.utoronto.ca/2009/2009communique0402.html.

[119] G20, "Declaration on Strengthening the Financial System", (April 2009) online: G20 Information Centre http://www.g20.utoronto.ca/2009/2009ifi.pdf.

[120] See, e.g., FSB, "Macroprudential Policy Tools and Frameworks- Update to G20 Finance Ministers and Central Bank Governors" (February 2011) online: FSB http://www.financialstabilityboard.org/list/fsb_pa/tid_161/index.htm; FSB, "Addressing Financial System Procyclicality: A Possible Framework" (April 2009) online: FSB http://www.financialstabilityboard.org/publications/r_0904e.htm.

[121] See, e.g., FSB, "Implementing OTC Derivatives Market Reforms" (October 2010) online: FSB http://www.financialstabilityboard.org/list/fsb_pa/tid_172/index.htm.

[122] See, e.g., FSB, Policy Measures to Address Systemically Important Financial Institutions (November 2011) online: FSB http://www.financialstabilityboard.org/publications/r_111104bb.pdf.

previous regime, outlined above [under section...OR on page...]. Finally, monitoring takes place in different forms including peer reviews. However, the IMF and the World Bank still retain their surveillance function through the FSAP.

The BCBS's mandate and policy outcomes, as discussed above, suggest that it primarily fits with the second category, namely, SSBs. In fact, the Committee is the oldest financial standard-setter, with 8 percent capital requirement for banks, widely known as the prime example of the IFS. However, the technical nature of the Committee's work and its stature gives it significant leeway in setting its own agenda. In addition, the introduction of the surveillance program for banking standards implies that the Committee has taken on a monitoring role. Thus, the BCBS's current functions seem to overlap with all three categories of activities in international financial regulation.

The Committee maintains channels for coordination with supervisors of non-bank financial institutions, a prime example being the Joint Forum (whose role as an important consultation base will be considered more fully later). Here, it suffices to say that the Joint Forum was established in 1996 under the aegis of the Basel Committee, IOSCO, and the International Association of Insurance Supervisors (IAIS) to address issues common to banking, securities, and insurance. The BCBS has also worked on a number of technical banking and auditing issues with other specialized SSBs such as the International Financial Reporting Standards Foundation (IFRS Foundation), the International Federation of Accountants (IFAC), and the International Forum of Independent Audit Regulators (IFIAR). This work has resulted in papers on topics such as the relationship between bank supervisors and external auditors and uniform rules for foreign exchange contracts. [123]

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[123] BCBS, "Basel Committee Cooperation with Other Standard-setting Bodies" (Accessed on 3 March 2014) online: BIS www.bis.org/bcbs/coop_with_sec_and_ins.htm.

3.5 Revisiting the BCBS as a Transnational Regulatory Network

Up until the present, international financial regulation and supervision have largely been conducted by institutions that rely on *soft* administrative structures. These institutions are not set up by international law instruments but rather by bylaws, agreements, and declarations that have no formal sense of international obligation or existence. On the other hand, formal international organizations mostly play a supporting role in financial regulation. They help monitor implementation of standards and provide administrative support for regulatory bodies that do not have secretariats. International organizations are, however, rarely a direct source of international financial regulation. [124]

Recent decades have witnessed a tendency on the part of states and sub-state entities to search for alternative methods of cooperation and rule-making that are less formal and institutionalized. Anne-Marie Slaughter argues that this trend indicates the emergence of a new world order, shifting the locus of power from traditional organizations to transgovernmental networks.[125] She defines *network* as "a pattern of regular and purposive relations among like government units working across the borders that divide countries and demarcate the "domestic" from the "international" sphere."[126] Networks "allow domestic officials to interact with their foreign counterparts directly, without much supervision by foreign offices or senior executive branch officials".[127] They demonstrate "loosely structured, peer-to-peer ties developed through frequent interaction rather than formal negotiation".[128]

The rise of networks is characterized as a corollary of the rise of *disaggregated state*. Whereas countries were traditionally represented on the international scene by heads of state or foreign

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[124] Chris Brummer, *Soft Law and the Global Financial System: Rule Making in the 21st Century* (Cambridge; New York: Cambridge University Press, 2012) at 63-64.

[125] Anne-Marie Slaughter, *A New World Order* (Princeton, N.J.: Princeton University Press, 2004) at 14.

[126] *Ibid*.

[127] *Ibid*.

[128] Anne-Marrie Slaughter & David Zaring, "Networks Go International: An Update" (2006) 6:12 Annual Review of Law and Social Science 215 at 215.

ministries, powers have increasingly been delegated to sub-state administrative agencies and regulators. These regulators or agencies have to address cross-border questions that lay within their regulatory mandate. Under traditional international law, the new actors cannot normally represent the state unless they are specifically accredited to do so. Thus, instead of resorting to formal international organizations and formal law making, these actors use networks and informal law making. [129]

Traditional explanations for the rise of networks often focus on procedural efficiency. By adopting informal rules of organization, participants retain flexibility to establish, reform, and dissolve institutions quickly. For instance, financial regulators do not require governmental consent to participate in international organizations or to assemble a multilateral treaty conference for developing financial standards. Instead, in collaboration with their colleagues, regulators organize an informal network to collaborate on international problems.[130] In addition, reforming networks seems easier in comparison to formal international organizations where enlargement or reform of membership may require renegotiation of treaties and ratification by national legislatures.[131] Speed, adaptability, and effectiveness in addressing new and unexpected challenges are also important reasons that explain the proliferation of transgovernmental networks.

The BCBS's governance and method of operation, as discussed above, clearly indicates that it is a transgovernmental regulatory network. A close examination reveals that the BCBS has

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[129] Joost Pauwelyn, Ramses A Wessel & Jan Wouters, “The Exercise of Public Authority through Informal International Lawmaking: An Accountability Issue?” (Jean Monnet Working Paper 06/11, New York University School of Law, 2011) at 13.

[130] David Zaring, “Informal Procedure, Hard and Soft, in International Administration” (2005) 5: 2 Chi J Int'l L 547 at 578.

[131] Brummer, *supra* note 124 at 64.

dispensed with certain formalities traditionally linked to international law. These formalities are closely associated with *actors*, *process* and *outputs*, which will be discussed in turn below.[132] First, in terms of *actor*, the BCBS's operation is informal in the sense that it does not engage traditional diplomatic actors, such as heads of states or foreign ministers. Under article 7 of the Vienna Convention on the Law of Treaties, only heads of state, foreign ministers, heads of diplomatic missions or specifically accredited representatives are presumed to have so-called full power to represent or bind a state.[133] The Basel Committee, however, is solely composed of officials from central banks and supervisory authorities.[134] These officials are not diplomats who represent their states, but bureaucrats representing sub-state agencies.

As Slaughter notes, "the essence of a network is a process rather than an entity; thus it cannot be captured or controlled in the ways that typically structure formal legitimacy in a democratic polity".[135] The *process* of international cooperation in BCBS is informal in the sense that it occurs in a loosely organized forum rather than a formal international organization. Unlike WTO or UN, the BCBS has little physical presence; it does not have its own budget, permanent staff or headquarters. Instead it operates under the auspices of the BIS. BCBS meetings and decision-making are considerably less tightly-regulated in comparison to international organizations. It must also be acknowledged that the Committee was informally constituted. It was not founded by an international treaty but by a press communiqué issued by the G10 governors. As a consequence of this informal process, the BCBS is less constrained by the controls under domestic or international law. Bank supervisors within the BCBS face fewer constraints than in their purely domestic capacities or as formal delegates to international organizations.

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[132] For a more detailed discussion of the characteristics of actors, processes and outcomes involved in informal international law making, see Pauwelyn, Wessel & Wouters, *supra* note 129 at 8-13.

[133] *Vienna Convention on the Law of* Treaties, 23 May 1969, UNTS 18232, art 7.

[134] *Charter*, *supra* note 66, s 4.

[135] Anne - Marie Slaughter, "Agencies on the Loose? Holding Government Networks Accountable" (Public Law and Legal Theory Working Paper No. 006, 1999) at 10, online: SSRN http://papers.ssrn.com/sol3/papers.cfm?abstract_id=209319.

Finally, the BCBS's *outputs* are informal in the sense that they do not lead to formal treaties or any other traditional source of international law, but rather to standards, guidelines and sound practices. At the domestic level, this output informality leads to weaker forms of oversight. For instance, in the US, Circular 175 procedure of the State department is designed to ensure the proper exercise of treaty making power and prescribes requirements for publication and transmittal of international agreements to the US Congress. This Circular, however, does not apply to the BCBS's documents because they "are not binding under international law".[136] The US constitutional rule that a two-third majority in the Senate must adopt treaties also does not apply to international agreements, which are not classified as treaties.[137] Similarly, in the UK, the formalities surrounding treaty-making does not include memoranda of understandings, which refers to those international commitments not legally binding. [138]

3.6 Conclusion

The BCBS was established at a time when existing institutional mechanisms were inadequate to cope with the risks arising from the international operations of financial intermediaries. Its establishment was an example of a larger trend to give authority to technical experts to deal with complex social and economic problems. The BCBS was founded as a transnational network intended to minimize the hardship of, and costs involved with, establishing formal international organizations. Its establishment represents a tradeoff in favour of informal constitution, minimal institutionalization, and closed operation.

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[136] US Department of State, "Circular 175 Procedure" (Accessed on 9 September 2013) online: Bureau of Public Affairs http://www.state.gov/s/l/treaty/c175/.

[137] Pauwelyn, Wessel & Wouters, *supra* note 129 at 20.

[138] Foreign & Commonwealth Office, "Treaties and MOUs: Guidance on Practice and Procedures" (March 2013) at 1, online: Government Digital Service: https://www.gov.uk/government/publications/treaties-and-mous-guidance-on-practice-and-procedures.

The BCBS’s network governance implies less representative legitimacy in contrast to formal international organizations, which are rooted in international law. Arguably, however, the BCBS’s network attributes can nurture other foundations for its legitimacy. The BCBS’s expertise and relative insulation from political interference indicates a higher likelihood of delivering public goods, particularly greater financial stability. Moreover, strong peer-to-peer ties among bank supervisors, twinned with institutional flexibility and consensus-based decisionmaking can be viewed as enhancing the deliberative quality of the BCBS's policy making.

Nevertheless, two caveats with respect to the argument that the BCBS’s networked governance enhance its legitimacy need to be voiced here. First, the global financial crisis of 2008 came to discredit international financial standards, including the prudential standards adopted by the BCBS. Such failure casts a shadow on the BCBS’s outcome-based legitimacy, reviving the public choice theorists’ concern that specialized technocratic bodies are prone to capture by private interests. The BCBS’s deliberative-based legitimacy also seems constrained, given that the Committee is solely comprised of officials from central banks and supervisory authorises – in other words, like-minded individuals with similar education and career backgrounds. Without mechanisms that provide exposure to competing views and access to a larger pool of arguments, the BCBS is in danger of adopting inferior policies.

Since the onset of the GFC, the BCBS has taken some modest steps towards greater formalization, such as the adoption of the BCBS *Charter* and surveillance of the implementation of banking standards. Such steps, however, have been adopted with the political backing of the G20, which itself remains an informal and loose forum for international cooperation. While the BCBS *Charter* and the surveillance of post-crisis reforms reflect a greater realization of the need for international cooperation and robust implementation of agreed reforms, they have not yet changed the underlying network characteristics of the BCBS. It remains to be seen whether such steps will ultimately give rise to a shift in the locus power from networks back to more formal and institutionalized regimes of governance.

Chapter 4: Assessment of the Legitimacy of the BCBS's Governance in the Post-crisis Era

4.1 Introduction

The previous chapter's discussion of the BCBS's history and governance sets the scene for the assessment of its legitimacy and accountability based on the criteria identified in the theoretical framework. The analysis in this chapter will be guided by four important questions: 1) Does the BCBS give reasons for its decisions? 2) Are the Committee's governance and decision-making procedures transparent? 3) How and by what means does the BCBS consult the public in its policy-making process? 4) How and by whom is the Committee's performance monitored? Due to space constraints the criterion of correction, which is of particular significance with respect to retrospective accountability, will not be considered here but will guide the next chapter's analysis of the BCBS's post-crisis reforms.

The chapter proceeds as follows. First it considers the application of the reasoned decision-making principle in the process that led to the adoption of Basel III. The chapter then moves to investigate the BCBS's transparency under three categories of internal governance, decision-making procedures, and implementation of standards. The third section is concerned with the sources of input for the BCBS's policy making and public consultation mechanism that are utilized to engage with the public. The last section assesses the extent to which the BCBS's policy outputs are subject to oversight by other international institutions. There is a background note at the start of each section, which introduces the relevant criterion and describes the plan and scope for the analysis in more detail. The conclusion represents the final findings and identifies the strengths and weakness that exist in the BCBS's legitimacy and accountability. Policy prescriptions will be, however, saved for the final concluding remarks.

4.2 Reason Giving

4.2.1 Background

The duty to give reasons is an important standard for public authorities and has been recognized by many national legal systems. The normative and functional reasons for reason giving were identified in the theoretical framework of this thesis and also illustrated that this requirement seems prevalent in many areas of global governance practice. Giving reasons seems to be of particular significance with respect to global regulatory regimes, including the BCBS, as such regimes do not have the same kind of input legitimacy that characterizes national representative institutions. One possible way to remedy this legitimacy deficit is to give reasons for decisions.[1] It is also important to note that reasoning is closely associated with other important tests for legitimacy, such as transparency and accountability, which are also considered in this thesis. Reasoned decision making helps ensure that information underlying the decisions are not entirely left in the hands of decision makers. It can also be regarded as a form of *explanatory accountability* given that it requires decision makers to give account of their actions and justify their decisions.[2]

The current section examines the application of the principle of reasoned decision making in the BCBS standard- setting activities. It also considers other issues of close relevance that are important for sound regulatory decision making, including costs-and-benefits analysis and open communication with those who should comply with the regulations. Since the analysis of all the BCBS's regulatory decisions are impossible, this section concentrates on Basel III, which represents the most important set of reforms by the BCBS. The substantive standards set out by Basel III will be considered to some length in the last chapter. The focus here is, therefore, the general administrative and procedural aspects of Basel III that are of significance to this section's analysis.

This section first provides a brief overview of the development of Basel III, highlighting the important events, documents and initiatives that were produced in the process. It then moves on

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[1] John Ferejohn 'Accountability in a Global Context' (International Law and Justice Working Paper IILJ 2007/5, Global Administrative Law Series, Institute for International Law and Justice, New York University School of Law, 2007) at 21-24.

[2] Rosa M Lastra & Heba Shams, "Accountability: Ex Ante or Scrutiny, Ex Post or Control and Transparency" (May 2000) at 5, online: LSE http://www.lse.ac.uk/fmg/documents/events/conferences/2000/rules/49_lastra.pdf.

to consider the rationale and objectives that the committee has outlined for the reforms. This section turns next to the measures that the BCBS has taken to assess the costs and benefits associated with its recommended reforms. Finally, this section looks at the strategies that the BCBS has devised in effort to increase the comprehensibility of its standards and to facilitate their implementation.

4.2.2 A Primer on the Development of Basel III

Basel III is the upshot of a series of steps that the BCBS has taken in recent years to increase the resilience of the banking system. The first of such steps dates back to the BCBS's annual meeting in October 2007, when the Committee's Chairman announced that the BCBS was considering a number of initiatives to "address the types of issues and risks arising from the recent financial market turbulence".[3] These included encouraging the full implementation of Basel II,[4] enhancing management and supervision of funding liquidity risk, improving the robustness of valuation practices, and increasing market transparency for complex and less liquid products. In the spring of 2008, the BCBS reiterated these initiatives[5] and in the summer of the same year released "Principles for Sound Liquidity Risk Management and Supervision"[6] and "Revisions to the Basel II Market Risk Framework".[7]

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[3] BCBS, "Financial Market Developments and the Work of the Basel Committee" (9 October 2007) online: BIS http://www.bis.org/press/p071009.htm.

[4] The assumption was that the Basel II implementation would help make the capital base more relevant to banks' changing risks profiles, and would create incentives for better risk measurement and management. *Ibid.*

[5] Basel Committee on Banking Supervision Announces Steps to Strengthen the Resilience of the Banking System" (16 April 2008), online: BIS http://www.bis.org/press/p080416.htm.

[6] BCBS, "Principles for Sound Liquidity Risk Management and Supervision" (17 June 2008) online: BIS http://www.bis.org/press/p080617.htm [BCBS, "Sound Liquidity"].

[7] BCBS, "Proposed Revisions to the Basel II Market Risk Framework" (July 2008) online: BIS http://www.bis.org/publ/bcbs140.htm.

Following the collapse of the Lehman Brothers and the Royal Bank of Scotland (RBS) and adoption of massive rescue packages in the fall of 2008,[8] the BCBS announced a "comprehensive strategy to address the lessons of the banking crisis" on 20 November 2008.[9] This announcement was the first time that the Committee publicly recognized the need for revision of the international regime of capital adequacy regulation. The building blocks of this strategy included strengthening the risk capture of the Basel II framework, enhancing the quality of tier 1 capital, building countercyclical capital buffers, evaluating the need to supplement risk-based measures with simple measures of exposure, and strengthening counterparty credit risk capital, risk management and disclosure. The BCBS chairman noted that the Committee expected to address these topics in more detail in the course of 2009.[10]

In December 2009, the BCBS issued two consultative documents that together became known as Basel III: "Strengthening the Resilience of the Banking Sector";[11] and "International Framework for Liquidity Risk Measurement Standards and Monitoring".[12] Both documents were published on the BIS website on 17 December 2009, and interested parties were invited to submit comments on all aspects of the consultative documents by 16 April 2010. [13]

In December 2010, the BCBS issued the Basel III rules text, which presents the details of the global regulatory standards on bank capital adequacy and liquidity.[14] Prior to publication, the

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[8] For the GFC timeline, see, "Global Recession Timeline", *BBC News* (Accessed on 1 March 2014) online: BBC http://news.bbc.co.uk/2/hi/8242825.stm.

[9] BCBS, "Comprehensive Strategy to Address the Lessons of the Banking Crisis Announced by the Basel Committee" (20 November 2008) online: BIS http://www.bis.org/press/p081120.htm.

[10] *Ibid.*

[11] BCBS, "Strengthening the Resilience of the Banking Sector- Consultative Document" (December 2009) online: BIS https://www.bis.org/publ/bcbs164.htm [BCBS, "Strengthening the Resilience"].

[12] BCBS, "International Framework for Liquidity Risk Measurement Standards and Monitoring-Consultative Document" (December 2009) online: BIS https://www.bis.org/publ/bcbs165.htm.

[13] *Ibid*; BCBS, "Strengthening the Resilience", *supra* note 11.

[14] BCBS, "Basel III: A Global Regulatory Framework for More Resilient Banks and Banking Systems" (December 2010) online: BIS https://www.bis.org/publ/bcbs189_dec2010.htm [BCBS, "Basel III: Capital"]; BCBS, "Basel III:

Basel III rules were endorsed by the Governors and Heads of Supervision (GHOS), the governing body of the BCBS, and the G20 leaders during their Seoul summit, held in November, of the same year.[15]

Basel III rules have been, and continue to be, revised. For example, in June 2010, the BCBS revised the Basel III capital treatment for counterparty credit risk in bilateral trades. The revisions were concerned with credit valuation adjustment (CVA), which is the risk of loss caused by changes in the credit spread of counterparty due to changes in its credit quality.[16] The liquidity risk coverage ratio and liquidity risk monitoring rules were also revised in January 2013.[17]

4.2.3 The Rationale and Objectives of Reforms

The press releases that were issued in the course of the development of Basel III, as well as the introductory remarks included in the text of Basel III, clearly sets out the *raison d'être* of the new rules: it is intended to address the weaknesses of the banking system that surfaced during the GFC. The introduction of Basel III points out that one of the main reasons that the GFC was so severe was the excessive leverage in the banking sector accompanied by the gradual erosion (in terms of level and quality) of the capital base.[18] At the same time, many banks did not hold sufficient liquid assets and the banking system was unable to absorb the credit losses. Many market participants lost confidence in the solvency and the liquidity of banks and the problems in the banking sector rapidly transmitted to the rest of the financial system and the broader economy. This resulted in a massive contraction of credit and liquidity. Ultimately, governments

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International Framework for Liquidity Risk Measurement, Standards and Monitoring" (December 2010) online: BIS https://www.bis.org/publ/bcbs188.htm [BCBS, "Basel III: Liquidity"].

[15] *Ibid*.

[16] BCBS, "Capital Treatment for Bilateral Counterparty Credit Risk Finalised by the Basel Committee" (June 2011) online: BIS https://www.bis.org/press/p110601.htm.

[17] BCBS, "Basel III: The Liquidity Coverage Ratio and Liquidity Risk Monitoring Tools" (January 2013) online: BIS https://www.bis.org/publ/bcbs238.htm.

[18] BCBS, "Basel III: Capital", *supra* note 14 at 1.

had to step in with huge injections of capital and liquidity as well as guarantees, exposing taxpayers to great losses. It was such centrality of the banking system in the crisis of 2008 that required the Basel Committee to revise the prudential framework for banks.[19]

Basel III departs from the normative perspective that a strong banking system is crucial to sustainable economic growth. Banks are at the center of the credit intermediation process and provide critical services to consumers, corporations and governments.[20] Basel III's objective is to improve the banking sector's ability to absorb shocks arising from financial and economic stress and to reduce the risk of spillover from the financial sector to the real economy. In particular, the Accord aims to improve risk management and governance and strengthen banks' transparency and disclosures. [21]

4.2.4 Costs and Benefits Analysis

In 2010, the BCBS conducted a quantitative impact study (QIS) to assess the impact of the Basel III capital and liquidity proposals.[22] A total of 263 banks from 23 member countries participated in the QIS. The participants in the exercise consisted of two groups: 94 Group 1 banks which had Tier 1 capital in excess of €3 billion; and 169 Group 2 banks, namely all other banks.[23] The exercise assumed full implementation of the Basel III package. However, no assumption was made about the banks' profitability or behavioral responses, such as changes in bank capital or balance sheet composition. For that reason, the QIS was different from industry estimates, which tend to be based on forecasts, which in turn are based on private information and which consider the management actions needed to mitigate the impact of new regulations. [24]

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[19] *Ibid*.

[20] *Ibid*.

[21] *Ibid*.

[22] BCBS, "Results of the Comprehensive Quantitative Impact Study" (December 2010) online: BIS http://www.bis.org/publ/bcbs186.htm.

[23] *Ibid*.

[24] *Ibid*.

The average common equity Tier 1 capital ratio (CET1) was 5.7% for Group 1 banks and 7.8% for Group 2 banks. The QIS found that to meet the new 4.5% CET1 ratio, Group 1 needed additional capital of €165 billion. For Group 2 that amount was €8 billion. The Committee did a similar study to assess the impact of the newly proposed liquidity standards. [25]

The QIS can be regarded as an important exercise for estimating the costs associated with the implementation of new standards. It was a sound policy decision to integrate the QIS into the early stages of the development of Basel III and to publicly disclose its results.[26] In addition to its significance as a regulatory impact assessment, the QIS seems noteworthy from a *rule-based* perspective of *legitimacy*; it helped banks, as the main *addressees* of new standards, to better estimate their capital shortfalls and take steps necessary for meeting the new ratios.

There are two other reports that are of significance with respect to the costs-and-benefits analysis and should, therefore, be considered here: "An Assessment of the Long-term Economic Impact of Stronger Capital and Liquidity Requirements"; [27] and "Assessing the Macroeconomic Impact of the Transition to Stronger Capital and Liquidity Requirements".[28] Together, these two documents provide an assessment of the macroeconomic implication of stronger capital and liquidity reforms both during the transition and once implementation of Basel III is complete.

The first assessment by the BCBS found that there were net long-term economic benefits from increasing the capital and liquidity requirements. Such benefits accrued from reducing the

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[25] *Ibid.*

[26] *Ibid.*

[27] BCBS, "An Assessment of the Long-term Economic Impact of Stronger Capital and Liquidity Requirements" (August 2010), online: BIS http://www.bis.org/publ/bcbs173.pdf [BCBS, "Long-term Impact of Stronger Capital"]

[28] Macroeconomic Assessment Group, "Assessing the Macroeconomic Impact of the Transition to Stronger Capital and Liquidity Requirements— Final Report" (December 2010) online: BIS http://www.bis.org/publ/othp12.pdf [MAG, "Final Report"].

probability of financial crises and the associated output losses. The benefits substantially exceeded the potential output losses for a range of higher capital and liquidity requirements.[29]

The second report was issued by FSB-BCBS Macroeconomic Assessment Group (MAG), which was jointly established by the chairs of the FSB and the BCBS in February 2010 to conduct an assessment of the Macroeconomic implications of the BCBS's proposed reforms. The group was comprised of macroeconomic modeling experts from central banks and regulators from 15 countries as well as representatives from international institutions such as the IMF and ECB.[30] The MAG applied common methodologies based on a set of scenarios for shifts in capital and liquidity requirements over transition periods. These scenarios served as inputs into a broad range of models developed for policy analysis in central banks and international organizations. Close collaboration with the IMF was an essential part of the process and experts were consulted in the private sector and in academia.[31]

The MAG's report found that in a transition period of four and a half years, a 1 percentage point increase in bank's actual ratio of tangible common equity to risk-weighted assets would lead to a maximum decline in the level of GDP relative to its baseline path by about 0.19 %.[32] In terms of growth rates, this means that the annual growth rate would be reduced by an average of 0.04 percentage points over this period. With respect to liquidity requirements, the report found that a 25% increase in liquid asset holdings would have an output effect less than half that associated with a 1 percentage point increase in capital ratios. In all estimates, GDP would return to its normal path in subsequent years.[33] In its final report, the MAG also stimulated the macroeconomic impact of the changes to capital standards for an extended transition period of

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[29] BCBS, "Long-term Impact of Stronger Capital", *supra* note 27 at 7.

[30] *Ibid* at 12-13.

[31] *Ibid* at 1; MAG, "Assessing the Macroeconomic Impact of the Transition to Stronger Capital and Liquidity Requirements - Interim Report" (August 2010) at 36-37, 58, online: BIS http://www.bis.org/publ/othp10.htm [MAG, "Interim Report"].

[32] MAG, "Interim Report", *ibid*, at 3.

[33] *Ibid.*

eight years, having been agreed upon by the GHOS in September 2010.[34] The MAG estimated that bringing the global common equity capital ratio to a level that would meet the agreed minimum would result in a maximum decline in GDP, relative to baseline forecasts, of 0.22%. In terms of growth rates, this means that annual growth would be 0.03 percentage points below its baseline level during this time. This decline was then followed by a recovery in GDP towards the baseline.[35]

The importance of these reports becomes clearer when it is considered that one of the most frequently-made arguments against regulatory reforms concerns their asserted negative implications. That is to say, that higher capital and liquidity are considered to have profoundly important implications for the nascent economic recovery and possibly serious implications in the medium and longer term.[36] These reports, however, helped justify the BCBS position that stronger prudential requirements were needed and that such measures would serve the financial systems and the wider economy in the long run and would not impose unreasonable costs in the short run. The fact that these reports were prepared by central bank modeling experts drawn from a fairly diverse set of countries and other international institutions, such as the IMF, and even private sector experts were consulted in the process (in the case of MAG), imbues them with greater credibility and rigor.

4.2.5 Structure, Comprehensibility, and Responsive Interaction with Likely Users

The BCBS standards are technical and not highly comprehensible for the average citizen. This complexity, however, is more related to the standards' substantive content than to the language of the Accord *per se*, which is ostensibly plain and clear.[37] The Accord follows a logical structure, precisely defining the important terminology and scope of application. One novel feature of the Accord can be found in its introduction, which provides a non-technical overview

[34] *Ibid* at 1-2.

[35] *Ibid* at 2.

[36] See, e.g., Goldman Sachs Group, "Strengthening the Resilience of the Banking Sector— Consultative document", comment (16 April 2010), online: BIS https://www.bis.org/publ/bcbs165/cacomments.htm.

[37] Complexity of Basel standards and its implications will be further explored in Chapter 5.

of the aim and substance of the new standards.[38] This overview seems particularly useful for non-finance audiences interested to learn about the reforms that have been introduced to minimize the prospect of bank failures and taxpayer-funded bailouts.

The BCBS has made some effort to make its regulations more comprehensible and accessible for its likely users, namely banks and national supervisors. The Committee often issues supplementary guidance on the requirements set out in Basel III. An example is "Guidance for National Authorities Operating the Countercyclical Capital Buffer".[39] The document sets out what is required of national authorities responsible for operating the newly-introduced countercyclical buffer regime, and the principles they should follow in calculation and in making decisions on the buffer.[40]

Further, in partnership with the BIS, the BCBS has established the Financial Stability Institute (FSI), to assist supervisors around the world with the implementation of the prudential standards.[41] The FSI provides supervisors with the latest information on market products, practices and techniques to help them adapt to rapid financial innovation and develop solutions to challenges.[42] This objective is achieved, in particular, through holding seminars, discussion forums and conferences, which allow supervisors to share experiences and learn from each other.[43] For instance, in 2014, the FSI will conduct more than 50 conferences, high-level

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[38] BCBS, "Basel III: Capital", *supra* note 14 at 1-11.

[39] BCBS, "Guidance for National Authorities Operating the Countercyclical Capital Buffer" (December 2010) online: BIS http://www.bis.org/publ/bcbs187.htm

[40] *Ibid* at 1.

[41] *Basel Committee on Banking Supervision (BCBS) Charter*, January 2013, s 15.4, online: BIS http://www.bis.org/bcbs/charter.htm [*Charter*].

[42] FSI, "The Financial Stability Institute (FSI)" (Accessed on 27 February 2014) online: BIS http://www.bis.org/fsi/aboutfsi.htm.

[43] FSI, "FSI events and programme" (Accessed on 27 February 2014), online: BIS http://www.bis.org/fsi/activities.htm [FSI, "Events"].

meetings, and seminars for financial sector supervisors.[44] These events will cover many important aspects of the post-crisis regulatory framework such as regulation and supervision of systemically important banks, macroprudential policies and countercyclical tools, managing liquidity risks, and implementing Pillar 2 (supervisory review) under Basel III.[45]

Finally, the Committee has published some material which provide answers to frequently asked questions as well as technical elaboration on various aspects of Basel III, such as definition of regulatory capital,[46] counterparty credit risk and exposure to central clearing counter parties,[47] and calculation of short term assets for the purpose of liquidity standards.[48] The BIS website also contains tables and charts illustrating important provisions of Basel II and phase-in arrangements for its implementation.[49] These measures can be regarded as responsive implementation strategies to help foster understanding and implementation of the prudential standards. In the concluding remarks, this thesis will come back to the principle of reasoned decision making and consider the BCBS's overall success in meeting this requirement in the light of this section's discussion.

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[44] FSI, "2014 Programme" (December 2013) at 8-9, online: BIS http://www.bis.org/fsi/fsi2014.pdf [FSI, "2014 Programme"].

[45] *Ibid*.

[46] BCBS, "Basel III Definition of Capital - Frequently Asked Questions (update of FAQs published in October 2011)" (December 2011) online: BIS http://www.bis.org/publ/bcbs211.htm?ql=1.

[47] BCBS, "Basel III Counterparty Credit risk and Exposures to Central Counterparties - Frequently Asked Questions (update of FAQs published in November 2012)" (December 2012) online: BIS http://www.bis.org/publ/bcbs237.htm?ql=1

[48] BCBS, "Basel III Framework for Liquidity - Frequently Asked Questions" (July 2011) online: BIS http://www.bis.org/publ/bcbs199.htm?ql=1

[49] BCBS, "International Regulatory Framework for Banks (Basel III)" (Accessed on 4 February 2014) online: BIS http://www.bis.org/bcbs/basel3.htm

4.3 Transparency

4.3.1 Background

The BCBS has historically been noted for the opacity surrounding its operations and deliberate attempt to maintain a low profile. Huib Muller, the former BCBS chairman, once said: "We don't like publicity. We prefer, I might say, our hidden secret world of the supervisory continent".[50] However, with the start of the Basel II process in the late 1990s, came a turning point in the BCBS's transparency. At that point, the committee put a procedural mechanism in place whereby consultative documents would be publicly released and interested parties would be invited to comment. This process, which is commonly referred to as notice and comment, will be considered in some detail in the next section. Here, it suffices to note that the establishment of this process was done amidst a background of more transparency in central banking (e.g., formal inflation targets, monetary policy reports, press releases). It was also motivated by increasing pressure from financial institutions for more transparency, as well as significant dissatisfaction with Basel I.[51]

Another important shift towards transparency occurred with the adoption of the BCBS *Charter* in 2013, which brought more clarity to the BCBS's governance. Any attempt to assess the BCBS's transparency must pay close attention to the provisions of the *Charter*, as it lays out the general framework within which the BCBS communicates with the outside world. The following seeks to make such an assessment. Departing from the normative perspective outlined in the introductory theoretical remarks, it will assess the BCBS's transparency around three focal points: internal governance, decision-making procedures, and implementation of standards.

4.3.2 Transparency of Internal Governance

Under s. 7 of the *Charter*, the BCBS is comprised of four bodies: the Committee; Groups, Working Groups, and Task forces; the Chairman; and the Secretariat. The ultimate decision-

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[50] Muller, cited in Tony Porter, *States, Markets, and Regimes in Global Finance* (New York: St Martin's Press, 1993) at 66.

[51] Michael S Barr & Geoffrey P Miller, "Global Administrative Law: The View from Basel" (2006) 17:1 EJIL 15 at 24.

making authority lies with the Committee, which is also responsible for “developing, guiding and monitoring the BCBS work programme”.[52] Under s. 8.1(e), the Committee is responsible for “deciding on the organizational regulations governing its activities”. Such regulations, however, have not been disclosed and it is not therefore clear how the Committee conducts its affairs.

The list of jurisdictions and organizations that sit on the Committee as member or observer, has been made public on the BIS website.[53] However, with the exception of the Committee‘s Chairman and chairs of the sub-committees, there is no information on the actual individuals who conduct the decision making at the Committee. The BCBS’s policy in this respect stands in contrast to its peer, the FSB, which discloses information on the individuals who sit on the FSB’s plenary and sub-committees, including their institutional affiliation.[54]

The Committee’s *work programme,* which is referred to in s. 8.1(e), is not disclosed in a clear and organized fashion. Some fragmented information on the BCBS agenda can be found in the BCBS press releases. For instance, as previously mentioned, the press release on 20 November 2008 announced the BCBS's “comprehensive strategy” to address the lessons learned from the recent crisis.[55] Subsequent press releases issued between 2009-2010 reiterated this strategy and sometimes updated the progress achieved in delivering the reform promised.[56]

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[52] *Charter*, *supra* note 41, s 8.

[53] BCBS, “Basel Committee Membership” (Accessed on 1 May 2014) online: BIS http://www.bis.org/bcbs/membership.htm [BCBS, “Membership”].

[54] FSB, “FSB Plenary, Committees and Regional Consultative Groups (RCGs) Membership” (Accessed on 1 June 2014) online: FSB https://www.financialstabilityboard.org/about/pac.htm.

[55] BCBS, “Basel Committee on Banking Supervision Announces Enhancements to the Basel II Capital Framework” (20 November 2008) online: BIS http://www.bis.org/press/p081120.htm.

[56] BCBS, “Initiatives In Response to the Crisis by the Basel Committee” (30 March 2009) online: BIS http://www.bis.org/press/p090330.htm; BCBS, “Comprehensive Response to the Global Banking Crisis” (7 September 2009), online: BIS http://www.bis.org/press/p090907.htm [BCBS, “Comprehensive Response”]; BCBS, “Progress On Regulatory Reform Package: Basel Committee Press Release” (16 July 2010), online: BIS http://www.bis.org/press/p100716.htm.

It is worth noting that the BCBS communication indicates the existence of a well-defined and precise work programme. For example, the press release of 6 January 2013 announced, "the GHOS discussed and endorsed the Basel Committee's medium-term work agenda". Although the press release provided some information on issues that would be further considered by the BCBS in future, the medium-term agenda, itself, was not published on the BIS website.

The general direction for the Committee's work programme comes from the Group of GHOS, the oversight body of the BCBS.[57] The internal governance and operation of the GHOS, however, is surrounded with considerable ambiguity, raising questions. For example, when and by who, was the GHOS established? Which individuals from what institutions, currently sit on the GHOS? How many representatives can member jurisdictions have on the GHOS? How often does the GHOS meet and how does it make decisions? It is also unclear whether the BCBS observers can be part of the GHOS, particularly because since June 2013, Mario Draghi, who is the president of the European Central Bank (ECB), has been the GHOS's chair.[58] This may seem a little odd given that the ECB is only an observer on the BCBS and does not have the right to take part in the Committee's decision making. [59]

More importantly, it is not entirely clear what type of guidance, if any, is provided by the GHOS. One of the rare occasions when the BCBS records speak of the GHOS's guidance is in the press release of 12 January 2014, which reads:[60]

> At its January 2013 meeting, the GHOS also asked the Committee to undertake further work in three areas related to the LCR: (i) disclosure requirements, (ii)

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[57] *Charter*, *supra* note 41, s 6(b).

[58] European Central Bank, "The President of the European Central Bank" (Accessed on 3 March 2014) online: ECB http://www.ecb.europa.eu/ecb/orga/decisions/html/cvdraghi.en.html.

[59] S 8.4 of the *Charter* provides: " Decisions by the Committee are taken by consensus among its members." [Emphasis added]. See, *Charter*, *supra* note 41, s 8.4.

[60] BCBS, "Important Steps Towards Completion of Post-crisis Regulatory Reforms Endorsed by Group of Governors and Heads of Supervision" (12 January 2014) online: BIS http://www.bis.org/press/p140112.htm.

> the use of market-based indicators of liquidity to supplement existing measures and (iii) the interaction between the LCR and the provision of central bank facilities. [61] [Emphasis added]

However, the BCBS press release of 6 January 2013 - issued on the same day that the GHOS met in 2013 - provides a somewhat different description of the GHOS's role with respect to the Committee's work programme for the Liquidity Coverage Ratio (LCR):[62]

> The Group of Governors and Heads of Supervision (GHOS), the oversight body of the Basel Committee on Banking Supervision, met today to consider the Basel Committee's amendments to the Liquidity Coverage Ratio (LCR) as a minimum standard. It <u>unanimously endorsed them</u>. Today's agreement is a clear commitment to ensure that banks hold sufficient liquid assets to prevent central banks becoming the "lender of first resort". . . .
> <u>The GHOS reaffirmed the LCR</u> as an essential component of the Basel III reforms. <u>It endorsed a package of amendments</u> to the formulation of the LCR announced in 2010. The package has four elements . . . [Emphasis added]

When examined carefully, the second press release does not say that the BCBS *was asked* by the GHOS to undertake further work in the above areas. Rather, it suggests that that the BCBS itself recommended those areas for further work and the GHOS simply "endorsed" or "reaffirmed" them.[63] Whether such endorsement or reaffirmation can qualify as guidance is open to question.

S. 9 of the *Charter* provides that "the BCBS's work is largely organised around groups, working groups and task forces".[64] The list of these bodies has not been included in the *Charter*. [65]The

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[61] *Ibid*.

[62] BCBS, "Group of Governors and Heads of Supervision Endorses Revised Liquidity Standard for Banks" (6 January 2013), online: BIS http://www.bis.org/press/p130106.htm.

[63] *Ibid*.

[64] *Charter*, *supra* note 41, s 9.

BCBS Secretariat, however, is responsible for disclosing the list of the groups and working groups. This gives the BCBS some flexibility to establish and dissolve, and assign tasks to such bodies, as it sees fit.

As previously mentioned, the Committee currently has 5 main groups or sub-committees: the Supervision and Implementation Group; the Policy Development Group; the Macroprudential Supervision Group; the Accounting Task Force; and the Basel Consultative Group.[66] These groups often have working groups and task forces working on specific issues. The Committee does not publish a consistent degree of information on the sub-committees or working groups. For instance, while the Committee has published the list of members of the Basel Consultative Group (BCG), the composition of other groups (as well as working groups and task forces) is not made public.[67] The function of groups and working groups can generally be understood from the information provided on the BIS website but the actual tasks assigned to them are not known.[68] Nevertheless, the Committee sometimes publishes the outcomes of the research conducted by these bodies in the form of "working papers".[69]

Finally, it is to be remembered that the most important contributor to the BCBS's transparency is its website, that is part of the larger BIS website, and is administered by the Secretariat.[70] The

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[65] *Ibid*.

[66] BCBS, "Main Expert Sub-Committees" (Accessed on 12March 2014) online: BIS http://www.bis.org/bcbs/mesc.htm [BCBS, "Sub-Committees"].

[67] For the list of the members of the Basel Consultative Group, see, BCBS, "Membership", *supra* note 53.

[68] *Ibid*.

[69] BCBS, "BCBS Working Papers - Last 5 Years" (Accessed on 12 March 2014) online: BIS http://www.bis.org/list/bcbs_wp/index.htm. For instance, the working paper, "liquidity stress testing: a survey of theory, empirics and current industry and supervisory practices" presents the outcomes of the research conducted by the Research Task Force's Workgroup on Liquidity Stress-Testing. See, BCBS, "Liquidity Stress Testing: A survey of Theory, Empirics and Current Industry and Supervisory Practices" (October 2013) online: BIS http://www.bis.org/publ/bcbs_wp24.htm.

[70] *Charter, supra* note 41, s 11(1)(g). Since the BCBS website is a part of the BIS website, the terms "BCBS website" and the "BIS website" have been used interchangeably in this thesis.

information on the website is organized around 12 headings, including, “about the Basel Committee”, “Basel III”, “publications” and “press releases”.[71] The website is equipped with search tools to help users find desired information. It also allows users to download full BCBS publications without any charge and upload comments on documents that are open for consultation.[72] All comments are published on the BIS website unless the BCBS is advised to treat a comment as confidential.[73] The BCBS can also be contacted by email or phone.[74]

4.3.3 Transparency of Decision Making

The decision-making procedures of the BCBS have been broadly described in the *Charter*. The Committee, which has decision-making authority,[75] usually meets four times per year unless the Chairman decides to hold additional meetings. [76] The meetings are presided over and directed by the BCBS’s Chairman. [77]All members and observers are entitled to attend the meetings but decisions are taken by “consensus” among members.[78] Those decisions that are of a “public interest “ nature are communicated though the BIS website.[79]

The term “consensus” has not been defined in the BCBS *Charter* but it indicates that the members continue deliberation until they reach agreement. Even prior to the adoption of the

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[71] See, BCBS, “Basel Committee on Banking Supervision” (Accessed on 12 March 2014) online: BIS http://www.bis.org/bcbs/index.htm.

[72] BCBS, “Comments on Basel Committee Documents Open for Consultation” (Accessed on 12 March 2014) online: BIS http://www.bis.org/bcbs/commentupload.htm.

[73] *Ibid.*

[74] BCBS, “Contact the Basel Committee on Banking Supervision” (Accessed on 12 March 2014), online: BIS http://www.bis.org/bcbs/contact.htm.

[75] *Charter*, *supra* note 41, s 8.

[76] *Charter*, *ibid*, s 8.2.

[77] *Charter*, *ibid*, s 8.3.

[78] *Charter*, *ibid*, s 8.4.

[79] *Charter*, *ibid*, s 8.5.

Charter, decision making by consensus was the unwritten rule governing the Committee's operations and there was almost no occasion where a vote was taken.[80]

The term "public interest" is also undefined. One possible interpretation is that the BCBS discloses decisions that fall into any of the three categories of policy outcomes that have been laid out in Part VI of the *Charter*, namely, standards, guidelines, or sound practices. Such an interpretation, however, implies that any decision made prior to the adoption a policy is not of public interest and need to be disclosed. In any event, what "public interest" is and when a decision takes on such a characteristic are questions that fall within the unbounded discretion of the BCBS.

The date of the BCBS' meetings and agendas are not disclosed in advance. There is also no regularity in disclosing meetings that have been already held. The Committee's meetings take place behind closed doors and the minutes and details of deliberations are not open to the public. However, the BCBS may publish some outcomes of its meetings in press statements. Often, this disclosure is made available when the BCBS's members have reached agreement on a particular policy. For example, following its 10-11 March 2009 meeting, the Committee issued two press statements. The first statement, dated 12 March 2009, announced that the BCBS's members agreed to raise the level of capital in the banking system.[81] This was to be achieved through a combination of measures such as countercyclical buffers, strengthening of the capital measures, and non-risk based supplementary measures. The second press statement, issued two days after the meeting, namely 13 March 2009, announced the decision to expand the BCBS membership to include representatives from seven countries (Australia, Brazil, China, India, Korea, Mexico and Russia).[82]

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[80] Charles A E Goodhart, *The Basel Committee on Banking Supervision: A History of the Early Years, 1974-1997* (Cambridge, UK; New York : Cambridge University Press, 2011) at 547.

[81] BCBS, "Initiatives on Capital Announced by the Basel Committee" (12 march 2009) online: BIS http://www.bis.org/press/p090312.htm.

[82] BCBS "Expansion of Membership Announced by the Basel Committee" (13 March 2009) online: BIS http://www.bis.org/press/p090313.htm.

Another example is the press statement of 1 December 2010, which was issued following the BCBS meeting on 30 November and 1 December of 2010.[83] The statement indicated that the members agreed on the details of the Basel III rules text and that the Committee expected to publish the text by the end of 2010. The press release also said that the BCBS had discussed issues with respect to the SIFIs, cross-border bank resolution and central counter parties (CCPs).[84]

While such press statements provide useful updates on the BCBS's decisions and agendas, their potential to advance transparency cannot be overstated. Press statements are, by their very nature, general and brief communications and cannot be expected to contain important details of deliberations. Further, as mentioned above, the BCBS tends to issue press releases when agreement has been successfully achieved on a particular topic. It goes without saying, however, that achieving consensus on sensitive regulatory and supervisory issues among 27 members that have different banking systems and regulatory regimes can prove arduous. The difficulty in achieving consensus is abundantly clear from BCBS's history, particularly the Basel II process, which took seven years of intense and heated negotiations to complete. [85] Notably, these negotiations took place at a time when the BCBS included only the G10 countries, a group far smaller and more homogeneous than the current group of members.

Thus, there are occasions where disagreements emerge among members and negotiations prove fruitless. Such occasions, however, seem to be left out of the BCBS press releases. This finding

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[83] BCBS, "Results of the December 2010 Meeting of the Basel Committee on Banking Supervision" (1 December 2010) online: BIS https://www.bis.org/press/p101201a.htm.

[84] *Ibid*.

[85] The first consultative paper on Basel II was issued in June 1999. The final Accord was published in June 2006. See, BCBS, "Consultative Paper on a New Capital Adequacy Framework" (3 June 1999) online: BIS http://www.bis.org/publ/bcbs50.htm; BCBS, "Basel II: International Convergence of Capital Measurement and Capital Standards: A Revised Framework - Comprehensive Version" (June 2006) online: BIS http://www.bis.org/publ/bcbs128.htm [BCBS, "Basel II Final"].

is also aligned with s. 8.5 of the *Charter*, which provides that "the Committee shall issue, when appropriate, press statements to communicate its decisions".[86] Accordingly, when all members do not unanimously approve a decision, or when the BCBS does not consider it appropriate to announce a decision, there is no requirement for public disclosure.

4.3.4 Transparency With Respect to Implementation

A unique feature of the post-crisis governance regime of global banking is its commitment to monitor compliance with internationally-agreed standards. This commitment in turn has resulted in an unprecedented level of transparency with respect to the domestic implementation of regulatory reforms.

As previously mentioned, following the East Asian Financial Crisis, the IMF and the World Bank launched the Financial Sector Assessment Program (FSAP).[87] The FSAP was not, however, specifically focused on monitoring compliance with banking standards. Rather, it was an overarching program to identify the "strengths, vulnerabilities, and risks" of financial systems, and to help countries build "robust infrastructure for financial development".[88] Since inception, the FSAP's effectiveness was constrained by its voluntary nature, with major economies such as the United States and China refusing to join.[89] Further, the assessments were not conducted frequently enough. Many countries that had undertaken the initial FSAP assessments were reluctant to engage in the program updates. In 2006, the Independent Evaluation Office (IEO) of the IMF noted that a significant proportion of the countries that are 'systematically important' (about 20 to 25 percent) did not participate in the FSAP, and also that

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[86] *Charter*, *supra* note 41, s 8.5.

[87] IMF, "Financial Sector Assessment Program (FSAP)" (12 February 2014) online: IMF https://www.imf.org/external/np/fsap/fssa.aspx.

[88] IMF, "Financial Sector Assessment: A Handbook" (29 September 2005) at 325, online: IMF http://www.imf.org/external/pubs/ft/fsa/eng/.

[89] This statement is concerned with the FSAP prior to the crisis. See, Jakob Vestergard, *Discipline in Global Economy: International Finance and End of Liberalism* (New York: Routledge, 2009) at 125.

a "significant proportion of FSAPs that have been undertaken for countries that fit these criteria are becoming dated".[90]

However, the post-crisis situation with respect to the surveillance of national implementation of international standards appears remarkably improved. S. 5(f) of the BCBS *Charter* specifically provides for the members' commitment "to undergo and participate in BCBS reviews to assess the consistency and effectiveness of domestic rules and supervisory practices in relation to BCBS standards". In order to achieve its mandate, s. 2(e) of the *Charter* also provides that the BCBS undertake "monitoring the implementation of BCBS standards in member countries and beyond with the purpose of ensuring their timely, consistent and effective implementation and contributing to a "level playing field" among internationally-active banks".[91] In line with these provisions, the BCBS has recently started issuing semiannual reports that show the progress of members in implementation of Basel regulatory reforms. [92]

BCBS progress reports are publicly available on the BIS website.[93] Their main focus is on the adoption of Basel III. However since Basel III builds on and enhances the regulatory framework set out under Basel II and Basel 2.5[94], the implementation status of these codes are also monitored. The most recent progress report was issued in October 2013. The report sets out the implementation status of risk-based capital requirements, requirements for global and domestic

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[90] Independent Evaluation Office, *Report on the Evaluation of the Financial Assessment* Program (5 January 2006) at 7, online: IEO http://www.ieo-imf.org/eval/complete/eval_01052006.html. It is important to note that this critique is concerned with the pre-crisis FSAP and thereby does not consider the important changes that the Program has undergone since the crisis.

[91] *Charter*, *supra* note 41, s 2(e).

[92] The first progress report was published in October 2011. See, BCBS, "Progress Report on Basel III Implementation" (October 2011) online: BIS http://www.bis.org/publ/bcbs203.htm.

[93] BCBS, "Monitoring Adoption of Basel III Standards and Reports to the G20" (Accessed on 1 March 2014) online: BIS http://www.bis.org/bcbs/implementation/bprl1.htm.

[94] Basel 2.5 was agreed in July 2009. It enhanced the measurement of risks related to securitization and trending books exposures. Basel 2.5 was due to be implemented no later than the end of 2011.

systemically important banks, and the LCR as of September 2013.[95] The data collected by the reports is based on the response received from members and presented in tables, using four classifications:[96]

1. "Draft regulations not published": no draft law, regulation or other official documents, containing domestic regulatory rules, has been made public.
2. "Draft regulation published": a draft law, regulation, or other official document with enough specific details has been published.
3. "Final rule published": the domestic legal or regulatory framework has been finalized but has not yet been applied to banks.
4. "Final rule in force": the domestic legal or regulatory framework is already applicable to banks.

In addition, a color code is used to indicate the implementation status of each jurisdiction: "Green = implementation completed; "Yellow = implementation in process"; "Red = no implementation".[97] It is to be noted that progress reports are part of the larger Regulatory Consistency Assessment Program (RCAP), which also assess the consistency of domestic rules with the BCBS standards and consistency of regulatory outcomes.[98]

Finally, it must be noted that the scope of monitoring the implementation of the Basel standards extends beyond the jurisdiction of member states. The FSI conducts annual surveys on the implementation of capital and liquidity rules in non-member jurisdictions.[99] The methodology

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[95] BCBS, Progress Report on Implementation of the Basel Regulatory Framework (October 2013) at 1, online: BIS http://www.bis.org/bcbs/implementation/bprl1.htm.

[96] *Ibid* at 2-3.

[97] *Ibid* at 3.

[98] BCBS, "Basel III Regulatory Consistency Assessment Programme (RCAP)" (October 2013) online: BIS http://www.bis.org/publ/bcbs264.htm.

[99] FSI, "FSI Survey - Basel II, 2.5 and III Implementation - Introduction and Background to the Survey" (July 2013) online: BIS http://www.bis.org/fsi/fsiop2013.htm.

used by the FSI is similar to the one adopted by the BCBS. Similar to the BCBS progress reports, the results of the FSI surveys are published on the BIS website. The last survey was published in July 2013, providing information on Basel II, 2.5, and III implementation in 74 non-BCBS/non-EU jurisdictions.[100]

4.4 Consultation

4.4.1 Background

The novel idea behind the Basel Committee was to set up an informal forum where members could freely discuss important supra-national regulatory and supervisory issues.[101] In spite of the significant changes the Committee has undergone throughout the past forty years, the idea of mutual learning and informal discussion still seems prevalent in its work. Today, the BCBS operates a significant number of informal networks and forums where officials from central banks and supervisory authorities from around the world can learn from each other and provide input for its policy making.

The BCBS's work on the First Capital Accord, which will be discussed in full below, was premised on a top-down approach that did not involve much discussion with people outside community of central banks and regulators. Things, however, changed dramatically in the mid-90s, when the BCBS's proposal for the regulation of market risk faced severe criticism from large international banks that asserted to possess more knowledge and expertise in modeling market risk than regulators. A tendency then emerged in which the BCBS engaged in close consultation with banks with regard to policy proposals, particularly those concerned with the amendments of Basel I. Importantly, the Committee devised a "notice and comment" process whereby all interested parties could submit comments on the draft policies. The notice and comment were used extensively in the context of the Basel II process and continues to be used for all major policy initiatives by the Committee.

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[100] FSI, "FSI Survey - Basel II, 2.5 and III Implementation" (July 2013) at 1, online: BIS http://www.bis.org/fsi/fsiop2013.pdf.

[101] George Blunden, "Control and Supervision of the Foreign Operations of Banks" in John Edvin Wadsworth et al, eds, *The Development of financial institutions in Europe 1956-1976* (Leyden : Sijthoff, 1977) at 195.

This section takes a closer look at the channels of communication and mechanisms for consultation that are in operation in the BCBS. The first part seeks to identify the diverse sources that provide the initial input for the BCBS policy making. It will be shown that the Committee operates many informal networks and forums that make contribution to its regulatory work. The second part focuses on the BCBS public consultation mechanism, namely notice and comment. It examines the origin of the procedure and the current status as well as its operation in the Basel II and Basel III processes. Finally, the third part revisits the notice and comment procedure by scrutinizing the patterns of participation and engaging with the political economy literature on regulatory capture.

4.4.2 Source of Input for the BCBS Policy Making

The input for BCBS policy making comes from supervisory authorities and central banks of all members. As previously mentioned, the representatives of member jurisdictions and observer organizations meet at least twice a year to discuss and take decision on important regulatory and supervisory issues. [102]An important source of input for such meetings is the BCBS sub-committees, particularly the Policy Development Group (PDG), which has the responsibility to develop "policies that promote a sound banking system and high supervisory standards".[103] There are 13 specialized working groups and task forces that report to the PDG.[104] Of particular significance is the Research Task Force that "acts as a forum for research economists to engage in research projects on supervisory and financial stability issues, and for liaison with the academic sector".[105] In collaboration with the BIS, which hosts the BCBS, the RTF convenes conferences and workshops on financial stability, regulation, and supervision.[106]

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[102] *Charter*, *supra* note 41, s 8.2.

[103] BCBS, "Sub-Committees", *supra* note 66.

[104] *Ibid.*

[105] *Ibid.*

[106] *Ibid.*

In addition, the FSI, which is also hosted by the BIS, regularly holds seminars, discussion forums and conferences to allow supervisors to share experiences and learn from each other. [107] For instance, in 2014-2015, the FSI will conduct more than 50 conferences, high-level meetings, and seminars for financial sector supervisors.[108] These events cover many important aspects of the post-crisis regulatory framework such as regulation and supervision of systemically important banks, macroprudential policies and countercyclical tools, managing liquidity risks, and implementing Pillar 2 (supervisory review) under Basel III. [109]

The BCBS maintains channels of communication with other international institutions, which also contribute to the BCBS policy making. This communication is particularly the case with cross-sectoral market and regulatory developments. Under s. 16 of the *Charter*, "the BCBS cooperates with other international financial standard setters and public sector bodies with the purpose of achieving an enhanced coordination of policy development and implementation".[110]

The oldest and most important institutional setting for collaboration is the Joint Forum, which brings together the representatives from the increasingly connected realms of banking, securities and insurance supervision, to discuss issues of mutual interest and concern.[111] The Joint Forum is currently comprised of 15 jurisdictions, three standard setting bodies (BCBS, IAIS, IOSCO), and three observer institutions (IMF, European Commission, FSB).[112] Its objective is twofold: supporting the banking, insurance and securities supervisors in meeting their regulatory and supervisory objectives; and contributing to the international regulatory agenda, especially where risks exist across, or in gaps between the three supervised sectors. [113] An area where such cross-

[107] FSI, "Events", *supra* note 43.

[108] FSI, "2014 Programme", *supra* note 44 at 8-9.

[109] *Ibid*.

[110] *Charter*, *supra* note 41, s 16.

[111] Joint Forum, "Mandate of the Joint Forum" (Accessed on 13 March 2014) online: BIS http://www.bis.org/bcbs/jfmandate.htm [Joint Forum, "Mandate"]

[112] Joint Forum, "Joint Forum" (Accessed on 13 March 2014) online: BIS http://www.bis.org/bcbs/jointforum.htm.

[113] Joint Forum, "Mandate", *supra* note 111.

sectorial gaps and risks are most evident is the oversight of financial conglomerates, which has been the primary focus of the Joint Forum since its inception. Indeed, the Joint Forum was initially referred to as the "Joint Forum on Financial Conglomerates", reflecting its original mandate in addressing the issues related to conglomerates.[114] The Joint Forum's "Principles for the Supervision of Financial Conglomerates" (September 2012) [115] is aimed at closing the regulatory gaps and supervisory "blind spots" and "ensuring effective supervision of risks arising from unregulated financial activities and entities".[116] It is, however, important to note that the Joint Forum mandate goes beyond issues related to the financial conglomerates and extends to issues of interest to all three sectors, such as special purpose entities,[117] and asset securitization.[118]

As it was explained before, the BCBS membership was limited to G10 countries for a long period of time. It was only in 2009 that the BCBS membership was expanded to include G20 countries. However, in spite of its limited membership, the Committee has always attempted to involve a wide group of countries in the work pursued in Basel, and has encouraged its members to maintain contact and cooperation with non-member supervisory authorities.[119] It was partly

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[114] Joint Forum, "Joint Forum History" (Accessed on 13 March 2014) online: BIS http://www.bis.org/bcbs/jfhistory.htm.

[115] Joint forum, "Principles for the Supervision of Financial Conglomerates" (September 2012) online: BIS http://www.bis.org/publ/joint29.htm.

[116] *Ibid*.

[117] Joint Forum, "Report on Special Purpose Entities" (September 2009) online: BIS http://www.bis.org/publ/joint23.htm.

[118] Joint Forum, "Report on Asset Securitisation Incentives" (July 2011) online: BIS http://www.bis.org/publ/joint26.htm. Another similar channel of communication between the BCBS and other standard setters is the Coordination Group, a senior group of supervisors comprising the Chairmen and Secretaries General of the Committee, the IOSCO and the IAIS, as well as the Joint Forum chairman and secretariat. The Coordination group meets twice a year to exchange views on priorities and key issues of interest to supervisory standard setters. BCBS, "Basel Committee Cooperation With Other standard-setting Bodies" (Accessed on 15 March 2014) online: BIS http://www.bis.org/bcbs/coop_with_sec_and_ins.htm.

[119] *Ibid*.

achieved through the use of regional supervisory grouping and association, created under the aegis, or with the full support of the BCBS, including the Offshore Group of Banking Supervisors (OGBS),[120] The Arab Committee on Banking Supervision, the Caribbean Banking Supervisors Group, the Group of Banking Supervisors from Central and Eastern Europe, and the GCC Committee of Banking Supervisors.[121] In addition to maintaining close contact with regional groups, the BCBS assists them in a variety of ways, such as providing suitable documentation, participation in their meetings (if appropriate), offering limited secretariat assistance, and hosting meetings.[122]

A body acting as an important consultation base with jurisdictions that are not represented on the Committee is the BCG, which provides "a forum for deepening the Committee's engagement with supervisors around the world on banking supervisory issues". [123] The BCG facilitates dialogue with non-member jurisdictions on new Committee initiatives early in the process, in order to ensure that the needs of the international banking community are appropriately addressed.[124] The BCBS website is silent on when the BCG was created. A speech by Tarisa Watanagase, Governor of the Bank of Thailand, however, suggests that the BCG was created after the GFC and met for the first time during 28-29 October of 2009.[125] The creation of the BCG is undoubtedly a welcome development. Its success, however, greatly depends on its ability to include non-member countries right from the beginning of the formulation of standards rather

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[120] See, Eurasian Group on Money Laundering and Financing of Terrorism, "The Offshore Group of Banking Supervisors (OGBS)" (Accessed on 15 March 2014) online: EAG www.eurasiangroup.org/ogbs.php.

[121] A more complete list of such groupings can be found at: The Group of Banking Supervisors from Central and Eastern Europe, "Contact Information of International Groups of Supervisors" (Accessed on 15 March 2014) online: http://www.bscee.org/groups/groups.html.

[122] BCBS, "Core Principles for Effective Banking Supervision" (September 1997) online: BIS http://www.bis.org/publ/bcbs30a.htm [BCBS, "Core Principles 1997"].

[123] *Charter*, *supra* note 41, s 15.1.

[124] *Ibid*; BIS, "83rd BIS Annual Report 2012/2013" (June 2013) at 99, online: BIS https://www.bis.org/publ/arpdf/ar2013e.htm.

[125] Tarisa Watanagase, "Setting a Balanced Regulatory Reform Agenda – The Global Challenge and An Emerging Market Perspective" (31 October 2009) at 4-5, online: BIS http://www.bis.org/review/r091120d.pdf.

than at a later stage of implementation. The lack of information on the BCG activities makes it very difficult to examine the extent to which it has achieved this aim. In the final concluding remarks, this thesis comes back to the topic of consultation with non-member jurisdictions.

A prime example of the involvement of non-member countries in the BCBS policy development is the Core Principles for Effective Banking Supervision, which was formulated in response to the Asian Financial Crisis in 1997.[126] The document's 25 principles cover seven distinct areas that the Committee considered necessary for any supervisory system to be effective: Preconditions for effective banking supervision; Licensing and structure; Prudential regulations and requirements; Methods of ongoing banking supervision; Information requirements; Formal powers of supervisors; and Cross-border banking.[127] In other words, the Core Principles were intended "to serve as a basic reference for supervisory and other public authorities in all countries and internationally".[128] The Principles were the product of a working group, which brought together the Basel members as well as representatives from sixteen non-member jurisdictions, including Chile, China, Czech Republic, Hong Kong, Mexico, Russia, and Thailand. Furthermore, all the regional supervisory committees immediately endorsed the Principles.[129] The Core Principles were revised in 2006 and 2012. As of September 2012, supervisory authorities in 100 countries had endorsed the Core Principles. [130]

4.4.3 The BCBS Public Consultation Process

Under s 17 of the *Charter*, the BCBS, "in principal ... seeks input from all relevant stakeholders on policy proposals".[131] There is no specific definition of "policy proposal" in the *Charter*, but the title of s. 17 suggests that the term refers to draft standards, guidelines, and sound practices

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[126] BCBS, "Core Principles 1997", *supra* note 122.

[127] *Ibid* at 2.

[128] *Ibid* at 2.

[129] *Ibid* at 2-3.

[130] BCBS, "Core Principles for Effective Banking Supervision - Revised Version Endorsed by Global Bank Supervisors" (September 2012) online: BIS http://www.bis.org/press/p120914.htm.

[131] *Charter, supra* note 41, s 17.

adopted by the Committee. [132] The consultation process includes "issuing a public invitation to interested parties to provide comments in writing to the Secretariat on policy proposals issued by the Committee, within a specified timeframe".[133] This process is compulsory for draft standards but optional for other policy proposals, namely, sound practices, and guidelines. This consultation period is normally 90 days, but the BCBS can set a shorter or longer timeframe. [134]As previously stated in the discussion on transparency, the general rule is that comments received by the BCBS will be published on its website unless confidential treatment is requested by respondents.[135]

The notice and comment process that has been laid out in s. 17 is the main public consultation mechanism of the BCBS. The origin of the process can be traced back to the 1990s, when the BCBS commenced its work on the Market Risk Amendment. Prior to that point, the main participants in the debate on the Basel policy proposals were officials from central banks and supervisory authorities. [136] As noted by Goodhart, the BCBS members had a *top-down* approach when formulating the Basel I standards. The Committee worked quite independently from the commercial banks and while a consultative document was sent out, the important decisions had been already made. [137]

However, a different course began in 1993 when the Committee, after several years of work, published a consultative paper on the amendment of Basel I to incorporate market risk.[138] The

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[132] *Charter, supra* note 41, s 17. It is entitled: "Public consultation process of draft BCBS standards, guidelines and sound practices".

[133] *Charter, ibid*, s 17.

[134] *Charter, ibid*, s 17.

[135] *Charter, ibid*, s 17.

[136] The introduction of the BCBC proposal for Basel I suggests that the proposal was primarily circulated for comments among central banks or supervisory authorities. See, BCBS, "Proposals for International Convergence of Capital Measurement and Standards - Consultative Document" (December 1987) at 1-2, online: BIS http://www.bis.org/publ/bcbs03a.htm.

[137] Goodhart, *supra* note 80 at 563-564.

[138] BCBS, "Supervisory Treatment of Market Risks" (April 1993) online: BIS http://www.bis.org/publ/bcbs11a.htm.

paper received severe backlash from the banking industry which argued that the approach adopted by the BCBS was complex, inaccurate, and inferior to that used by international banks, namely, Value at Risk (VAR).[139] It took the BCBS three more years and two more consultative documents to modify its initial approach. The final amendment was the first set of Basel standards to recognize the use of internal models for regulatory purposes. [140]

The notice and comment became a key component of the Basel II process. After a small number of amendments from 1988 to the mid-1990s, including the market risk amendment mentioned above, the BCBS decided to undertake a comprehensive revision of Basel I. In June 1999, the Committee published a 62 page consultative paper, "A new Capital Adequacy Framework", which laid out the three pillars of the new accord: "minimum capital requirements, a supervisory review process, and effective use of market discipline".[141] The Committee sought comments from all interested parties by 31 March 2001.[142] The comments received by the BCBS were not released but Duncan Wood estimates that by May 2000, the BCBS had received more than 200 comments.[143] The comments covered various key issues, such as, disclosure, external credit rating, and internal rating by banks, operational risk, and criticism with respect to the procylicality of the new accord.[144] In January 2001, the BCBS published the second consultative package, a revised version of the 1999 package that was modified in the face of comments received by the BCBS. The new draft maintained most key elements of the first proposal, particularly the emphasis "on three mutually reinforcing pillars that allow banks and supervisors to evaluate properly the various risks that banks face". [145] It was, however, considerably longer

[139] Goodhart, *supra* note 80 at 564.

[140] BCBS, "Amendment to the Capital Accord to Incorporate Market Risks" (January 1996) online: BIS http://www.bis.org/publ/bcbs24.htm.

[141] BCBS, "A New Capital Framework" (June 1999) online: BIS http://www.bis.org/publ/bcbs50.htm.

[142] *Ibid* at 7.

[143] Duncan Wood, *Governing Global Banking: The Basel Committee and the Politics of Financial Globalization* (Aldershot, Hants, England ; Ashgate, 2005) at 134.

[144] *Ibid* at 134-137.

[145] BCBS, "Basel II: The New Basel Capital Accord - Second Consultative Paper" (January 2001) online: BIS http://www.bis.org/bcbs/bcbscp2.htm.

and more detailed than the first package, exceeding five hundred pages.[146] In order to increase the transparency of the consultative process, the BCBS published the comments (over 250) that it received during the second consultative process on its website.[147]

The BCBS had intended for the finalization of the new accord by the end of 2001. [148] However, due to the number of comments and their nature, the BCBS decided in June 2001 to modify the timetable for the completion of the accord and "to continue working cooperatively with the industry to achieve the best possible proposals".[149] In April 2003, the Committee issued its proposals for the third round of consultation and received more than 200 comments which were publicly released on its website.[150] An additional round of consultation was held in October 2003 on specific aspects of the Committee's proposals, such as treatment of expected and unexpected losses, and the treatment of securitization.[151]

In May 2004, the BCBS announced that it had reached agreement on the remaining issues and released the contours of the consensus on Basel II proposals.[152] In June 2004, the G10 central bank governors and heads of supervision endorsed the publication of the revised capital

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146 *Ibid*.

147 BCBS, "The New Basel Capital Accord: Comments Received on the Second Consultative Package" (Accessed on 12 March 2014) online: BIS http://www.bis.org/bcbs/cacomments.htm.

148 BCBS, "The New Basel Capital Accord: An Explanatory Note" (January 2001) online: BIS http://www.bis.org/bcbs/bcbscp2.htm.

149 BCBS, "Update on the New Basel Capital Accord" (25 June 2001) online: BIS http://www.bis.org/press/p010625.htm.

150 BCBS, "Basel II: The New Basel Capital Accord - Third Consultative Paper" (April 2003) online: BIS http://www.bis.org/bcbs/bcbscp3.htm; BCBS, "The New Basel Capital Accord: Comments Received On the Third Consultative Paper" (Accessed on 15 March 2014) online: BIS http://www.bis.org/bcbs/cp3comments.htm.

151 BCBS, "Basel II: Significant Progress On Major Issues" (11 October 2003) online: BIS http://www.bis.org/press/p031011.htm.

framework. [153] The governors and supervisors extended thanks to all who contributed to the Basel II process, helping develop and strengthen the quality of the revised framework over the six years of negotiations.[154] They also indicated that the Committee's work "benefited from the transparency and scale of the public consultations that took place both within the G10 countries and around the world, helping to make the new framework a global product".[155]

The notice and comment rule making was used in a similar fashion with respect to Basel III. As previously mentioned, the new standards on capital and liquidity were issued in the form of two consultative documents on 17 December 2009 and all interested parties were invited to comment within four months (by 16 April 2010). The BCBS received 272 comments on both documents, which were published on its website. [156]

Interestingly, the Basel III process was remarkably shorter than that of Basel II, which took six years to complete. The Committee conducted only one round of consultation on new rules and the final rules were issued in less than eight months after the closure of the consultation period.[157] One reason for expeditious completion of Basel III was that the BCBS was determined, and under pressure, to respond to the GFC in a timely manner. Strengthening the prudential oversight of banks was one of the key priorities of the G20 leaders in the Washington Summit. As the primary global prudential standard setter, the BCBS had been asked to strengthen the capital requirements and develop robust rules for liquidity supervision.[158]

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[153] BCBS, " Basel II Final", *supra* note 85.

[154] BCBS, "G10 Central Bank Governors and Heads of Supervision Endorse the Publication of the Revised Capital Framework" (26 June 2004), online: BIS http://www.bis.org/press/p040626.htm.

[155] *Ibid.*

[156] The number of comments is based on the author's calculation. BCBS, "Comments received on the consultative documents "Strengthening the resilience of the banking sector" and "International framework for liquidity risk measurement, standards and monitoring"" (Accessed on 15 March 2014) online: BIS http://www.bis.org/publ/bcbs165/cacomments.htm.

[157] BCBS, "Basel III: Capital", *supra* note 14; BCBS, "Basel III: Liquidity", *supra* note 14.

[158] G20, "Declaration of the Summit on Financial Markets and the World Economy Washington Summit" (15 November 2008) online: G20 Information Centre www.g20.utoronto.ca/2008/2008declaration1115.html.

Furthermore, as it will later be shown, Basel III maintains the key elements of Basel II, including its three-pillar structure. The revisions made to Basel III are largely concerned with upgrading the quantity and quality of regulatory capital, departing from the premise laid out by Basel II. Thus, in contrast to Basel II, Basel III did not overhaul the pre-existing capital adequacy regime. Finally, it is to be noted that Basel III is by no means a final or exhaustive body of post-crisis regulatory reforms. Some important parts of Basel III, such as liquidity rules and leverage ratio, are still under development or revision.[159] There are also reform initiatives such as special resolution regimes and prudential regulation of G-SIBs, which are pursued outside the Basel III framework.[160]

4.4.4 The BCBS Public Consultation Revisited

The establishment of notice and comment rulemaking at the BCBS has been largely welcomed. For instance, Barr and Miller consider the process evidence of the long way the committee has come from the closed "club" model of its origins and of the possibility for greater accountability of international regulation.[161] Germain also considers the use of notice and comment in the context of Basel II an important deliberative process that demonstrates “unprecedented openness together with the expanded number of ‘participants’”.[162]

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[159] BCBS, “Amendments to Basel III's Leverage Ratio Issued by the Basel Committee” (12 January 2014) online: BIS http://www.bis.org/press/p140112a.htm; BCBS, “Proposed Requirements on Banks' Disclosure of the Liquidity Coverage Ratio Issued by the Basel Committee” (19 July 2013) online: BIS http://www.bis.org/press/p130719.htm.

[160] See, BCBS, “Report and Recommendations of the Cross-border Bank Resolution Group - Final Paper” (March 2010) online: BIS http://www.bis.org/publ/bcbs169.htm; BCBS, “Global Systemically Important Banks: Updated Assessment Methodology and the Higher Loss Absorbency Requirement” (July 2013) online: BIS http://www.bis.org/publ/bcbs169.htm.

[161] Barr & Miller, *supra* note 51 at 24-28.

[162] Randall D Germain, “Financial Governance and Transnational Deliberative Democracy (Paper prepared for the conference, “Pathways to Legitimacy? The Future of Global and Regional Governance” Centre for the Study or Regionalisation and Globalisation University of Warwick, 17-19 September 2007) at 18.

While there is certainly merit in these observations, it is important to note that since its adoption, the notice and comment process has been dominated by the banking industry, with most comments lobbying for less robust regulation. For instance, with respect to Basel III (which will be discussed in the next section), approximately 230 comments (out of 274) came from industry players.[163] In their comments, large firms such as Goldman Sachs,[164] Morgan Stanley,[165] and the Bank of America[166] expressed concern over the committee's proposals aimed at strengthening the resilience of the banking sector. In particular, these large firms warned against the new rules' rigidity, risk-insensitivity, and disproportionality, as well as unrealistic implementation timeline and potential negative impact on the broader economy. A similar pattern of participation from banks was also observable with respect to the previous Basel Accord. In fact, the extensive mobilization and lobbying efforts by private sector groups led many international political economy (IPE) scholars to cite Basel II as the primary example of "capture of the regulatory process by the industry it is supposed to regulate".[167] For Baker, Basel II is an excellent example of regulatory capture in the international setting;[168] for Underhill and Zhang, Basel II is a prime example of "the domination of global financial supervision and regulation by private actors".[169] In addition, IPE scholars have argued that concerted lobbying by financial institutions actively

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[163] The numbers are based on the author's calculation. BCBS, "Comments Received on the Consultative Documents "Strengthening the resilience of the banking sector" and "International framework for liquidity risk measurement, standards and monitoring" (2009) online: BIS http://www.bis.org/publ/bcbs165/cacomments.htm.

[164] Goldman Sachs, "Comment Submitted to the BCBS on "Strengthening the Resilience of the Banking Sector_ Consultative Document"" (2010) at 1-2, online: BIS http://www.bis.org/publ/bcbs165/goldmansachscap.pdf.

[165] Morgan Stanley, "Comment Submitted to the BCBS on "Strengthening the Resilience of the Banking Sector_ Consultative Document"" (2010) at 1-2, online: BIS http://www.bis.org/publ/bcbs165/morganstanley.pdf.

[166] Bank of America, "Comment Submitted to the BCBS on "Strengthening the Resilience of the Banking Sector_ Consultative Document"" (2010) at 3-4, online: BIS http://www.bis.org/publ/bcbs165/boac.pdf.

[167] Eric Helleiner & Tony Porter, "Making Transnational Networks More Accountable" in Sara Burke, ed "Re-Defining the Global Economy" (Friedrich Ebert Stiftung Occasional Paper No. 42, New York, 2009) 14 at 20.

[168] Andrew Baker, "Restraining Regulatory Capture? Anglo-America, Crisis Politics and Trajectories of Change in Global Financial Governance" (2010) 86:3 International Affairs, 647 at 650.

[169] Geoffrey R D Underhill & Xiaoke Zhang, "Setting the Rules: Private Power, Political Underpinnings, and Legitimacy in Global Monetary and Financial Governance" (2008) 84:3 International Affairs 535 at 553.

contributed to the permissive regulatory characters of the Basel II, which was completed prior to the eruption of the crisis of 2007-2009. As such, some scholars have traced the flaws to successful lobbying by banks against robust regulations. Mattli and Woods, for instance, argue that Basel II rules, which allowed large banks to use their own risk modes in determining the minimum regulatory capital buffers, created perverse incentives for banks to underestimate credit risk in order to minimize the required regulatory buffers and maximize return on equity.[170] Similarly, Helleiner and Porter note that the "loose, elite, and highly technical character" of the BCBS provides privileged access points for business groups. In particular, they point out that the Institute of International Finance (IIF), which represents global financial firms, successfully promoted the use of internal risk models in Basel II, which proved to be inadequate in the crisis.[171]

Interestingly, the argument for regulatory capture goes beyond the IPE literature. Goodhart, a BCBS historian, argues that after the Market Risk Amendment (1997), the BCBS adopted a tendency "to believe that the right approach for the BCBS was to base regulatory norms on the 'best' models constructed by the banks for their own risk management purposes".[172] He considered this tendency "a variant of the 'capture' hypothesis wherein regulators came to adopt the self-interested positions of the regulated", ignoring the crucial difference that exist between the objectives of regulators (i.e. preventing externalities and market failures) and those of bankers (i.e. maximizing the current value of future discounted income flows).[173] In fact, Goodhart was among the seven economists who strongly warned the BCBS against the adoption of internal models for regulatory purposes. In a comment submitted during the Basel II consultation process, these economists argued that internal models used by banks for forecasting

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[170] Walter Mattli & Ngaire Woods, "Introduction" in Walter Mattli and Ngaire Woods, eds, *The Politics of Global Regulation* (Princeton: Princeton University Press, 2009) at ix.

[171] Helleiner and Porter, *supra* note 167 at 20.

[172] Goodhart, *supra* note 80 at 564.

[173] *Ibid*.

risks "have been proven to give inconsistent and biased forecasts" and can become an *endogenous* source of instability.[174]

While the capture hypothesis is a ubiquitous theme in the literature on Basel II, the extent to which campaigns by banks have actually influenced the BCBS policy outcomes still seems to be an unsettled question. In a recent study, Young argues that the private sector's influence over the Accord's content was more circumscribed than the regulatory capture narrative suggested by the IPE scholars.[175] He presents three case studies where private interest groups, such as the IIF, were not successful in weakening the Basel II regulatory standards on internal risk modelling and operational risk.[176] At the same time, however, it is important to note that the banking industry obtained important concessions in the Basel II consultation process, including removal of the minimum capital requirement for operational risk,[177] elimination of capital buffers for

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[174]Jon Danielsson et al, "An Academic Response to Basel II" (LSE Financial Markets Group, Special Paper No 130, 2001) at 3, online: Istituto Einaudi
:http://www.istein.org/e-library/advanced-search/item/5341-an-academic-response-to-basel-ii.html.

[175] Kevin L Young, "Transnational Regulatory Capture? An Empirical Examination of the Transnational Lobbying of the Basel Committee on Banking Supervision" (2012)19:4 Review of International Political Economy 663 at 665.

[176] *Ibid* at 671-677.

[177] The BCBS defines the operational risk as "the risk of direct or indirect loss resulting from inadequate or failed internal processes, people and systems or from external events". In other words, operational risk is anything that could severely disrupt banks' operation such as computer failures, fraud or severe weather conditions. BCBS, "Operational Risk_ Consultative Document" (2001) online: BIS http://www.bis.org/publ/bcbsca07.pdf.
The BCBS's press statement of 10 July 2002 reads as follows:

> Against this background of significant progress, the Committee reaffirms its intention to proceed with a Pillar One approach to operational risk. However, in the light of the continuing evolution of analytical approaches for operational risk, the Committee intends that the AMA [advanced measurement approach] will provide significant flexibility to banks in the development of operational risk measurement and management systems. Accordingly, the Committee will no longer mandate a floor capital requirement on operational risk in conjunction with the AMA. The Committee intends to work closely with the industry and monitor its progress in regard to operational risk approaches. [emphasis added]

derivatives,[178] as well as an acceptance of the reduction of capital buffers below the 8% requirement.[179] Thus, while Young's analysis shows that the degree of private sector influence varied in different stages and needs to be empirically investigated further, it does not question the influence that the banking industry exercised over the development of BCBS standards prior to the crisis.

Another important theme relevant to the BCBS's consultation process is the phenomenon of 'Groupthink'. Broadly speaking, groupthink refers to the tendency among homogenous, cohesive groups to only consider issues within a certain paradigm, often leaving the basic premises of issues unchallenged.[180] Sunstein uses the term 'enclave deliberation' to explain a similar phenomenon: deliberation among like-minded people who spend much of their time in isolated enclaves without sufficient exposure to competing views and voices other than echoes of their own.[181] The BCBS's composition of like-minded regulators, with similar education and career backgrounds, restricts the range of arguments and perspectives heard during the deliberations of policy options, thus increasing the likelihood of enclave deliberation. Indeed, groupthink or

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See, BCBS, "Basel Committee Reaches Agreement on New Capital Accord Issues" (2002) online: BIS http://www.bis.org/press/p020710.htm [BCBS, "Agreement on New Accord"].

[178] Wood, *supra* note 143 at 141.

[179] The decision to allow banks to maintain capital buffers below 8% was announced by the BCBS in 2002:

> Under the new approach, there will be a single capital floor for the first two years following implementation of the new Accord. This floor will be based on calculations using the rules of the existing Accord. Beginning year-end 2006 and during the first year following implementation, IRB capital requirements for credit risk together with operational risk capital charges cannot fall below 90% of the current minimum required, and in the second year, the minimum will be 80% of this level.

See, BCBS, "Agreement on New Accord", *supra* note 177.

[180] Irving L Janis, *Groupthink: Psychological Studies of Policy Decisions and Fiascoes*, 2nd ed (Boston, Massachusetts: Houghton Mifflin, 1982).

[181] Cass R Sunstein, "The Law of Group Polarization" (2002) 10:2 Journal of Political philosophy 175 at 188; Andrew Baker, "Deliberative International Financial Governance and Apex policy forums: Where We Are and Where Should be Headed" in Geoffrey R D Underhill, et al, eds, *Global Financial Regulation Thirty Years On: From Reform to Crisis* (New York: Cambridge, 2010) at 65.

enclave deliberation can partly explain why the BCBS failed to detect the key flaws of the Basel Accords regulations that later contributed to the GFC.[182] This thesis comes back to the issue of groupthink in the final chapter where it offers some thoughts on enhancing the BCBS's exposure to a more diverse range of approaches and arguments.

Prior to leaving the discussion on consultation, it should be pointed out that in addition to notice and comment the BCBS uses meetings to discuss its regulatory initiatives with stakeholders. Not only is the official record of such meetings not publicly available, participation appears limited to regulatory officials and industry representatives. For instance, in 2009, a group of European and US bank executives were invited to the BIS for a closed-door meeting with regulators and central bankers to discuss the post-crisis regulatory agenda. [183]

In recent years, some civil society associations have expressed serious concerns with "the one-sided involvement of the financial industry within the Basel framework" and have requested similar access to BCBS meetings. [184] To date, however, there has been no occasion for civil society participation in such meetings and no sign that the BCBS is going to change this precedent.

4.5 Oversight

4.5.1 Background

The last section of this chapter seeks to examine the oversight arrangements for the BCBS's policy making. The focus is on international oversight mechanisms, namely those that operated prior to the transposition of the BCBS standards into the national systems. International oversight of the BCBS is of particular significance for a number of reasons. First, the institutional design of the BCBS means that its decisions are several steps removed from national authorities. The

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[182] A brief discussion of such shortcomings is provided in Chapter 5 of this thesis.

[183] Myriam V Stichele et al, "Letter to the Chairman of the Basel Committee on Banking Supervision" (2009) online: Bank Track http://www.banktrack.org/manage/ems_files/download/letter_to_basel_committee_on_consultations.

[184] *Ibid*.

participants at the BCBS are neither elected representatives nor diplomats. Instead, they are bureaucrats in sub-national regulatory agencies and central banks—institutions that typically have substantial autonomy from elected legislatures and government executives.[185] Second, BCBS decisions are not subject to formal ratification by national governments but are usually implemented by the broad rule-making powers of financial regulators.[186] Currently, there are two institutions that can exercise oversight over the BCBS at the international level: the GHOS and the G20. The GHOS has been expressly designated as the BCBS oversight body in the *Charter* and appears to have been in operation since 2009.

The G20 does not have any formal authority over the BCBS but it seems noteworthy for the purpose of this analysis given the influence that it exercises over the post-crisis financial reform. The example of such influence include the BCBS expansion of membership at the G20's request in 2009, the G20's endorsement of major BCBS policy initiatives such as Basel III, and regular reporting by the BCBS to the G20 on implementation of banking standards. The nature and channels of oversight employed by both institutions will be investigated in detail below.

As a final introductory note, it must be pointed out that the focus on the international oversight mechanisms in this section is a choice of method and not meant to underestimate the significance of domestic oversight arrangements. Moreover, the contribution that domestic mechanisms can make to the BCBS accountability will be considered in the concluding remarks.

4.5.2 The Group of Governors and Heads of Supervision

The issue of oversight has been addressed in part III of the BCBS *Charter*. Under s. 6, "The GHOS is the oversight body of the BCBS".[187] The Committee reports to the GHOS and "seeks its endorsement for major decisions".[188] S. 6 also gives the GHOS other powers which are

[185] Young, *supra* note 175 at 41.

[186] Chris Brummer. *Soft Law and the Global Financial System: Rule Making in the 21st Century* (Cambridge; New York: Cambridge University Press, 2012) at 188.

[187] *Charter*, *supra* note 41, s 6.

[188] *Ibid*.

significant in terms of oversight: approving the BCBS *Charter* and its subsequent amendments; providing general direction for the Committee's work program; and appointing the BCBS Chairman.[189]

As previously mentioned, the governance and operations of the GHOS is surrounded by uncertainty, in turn making difficult the analysis of its oversight function. Although it is not clear when the GHOS came into existence, the BCBS communications have been referring to the GHOS since 2009. The first reference was in the press release of 7 September 2009, which announced that the GHOS had met "to review a comprehensive set of measures to strengthen the regulation, supervision and risk management of the banking sector".[190] The key measures agreed by GHOS, such as raising the quality, consistency and transparency of Tier 1, were the same as those announced earlier by the BCBS as part of its comprehensive response strategy to the crisis.[191] Subsequent press statements also spoke of the GHOS meeting to review the Committee's work on regulatory capital,[192] G-SIBs,[193] liquidity standards,[194] and leverage ratio.[195] The results of such meetings, to the extent evident from publicly available information, have been endorsements of the BCBS policies. There is no occasion where the GHOS has overturned the BCBS proposals or asked for their revision.

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[189] *Ibid.*

[190] BCBS, "Comprehensive Response", *supra* note 56.

[191] *Ibid.*

[192] BCBS, "Basel Committee Issues Final Elements of the Reforms to Raise the Quality of Regulatory Capital" (13 January 2011) online: BIS http://www.bis.org/press/p110113.pdf.

[193] BCBS, "Measures for Global Systemically Important Banks Agreed by the Group of Governors and Heads of Supervision" (25 June 2011) online: BIS http://www.bis.org/press/p110625.htm.

[194] BCBS, "Basel III Liquidity Standard and Strategy for Assessing Implementation of Standards Endorsed by Group of Governors and Heads of Supervision" (8 January 2012) online: BIS http://www.bis.org/press/p120108.htm; BCBS, "Group of Governors and Heads of Supervision Endorses Revised Liquidity Standard for Banks" (6 January 2013) online: BIS http://www.bis.org/press/p130106.pdf.

[195] BCBS, "Iimportant Steps towards Completion of Post-crisis Regulatory Reforms Endorsed by Group of Governors and Heads of Supervision" (12 January 2014) online: BIS http://www.bis.org/press/p140112.htm.

The oversight exercised by the GHOS can be compared with that of the G10 central bank governors to whom the BCBS solely reported prior to the expansion of its membership in 2009. Theoretically, the G10 central bank governors had the authority to reject the BCBS proposals. Goodhart's study of the BCBS's history (1974-1997), however, suggests that the real position was different.[196] The G10 had established the BCBS as a committee of specialists in bank regulation. The G10 would, therefore, consider it very difficult to reject a BCBS proposal, particularly on a technical basis.[197] It is true that the G10 often set priorities for the BCBS and frequently require papers to be revised. At the same time, however, the committee was given significant freedom to decide its own agenda and the policies emerging from it were frequently "rubber-stamped".[198] In short, the G10 governors did not have the time or the desire to critically assess the BCBS proposals. Their oversight was general and the details left to be finalized within the committee.[199]

To be sure, the composition of the GHOS is different from that of the G10, as the former includes non-central bank supervisors, and hosts a larger number of jurisdictions, including emerging economies. Interestingly, however, the quality of its oversight seems similar to and perhaps milder than that exercised by the G10 governors, given that it has so far rubber-stamped all the BCBS proposals without requiring any revisions. Important questions also arise regarding the independence of the GHOS from the BCBS. While the officials on the GHOS seem to have higher ranks than those present on the Committee, they all come from the same set of institutions (central banks and supervisory authorities). The BCBS records even indicate the Committee's Chairman has been present at the GHOS meetings.[200] Therefore, one should be cautious not to

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[196] Goodhart, *supra* note 80 at 544-545.

[197] *Ibid*.

[198] *Ibid* at 545.

[199] *Ibid* at 544-545.

[200] BCBS, "Group of Governors and Heads of Supervision Announces Higher Global Minimum Capital Standards" (September 2010) online: BIS http://www.bis.org/press/p100912.htm; BCBS, "The Group of Governors and Heads of Supervision Reach Broad Agreement on Basel Committee Capital and Liquidity Reform Package" (26 July 2010) online: BIS http://www.bis.org/press/p100726.htm.

consider the GHOS an independent oversight body at arm's length from the Committee, tasked with neutral evaluation of its policies.

4.5.3 The G20

As state above, the transposition of Basel III standards into domestic regulations is now monitored by the BCBS, based on the information provided by the member jurisdictions. A key element of the monitoring process is increasing transparency, including reporting to the G20. [201] The reports prepared for the G20 are very similar to the regular progress reports published on the BCBS website. They are published on a semi-annual basis and use the numerical grades with an overlay of color codes denoting different stages of adoption of standards. The latest BCBS report also seeks to update the G20 officials on the Committee's work on banks' calculation of risk-weighted assets and policy options under consideration to ensure harmonized and consistent application of the standards.[202] In the past, and prior to the launch of the monitoring program, the BCBS also submitted a report to the G20 on the initiatives it adopted in response to the crisis. "The Basel Committee's Response to the Financial Crisis" was in fact the first report prepared by the Committee for the G20. [203] It detailed the key elements of the BCBS reform program and future work to strengthen the resilience of banks and the global banking system. [204]

Although the nature of the relationship between the BCBS and the G20 is far from clear, the BCBS reporting to the G20 could suggest a hierarchical relationship whereby the Committee's operations and policies are monitored by the G20. A parallel in this respect can be drawn with the accountability of national regulators to parliaments, which is partly achieved through reporting requirements. Reason for such inference of oversight is reinforced considering the

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[201] BCBS, "Monitoring adoption of Basel III standards and reports to the G20" (Accessed on 25 March 2014) online: BIS http://www.bis.org/bcbs/implementation/bprl1.htm.

[202] BCBS, "Report to G20 Leaders on Monitoring Implementation of Basel III Regulatory Reforms" (August 2013) online: BIS http://www.bis.org/publ/bcbs260.htm.

[203] BCBS, "The Basel Committee's Response to the Financial Crisis: Report to the G20" (October 2010) online: BIS http://www.bis.org/publ/bcbs179.pdf.

[204] *Ibid*.

G20's prominence as a forum for cooperation in the post-crisis global economic order.[205] In the wake of the GFC, the G20 took the lead in coordinating the response to the financial crisis. In the organizations' first Leaders Summit in Washington, heads of states tasked finance ministers with, among other things, enhancing sound regulation, promoting integrity of financial markets and reinforcing international cooperation.[206] The Washington Summit's Declaration contained a 47-point action plan to arrest deteriorating financial market conditions and improve financial regulation over the medium term.[207] In 2009 in London, the G20 released a Leaders' Statement that took a step forward by committing to take whatever action necessary to strengthen financial regulation and supervision.[208] The statement was completed by a Declaration, *Strengthening the Financial System*, which tackled a range of inadequately addressed issues in the previous regulatory order such as hedge funds, OTC derivatives, executive compensation, and credit rating agencies. [209] The work of these two summits continued in subsequent summits such as Pittsburg, Seoul, and Cannes and covered not only financial regulation but account imbalances, IMF governance reform, anti-protectionism and facilitation of international trade.

What is said above leaves little doubt that the G20 exerts influence over the financial reform agenda, its pace and implementation. The forum seems to have taken over from the G10, an earlier "G" that was the BCBS's parent for more than 30 years. This transition of power was reflected in the BCBS expansion to include the G20 countries in 2009. Nonetheless, it is hard to conceive the G20 as a true oversight body for an international technocratic institution, such as the BCBS. In fact, the G20's output on financial regulation is hardly novel, given that it mostly reiterates the initiatives that are underway in other forums. For instance, consider the

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[205] Brummer, *supra* note 186 at 71-72.

[206] G20, "2008 Washington" (Accessed on 21 June 2015) online: G20 https://www.g20.org/about_g20/past_summits/2008_washington

[207] *Ibid.*

[208] G20, "Global Plan for Recovery and Reform" (Statement Issued by the G20 Leaders London, 2 April 2009) online: G20 Research Group http://www.g20.utoronto.ca/2009/2009communique0402.html.

[209] G20, "Global Plan Annex: Declaration on Strengthening the Financial System" (Statement Issued by the G20 Leaders London, 2 April 2009) online: G20 Information Centre http://www.g20.utoronto.ca/2009/2009ifi.html.

Washington Summit, which at the time was hoped to be a "Bretton Woods II", and to redesign international financial architecture.[210] As mentioned above, at the end of the summit the G20 leaders published a very detailed communiqué, outlining a wide range of commitments on the regulatory front. However, the G20 policy agenda did not go much beyond the pre-existing international initiatives that had already been developed in international regulatory forums, such as the FSF (FSB's predecessor).[211]

In April 2008, the FSF published a comprehensive set of reforms drawing on the extensive body of work by national authorities and international regulatory and supervisory bodies, such as BCBS, IOSCO, and the IASB. [212] These reforms were quickly endorsed by the G7 countries and in the process of implementation by the time of the Washington Summit. At the core of the FSF's recommendation was strengthening capital adequacy standards, particularly with respect to securitization and trading book.[213] Prior to the G20 summits, the BCBS had already started its work closing the regulatory loopholes of Basel II, proposing amendments which would require banks to hold capital against trading book assets or off-balance sheet items (known as Basel 2.5).[214] The BCBS had also taken steps to ensure sound liquidity risk management.[215]

The final declaration of the Washington Summit supported the initiatives undertaken by the FSF and BCBS, among others, requesting regulators to 'set out strengthened capital requirements for

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[210] "Financial Crisis: Gordon Brown Calls for 'New Bretton Woods'" *The Telegraph* (13 October 2008) online: www.telegraph.co.uk; George Parker & Daniel Dombey, "European call for 'Bretton Woods II'" *Financial Times* (October 16, 2008) online: http://www.ft.com.

[211] Eric Helleiner & Stefano Pagliari, "Towards a New Bretton Woods? The First G20 Leaders Summit and the Regulation of Global Finance" (2009) 14(2) New Political Economy 276 at 276.

[212] FSF, *Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience* (April 2008) online: Financial Stability Board http://www.financialstabilityboard.org/publications/r_0804.pdf.

[213] *Ibid* at 12-20.

[214] BCBS & IOSCO, *Guidelines for Computing Capital for Incremental Risk in the Trading Book* (July 2008) online: BIS http://www.bis.org/publ/bcbs141.htm.

[215] BCBS, "Sound Liquidity", *supra* note 6.

banks' structured credit and securitization activities', and 'to ensure that financial firms implement policies to better manage liquidity risk, including by creating strong liquidity cushions'.[216] A similar pattern can be discerned with respect to other regulatory reforms recommended by the G20, such as ending too-big-to-fail, making derivatives safer, and transforming shadow banking. The policy initiatives with respect to these issues were started and developed in other forums.[217]

The feedback provided by the G20 on the BCBS initiatives is very general, lacking any specific details or assessment. For instance, the Los Cabos Declaration (2012) recognized the "substantial progress" in implementing the Basel capital and liquidity framework, urged "jurisdictions to fully implement the standards according to the agreed timelines", and welcomed "the Basel Committee's consultative proposals for a fundamental review of the market risk framework".[218] Similarly, the G20 Finance Ministers and Central Bank Governors Communiqué (April 2012) reaffirmed their "commitment to common global standards by pursuing the financial regulatory reform agenda" according to the agreed timetable, and took note of and looked forward to the completion of the FSB and BCBS's work on "extending the SIFI framework to domestic systemically important banks (D-SIBs)".[219]

4.6 Conclusion

This chapter examined the BCBS's legitimacy and accountability against the criteria introduced in the theoretical framework. The findings of the analysis suggests that the BCBS does not score equally on all criteria. The best score seems to be achieved on reasoned decision making. In the

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216 G20, "Declaration— Summit on Financial Markets and the World Economy" (15 November 2008) online: G20 https://www.g20.org/sites/default/files/g20_resources/library/Washington_Declaration_0.pdf.

217 FSB, "To G20 Finance Ministers and Central Bank Governors Financial Reforms – Progress and Challenges" (17 February 2014), online: G20 Library https://www.g20.org/official_resources/library.

218 G20, "G20 Leaders Deceleration" (Las Cabos, Mexico, 19 June 2012) online: G20 Information Centre http://www.g20.utoronto.ca/2012/2012-0619-loscabos.html.

219 G20, "Final Communiqué: Meeting of G20 Finance Ministers and Central Bank Governors" (20 April 2012) online: G20 Information Centre http://www.g20.utoronto.ca/2012/2012-120420-finance-en.html.

Basel III process, the BCBS published its draft proposals for Basel III in a timely manner and invited the interested parties to comment on all aspects of proposal. The document produced under this process, namely Basel III, has a logical structure and clearly articulates the rational and objective of the reforms. The Quantitative Impact Study combined with other robust regulatory impact assessments helped justify the case for stronger capital and liquidity requirements. The BCBS also took important steps to maintain its communication with the likely users of its standards and to facilitate their comprehensibility and implementation.

The BCBS has undoubtedly become more transparent over time. The adoption of the notice and comment, the online disclosure of policy documents and the newly-adopted *Charter* has made the Committee's work more visible to the public. In addition, the BCBS surveillance program has brought unprecedented transparency to the implementation of the post-crisis reforms. However, there remains significant information gaps regarding the BCBS's internal governance and decision making. Importantly, the only publicly available source of information on the BCBS's deliberations is press statements, which often disclose selective facts and remain silent on the critical aspects of negotiations. As a result, the BCBS's constituencies are not aware of the reasoning and deliberations that shape BCBS policy decisions, neither are they savvy to both the tradeoffs that have been made and other available policy options.

The BCBS's efforts to facilitate communication and mutual learning among central banks and supervisory authorities and to maintain contact with other international regulatory organizations and fora is remarkable and must be acknowledged. The BCBS's notice and comment is also a sound procedural device to keep the public informed and seek their input on important initiatives. From the perspective of accountability, however, the real benefits of notice and comment cannot be overstated given that it has been mostly used as a lobbying tool by banks rather than as a mechanism for conveying the demands and concerns of a broad set of stakeholders. It is also important to remember that notice and comment only applies to the final stage of the Basel process - in other words, completed drafted policies and rules. Thus, the committee's detailed working procedures are clouded by great uncertainty.

To the extent that public information is available, the BCBS is not currently subject to any form of robust international oversight. The overlapping membership of the GHOS twinned with the technical nature of the BCBS's work, makes it unlikely for the GHOS to conduct a strict review or reach a different conclusion than the BCBS. And while the G20 provides the political support for the BCBS initiatives, it does not engage in any meaningful evaluation of its regulatory outputs. To date, the G20 leaders have merely vowed their support for the BCBS initiatives, deferring completely to the Committee's knowledge and expertise in the realm of bank regulation. The reports submitted by the BCBS are therefore meant to update political leaders on the implementation status of reforms, rather than provide a basis for assessment.

Chapter 5: Assessment of the BCBS's Post-crisis Regulatory Reforms

5.1 Introduction

As argued earlier in this thesis, correction is an important aspect of accountability. An accountable governance institution takes measures to reform the policies that have proven ineffective or flawed. In the realm of banking regulation, the theme of reform rose to prominence with the outburst of the GFC in 2008, which discredited the regulatory system that was in place prior to the crisis. There now seems to be broad agreement that the international financial standards not only failed to prevent the crisis but also contributed to it in significant ways. As a result, many policymakers, regulators and academics around the world have devoted their full attention to the debate on how to reform the international regulatory system.

This chapter seeks to explore the theme of correction in the work of the BCBS. It demonstrates the shortcomings of the Basel Accords that surfaced with the outbreak of the GFC, and seeks to examine the corrective measures that the BCBS has adopted in response to the crisis. The key question that guides the analysis of post-crisis reforms is whether such reforms have made the international banking system more resilient, or if there still remain structural vulnerabilities in the system that pose threats to financial stability. This question not only has important implications for BCBS accountability, but also for its *performance-based legitimacy*. As mentioned in the introductory theoretical approach, the BCBS is perceived as more legitimate if its post-crisis policies help reduce the likelihood of financial crises and increase the prospect of financial stability.

I argue that while the BCBS has taken steps to reform the pre-crisis regime of banking standards, such measures fall short of addressing the underlying problems. The BCBS, therefore, cannot be regarded as having successfully met the requirement of correction. My argument will be based on an investigation of three key areas of post-crisis reforms: minimum capital requirements, liquidity standards, and leverage ratio. In the wake of the GFC, there was a clear understanding among Basel officials and the broader regulatory and academic community that the Basel rulebook needs to raise capital buffers, prevent the buildup of excessive leverage, and address the liquidity risk that destabilized the banking system. My investigation, however, shows that the BCBS has either failed to take the required measures in these areas or has diluted its original reforms so that they can no longer attain the intended objectives.

Additionally, I argue that the failure and dilution of the reforms reflect important accountability problems, particularly with respect to the BCBS's transparency and consultative practices. The reform process took place in an institutional setting which was exclusive and closed to the general public as well as well non-transparent and conducive to regulatory capture. While the general public was left ignorant on the formulation of standards, large international banks had privileged access to the reform process. The subsequent consultation process was dominated by actors who had a strong preference for the status quo and lobbied heavily for weaker regulatory standards. These accountability deficits lead to the adoption of policy outcomes that largely reflect the interests of a narrow set of *regulatees* rather than the broader public interest in financial stability.

The chapter is organized as follows. It starts with a short overview of the Basel Accords that were developed prior to the GFC. It then considers the role of the Basel Accords in the crisis. In addition to presenting some important shortcomings of Basel II, the chapter explores the question of whether Basel II should be removed as a contributing factor given its delayed implementation in some jurisdictions. The following section turns to the post-crisis reform initiatives that have been taken by the BCBS, commonly known as Basel III. After a brief overview of Basel III provisions, a critical analysis of the key reforms and their evolution is conducted. Finally, the chapter puts Basel III in the broader institutional setting within which it was developed and revisits it from the perspective of other accountability measures that are considered in this thesis.

5.2 The Pre-crisis Regulatory Framework

5.2.1 Overview of Basel I and Basel II

The BCBS develops standards for myriad regulatory and supervisory areas. However, the committee is best known for its work on capital requirements for internationally active banks, known as the Basel Accords. The Basel Accords were developed and revised in stages. They began in 1988 with Basel I which established a general rule requiring banks to hold 8% capital against risk-weighted assets. The risk weight of the asset was as follows:

1. Claims on the OECD governments and central banks to have zero risk weight (0% capital);
2. Claims on other OECD public-sector entities and short-term claims on banks to have 20% risk weight (1.6% capital);
3. Home mortgages to have 50% risk weight (4% capital);
4. All other assets, including ordinary commercial loans, to have 100% risk weight. Banks (8% capital).[1]

Basel I divided a bank's capital into two tiers. Tier one was comprised of "core capital", which included common equity shares, disclosed reserves, non-cumulative preferred stock, other hybrid equity instruments and retained earnings. Tier two was comprised of "supplementary capital", which included items such as cumulative perpetual preferred stock, loan loss allowances, undisclosed reserves, revaluation reserves and general loan loss reserves.[2]

Soon after its adoption, market participants widely criticized Basel I complaining that it was risk-insensitive. Critics argued that the risk weights in Basel I were indifferent to the quality of the assets and the real risks they could pose to the banks.[3] In response to such criticisms, the committee started to work on a new capital accord in 1999. After several years of negotiation, market testing and revision, the committee finally released a comprehensive document in 2006 that contained the unchanged elements of Basel I and subsequent amendments known as Basel II.[4]

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[1] BCBS, "International Convergence of Capital Measurement and Capital Standards" (1988) at 8-13, online: BIS http://www.bis.org/publ/bcbs04a.htm [BCBS, "Basel I"].

[2] *Ibid* at 3-8.

[3] Irina Molostova, "Introduction to the Internal Ratings Based Approach under Basel II" (2008) 1 JIBFL 19, (LexisNexis).

[4] BCBS, "International Convergence of Capital Measurement and Capital Standards: A Revised Framework Comprehensive Version" (June 2006) online: BIS http://www.bis.org/publ/bcbs128.pdf [BCBS, "Basel II"].

The aim of Basel II was to provide an overall framework for risk assessment and risk management. Basel II implemented a number of revisions through three pillars: pillar 1 addressed minimum capital requirements, pillar 2 considered supervisory review, and pillar 3 considered market discipline through a disclosure requirement.[5]

Pillar 1 determined the capital requirements for banks. It kept the tier 1 and tier 2 system of Basel I and its 8% capital requirements.[6] The only significant change that Basel II made was in determining the risk weights of individual assets. Banks could assess the riskiness of different assets based on two main approaches: *standardized approach* and *internal rating based (IRB) approach*.[7]

Standardized approach was similar to the Basel I approach in that banks would allocate their exposure to one of the fixed risk-weighted categories (though Basel II introduced more categories).[8] However, banks had to use an external credit rating to determine the counter-party risk. Where the credit rating was not available, a 100% risk was allocated to the asset.[9]

The IRB approach allowed the banks to use their own assessment of all or some of the key risk drivers, such as probability of default or loss given default. The IRB approach was then divided into two models: *foundational* and *advanced*. The difference between these two models was the degree to which they relied on the banks' assessment of different risk components. While the foundational approach focused on the probability of default, the advanced approach allowed the banks to determine all risk drivers.[10]

Pillar 2 was concerned with the role of banking supervisors. Under pillar 2, supervisors needed to assess the banks' internal assessments of capital adequacy and indicate if they were

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[5] *Ibid* at 6.

[6] *Ibid* at 8.

[7] *Ibid* at 19.

[8] *Ibid* at 19-27.

[9] *Ibid* at 9-10.

[10] *Ibid* at 59-61.

inadequate. They could also intervene as soon as a bank's capital ratio fell below the appropriate level.[11] Pillar 3 was concerned with market discipline. It recognized the role of market discipline in reinforcing capital regulation and ensuring the safety of the banking system. It also laid out wide disclosure standards that could add more transparency to the banks' capital position.[12]

5.2.2 Emergence of Basel II Shortcomings in the Wake of GFC

The outbreak of the GFC was coincided with the programmed phase-in of Basel II. The failure of major banks in other financial firms in the United Stated and Europe prompted a sober reevaluation of capital adequacy standards. Basel II ceased to have operational significance when banks suffered huge losses and national authorities become major contributors to bank capital. The Basel II framework proved inadequate to save many important banks from destruction during the crisis. Some of the important drawbacks of the Basel II, which became subject to significant debate, were the following:

5.2.2.1 Procyclicality

One major criticism of Basel II was its tendency to exacerbate economic cycles. Capital requirements tend to fall in periods of strong credit growth characterized by high asset value and low credit losses. This tends to accentuate the boom by encouraging well-capitalized banks to aggressively expand lending. Conversely, capital requirements tend to rise in difficult times, leading banks that are facing capital constraints to cut back on lending, making the recession worse.[13]

Procyclicality seems particularly worrisome with respect to Basel II because of the risk-sensitivity it introduces into the capital adequacy regime.[14] In contrast to Basel I, which divides

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[11] *Ibid* at 205-212.

[12] *Ibid* at 225-228.

[13] FSA, "Turner Review: A Regulatory Response to the Global Banking Crisis" (2009) at 59, online: FSA http://www.fsa.gov.uk/pubs/other/turner_review.pdf [FSA, "Turner Review"]; Jeffery Atik, "Basel II: A Post-Crisis Post-Mortem" (2011) 19 Transnat'l L & Contemp Probs 731 at 752.

[14] BCBS, "Basel II", *supra* note 4 at 2.

assets into broad risk buckets, Basel II relies on banks' detailed analysis of multiple sub-classes of assets on a granular level.[15] Thus, while all residential mortgages have the same risk weight (50%) under Basel I, Basel II's IRB approach requires banks to examine each mortgage exposure in isolation and calculate the capital requirement with respect to its specific risk characteristics.[16] Thus, if the credit worthiness of a mortgage borrower increases in the time of a housing boom, the bank can assign a smaller risk weight to the mortgage and hold less capital against it. The bank then has an incentive to further reduce its capital buffers by extending more mortgage loans to similar borrowers, which can further intensify the housing boom.[17]

5.2.2.2 Credit Rating Agencies

In the context of the standardized approach to credit risk, Basel II relied significantly on external ratings of borrowers' credit worthiness by credit rating agencies (CRA). Under Basel II, asset-backed securities (ABSs) that were graded AA and AAA by rating agencies had only 20% risk weight. This meant that banks had to keep only 1.6% capital against such assets.[18] Doubts on the quality and reliability of ratings, however, emerged with the massive failure of ABSs that were given inflated ratings by CRAs. By one estimate, 36% of all collateralized debt obligations (CDOs) that were based on US asset-backed securities had defaulted by July 2008.[19]

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[15] *Ibid* at 52-59.

[16] It is important to note that Basel II is structured so that the probability of default is calculated in respect of each individual asset, and the result of each individual calculation is then added together in order to assess the probability of default of the total portfolio of exposures held by the bank. Thus, one must be cautious not to assume that Basel II uses a "whole banking model" - that is, calculation of the probability of default across an institution's total portfolio of assets. See, Simon Gleeson, *International Regulation of Banking— Basel II: Capital and Risk Requirements* (Oxford, New York: Oxford University Press, 2010) at 197.

[17] For the rules on risk weighting of residential mortgages, which are considered as retail exposures, see BCBS, "Basel II", *supra* note 4 at 77-79.

[18] *Ibid* at 126.

[19] John P Hunt, "Credit Rating Agencies and the 'Worldwide Credit Crisis: The Limits of Reputation, the Insufficiency of Reform, and a Proposal for Improvement" (2008) at 12, online: SSRN http://ssrn.com/abstract=1267625.

In theory, CDOs received an AAA rating because rating agencies concluded that sufficient debt obligations had been subordinated to the senior tranches to justify their AAA rating. However, subsequent defaults called into question the sufficiency of such subordination.[20] A study by Griffen and Tang of 916 CDOs issued between January 1997 and December 2007 found that the rating agencies did not follow a consistent policy with respect to subordination and regularly made adjustments based on subjective grounds. While these adjustments could have been positive or negative, 84% of them were, in fact, positive and significantly increased the size of the top-rated AAA tranche.[21] This meant that the CRA's valuation models were systemically overridden to increase the size of AAA tranches.[22] Subsequent investigations also indicated that rating agencies did not conduct factual verification with respect to the information on the quality of collateral in the securitized pools. Rather, they simply disclosed that they were relying on information supplied to them by others.[23]

5.2.2.3 Internal Risk Models

As previously mentioned, Basel II foundation and advanced approaches allowed banks to use their internal rating-based models to calculate appropriate risk charges. However, the credibility of internal models was brought into question by their failure to forecast the cascade of risk that began in 2007, including the including the widespread defaults on subprime mortgages.[24] An important argument against the models is concerned with their short observation periods. For instance, the Turner Review notes that Value-at-Risk models, whose uses were actively

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[20] John Coffee, "Ratings Reform: The Good, The Bad, and The Ugly" (Columbia Law and Economics Working Paper, No. 375, 2010) at 12, online: http://ssrn.com/abstract=1650802.

[21] John M Griffin & Dragon Yongjun Tang, "Did Subjectivity Play a Role in CDO Credit Ratings?" (McCombs Research Paper Series No. FIN-04-10, 2011) at 4, online: SSRN http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1364933 .

[22] Coffee, *supra* note 20 at 13.

[23] SEC, "Summary Report of Issues Identified in the Commission's Staff's Examination of Select Credit Rating Agencies" (2008) at 18, online: SEC http://www.sec.gov/news/studies/2008/craexamination070808.pdf.

[24] Maziar Peihani, "The Global Financial Crisis of 2008: An Analysis of Contributing Trends, Policies and Failures" (2012) 27(3) BFLR 465 at 482.

encouraged by Basel II, used relatively short periods of observation of one year when much longer periods were required.[25] Crouhy also notes that many models did not go back in time far enough for collecting data and missed important periods of market disruptions.[26] For example, a 2006 model that used five years of data would have missed the Asian Crisis. Similarly, the models used by credit rating agencies based their estimates of default on a very short history. The data used by these models only went back to 2001, a period which was characterized by a fairly benign risk environment for real estate.[27] Internal models are also considered to contribute to systemic risk by creating a kind of feedback, which makes the sources of risk partly endogenous. That is, when the creditworthiness of a particular type of asset declines, the internal risk rating of exposures associated with such an asset will also deteriorate, requiring additional capital set-asides. Similar models in different banks could then provide a shared incentive to dispose of those assets in order to protect their capital ratios. This would, in turn, lead to an abundance of similar assets on the market, further amplifying downward pressure on asset prices and exacerbating banks' capital positions.[28]

5.2.3 Did Basel II Really Contribute To the Crisis?

In spite of important criticism of Basel II, it may be argued that Basel II was not an important contributor to the crisis as it was not completely implemented prior to the crisis.[29] For instance, in the United States (which was the epicentre of the GFC) it was not until December 2007 that

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[25] FSA, "Turner Review", *supra* note 13 at 44.

[26] Michael Crouhy, "Risk Management Failures During the Financial Crisis" in Robert W Kolb, ed, *Lessons from the Financial Crisis: Causes, Consequences, and Our Economic Future* (New Jersey: Wiley, 2010) 283 at 283-284.

[27] *Ibid* at 286.

[28] Daniel K Tarullo, *Banking on Basel: Future of Financial Regulation* (Washington: Peterson Institute for International Economics, 2008) at 155; Jon Danielsson et al, "An Academic Response to Basel II" (LSE Financial Markets Group, Special Paper No 130, 2001) at 5-8, online: Istituto Einaudi http://www.istein.org/e-library/advanced-search/item/5341-an-academic-response-to-basel-ii.html.

[29] See, e.g., Francesco Cannata & Mario Quagliariello, "The Role of Basel II in the Subprime Financial Crisis: Guilty or Not Guilty?" (Carefin Working Paper, n.3/09, 2009) at 14, online: SSRN http://ssrn.com/abstract=1650802.

the primary US federal regulators passed a final rule for implementation of Basel II. [30] The implementation process also proved much longer than expected and did not start for most US banks until mid-2010. [31]

While this argument may have some merit with respect to Basel II, it can hardly question the broader role that capital adequacy regulations played in the crisis. In fact, some important criticisms of Basel II, such as procylicality, are equally relevant in the context of Basel I. It is also important to note that the risk weighing mechanisms recognized by Basel II were in use long before the crisis. A good example in this respect is the use of external ratings for determining the credit quality and capital treatment of securitization, which was developed as a key modification to the Basel regulations between 1997 and 2001.[32] This new rule broadened the definition of low-risk securities to include securities graded AA or higher by CRAs, meaning that such assets had a risk weight of 20%. Banks were therefore required to hold only 1.6% capital against them. The US regulators put the new rules in place in January 2001.[33]

Furthermore, while Basel II was largely unimplemented in the US with respect to commercial banks, in 2004 the US Securities and Exchange Commission (SEC), decided to apply Basel II to

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[30] US Department of Treasury, "Risk-Based Capital Standards: Advanced Capital Adequacy Framework – Basel II" (72 Federal Register, Vol. 69, No. 288, 2007) online: US Government Printing Office http://www.gpo.gov/fdsys/pkg/FR-2007-12-07/pdf/07-5729.pdf.

[31] Mark Sobel, "Transatlantic Cooperation on Financial Regulatory Reform" (2010) online: US Mission to the EU http://useu.usmission.gov/sobel_042710.html.

[32] Michael J. Zamorski, "Final Rule to Amend the Regulatory Capital Treatment of Recourse Arrangements, Direct Credit Substitutes, Residual Interests in Asset Securitizations, and Asset-Backed and Mortgage-Backed Securities" (2001) online FDIC http://www.fdic.gov/news/news/financial/2001/fil0199.html; US Department of Treasury et al, "Risk-Based Capital Guidelines; Capital Adequacy Guidelines; Capital Maintenance: Capital Treatment of Recourse, Direct Credit Substitutes and Residual Interests in Asset Securitizations; Final Rules" (Federal Register/ Vol. 66, No. 230, 2001) online: FDIC http://www.fdic.gov/regulations/laws/federal/01riskbased.html.

[33] *Ibid*; Arnold Kling, "Not What They Had in Mind: A History of Policies that Produced the Financial Crisis of 2008" (2009) at 25, online: SSRN http://ssrn.com/abstract=3D1474430.

broker-dealer entities, their affiliates and holding company parents.[34] This decision was made under the Consolidated Supervised Entity (CSE) Program, which included the largest US investment banks, such as Bear Stearns and Lehman Brothers.[35] Under the net capital rule (the standard framework that was in place prior to the CSE Program), broker dealers were required to maintain capital according to fairly mechanical financial ratios that would vary according to the securities business that a broker–dealer was conducting. However, the CSE Program allowed the broker–dealers and their holding companies to set capital requirements according to their internal models.[36] Finally, it is arguable that further implementation of Basel II could have exacerbated the crisis by causing a significant decline in banks' capital ratios. In 2004, US regulators conducted the Quantitative Impact Study (QIS-4) to assess the impact of Basel II on the capital levels of US banks. The study's findings revealed that capital levels for half of the thirty largest US banks would decline by at least 20%, and up to 40% for some.[37]

5.3 Post-crisis Regime of Global Bank Regulation

5.3.1 Overview of Basel III

Basel III is a comprehensive set of reforms that the BCBS developed in response to the crisis that sets out the new international regulatory framework for banks.[38] The primary purpose of Basel III is to raise the resilience of the banking sector by strengthening the regulatory capital minima,

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[34] SEC, "Alternative Net Capital Requirements for Broker-Dealers That Are Part of Consolidated Supervised Entities" (Federal Register/ Vol. 69, No. 118, 2004) online: SEC http://www.sec.gov/rules/final/34-49830.pdf [SEC, "Alternative Net Capital"].

[35] Erik F Gerding, "The Outsourcing of Financial Regulation to Risk Models and the Global Financial Crisis: Code, Crash, and Open Source" (2009) at 36-37, online: SSRN http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1273467.

[36] SEC, "Alternative Net Capital", *supra* note 34.

[37] Damian Paletta & Barbara Rehm, "New Study Sees Steep Capital Dips From Basel" (2005) 170 (87) American Banker, at 1-2, online: Business Source Complete http://www.ebscohost.com/academic/business-source-complete.

[38] BCBS, "International Regulatory Framework for Banks (Basel III)" (Accessed on 7 January 2014) online: BCBS http://www.bis.org/bcbs/basel3.htm.

building on the three pillars of Basel II. The reforms raise the quality, quantity and consistency of the capital buffers and enhance the risk coverage of the capital framework.[39]

Under the new regime, common equity continues to qualify as the core component of regulatory capital and increases from 2% of risk-weighted assets to 4.5 %.[40] The remainder of tier 1 capital must be comprised of instruments that are subordinated and have fully discretionary non-cumulative dividends or coupons. Such instruments should not have a maturity date or an incentive to redeem. Innovative hybrid instruments with incentives to redeem are to be phased out. [41]

A number of measures have been taken to reduce cyclicality in the banking system. The most important of such measures is the introduction of two new capital buffers: the capital conservation buffer (2.5%, which increases the overall minimum requirement from 8% to 10%) and the counter-cyclical buffer (which ranges from 0% to 2.5%).[42]
The risk-weighted capital framework is supported by a leverage ratio of 3%. The leverage ratio is intended to contain excessive leverage in the banking system and provide additional protection against model risk and measurement error.[43]

The BCBS acknowledges that the failure to capture major on-and-off balance sheet risks, as well as derivative related exposures, was a key destabilizing factor in the crisis. In response, the Committee raised the capital requirements for trading books and complex securitization exposures. The enhanced treatment introduces a stressed value-at-risk (VAR) capital requirement based on a 12-month long stress scenario. The reforms also raise the capital requirements for

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[39] BCBS, "Basel III: A Global Regulatory Framework for More Resilient Banks and Banking Systems" (December 2010) at 2, online: BIS https://www.bis.org/publ/bcbs189_dec2010.htm [BCBS, "Basel III: Capital"].

[40] *Ibid* at 64.

[41] *Ibid* at 2.

[42] *Ibid* at 55-60, 64.

[43] *Ibid* at 4, 61.

derivatives, repo, and securities financing activities, and also provide incentives for banks to move their OTC derivative contracts to central clearing counterparties (CCPs).[44]

Under the new rules, banks must determine their capital requirements for counterparty credit risk using stressed inputs. They are subject to a capital charge for mark-to-market losses associated with deterioration in the credit worthiness of a counterparty. Standards for collateral management and initial margining have been strengthened. Banks with large and illiquid derivative exposures to a counterparty have to apply a longer margining period as the basis for determining their regulatory capital requirements. Capitalization of bank exposures to CCPs are partly based on the CCP's compliance with standards devised by the Committee on Payments and Settlement Systems (CPSS) and the IOSCO to strengthen the financial market infrastructure and to address systemic risk arising from derivative transactions. [45]

For the first time, Basel III introduces two internationally harmonized liquidity standards: the Liquidity Coverage Ratio (LCR) and the Net Stable Funding Ratio (NSFR).[46] The LCR is designed to ensure that a bank has sufficient highly liquid assets to offset the cash flows that it may encounter under a month-long serious stress scenario, such as the downgrade of a bank's credit rating, a partial loss of deposits, a loss of wholesale funding, and an increase in derivative collateral calls.[47]

While the LCR is intended to ensure short-term liquidity in times of severe stress, the NSFR seeks to promote medium and long-term funding by establishing a minimum acceptable amount of stable liquidity.[48] This amount is determined on the basis of the bank's assets and activities, including those related to off-balance sheet (OBC) commitments, over a one-year period of

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[44] *Ibid* at 3.

[45] *Ibid* at 3-4.

[46] BCBS, "Basel III: International Framework for Liquidity Risk Measurement, Standards and Monitoring" (December 2010) online: BIS https://www.bis.org/publ/bcbs188.htm [BCBS, "Basel III: Liquidity"].

[47] *Ibid* at 3-4.

[48] *Ibid* at 25.

extended stress. The NSFR requires that a bank's Available Stable Funding (ASF) exceeds its Required Stable Funding (RSF) for assets and OBS exposures.[49] ASF refers to those equities and liabilities that are expected to be reliable sources of funding over a one-year period of extended stress.[50] On the other hand, RSF is the amount of stable funding required by supervisors and is determined in reference to the liquidity risk profiles of a bank's assets and off-balance sheet exposures.[51]

5.3.2 Is Basel III an Adequate Corrective Response to the Pre-crisis Regulatory Failures?

In spite of the scope and sophistication of its various provisions, Basel III cannot be considered an adequate corrective response to the regulatory failures it intends to remedy. The following reveals the failure of Basel III in three key areas of post-crisis reform: minimum capital requirements; liquidity standards; and the leverage ratio. I argue that the BCBS has either failed to take robust measures in these areas or has diluted its initial proposals so that they can no longer achieve the intended outcomes.

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[49] *Ibid*.

[50] ASF includes:

- regulatory capital
- preferred stock with a maturity of one year or more
- liabilities with a maturity of maturity of one year or more, and
- non-maturity and term deposits and wholesale funding that have the maturity of less than one year but are expected to stay with the bank for an extended period in an stressed scenario. *Ibid*., at 26.

[51] The formula for calculating the amount of RSF is as follows:

(The value of each bank's assets × RSF factor assigned to that asset) + (the amount of off-balance sheet exposures × the associated RSF factor)

These RSF factors are designed to approximate the amount of a particular asset that could not be monetized (through sale or use as collateral in a secured borrowing) during a year-long stress scenario. For instance Cash and unencumbered securities with remaining maturities of less than one year are assigned a NSR factor of 0 percent, while encumbered assets will generally receive a 100 percent RSF weighting. *Ibid* at 28.

Minimum Capital Buffers

A clear lesson from the GFC is that the banking system needs to operate with capital buffers substantially higher than the minimum requirements that were in place in the run-up to the Crisis.[52] However, Basel III only increases the minimum capital requirement to 10 percent, a ratio that is actually lower than capital held by many distressed financial institutions prior the Crisis. For instance, consider the five largest financial institutions that were subject to Basel rules in the United States: Bear Stearns, Washington Mutual, Lehman Brothers, Wachovia and Merrill Lynch. In 2008, all these firms either failed or were forced into government-assisted mergers. But, astonishingly, these banks had regulatory capital ranging from 12.3 per cent to 16.1 percent.[53] While the US banking system experienced some of the most severe problems possible in the recent crisis, the regulatory capital ratio for the top US banks, accounting for almost two-thirds of the US banking assets, averaged 11.7 percent in 2007.[54] Thus, Basel III ends up with a minimum capital requirement no higher than what was proved to be inadequate in the run-up to the Crisis. Senior economists at the Bank of England and academics at Stanford University have argued that capital ratios should be considerably higher than the targets agreed under the Basel III framework. They recommend buffers as high as 20 % of risk-weighted assets.

Although Basel III had originally proposed a countercyclical capital buffer and a capital surcharge for systemically important banks, these buffers were later moved from Pillar I to Pillar II.[55] This change means that the new buffers are no longer binding and their implementation is

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[52] FSA, "Turner Review", *supra* note 13 at 53-57; G20 Working Group 1, "Enhancing Sound Regulation and Strengthening Transparency" (March 2009) at 24-25, online: http://rbidocs.rbi.org.in/rdocs/PublicationReport/Pdfs/20_010409.pdf.

[53] Andrew Kuritzkes & Hal Scott, "Markets Are the Best Judge of Bank Capital" *The Financial Times* (24 September 2009) at 11, online: ProQuest https://www.proquest.com/en-US/.

[54] *Ibid*.

[55] BCBS, "Strengthening the Resilience of the Banking Sector- Consultative Document" (December 2009) at 9, online: BIS http://www.bis.org/publ/bcbs164.pdf. [BCBS, "Basel III-Capital- Consultative"]; BCBS, "Basel III: A Global Regulatory Framework for More Resilient Banks and Banking Systems" (June 2011) at 58-59, online: BIS http://www.bis.org/publ/bcbs189.pdf [BCBS, "Basel III-Capital-2011"]; BCBS, "Global Systemically Important

completely up to the national authorities. It is also important to note that Basel III has a considerably extended transitional period. The higher standards will not be fully binding until 2019, by which time the international financial system may have already seen another crisis.[56]

Finally, it is crucial to note that the Committee has not accepted that the Crisis revealed significant weakness in the fundamental basis for the capital regulatory system. Large and complex banks are therefore still authorized to calculate their regulatory capital requirements based on their internal models. As previously mentioned, the Fourth Quantitate Impact Study suggested that IRB banks would benefit from regulatory capital reductions of up to 40 percent.[57] Another study by the IMF, which examines the evolution of RWAs over total assets (1998–2011), confirms that the gradual shift from Basel I to Basel II has enabled banks to benefit from lower RWAs.[58] The decline in RWAs has occurred as banks have moved their portfolios to the advanced IRBs.[59] For instance, Martin Hellwig notes that in the run-up to the crisis, internal ratings allowed some large banks to report Core Tier 1 capital ratios of 10 percent when they held equity amounting to just 2 percent of non-risk-weighted assets.[60] Most recently, a 2013 BCBS study reveals enormous variation in capital buffers held by major banks for same assets

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Banks: Updated Assessment Methodology and the Higher Loss Absorbency Requirement" (July 2013) at 14, online: BIS http://www.bis.org/publ/bcbs255.pdf.

[56] BCBS, "Basel III Phase-in Arrangements" (Accessed on 21 November 2014) online: BIS http://www.bis.org/bcbs/basel3/basel3_phase_in_arrangements.pdf; Martin Wolf, "Basel: The Mouse that Did Not Roar", *Financial Times* (14 September 2010) online: http://www.ft.com.

[57] Damian Paletta & Barbara Rehm, "New Study Sees Steep Capital Dips From Basel" (2005) 170 (87) American Banker, at 1-2, online: Business Source Complete http://www.ebscohost.com/academic/business-source-complete.

[58] Vanessa Le Leslé & Sofiya Avramova, "Revisiting Risk-Weighted Assets: Why Do RWAs Differ Across Countries and What Can Be Done About It?" (2012) at 11-13, online: IMF https://www.imf.org/external/pubs/ft/wp/2012/wp1290.pdf.

[59] *Ibid*.

[60] Martin Hellwig, "Capital Regulation after the Crisis: Business as Usual?" (Preprints of the Max Planck Institute for Research on Collective Goods Bonn 2010/31) at 3.

because of the contrasting assumption made under the advanced IRB approach.[61] Thus, while there is strong evidence that IRB banks can significantly lower their regulatory capital buffers by manipulating their RWAs, the BCBS has yet questioned the model-based approach of capital adequacy.

Liquidity Standards

Throughout the GFC, many banks struggled to maintain adequate liquidity. Central banks had to provide an enormous level of liquidity support, and even with such unprecedented support, important banks failed or were forced into mergers or resolution.[62] In recognition of the need for banks to improve their liquidity risk management and control their liquidity risk exposure, Basel III introduced two minimum liquidity standards, which were briefly discussed above. The new liquidity standards may first appear as robust corrective initiatives by the BCBS in response to the inadequate treatment of liquidity risk under the pre-crisis regulatory regime. However, upon careful examination of their evolution it becomes clear that they have been significantly watered down, both in terms of substance and of implementation. For instance, consider the LCR that was praised as one of the soundest measures in response to the GFC. To comply with the LCR, banks are advised to keep a stock of assets that are highly liquid in times of crisis and that can be converted to cash with little or no loss. However, the definition of high quality liquid assets (HQLA) has changed significantly since their inception. In the 2008 BCBS proposal on liquidity risk, HQLA consisted primarily of cash, central bank reserves, and high quality sovereign bonds.[63] However, subsequent revisions in 2010 and 2013 expanded the definition of HQLA to include corporate bonds, equity investments, and residential mortgage-backed securities

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[61] BCBS, "Regulatory Consistency Assessment Programme (RCAP): Analysis of Risk-Weighted Assets for Credit Risk in the Banking Book" (July 2013) at 7, online: BIS http://www.bis.org/publ/bcbs256.htm.

[62] BCBS, "International Framework for Liquidity Risk Measurement Standards and Monitoring-Consultative Document" (December 2009) at 1, online: BIS https://www.bis.org/publ/bcbs165.htm.

[63] BCBS, "Principles for Sound Liquidity Risk Management and Supervision" (17 June 2008) at 30, online: BIS http://www.bis.org/press/p080617.htm.

(RMBS)—assets that are very unlikely to be liquid in times of financial turmoil.[64] The deadline for the implementation of the liquidity requirements has also been relaxed. Originally, banks had to fully comply with the LCR by January 2015. However, under the revised timetable, the minimum LCR in 2015 would be 60% and increase by 10 percentage points per year.[65] Finally, it is worth noting that although the NSFR was proposed in 2009, the minimum NSFR will not be introduced until 2018, and will then be subject to similarly extensive phase-in timelines.[66]

Leverage Ratio

Recognizing that "the build up of leverage also has been a feature of previous financial crises," the BCBS has introduced a leverage ratio that is intended to achieve two objectives: (1) constrain leverage in the banking sector, thus helping to mitigate the risk of the destabilizing deleveraging processes; and (2) introduce "safeguards against model risk and measurement error by supplementing the risk-based measure with a simple, transparent, independent measure of risk."[67] The Basel III leverage ratio introduces a number of novelties. First, the proposed minimum ratio is 3 percent (tier 1 capital) of total exposure. The exposure measure for leverage is typically assets, but the Basel III leverage ratio adds off-balance-sheet exposures and percentage of derivatives notional. In addition, it disallows the use of physical or financial collateral to reduce on-balance-sheet exposures.[68]

Similar to the minimum capital requirements and liquidity standards, however, the leverage ratio is unlikely to achieve its intended objectives. First, the ratio is too low, allowing banks to be leveraged up to thirty-three times. It is therefore unlikely that such a low ratio can constrain

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[64] BCBS, "Basel III-Liquidity", *supra* note 46 at 9-10; BCBS, "Basel III: The Liquidity Coverage Ratio and Liquidity Risk Monitoring Tools" (January 2013) online: BIS http://www.bis.org/publ/bcbs238.htm [BCBS, "Liquidity Coverage Ratio"].

[65] BCBS, "Liquidity Coverage Ratio", *ibid*.

[66] BCBS, "Seventh Progress Report on Adoption of the Basel Regulatory Framework" (October 2014) at 3, online: BIS http://www.bis.org/publ/bcbs290.pdf.

[67] BCBS, "Basel III-Capital-2011", *supra* note 55 at 4.

[68] *Ibid* at 61-63.

leverage in the banking sector or act as a backstop against risk-based capital ratios. Quantification of an appropriate leverage ratio requires substantial empirical research and supervisory testing and is, therefore, beyond the scope of a law thesis. There is, however, an increasing body of research indicating that the leverage ratio must be higher than the 3 percent figure of Basel III.[69] Second, the BCBS announced a new series of amendments in 2014 that have significantly diluted the leverage ratio framework. Under these amendments, banks can use securities financing transactions, such as repos, to reduce their leverage ratio exposure measures. Off-balance-sheet items are no longer converted to an on-balance-sheet equivalent using a 100 percent credit conversion factor (CCF). Instead, banks can use the same CCFs that are used in the Basel framework's standardized approach for credit risk under the risk-based requirements. This means that the CCF can be as low as 10 percent. Banks are also allowed to reduce their derivative exposures with netting and cash variation margin, and cap their derivative exposure at the level of the maximum potential loss.[70] These modifications leave little, if any, doubt that the leverage ratio is no longer a simple or objective measure and that it has been opened up to the same weaknesses (of the risk-based capital requirements) that it was intended to remedy. Third, the way the leverage ratio is incorporated into the Basel framework also poses challenges to its efficacy. While Basel III introduced the leverage ratio in 2011, its full implementation cannot be expected until 2018.[71] As the new amendments suggest, the BCBS can still make changes to the leverage ratio that further attenuate the requirement. More importantly, the leverage ratio carries

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[69] Sheila Bair, the former chairman of the FDIC, proposes a leverage ratio of 8 percent, arguing that such a requirement would be consistent with the amount of capital healthy banks maintained up to and during the crisis. Research by Blundell-Wignall and Atkinson similarly show that the Basel III leverage ratio adds little security to the system and a much higher leverage ratio is required. See, Sheila Bair, *Bull by the Horns: Fighting to Save Main Street from Wall Street and Wall Street from Itself* (New York: Free Press, 2012) at 325-326; Adrian Blundell-Wignall & Paul E Atkinson "Deleveraging, Traditional versus Capital Markets Banking and the Urgent Need to Separate and Recapitalise G-SIFI Banks" (2012) 1 Financial Market Trends, online: OECD http://www.oecd.org/finance/financial-markets/Deleveraging,%20Traditional%20versus%20Capital%20Markets%20Banking.pdf; http://ssrn.com/abstract=2344831.

[70] *Ibid*.

[71] BCBS, "Basel III-Capital-2011", *supra* note 55 at 63.

a Pillar 2 designation during the seven-year initial transition period, which means that it is not a binding Pillar 1 requirement.[72]

5.3.3 What Does the Failure of Basel II Mean for Transparency and Consultation?

The above remarks argued that the BCBS post-crisis reform initiatives have not successfully addressed the flaws of the pre-crisis regulatory regime and therefore cannot be considered corrective. However, it is arguable that the failure of Basel III can also be explained by reference to other BCBS accountability deficits. As the previous chapter explained, the development of Basel II was significantly influenced by large international banks. These banks managed to shape important regulatory outcomes and receive significant concessions from rule makers. A similar pattern of influence can be observed with respect to the development and subsequent revisions of Basel III. There is little doubt that the major part of BCBS decision-making, namely drafting and deliberation of standards, occurs prior to the start of notice and comment. This key stage of the Basel process, however, is largely opaque as the Committee discloses very little information on its policy agenda and the actual work undertaken by the Working Groups. All the deliberations of standards take place secretly and the minutes of the meetings are never publicly disclosed. As a result, the broader public is left ignorant and prevented from monitoring the design and deliberation of standards. On the other hand, transnationally private interest groups have privileged access to the Basel process from a very early stage. In fact, as Ranjit Lall notes, a strong personal link can be observed between international financial institutions and the Basel Committee during Basel III negotiations.[73] One of the most prominent BCBS members, Marc Saidenberg, was the managing director for finance at Merrill Lynch until 2008. As recently as October 2007, the same month in which Merril Lynch announced a record $7.9 billion loss on

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[72] *Ibid*.

[73] Ranjit Lall, “From failure to failure: The politics of international banking regulation” (2012) 19:4 Review of International Political Economy 609 at 627-628.

subprime instruments,[74] he was urging regulators "to avoid a knee-jerk reaction to recent events".[75] A number of other senior BCBS figures were also high-ranking members of the Institute of International Finance (IIF), a transnationally organized private interest group and "the leading voice for the financial services industry on global regulatory issues."[76] Roger Ferguson, the former chairman of the Federal Reserve Board of governors, sat on the IIF's board of directors. Darryll Hendricks, formerly of the Federal Reserve Bank of New York, was the chairman of the IIF Working Group on Valuation. Patricia Jackson, formerly from the Bank of England, chaired the IIF Working Group on Ratings.[77]

This revolving door between the IIF (acting on behalf of the *regulatees*), and the Committee (acting as the *regulator*) enabled the former to remain informed and influence the reforms at a stage largely closed to the broader public. For instance, the BCBS decision not to reform the IRB approach, which was highlighted above, was consistent with the recommendations of an IIF report on regulatory reform, which was published long before the commencement of the Basel III public consultation. The report insisted that Basel II was "the best framework for setting the regulatory capital requirements" and warned regulators that any reform should take place "within the framework of the Basel II risk-based approach."[78]

In addition to their first-mover advantage during the early phase of negotiations, the leading international banks had the dominant influence during the public notice and comment process. As discussed above, Basel III first introduced the leverage ratio as a binding requirement under

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[74] FCIC, "Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States" (2011) at 257, online: Financial Crisis Inquiry Commission http://fcic-static.law.stanford.edu/cdn_media/fcic-reports/fcic_final_report_full.pdf.

[75] Eoin Callan, David Wighton & Krishna Guha, "Regulators Urged to Take Back Seat" *Financial Times* (25 October 2007) online: www.ft.com.

[76] IIF, "About the IIF" (Accessed on 19 November 2014) online: IIF https://www.iif.com/about.

[77] Ranjit Lall, *supra* note 73 at 627-628.

[78] IIF, "Restoring Confidence, Creating Resilience: An Industry Perspective on the Future of International Financial Regulation and the Search for Stability" (July 2009) at 36, 40.

Pillar I. In a 151-page comment letter, the IIF, however, asserted that "a Pillar 1 ratio, with its one-size-fits-all nature would never be able to provide an effective, fair, and economically realistic view of leverage".[79] The revised version of Basel III, which was released in December 2010, moved the leverage ratio to the non-binding Pillar II.[80] Additionally, the IIF, along with G-SIBs such as Bank of America, Citigroup, JP Morgan Chase, and Morgan Stanley, criticized the proposed leverage ratio's unwarranted disregard of risk mitigation tools and its exaggerated treatment of off-balance sheet assets.[81] Instead, they recommended that the Committee allow banks to use netting and collateral to reduce their derivatives and repo exposures and eliminate the proposed 100 percent CCF for off-balance sheet items. As can be discerned from the earlier discussion on leverage ratio, these recommendations were followed in the recent amendment of the leverage ratio framework.

Similarly, the dilution of liquidity standards can be traced back to significant pressure from banks during the consultation process. The IIF asserted that the assumptions behind the stress scenarios were "predicated on a level of severity and correlation of market disturbances that, even in light of the recent crisis, is implausible, and therefore excessively restrictive." The IIF attacked the LCR for its "much-too-narrow definition of eligible liquid assets" that would "compound rather than resolve liquidity tensions in a future crisis." The IIF was equally critical of the NSFR, asserting that it was "much too prescriptive in an area where there is no sound grounding for a highly prescriptive approach." Again, as can be discerned from the discussion on

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[79] IIF, "Re: "Strengthening the Resilience of the Financial Sector" and "International Framework for Liquidity Risk, Measurement, Standards and Monitoring" (April 2010) at 12-14, online: BIS http://www.bis.org/publ/bcbs165/cacomments.htm [IIF, "Comment on Basel III"].

[80] BCBS, "Basel III-Capital-2011", *supra* note 55 at 60.

[81] IIF, "Comment on Basel III", supra note 79 at 12-14; Bank of America, "Re: "Strengthening the Resilience of the Financial Sector" and "International Framework for Liquidity Risk, Measurement, Standards and Monitoring" (April 2010) online: BIS http://www.bis.org/publ/bcbs165/cacomments.htm; Citigroup, "Re: Proposal to Strengthen Capital Regulation" (April 2010) online: BIS http://www.bis.org/publ/bcbs165/cacomments.htm;; Letter from the JP Morgan Chase to the Basel Committee (April 2010) online: BIS http://www.bis.org/publ/bcbs165/cacomments.htm; Letter from Morgan Stanley to the BCBS Secretariat, (April 2010) online: BIS http://www.bis.org/publ/bcbs165/cacomments.htm.

liquidity rules, such criticisms were fully embraced upon subsequent modifications of the liquidity standards. The definition of HQLA for LCR was expanded to include corporate bonds, covered bonds and MBS.[82] The BCBS also backtracked on the NSFR, assuring that it would not introduce the binding NSFR until 2018.[83]

Heavy dilution of the post-crisis reforms clearly illustrates how transparency and consultation on the one hand, and performance on the other hand, work in tandem to enhance or diminish an institution's overall legitimacy. Notice and comment was significantly inadequate to consult a broad set of stakeholders on Basel III, an initiative that was the centrepiece of the international reform framework. The BCBS remained invisible to the broader public at the key stage of standards formulation and deliberation. The general public was subsequently unable to take advantage of the notice and comment given that it was at a distinct disadvantage in terms of information, resources and expertise relative to concentrated interest groups that had a strong preference for the regulatory status quo. The consequence was that the major international banks captured the Basel III process in the same way that they hijacked Basel II: they succeeded in preventing the reforms from addressing regulatory gaps and flaws that the Basel Committee intended to remedy in the wake of the GFC.

A key lesson that can be taken from the Basel III process is that Basel policy outcomes are unlikely to minimize future financial crises unless the Committee makes conscious, explicit and continuous efforts to restrain the capture of its policy making by the actors it seeks to regulate. Unless the Committee opens up its deliberations to public scrutiny and takes affirmative steps to solicit input from a broader representation of the public in its consultations, it will suffer a great deficit in its outcome-based legitimacy.

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[82] BCBS, "Liquidity Coverage Ratio", *supra* note 64.

[83] BCBS, "Basel III: Liquidity", *supra* note 46 at 40.

5.4 Conclusion

The aim of this chapter was to analyze BCBS standards on capital adequacy from the perspective of accountability. The chapter discussed the shortcoming of the Basel Accords which contributed to the GFC, and examined the post-crisis reform initiatives adopted by the BCBS. The findings of the analysis indicate that the BCBS has not met the test of correction for two primary reasons. First, the Committee failed to remedy the flaws and weaknesses that surfaced in the recent Crisis, including insufficiency of capital buffers and the use of internal models to manipulate and distort the intentions of the capital adequacy rules. Second, some of the key reforms that the BCBS adopted, such as the liquidity standards and the leverage ratio, have been so heavily diluted and fall far short of their objectives.

The unsatisfactory experience with the post-crisis reforms highlights a number of important accountability problems with regard to the BCBS. First, the opaque and highly technical nature of the Committee's work provides privileged access points for the actors that are supposed to be regulated. This problem was most evident with respect to the IIF, which maintained strong personal links to the BCBS and was greatly influential in shaping regulatory outcomes. A second interrelated problem is that the BCBS is exclusive and unresponsive to the broader public. Bank failure and capital adequacy rules affect many social and economic constituencies. Stakeholders outside the banking industry, however, have been largely absent for the Basel consultative processes. Such exclusivity undermines the public's trust in the Basel Committee as a governance institution. Equally important, it makes the BCBS most prone to capture by powerful industry groups. The BCBS cannot produce common interest regulations when those who have the strongest interest in financial stability are marginalized and cannot counteract the influence of concentrated interest groups. Addressing these accountability problems are at the heart of repairing a governance system that has been discredited by the GFC. The recommendations outlined in the next chapter are intended to help achieve this aim.

Chapter 6: Concluding Remarks and Policy Recommendations

6.1 Introduction

As noted from the outset, legitimacy appears to be a matter of degree. An institution is not simply legitimate or illegitimate, but rather more legitimate or less legitimate, depending on how it scores on legitimacy criteria. Applying legitimacy criteria to the issue at hand, the BCBS has indeed become incrementally more legitimate since its inception. It clearly articulates the rationale for its policies and discloses more information on its operations and policies. It attempts to engage with the public through notice and comment. Lastly, its performance and policies are also subject to some form of oversight by a superior body. That said, a close examination of the BCBS also reveals that there is considerable room for the BCBS to become more legitimate. Thus, this thesis concludes by outlining some recommendations for improved BCBS legitimacy. It must be borne in mind that these recommendations are by nature preliminary, as they represent the first attempt in the literature to make the BCBS more legitimate. Moreover, the reforms promoted are necessary, but by no means exhaustive, to ensure meaningful BCBS accountability now and into the future. The institutional supply of such reforms as enhanced transparency and consultation must be met by strong societal demand for public interest banking regulation to emerge. Undoubtedly, the GFC of 2008 served as a catalyst for the emergence of such demand. An array of public sector officials, civil society organizations, and private sector actors have come to realize the shocking extent of recent externalities and have urged for sound and socially desirable banking systems. However, in order to change the status quo, such actors need to further appreciate the global dimension of financial regulation and the necessity of participation in global standard-setting processes. Provided that the conditions for such societal demand exist and will be sustained as the crisis memories fade away, the following safeguards can work in tandem with societal demand to help reinvent a more legitimate and accountable BCBS.

6.2 Enhancing Reasoned Decision Making and Transparency at the BCBS

The analysis of the Basel III process indicated that the BCBS was largely successful in meeting the reasoned decision-making requirement. This thesis acknowledged that timely publication of proposals, integration of impact assessment in the policy-making process, invitation for public input and publication of comments received were all sound regulatory decisions. There still seems, however, room for the BCBS to increase its score on reasoned decision making. Although the BCBS publishes the comments received on its policy drafts, it is still considerably difficult to understand the extent to which such comments have been taken into account in subsequent revisions. Though, given the high number of comments and the Committee's limited resources,[1] it is unrealistic to expect the BCBS to provide a response for every single comment received. It is also important that the Committee maintains discretion as to whether and to what extent the comments received should prompt changes in its proposals. Nevertheless, when the Committee releases a revised proposal after public consultation, it could explain the characteristics that distinguish the revised proposal from the previous drafts and the extent to which the Committee's revisions have been influenced by the issues raised in the comments. Such measure can positively contribute to the deliberative quality of the BCBS policies as well as their transparency. It would show that not only does the Committee welcome comments on its proposals but that it is also responsive to important concerns and arguments raised during the consultation. It would also shed more light on the BCBS policy making by revealing whose arguments have won the debate and whose interests have been promoted by the policy changes.

With regard to transparency, it needs to be emphasized that much of the Committee's decision making occurs prior to the publication of policy drafts. Thus, the notice and comment process, which relies on the disclosure of policies that have already been agreed upon, is not sufficient for informing the public in times when the committee is in the process of reaching crucial decisions. There are two areas in particular where the BCBS could take steps to enhance its transparency. First, it could disclose more information about its actions and decision-making process, especially the deliberations that occur prior to policy adoption and meetings with interest groups from the banking industry. Second, and more significantly, it could devise an overarching framework for transparency. This framework should establish a presumption in favour of

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[1] The constraint of resources can be best understood from the BCBS's network characteristics. As it was explained in Chapter 2, the BCBS has little physical presence; it does not have its own budget, permanent staff or headquarters. Instead it operates under the auspices of the BIS.

disclosure, except where it could compromise financial stability. It should include an articulated definition of areas requiring confidentiality and the criteria thereof. This definition should be published and revisited periodically in light of comments received from the public.

6.3 Toward New Consultation Mechanisms: Going Beyond Notice and Comment

The analysis of the BCBS public consultation process revealed inadequacies with the notice and comment. Stark asymmetries in information, financial resources, and technical expertise between transitionally organized private sector associations and civil society actors often hamper active participation by the latter in the notice and comment process. The BCBS, therefore, must take affirmative steps to elicit feedback from under-represented constituencies, particularly those without business interests or sufficient financial resources. As an initial step, the BCBS could appoint an independent advisor to review its current consultation practices and recommend new strategies to enhance non-industry stakeholders' participation in the BCBS's policy making. The independent advisor could devise a new guide for the BCBS's engagement with civil society. Since civil society's input will be key in preparation of such a guide, an online consultation platform should be created so that all interested parties, including NGOs, academia, and think tanks could provide comments early in the process.

The BCBS's measures to enhance engagement with under-represented constituencies could take different forms. For instance, a *proxy advocate* is a mechanism that has been used outside of finance [2] and has the potential to serve as a model for the BCBS. Proxy advocates, which are common among utility regulators, are internal departments tasked with bringing expert consumer input into the regulatory process.[3] A proxy advocate at the BCBS could provide policymakers

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[2] Stefano Pagliari, "How Can We Mitigate Capture in Financial Regulation" in Stefano Pagliari, ed, *The Making of Good Financial Regulation: Towards a Policy Response to Regulatory Capture* (London: Grosvenor House, 2012) 1 at 22.

[3] *Ibid*. Consistent evidence in United States indicate that proxy advocates in utilities regulation help counteract industry influence. They result in a lower percentage of rate increase requests being granted, a decreased likelihood that utilities will seek to increase rate in the first place and overall decreased rates. See, William Berry, An Alternative to Capture Theory of Regulation: The Case of State Public Utilities Commissions", 28 (1984) American

with expertise and information from the perspective of stakeholders such as consumers, retail investors, and NGOs. Since these stakeholders are small, dispersed, and unfunded, they are less likely to take advantage of the existing channels of accessing BCBS policymaking (e.g., notice and comment). The proxy advocate could facilitate proactive engagement with such groups, thereby helping keep the influence of powerful industry players in check and limiting the potential for capture.

Another option for enhancing engagement with under-represented constituencies is the direct empowerment of these constituencies based on the tripartism model developed by Ian Ayres and John Braithwaite.[4] Under this approach public interest groups (PI groups) which are well informed about the BCBS's regulatory work, will be allowed to participate in the negotiation of regulatory outcomes, and will be permitted to challenge the banking industry's positions. By doing so, PI groups can help change the deliberative habits of actors involved in the Basel process and ensure that industry influence does not wield undue power over the Committee at the expense of the public. As Ayres and Braithwaite eloquently pointed out, PI groups should themselves at the same time be "contestable", such that alternative PI groups can be empowered.[5] In addition, the tripartite system needs to include mechanisms to ensure that empowered PI groups are effectively representing their constituencies.[6]

In sum, carefully deigned mechanisms that help open the Basel process to a broader influence would create two important benefits. First, it will increase public confidence in the Basel process

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Journal of Political Science 524; Guy L Holburn & Pablo T Spiller, "Interest Group Representation in Administrative Institutions: The Impact of Consumer Advocates and Elected Commissioners on Regulatory Policy In United States" (University of California Energy Institute, Energy Policy and Economics Paper 002, 2002) online: University of California http://www.ucei.berkeley.edu/PDF/EPE_002.pdf.

[4] Ian Ayres & John Braithwaite, "Tripartism: Regulatory Capture and Empowerment" 16 (3) 1991 *Law & Social Inquiry* 435.

[5] *Ibid* at 440.

[6] Mark Seidenfeld provides a very interesting perspective on this issue. See, Mark Seidenfeld, "Empowering Stakeholders: Limits on Collaboration as the Basis for Flexible Regulation" (2000) 41 WM & MARY L REV 411.

and its legitimacy. Second, it will help the Committee revisit and test the assumptions and concepts underlying its policies and will make the Committee more successful in detecting systemic risks. It is also important that the Committee treat all interest groups even-handedly. Thus, if the Committee maintains an open door for banking industry representatives, there is no reason why the committee should not also make itself available to civil society groups.

6.4 Promoting the BCBS's Accountability at the National and International Level

The BCBS's policies have become increasingly subject to public debate and scrutiny. However, this scrutiny does not fill the gaps in knowledge surrounding the committee’s decisions that this thesis identified in formal, meaningful oversight. Building upon the previous analysis, this thesis proposes the establishment of an independent oversight body with a different composition of institutional independence and technical expertise. The new oversight body, designated here the Independent Evaluation Committee (IEC), would periodically revisit and assess the BCBS's performance against its mandate as set out in the Charter. An important dimension of the IEC’s work would be the substantive analysis of the BCBS's policy outcomes, especially the capital and liquidity standards. IEC’s evaluations, however, can go beyond the Capital Accords to encompass other important aspects of the BCBS’s activities, such as surveillance of the implementation of agreed standards, consultation with non-member authorities, and public consultation practices.

Independent evaluation by the IEC could improve BCBS’s governance and transparency, and help to develop a learning culture within the BCBS. In particular, the IEC could help address ‘groupthink’ issues, which have become a growing source of concern with respect to insular regulatory bodies. External assessment of the BCBS policies can help discern vulnerabilities of prudential standards and alert the BCBS in time to prevent or mitigate the impact of future crises.

From an institutional perspective, the IEC could be established as a new standing committee of G20. It would have to operate at arm’s length from the BCBS. In order to preserve its independence, the IEC should have a different intuitional host than the Bank for International Settlements (BIS), which currently hosts the BCBS and a number of other important regulatory forums. The IEC members would have to be appointed for a limited term (e.g. 3-5 years) and come from diverse educational and career backgrounds. Particular attention would be needed with respect to including perspectives from non-G10 economies, which tend to be significantly under-represented within the BCBS and other transnational regulatory bodies.

This thesis recommends the appointment of individuals who are known for holding alternative or dissenting views and are ready to challenge the BCBS's perceptions with well-founded analyses. The IEC must be granted full access to the BCBS's documents and records. To preserve confidentiality of sensitive information, the IEC members and staff could be required to not disclose or use any information (for the benefit of their own or others) without the BCBS's consent. To increase the depth and rigor of its proposals, the IEC could conduct overviews with the BCBS's staff, civil society groups, academics and banking practitioners. IEC's evaluations would then be published to raise awareness of BCBS performance and to hold it publicly accountable.

In addition to the proposed IEC, the BCBS can also be made more accountable through domestic oversight mechanisms. Although international financial standards do not go through the same adoption process as formal treaties, they are not immune from the scrutiny of domestic governments. Elected representatives can always scrutinize the domestic implementation of international standards, including those adopted by the BCBS. An example is the US congressional hearings on the implementation of Basel II. Such hearings pushed US regulators to delay implementation of IRB approaches for some banks, adopt additional safety and soundness safeguards, and alleviate adverse competitive effects of the accord for small community banks.[7]

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[7] Pierre-Hugues Verdier, "US Implementation of Basel II: Lessons for Informal International Lawmaking" (2011) at 14-20, online: SSRN http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1879391; Rob Garver, "Final? Not Quite, as Hill Finally Gets Started on Basel II Debate" *American Banker* 168: 119 (June 2003) 1 at 1, online: Business Source Complete http://www.ebscohost.com/academic/business-source-complete; Richard J Herring, "The Rocky Road to Implementation of Basel II in the United States" (2007) 35 Atlantic Economic Journal 411 at 421-424.

As previously said, the BCBS standards are non-binding and need to be implemented through national processes. Such processes, which often involve rule-making by domestic regulators, can provide additional avenues for transparency and informed assessment of the implications of BCBS policies for national markets and institutions. Importantly, national regulators can use broad statutory powers to give voice to constituencies that did not have access to international policy-making processes.

National authorities also have the power to go beyond the BCBS's minimum standards and adopt additional or stricter prudential standards. A successful example is the Canadian regulator, Office of the Superintendent of Financial Services (OSFI), which required Canadian banks to comply with a leverage ratio when there was no such equivalent requirement under the Basel regime. [8] In the run-up to the crisis, the leverage ratio helped contain leverage in the Canadian banking system and prevented the banks from gaming risk-based capital requirements.

Most recently (April 2014), US federal regulators followed a similar path, requiring large bank holding companies (those with more than $700 billion in consolidated total assets or more than $10 trillion in assets under custody) to maintain a leverage ratio of more than 5 percent. In addition, the insured depository institution (IDI) subsidiaries of the bank holding companies must maintain a supplementary leverage ratio of at least 6 percent to be considered well capitalized.[9]

It is interesting to note that US regulators have adopted these new measures despite the existence of an unlevel playing field on the leverage ratio at the global level. In particular, the European Banking Authority (EBA), which works to ensure effective and consistent prudential regulation and supervision across the European banking sector, has recently recommended the European

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[8] Carol A Northcott et al, "Lessons for Banking Reform: A Canadian Perspective" (2009) 19:4 Central Banking 43 at 46, 49.

[9] Federal Reserve Board of Governors, Joint Press Release, "Agencies Adopt Enhanced Supplementary Leverage Ratio Final Rule and Issue Supplementary Leverage Ratio Notice of Proposed Rulemaking" (8 April 2014) online: Federal Reserve http://www.federalreserve.gov/newsevents/press/bcreg/20140408a.htm.

Commission to align the Capital Requirements Regulation (CRR) with the recently revised Basel III framework.[10] If this recommendation is taken on the by the European Commission, European banks will be subject to a leverage ratio as low as low as 3% and can at the same time take advantage of recent revisions of the Basel framework to reduce their calculated total exposures.[11] The fact that European banks are subject to laxer rules does not seem to have driven US regulators to take a more permissive approach.

The US and Canadian examples considered here show that domestic regulators have the power to give higher priority to financial stability over other considerations such as international competitiveness of their banks. In this respect, the examples highlight the principle of host country regulation, which dictates that all institutions that carry out financial activities, such as taking deposits or giving loans, must be subject to adequate local regulation. Host country regulation is a particularly useful principle in guiding the domestic regulation of international banking, especially currently, when achieving consensus on robust reforms is difficult and existing reforms are in danger of attenuation. Accordingly, national regulators bear ultimate responsibility for setting appropriate capital requirements as well as additional safety and soundness safeguards for banks operating under their jurisdiction.

6.5 Making the BCBS a More Inclusive Global Standard Setter

The institutions of global financial governance were long viewed as undemocratic and of reduced effectiveness due to the exclusion of the emerging markets and developing economies (EMDEs).[12] Since the late 90s various academics and NGOs had criticized the lack of any developing country representation. Similarly, developing countries had continuously voiced their wish to be represented on bodies that formulated the regulatory standards, which they had to

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[10] EBA, “EBA Reports on Impact of Possible Leverage Ratio Definitions” (5 March 2014) online: EBA http://www.eba.europa.eu/-/eba-reports-on-impact-of-possible-leverage-ratio-definitions.

[11] EBA, “Report on Impact of Differences in Leverage Ratio Definitions” (March 2014) at 7, online: http://www.eba.europa.eu/documents/10180/534414/EBA+-+Leverage+ratio+analytical+report.pdf.

[12] See, e.g., Commonwealth Secretariat, “Perspectives on the Governance of Global Financial Regulation” (September 2009) online: Columbia University http://academiccommons.columbia.edu/catalog/ac:153941.

implement in their jurisdictions.[13] In 2002, 50 Heads of State and two hundred Ministers of Finance, Foreign Affairs, Development and Trade, who had come together in the United Nations International Conference on Financing for Development called on the BIS, the BCBS, and the Financial Stability Forum (FSF) to “enhance their outreach and consultation with developing countries” and “to review their membership to allow for adequate participation of developing countries.”[14] In spite of all such demands and criticism, there was no reform of governance of the international regulatory bodies until the G20 Washington Summit in 2008, which led to rather significant changes.[15]

Today, the BCBS includes important EMDEs, such as Brazil, China, India, Korea and Mexico. These jurisdictions are formally represented on the BCBS and can fully take part in its decision making. Even with such expansion, however, the BCBS's regulatory initiatives have been mostly concerned with the crisis-related problems of the old members. For instance, Basel III is largely a response to the driving factors of bank failures in US and Europe, including poor capitalization, retention of high risk asset-backed securities, and fragilities in the funding structures.[16] In general, EMDEs did not suffer from these problems and had healthier banks throughout the GFC.[17]

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[13] *Ibid*.

[14] “Monterrey Consensus of the International Conference on Financing for Development” (International Conference on Financing for Development, 2002) at 20, online: UN http://www.un.org/esa/ffd/monterrey/MonterreyConsensus.pdf.

[15] G20, “Declaration of the Summit on Financial Markets and the World Economy Washington Summit” (15 November 2008) online: G20 Information Centre www.g20.utoronto.ca/2008/2008declaration1115.html.

[16] The Financial Stability Report (2008) by the Bank of England, provides a good overview of such factors. See, Bank of England, “Financial Stability Report” (October 2008) online: http://www.bankofengland.co.uk/publications/Pages/fsr/2008/fsr24.aspx.

[17] See, e.g., Wim Naude, “The Financial Crisis of 2008 and the Developing Countries” (WIDER Discussion Papers, 2008) online: World Institute for Development Economics http://www.econstor.eu/handle/10419/84665.

There are also key differences between EMDEs and advanced economies in terms of the structure and operation of banks.[18] For instance, many EMDEs do not have well-developed markets for structured asset-backed securities and their banks have little holding of such assets.[19] Moreover, in many Asian EMDEs, such as China, India, Korea and Indonesia, the state owns a significant share of the equity in the banks for strategic and economic reasons.[20] Such state capitalism does not mean that banks in Asian countries do not suffer losses or should operate within a lax regulatory environment. It does, however, blur the distinction between taxpayer and shareholder, giving the state more flexibility and power for intervention.[21] Blurring of this distinction also makes state intervention less morally questionable in an Asian country, given that taxpayers directly benefit from any form of government assistance.

Although Basel III may not sufficiently address the vulnerabilities of the crisis-stricken financial systems, such as those of UK and US, it is hardly deniable that its implementation raises significant challenges for EMDEs. Sarra, for instance, notes that the World Bank's financing arm was undertaking contingency planning for Eastern European and southern nations' failure to meet the new international standards, "even as the link was drying on Basel III".[22] More problematically, Basel III complex standards have been written with the US and Europe in mind. For instance, consider the LCR which is designed to ensure that banks have enough highly liquid assets to survive a 30-day stress scenario. Unlike their American and European peers, EMDEs' banks often lack the so-called liquid securities (such as highly-rated government bonds and corporate bonds), which meet the LCR requirements. In addition, the LCR calibration can prove

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[18] B20, "The Impact of Regulatory Reforms on Emerging Markets" (2012) at 26, online: http://www.b20.org/pdf/03.The.Impact.of.Regulatory.Reforms.on.Emerging.Markets.pdf.

[19] *Ibid*.

[20] Fung Global Institute, "Basel III and Asia" (Finance Working Paper, May 2013) at 12, online: http://www.fungglobalinstitute.org/.

[21] *Ibid*.

[22] Janis Sarra, "Embedding Fairness as a Fundamental Norm in Financial Markets" in Janis Sarra, ed, *An Exploration of Fairness: Interdisciplinary Inquiries in Law, Science and the Humanities* (Carswell: Canada, 2013) 194 at 217.

challenging in the emerging economies given that the stress scenarios built into the framework, such as loss of wholesale funding or an increase in derivative collateral calls, reflect the features of the Western banking systems and are therefore irrelevant to EMDEs.[23]

Undoubtedly, the BCBS expansion of membership is a welcome step toward a more inclusive and legitimate global financial governance. Additional measures are, however, required to ensure that the specific features and demands of the EMDEs are adequately taken into account in the BCBS's agendas and initiatives. While stronger capital and liquidity standards are of utmost importance, they hardly provide a solution to the specific challenges that face EMDEs, including providing access to basic banking services, and elimination of discriminatory and exploitative lending practices.[24] The BCBS needs to more carefully consider the feasibility and even the desirability of its standards for EMDEs and reinforce its focus regarding how banks in EMDEs can better serve local financial needs. Enhanced research and collaboration with other institutions, particularly the World Bank, can be among the first steps in formulating fair standards and best practices that are better aligned with the priorities of EMDEs.

Another issue that needs to be revisited here is the BCBS's relationship with non-member jurisdictions. As it has been said throughout this thesis, the BCBS is the primary *global* standard setter for the prudential regulation and supervision of banks.[25] The reach and influence of the

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[23] Some difficulties involved in the Basel III implementation have been recently noted by the IMF and the FSB. See, e.g., FSB, "Monitoring Note on the Effects of Regulatory Reforms on Emerging Market and Developing Economies*"* (12 September 2013) online: BIS https://www.financialstabilityboard.org/publications/r_130912.htm; Lukas Becker, "Developing Needs" (2013) 26:10 Risk 72 at 72.

[24] According to the Global Findex dataset, based on nationally representative survey of more than 150,000 adults in 148 economies, approximately 2.5 billion adults lack a formal bank account. Most of these people are concentrated in developing economies. See, World Bank, "Financial Inclusion Data" (Accessed on April 10 2014) online: World Bank http://datatopics.worldbank.org/financialinclusion/; Asli Demirjuc-Kunt, "Measuring Financial Exclusion: How Many People Are Unbanked?" (24 April 2014) online: Consultative Group to Assist the Poor http://www.cgap.org/blog/measuring-financial-exclusion-how-many-people-are-unbanked.

[25] *Basel Committee on Banking Supervision (BCBS) Charter,* January 2013, s 1, online: BIS http://www.bis.org/bcbs/charter.htm [*Charter*].

BCBS policies go far beyond the member jurisdictions. In fact, the Charter explicitly provides that the BCBS promotes the implementation of its standards, guidelines and sound practices "beyond BCBS member countries". [26]

The BCBS's standards cannot be viewed as legitimate with respect to non-member countries unless they are devised with real and timely input from such countries. To date, the BCBS has taken two initiatives to facilitate consultation with non-members: the regional supervisory grouping and associations (RSGAs), and the Basel Consultative Group (BCG). Both initiatives were discussed and their merit was acknowledged earlier in this thesis. However, there still remains important ways that the BCBS can strengthen its efforts to reach non-member countries. First, the consultation outcomes and recommendations of the RSGAs should be published on the BCBS's website. Second, the Committee should provide feedback on the RSGAs' reports and explain how it seeks to incorporate them in its initiatives. Third, the RSGAs' chairs should be invited to participate in the Committee's meetings and the RSGAs' members should play a more active role in the work of the BCBS's various working groups and task forces.

In addition to following the above initiatives in the short run, the long-term goal should be to create a Basel Committee with more universal membership. Currently, the BCBS does not have objective membership criteria and excludes a large number of countries (around 170) from its decision-making process. Particularly troubling is the fact that only one African country, South Africa, is included in the BCBS membership and not a single low-income country is represented. As Paul Martin, then Canada's Finance Minister, noted in the wake of the FSF establishment, "it is not reasonable to expect sovereign governments to follow rules and practices that are "forced" on them by a process in which they did not participate. Whatever form the renewed global financial architecture ultimately takes, all countries must "buy into it" and take ownership. Only

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[26] *Charter*, *ibid*, s 2.

then will the framework have legitimacy.” While this statement was made 15 years ago, the same logic still applies to the global governance regime for banking.[27]

[27] Paul Martin, “The International Financial Architecture: The Rule of Law” (12 July 1999) online: Government of Canada Web Archive http://www.collectionscanada.gc.ca/webarchives/20071122081549/http://www.fin.gc.ca/news99/99-063_2e.html.

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