

# GLOBAL FINANCIAL STANDARD SETTING, THE G10 COMMITTEES, AND INTERNATIONAL ECONOMIC LAW

*Kern Alexander\**

## INTRODUCTION

The global financial and credit crisis of 2007–2009 has highlighted the important role of the G10 committees in setting international standards for the regulation of bank capital adequacy, payment systems, and related issues pertaining to global financial stability. The main three G10 committees—consisting of the Basel Committee on Banking Supervision (“Basel Committee” or “BCBS”), the Committee on Payment and Settlement Systems (“CPSS”), and the Committee on the Global Financial System—are the most influential international financial standard-setting bodies and exercise either direct or indirect influence over the development of banking and payment system law and regulation for all developed countries and most developing countries. Specifically, the Basel Committee has produced a number of important international agreements that regulate the amount of capital that banks must set aside against their risk-based assets, and the allocation of jurisdictional responsibility for bank regulators in overseeing the international operations of banks. Its activities have usually been kept away from the fanfare of high politics, but its recent efforts to amend the 1988 Basel Capital Accord by adopting the Basel II Capital Agreement (“Basel II”) and to extend its application to all countries where international banks operate have attracted significant critical comment and brought its work under close scrutiny by leading policymakers and regulators. The CPSS has created important agreements setting forth principles and recommendations for the regulation of bank payment systems and for the regulation of clearing and settlement of securities trading, and recommendations regarding counterparties. The Committee on Global Financial Systems, though it has not yet adopted regulatory principles or recommendations, has produced a number of influential reports that have influenced the debate on

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\* Ph.D., J.D., MPhil, A.B. Director of Research in Financial Regulation, the Centre for Financial Analysis and Policy, University of Cambridge. I would like to thank Professor Dr. Christine Kaufmann and Professor Dr. Rolf Weber of the University of Zurich Law Faculty for their collaboration, comments, and support. Special thanks to the Swiss National Science Foundation for its financial support on the research project entitled “Trade and Finance: the Regulatory Impact of Liberalized Financial Services” and to Laura Paez and Xenia Roduner at the University of Zurich Rechtswissenschaftliches Institut for their research assistance from 2006 to 2008. All errors are mine.

the credit crisis and have analyzed other issues that affect financial stability.

This Article considers the role of these Committees in influencing the development of international financial law norms that govern domestic law standards, and rules of banking and financial regulation. This Article also examines how the Committees' decision making influences international norms of banking regulation and constitutes an alternative form of international lawmaking. In particular, it will focus on the decision making of the Basel Committee and address how its decision-making process led to the adoption of Basel II and how Basel II has put the global financial system at serious risk. Finally, this Article suggests that the voluntary, nonlegally binding decision-making process of these Committees has important international public policy implications because of the influence they exert on the development of national banking law and regulation, and on the stability of financial markets.

#### I. SOURCES OF INTERNATIONAL ECONOMIC LAW AND FINANCIAL REGULATION

International economic law has become important for economic policymakers who seek to design legal rules by which to manage the growth of global economic interdependence.<sup>1</sup> In 1965, Vellas defined the foundations of international economic law as "dynamic and evolutionary," in contrast to the traditional sources of "general public international law," which he found to be more primitive because they are limited to elementary relationships, such as the concept of state sovereignty; these relationships have made filling in the gaps in international legal rules and principles extremely difficult.<sup>2</sup> Vellas further noted that international economic law is characterized by the specific qualities that constitute a supranational legal order, an empirical and nonformalistic order, one of pragmatism, realism, flexibility, and mobility.<sup>3</sup>

More recently, Lowenfeld suggested that international economic law should be considered all "rules . . . [that] have been developed against the

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1. See PETER MALANCZUK, *AKEHURST'S MODERN INTRODUCTION TO INTERNATIONAL LAW*, 222 & nn.2, 4-5 (7th rev. ed. 1997) (with further references).

2. The U.S. Restatement (Third) of Foreign Relations defines international economic law as "all the international law and international agreements governing economic transactions that cross state boundaries or that otherwise have implications for more than one state, such as those involving the movement of goods, funds, persons, intangibles, technology, vessels or aircraft." *RESTATEMENT (THIRD) OF FOREIGN RELATIONS OF THE UNITED STATES* pt. 8, intro (1987).

3. PIERRE VELLAS, *DRIT INTERNATIONAL ECONOMIQUE ET SOCIAL* [INTERNATIONAL ECONOMIC AND SOCIAL LAW] 21-34 (1965) (Fr.).

backdrop of the theory of international trade, and . . . the question—sometimes explicit, at other times tacit—how far deviations from the theory should be allowed.”<sup>4</sup> A broader doctrine of international economic law includes the role of money, exchange rates, and the balance of payments, in addition to related areas concerning international finance. According to this view, international economic law covers many specialized areas such as trade in the World Trade Organization (“WTO”) agreements, and finance and monetary policy under the Bretton Woods Agreements, as well as the work of the Organisation for Economic Cooperation and Development (“OECD”), the U.N. Commission on International Trade Law, and the Bank for International Settlements (“BIS”). Also, international economic law is usually governed by bilateral and multilateral agreements rather than custom or general principles of law.<sup>5</sup>

International financial law has been defined as covering both the private law relationships of banking and financial services and the public international law of currency and foreign exchange arrangements.<sup>6</sup> The inclusion of international financial law in the broader regime of international economic law, as well as the emergence of the specialized field of international monetary law, can be attributed to the works of the late Sir Joseph Gold.<sup>7</sup> Indeed, according to Gold, the purpose of international monetary law is to form “a complex of relationships among countries on matters . . . that are governed by rules and understandings that are more extensive than international monetary law as a branch of public international law.”<sup>8</sup>

Global economic law has also been interpreted as a self-replicating process in which legal norms arise from nonstate actors, such as associations of private market participants and multinational corporations that operate on a transnational basis. Teubner and others, building on Eh-

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4. ANDREAS F. LOWENFELD, *INTERNATIONAL ECONOMIC LAW* 8 (2003).

5. Cf. MALANCZUK, *supra* note 1, at 223.

6. See ROSA M. LASTRA, *LEGAL FOUNDATIONS OF INTERNATIONAL MONETARY STABILITY* 18–20 (2006). See also Stephen Zamora & Sir Joseph Gold, *Development of International Monetary Law*, in *FESTSCHRIFT IN HONOR OF SIR JOSEPH GOLD* 439 & n.2 (Werner F. Ebke & Joseph J. Norton eds., 1990) (providing further references) (discussing international financial law as “encompassing both private and public international law, the private law of international banking relationships, national regulation of financial transactions, and the public international law of money, including the rules of the IMF”).

7. Sir Joseph was the IMF’s General Counsel from 1960 to 1979, and was the drafter of the First and Second Amendments to the IMF Articles of Agreement. See Kenneth W. Dam, *Introduction*, in *FESTSCHRIFT IN HONOR OF SIR JOSEPH GOLD*, *supra* note 6, at 17–19; Zamora, *supra* note 6, at 440.

8. Zamora, *supra* note 6, at 446. Gold argued that the IMF administered a legal regime. *Id.*

rich's "Bukowina," argue that a modern *lex mercatoria* has emerged outside public law sources and relatively insulated from state institutions to constitute a new "trans-national law of economic transactions."<sup>9</sup> A theory of legal pluralism can explain this global nonstate law governing commercial and economic transactions that has arisen from diverse social systems and is subject to "a highly asymmetric process of legal self-reproduction."<sup>10</sup> For example, the model contracts for cross-border investments, such as project finance or financial services between wholesale counterparties, are often governed by terms that do not have a necessary link to a national legal system. Moreover, accountants and lawyers have agreed to use transnational rule-making processes to govern multinational insolvencies. Similarly, the internal legal regimes of multinational corporations are often devised independently of any one country's corporate law and apply *sui generis* to particular areas of corporate activity. This has also been recognised in the area of labour relations, where multinational firms adopt agreements to govern employee relations with transnational labor unions that are outside the laws of any state legal system.

The generation of international economic norms has also been analyzed through various institutional perspectives. For instance, Slaughter describes the current global order as a world of "disaggregated" States rather than the traditional realist notion of unitary States.<sup>11</sup> These disaggregated states interact with each other not only through foreign ministries, but also through regulatory, judicial, substate, and legislative bodies.<sup>12</sup> She views this "network" system as a novel development in response to globalization. Networks involve mainly government officials who create links across national borders and between national and supranational institutions. These networks perform a variety of functions, including the facilitation of information collection and sharing, technical assistance, and coordination of cross-border enforcement. The scope of these networks can be bilateral, plurilateral, regional, or global, and they interact with a wide range of international organizations, nongovernmental organizations, and civil society movements.<sup>13</sup> Upon closer analysis, however, the novelty of the "network" theory is undermined by the fact that economic, financial, and commercial diplomacy has been conducted through interstate networks since the early nineteenth century and, there-

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9. Gunther Teubner, "Global Bukowina": *Legal Pluralism in the World Society*, in *GLOBAL LAW WITHOUT A STATE* 3, 3 (Gunther Teubner ed., 1997).

10. *Id.* at 11.

11. ANN-MARIE SLAUGHTER, *NEW WORLD ORDER* 5 (2004).

12. *Id.*

13. *Id.* at 5-6.

fore, is not a new form of international cooperation.<sup>14</sup> Nevertheless, as Howse observes, the theory of networks helps to “keep in perspective the role of international law and international institutions in contrast to other mechanisms and tools of governance.”<sup>15</sup>

## II. GLOBALIZATION AND INTERNATIONAL STANDARD SETTING

State borders no longer contain and define economic activity.<sup>16</sup> While sovereign nation states regulate domestic markets, advances in transportation and communication links, which require transnational management and international regulation, facilitate cross-border trade in goods, services, capital, and labor. The growth of financial markets, cross-border capital flows, and financial transactions has led States to create multilateral institutions and international standard-setting bodies to attempt to regulate the cross-border activities of transnational corporations and other firms, and to control and minimize the cross-border externalities produced by certain types of economic and financial risk taking.<sup>17</sup> It is recognized that the influence of these multilateral institutions and standard-setting bodies has grown immensely and that many States have responded by building parallel structures to counterbalance their influence.<sup>18</sup> This has raised several questions: how state decision-making and standard-setting practices should be regulated in these multilateral institutions; what type of legal competency States should exercise when engaged in standard setting; and what the optimal allocation of competency is between international and state-level actors.

Although nation states remain the principal actors in public international law, it is widely accepted today that legal personality can extend to international organizations and, in certain circumstances, to other non-state actors, such as individuals and juridical or corporate persons.<sup>19</sup> Sov-

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14. Extensive networks of economic, financial, and central bank policymakers were involved in the negotiations leading up to the London Conference in 1932 on currency and trade arrangements, as well as in the creation of the Bretton Woods institutions in 1944, and the General Agreement on Tariffs and Trade in 1947.

15. Robert Howse, Book Review, 101 *AM. J. INT'L L.* 231, 232 (2007).

16. JOHN EATWELL & LANCE TAYLOR, *GLOBAL FINANCE AT RISK* ch. 1 (1999).

17. For a discussion of the negative externality of systemic risk in financial systems and its cross-border dimension, see KERN ALEXANDER, RAHUL DHUMALE & JOHN EATWELL, *GLOBAL GOVERNANCE OF FINANCIAL SYSTEMS: THE INTERNATIONAL REGULATION OF SYSTEMIC RISK* 23–25 (2006).

18. See ALVIN LEROY BENNETT, *INTERNATIONAL ORGANIZATIONS: PRINCIPLES AND ISSUES* 265 (1996). See also Ngaire Woods, *The Political Economy of Globalization, in THE POLITICAL ECONOMY OF GLOBALIZATION* 1, 4–5 (Ngaire Woods ed., 2000).

19. IGNAZ SEIDL-HOHENVELDERN, *INTERNATIONAL ECONOMIC LAW* 13 (2nd rev. ed. 1992).

oreign States also continue to be the main actors in economic policy and regulation, usually in both formal international economic organizations, such as the International Monetary Fund (“IMF”) and the WTO, and international financial standard-setting bodies, such as the G10 committees, which include the Basel Committee. In these international institutions, States typically establish the initial terms of reference and decide on membership for States, interstate organizations, and nonstate actors, as well as approve the financing and general operational oversight of these international bodies and organizations. States, though, are finding it increasingly difficult to regulate and manage cross-border trading activities and financial transactions, given the new modes of production, distribution, and consumption, and the rising interconnectedness of governments, societies, and private actors in the world economy. Indeed the forces of globalization are changing the structure of the world economy and are posing major regulatory challenges for States.<sup>20</sup>

As a response to the growing cross-border flow of goods, services, ideas, and people, States have sought to enhance their management and surveillance of cross-border economic activities by coordinating their economic and financial policies with other States through international organizations and multilateral institutions. States have also facilitated the rise and transformation of domestic corporations and firms into multinational enterprises, thus creating new and influential entities at the international level. For international financial markets, the process of globalization has been no different. Expansion, diversification, and international coordination of banking activities and operations have been transformed with the increase of “global competition among bank and non-bank financial intermediaries” and have resulted in the rise of global financial service companies and the consolidation and conglomeration of the banking and financial services industry.<sup>21</sup>

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20. See, e.g., Jost Delbrück, *Structural Changes in the International System and Its Legal Order: International Law in the Era of Globalization*, in 11 SCHWEIZERISCHE ZEITSCHRIFT FÜR INTERNATIONALES UND EUROPÄISCHES RECHT 1, 16 (2001) (Switz.) (defining globalization “as the process or the processes of denationalization/deterritorialization of politics, markets, and laws or, more specifically, process of denationalization/deterritorialization of clusters of political, economic and social transactions involving national and international actors, public and private, leading to a global interconnectedness of these actors in time and space including individuals”).

21. See Joseph J. Norton, *The Multidimensions of the Convergence Processes Regarding the Prudential Supervision of International Banking Activities: The Impact of the Basel Supervisors Committee’s Efforts Upon, Within and Without the European Community*, in FESTSCHRIFT IN HONOR OF SIR JOSEPH GOLD, *supra* note 6, at 249.

## III. INTERNATIONAL STANDARD SETTING AND THE G10 COMMITTEES

In contrast to international economic organizations such as the WTO,<sup>22</sup> or BIS,<sup>23</sup> international standard-setting bodies are not entities with separate legal personality created by States, but rather informal associations of state representatives and/or professionals that meet to address specific problems or to identify issues of concern. In international finance, the globalization of financial services has necessitated that regulators develop cooperative relations to facilitate their oversight and regulation of banking and financial services. Beginning in 1962, the central banks of the ten leading industrialized nations, as well as the Swiss National Bank, began to meet regularly at the BIS and other venues to coordinate central bank policy and to organize lending to each other through the General Arrangements to Borrow.<sup>24</sup> These ten countries plus the Swiss National Bank became known as the Group of Ten or G10.<sup>25</sup> Goodhart has described the relationship of the G10 with one of its standard-setting committees—the Basel Committee—as one of delegated authority to engage in regulatory standard setting:

Having established a standing committee of specialists in this field, the G-10 Governors would find it difficult to reject a proposal from them, especially on a technical matter. The relationships between the G-10 Governors and the BCBS emerge from the analysis of what the BCBS actually did and were quite complex. The G-10 Governors set priorities for work, and frequently required papers to be revised and reconsidered. But at the same time they often gave the BCBS considerable

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22. The WTO was created by the Uruguay Round of Multilateral Trade Negotiations which adopted the WTO Agreements. See Marrakesh Agreement Establishing the World Trade Organization pmbl., Apr. 15, 1994, 1867 U.N.T.S. 154, 33 I.L.M. 1144.

23. The BIS is an international organization created under the Hague Agreements of 1930 and the Constituent Charter of the Bank for International Settlements of 1930. It was established in the context of the Young Plan, which dealt with the reparation payments imposed on Germany by the Treaty of Versailles following the First World War. See JAMES C. BAKER, *THE BANK FOR INTERNATIONAL SETTLEMENTS: EVOLUTION AND EVALUATION* 34 (2002). The BIS served as the payment agent for the European Payments Union, which facilitated the restoration of currency convertibility for the western European countries following the Second World War. For more on the European Payment Union, see DANIEL GROS & NIELS THYGESEN, *EUROPEAN MONETARY INTEGRATION* 4–8 (1998).

24. For a discussion of the General Arrangements to Borrow, see Kern Alexander, *The Fund's Role in Sovereign Liquidity Crises*, in 5 *CURRENT DEVELOPMENTS IN MONETARY AND FINANCIAL LAW* 131, 140–46.

25. The G10 central banks today consist of the central governors of eleven countries—Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Sweden, Swiss National Bank, United Kingdom, and United States—as well as the European Central Bank.

freedom to decide its own agenda, and frequently rubber-stamped the papers emerging; basically the Governors did not have the time or the desire for textual criticism. They had a general oversight role; the detail was to be hammered out in the BCBS.<sup>26</sup>

The G10 established several committees whose secretariats were based at the BIS. The first of these committees was the Eurocurrency Standing Committee. Founded in 1962, it was formed to monitor and assess the operations of the then newly established Euro-currency markets. This Committee later became the Committee on the Global Financial System in 1971. It now deals with broader issues of systemic risk and financial stability. The best-known Committee, the Basel Committee on Banking Regulation and Supervisory Practices, was established in 1974, and today is known as the Basel Committee on Banking Supervision. Finally, the Committee on Payment and Settlement Systems was formed in 1990 to negotiate and set standards to support the continued functioning of payment and settlement systems.<sup>27</sup>

These Committees have examined many important economic policy and financial regulatory issues, as well as elaborated and promulgated best practices in supervision and regulation, the functioning of payment, settlement systems, and the overall operation of financial markets. The Committees are usually chaired by senior officials of member central banks and are composed of experts from central banks, regulatory authorities, and finance ministries. In the case of the BCBS, members also include noncentral bank supervisory authorities and other regulatory and economic policy experts. Members of the Committees have voting power and decision-making authority, while non-G10 country representatives are often consulted for their views on a variety of regulatory and economic issues. Frequently, special initiatives are undertaken to share experience with, and invite the opinions of, those not directly involved in the work of the Committees. In promoting cooperation in their respective areas, the Committees determine their own agenda and, within their mandate, operate independently from their host organization, the BIS,

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26. CHARLES A.E. GOODHART, *A HISTORY OF THE BASEL COMMITTEE ON BANKING SUPERVISION* (forthcoming 2009) (manuscript at ch. 14, on file with author).

27. The CPSS adopted the *Core Principles of Systemically Important Payment Systems*, CPSS Publications, No. 43 (Jan 2001). See also CPSS, *Recommendations for Securities Settlement Systems*, CPSS Publications, No. 46 (Nov. 2001). Three other secretariats for international financial standard setting bodies operate out of the BIS: the Financial Stability Board ("FSB") (originally established as the Financial Stability Forum in 1999), the International Association of Deposit Insurers ("IADI"), and the International Association of Insurance Supervisors ("IAIS").



which only provides its good offices for meetings as well as administrative and research support.

Significantly, these Committees have resolved not to adopt legally binding international standards in a public international law sense, but rather to influence domestic regulatory law, practices and standards by adopting what has become known as “international soft law.” Indeed, Giovanoli, examining some of the issues in the international soft law debate as it relates to financial regulation and markets, has observed that

[f]rom the institutional point of view, the new international financial system involves a great number and variety of institutions, entities and bodies which are directly or indirectly concerned with setting international financial standards. In other words, the new system is decentralized, although some institutions, in particular the IMF, have a prominent position as a result of their strong institutional basis and broad membership. The legal status of the multitude of entities involved varies significantly. The [international financial institutions] are fully-fledged international organizations, while the ‘Gs’ (G-7, G-10 or G-20) are *de facto* groupings created at the initiative of the governments of a number of states and meeting at different levels. There also are sector-specific international groupings of supervisors and regulators, central bank experts’ committees and other groupings such as the FSF. However, what all these bodies have in common is the fact that, as a whole, they have no competence with regard to law-making or rule-making at either the national or international level.<sup>28</sup>

The Basel Committee has been the most important G10 committee with respect to its impact on developing legally nonbinding international financial standards. In December 1974, the Basel Committee was formed by the G10 central bankers to respond to a financial crisis that had arisen from the collapse of the German bank Herstatt, which had led to signifi-

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28. Mario Giovanoli, *A New Architecture for the Global Financial Market: Legal Aspects of International Financial Standard Setting*, in *INTERNATIONAL MONETARY LAW: ISSUES FOR THE NEW MILLENNIUM* 3, 11 (Mario Giovanoli ed., 2000). The FSF was established by the G7 in 1999 in response to the Asian financial crisis, partly to coordinate the work of the multifarious bodies already established, including the BCBS and the various departments of the OECD. See Financial Stability Forum, History, <http://www.financialstabilityboard.org/about/history.htm> (last visited June 3, 2009). The FSF Compendium of Standards with a summary and classification of the most significant rules, best practices, principles, and guidelines of international financial regulation. They are categorized based on twelve key standards, which are broken into three categories: macroeconomic policy and data transparency; institutional and market infrastructure; and financial regulation and supervision. See Financial Stability Forum, Compendium of Standards, 12 Key Standards for Sound Financial Systems, [http://www.financialstabilityboard.org/cos/key\\_standards.htm](http://www.financialstabilityboard.org/cos/key_standards.htm) (last visited June 3, 2009). See LASTRA, *supra* note 4, at 459–60.

cant problems with foreign exchange and settlement risk between U.S. and European banks. In the same year, the U.S. Franklin National Bank became insolvent and posed a risk to counterparty banks because of its miscalculations of foreign exchange risk in the wholesale loan market. Both of these crises exposed substantial gaps in the ability of central bankers and national regulators to control and manage a crisis with cross-border effects. The Basel Committee adopted a Concordat, in February 1975, that established principles of information exchange and coordination for the oversight of the cross-border operations of banking institutions.<sup>29</sup> The 1975 Concordat was amended in 1983, in response to the collapse and insolvency of the Italian bank Banco Ambrosiano.<sup>30</sup> The 1983 Revised Concordat contained the principle of consolidated supervision; this principle provides that home country regulators shall have responsibility for ensuring that the transnational operations of their home country banks are sound regarding credit risk exposure, quality of assets, and the capital adequacy of the banking group's global operations.<sup>31</sup>

Later, following the Latin American sovereign debt crisis of the early 1980s, and the resulting near collapse of several major U.S. banks because of their excessive lending to emerging market sovereigns, the Basel Committee adopted the 1988 Capital Accord, which established a minimum eight percent capital adequacy requirement on internationally active banks within G10 country jurisdictions.<sup>32</sup> The Capital Accord was originally calculated based on a bank's credit risk exposure, but was later

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29. See GEORGE A. WALKER, *INTERNATIONAL BANKING REGULATION: LAW, POLICY AND PRACTICE* 87 (2001).

30. The 1983 Revised Concordat was entitled "Principles for the Supervision of Banks' Foreign Establishments."

31. See ALEXANDER, *supra* note 17, at 47-48.

32. The 1988 Capital Accord's original purpose was to prevent the erosion of bank capital ratios resulting from aggressive competition for market share by the leading banks during the 1980s. The Accord also hoped to harmonize the different levels and approaches to capital among the G10 countries. In adopting the 1988 Accord, banking regulators wanted to establish an international minimum standard that would create a level playing field for banks operating in the G10 countries, and banking regulators wanted capital requirements to reflect accurately the true risks facing banks in a deregulated and internationally competitive market. The 1988 Capital Accord required banks actively engaged in international transactions to hold capital equal to at least eight per cent of their risk-weighted assets. This capital adequacy standard was intended to prevent banks from increasing their exposure to credit risk by imprudently incurring greater leverage. The Accord was entitled "International Convergence of Capital Measurement and Capital Standards," and it applied, according to the principle of home-country control, to banks based in G10 countries with international operations. Basle Comm. on Banking, *International Convergence of Capital Measurement and Capital Standards*, July 1988, <http://www.bis.org/publ/bcbs04a.pdf?noframes=1>.

amended in 1996 to include a bank's market risk exposure (i.e., trading book exposure), thereby extending the eight percent capital adequacy requirement to a bank's trading book activities.<sup>33</sup> Between 1999 and 2004, the Committee engaged in a lengthy and radical revision of the Accord known as "Basel II." The revision was concluded in 2004, and the Committee published a final text of the revised Capital Accord in June 2004.

Basel II aims to make regulatory capital more sensitive to the risks that banks face in the marketplace. In doing so, it allows banks, under most conditions, to hold less regulatory capital for their credit, market, and operational risk exposures. The global credit crisis, however, revealed that banks are also exposed to significant liquidity risks, especially in their off-balance sheet exposures. Basel II regulatory capital requirements fail to address the liquidity risks to which banks are exposed and also do not require banks to hold adequate capital for the systemic risk that their lending and risk-taking creates.<sup>34</sup> These issues are now under review by the Basel Committee in light of the credit crisis. Having committed themselves to implementing Basel II into their domestic legal systems, the G10 countries have begun to do so or have already completed the implementation process.<sup>35</sup>

#### *A. Decision Making and Implementation*

The Basel Committee's decision making operates on a consensus basis. Although the Committee's decision making has traditionally been secretive and substantially relied on personal contacts, it has become more formalized in recent years because of the considerable attention given to the deliberations over Basel II.<sup>36</sup> As discussed above, the Com-

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33. This was known as the "Market Risk Amendment 1996." See ALEXANDER, *supra* note 17, at 38–39.

34. See KERN ALEXANDER ET AL., FINANCIAL SUPERVISION AND CRISIS MANAGEMENT IN THE EU 2–7 IP/A/ECON/ST/2007-26 (Dec. 2007) (Commissioned Report by the EU Parliament Committee on Economic and Monetary Affairs), available at <http://www.europarl.europa.eu/activities/committees/studies/download.do?file=19191#search=%20Financial%20supervision> [hereinafter FINANCIAL SUPERVISION].

35. In Europe, the European Community adopted Basel II as EC law in 2006, when the Council of Ministers and the EU Parliament approved the Capital Requirements Directive, which is contained in Council Directives 2006/48/EC, 2006 O.J. (L 177) and 2006/49/EC, 2006 O.J. (L 177).

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

mittee's decisions are *legally nonbinding* in a traditional public international law sense and place a great deal of emphasis on decentralized implementation and informal monitoring of member compliance.<sup>37</sup> The Committee has sought to extend its informal network with banking regulators outside the G10 through various consultation groups.<sup>38</sup> It has conducted seminars and consultations with banking regulators from over one hundred countries as part of the deliberations over adopting the Basel II agreement. Most recently, in response to criticism over Basel II and to the lack of accountability and legitimacy in its decision-making structure, the Committee expanded its membership from thirteen to twenty countries in March 2009.<sup>39</sup>

Although some have viewed the informality of the Committee's decision-making process as effective for developing international banking regulatory standards,<sup>40</sup> others have considered it a constraint on effective implementation.<sup>41</sup> As Goodhart has observed, "The way that the BCBS, under its various Chairmen, interpreted this constraint was that all proposals for forward transmission to the G-10 Governors, and thence to the

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37. Indeed, the Basel Committee states the following on the BIS website:

The Committee does not possess any formal supranational supervisory authority, and its conclusions do not, and were never intended to, have legal force. Rather, it formulates broad supervisory standards and guidelines and recommends statements of best practice in the expectation that individual authorities will take steps to implement them through detailed arrangements—statutory or otherwise—which are best suited to their own national systems. In this way, the Committee encourages convergence towards common approaches and common standards without attempting detailed harmonisation of member countries' supervisory techniques.

Basel Comm. on Banking Supervision, *History of the Basel Committee and Its Membership* 1 (Jan. 2007), <http://www.bis.org/bcbs/history.pdf>.

38. The Core Principles Liaison Group remains the most important forum for dialogue between the Committee and systemically-relevant non-G10 countries. Moreover, the BIS established the Financial Stability Institute to conduct outreach to non-G10 banking regulators by holding seminars and conferences on implementing international banking and financial standards.

39. See Bank for Int'l Settlements, *Expansion of Membership Announced by the Basel Committee* (Mar. 13, 2009), <http://www.bis.org/press/p090313.htm> (announcing that the Basel Committee decided on March 10–11, 2009, to expand its membership from thirteen to twenty countries by adding Australia, Brazil, China, India, South Korea, Mexico, and Russia). The BCBS's expanded membership, however, does not apply to the membership of the G10 central bank governors, which remains the same with twelve developed countries plus the European Central Bank.

40. Patricia Jackson, Bank of Eng., Lecture at the Judge Institute of Management, University of Cambridge (Mar. 15, 2002).

41. See GOODHART, *supra* note 23.

wider community of regulators/supervisors around the world, had to be accepted consensually by all country members of the Committee.<sup>42</sup> As a consensus of all Committee members was required to adopt any standards or agreement, each country had a veto. According to Goodhart, however, this was in practice “somewhat less of a constraint than it might seem at first sight.”<sup>43</sup> The smaller countries, for example, Benelux, Canada, Italy, Sweden, and Switzerland, were reluctant to object to proposals by the United States and United Kingdom and rarely took a minority position, “except on a matter of extreme national importance, an example of [which is] . . . banking secrecy for Switzerland.”<sup>44</sup> Despite Japan’s substantial economic and financial influence, Goodhart notes that Japanese representatives on the Committee “usually remained quiet and withdrawn . . . partly due to their rapid turn-over of personnel, so they had little opportunity to build up expertise.”<sup>45</sup>

Monitoring noncompliance has generally been a decentralized task that is the responsibility of Member States themselves, not international organizations, such as the BIS, or other international bodies.<sup>46</sup> Nonetheless, the Committee monitors and reviews the Basel framework with a view to achieving greater uniformity in its implementation and convergence in substantive standards. Moreover, the Committee claims that the legitimacy of the international standards it adopts derives from a communiqué issued by the G7 Heads of State in 1998 that encouraged emerging economies to adopt “strong prudential standards” and “effective supervisory structures.”<sup>47</sup> To ensure that its standards are adopted, the Committee expects the IMF and World Bank to play a surveillance role in overseeing Member State adherence through its various conditionality programs. In addition, because most G10 countries are members of the European Union, they are required by EU law to implement the Capital Accord into domestic law.<sup>48</sup> In fact, the only G10 countries not required by local law to implement the Capital Accord are Canada, Japan, and the United States.<sup>49</sup> This extended application of the Basel Committee’s standards to

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42. *Id.*

43. *Id.*

44. *Id.*

45. *Id.*

46. See JOSEPH NORTON, *DEVisING INTERNATIONAL STANDARDS OF BANKING SUPERVISION* (1995).

47. *Id.*

48. See Council Directive 2006/48/EC, 2006 O.J. (L 177); Council Directive 2006/49/EC, 2006 O.J. (L 177).

49. In fact, a major obstacle in negotiations over Basel II had been the initial reluctance of the U.S. Congress and the refusal of some U.S. bank regulators to apply Basel II to most U.S. banks. The Federal Reserve, which has been an important supporter of Basel

non-G10 countries has raised questions regarding the accountability of its decision-making structure and its suitability for application in developing and emerging market economies.<sup>50</sup>

As an international legal matter, the Basel Capital Accord and its amended version, Basel II, are not legally binding in any way for G10 countries or other countries that adhere to it. The Capital Accord has been analyzed and classified as a form of “soft” law.<sup>51</sup> On an institutional level, the BCBS has no authority to take a decision of its own and has no formal legal mandate. It merely serves as a forum for discussion amongst central bankers and bank supervisors. It voluntarily adopts common regulatory standards and suggested financial policies, but leaves it to the discretion of national authorities to implement them into their national systems.<sup>52</sup>

The work of the Basel Committee does generate international standards of financial regulation, but these standards are not intended to have legally binding effect under public international law. Basel Committee standards only become legally effective when national authorities adopt

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II and has the authority to apply it to U.S. financial holding companies, has begun applying it to the largest of such companies, while all other U.S. credit institutions will follow a different implementation schedule that will result in Basel II being fully adopted by U.S. banks between 2013 and 2015. *See* Risk-based Capital Guidelines; Capital Adequacy Guidelines; Capital Maintenance; Domestic Capital Modifications, Advanced Notice of Proposed Rule-Making, 12 C.F.R. pt. 3 (Oct 6, 2005).

50. ALEXANDER, *supra* note 17, at 135–37.

51. *See id.* ch. 3 (discussing international soft law). *See also* Giovanoli, *supra* note 28, at 11–12.

52. Walker observes that

[i]nternational standards have become of particular importance in recent years due to the need to develop some common or, at least, minimum level of rules and regulations in various core areas of modern financial and economic practice. In light of the difficulties that naturally arise in attempting to agree [to] any formal treaty, convention or similar formal prescriptive solution at the international level, a more informal consensus based approach has to be attempted, at least[] during the early stages until some basic common agreement (and supporting sense of self-interest and commitment) may be achieved. This will certainly be the case in many such sensitive and complex areas as international bank and financial market control. A standards based approach also has the obvious advantage of flexibility and informality although this necessarily means that it suffers from the associated operational limitations of weak adoption and compliance. The key issues that then arise with international standards are not with regard to legal classification and formal enforcement but with national adoption and implementation[,] and implementation review.

GEORGE ALEXANDER WALKER, LAW, POLICY AND PRACTICE, at xxiii (2000).

them into domestic law and regulation. Although there is a tendency to attribute international legal significance to the international standards generated by the various committees that meet at the BIS, the overwhelming opinion of experts and policymakers clearly holds that the international standards adopted by these committees are not legally binding in any sense. They are, however, important international norms that influence and shape state behavior and are an effective form of legally nonbinding international soft law that has significant public policy relevance in the global financial governance debate.

The Basel Committee's capital adequacy standards and rules on consolidated supervision were intended to apply only to credit institutions based in G10 countries that had cross-border operations. But this changed in 1998 during the Asian financial crisis when, at the urging of the G7 finance ministers and the world's largest financial institutions, which were lobbying for more market sensitive capital standards, the Basel Committee stated its intent to amend the Capital Accord and to begin working on Basel II with a view to making it applicable to all countries where banks operate on a cross-border basis. Many non-G10 countries have incorporated the Basel standards into their regulatory frameworks for a variety of reasons, including strengthening the soundness of their commercial banks, raising their credit rating in international financial markets, and achieving a universally recognized international standard. The IMF and World Bank have also required many countries to demonstrate adherence or a realistic effort to implement the Basel Accord in order to qualify for financial assistance as part of IMF Financial Sector Assessment Programs and World Bank Financial Sector Adjustment Programs. Moreover, as a condition for obtaining a bank license, all G10 countries require foreign banks to demonstrate that their home country regulators have adopted the Capital Accord and other international agreements. International reputation and market signals are also important in creating incentives for non-G10 countries to adopt the Capital Accord. Many non-G10 countries (including developing countries) have found it necessary to require their banks to adopt similar capital adequacy standards in order to attract foreign investment as well as to stand on equal footing with international banks in global financial markets.

#### *B. The CPSS and the Committee on the Global Financial System*

The other G10 committees that serve as international financial standard setting bodies—the CPSS and the Committee on Global Financial System—have adopted standards, principles, codes, guidelines, frameworks, and reports that have had a significant impact on the development of domestic public law standards, national regulations, and supervisory prac-

tices. The CPSS consists of the G10 central bank officials who examine issues of payment system regulation as well as clearing and settlement of securities and foreign exchange transactions. The Committee undertakes specific studies in the field of payment and settlement systems at its own discretion or at the request of the G10 Governors. It has published several important sets of principles and recommendations in the areas of payment system regulation and clearing and settlement of securities.<sup>53</sup> The Committee operates through a network of working groups. To address concerns that it is merely an exclusive committee of G10 central bankers, the Committee has in recent years developed relationships with other central banks, particularly those of emerging market economies, so that its work can have more influence with, and be influenced by, central banks outside the G10. The CPSS has also published a number of reports that have influenced the regulation of payment infrastructure and settlement systems.<sup>54</sup> As with the Basel Committee, the principles and recommendations issued by the CPSS are not legally binding, as regulators seek to agree on standards that different jurisdictions can flexibly implement into their regulatory regimes. Although these international standards are without legal effect, they provide an important set of international norms that influence regulatory and supervisory practices and the standards for controls and oversight of financial infrastructure.

Similarly, the Committee on Global Financial Systems monitors developments in global financial markets for the G10 central bank Governors. The G10 Governors have provided a mandate to the Committee to identify and assess potential sources of stress in global financial markets.<sup>55</sup> The Committee engages in research to identify issues and threats to systemic stability in global financial markets, examine the structural underpinnings of financial markets, and promote improvements to the functioning and stability of these markets. Representatives of the G10 monitor on a quarterly basis the discussions and reports issued by the

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53. The CPSS's publication of the Core Principles for Systemically Important Payment Systems, the CPSS/IOSCO Recommendations for Securities Settlement Systems, and the CPSS/IOSCO Recommendations for Central Counterparties has contributed to the set of standards, codes, and best practices that are deemed essential for strengthening the international financial system. Committee on Payment and Settlement Systems, CPSS Publications, <http://www.bis.org/cpss/index.htm> (last visited Apr. 26, 2009).

54. The Committee has published various reports examining large-value funds transfer systems, securities settlement systems, settlement mechanisms for foreign exchange transactions, clearing arrangements for exchange-traded derivatives, and retail payment instruments, including electronic money. Its "Red Book" on payment systems provides extensive information on the most important systems in the CPSS countries.

55. Bank for Int'l Settlements, *Committee on the Global Financial System: Mandate*, Feb. 8, 1999, <http://www.bis.org/cgfs/mandate.htm>.



Committee; they also work with the Committee to identify long-term research projects involving working groups, which consist of central bank and regulatory staff, and the drafting of various reports.

Other international supervisory bodies have also played a key role in developing international standards and rules for the regulation of financial markets. The International Association of Deposit Insurers meets at the BIS and discusses and adopts international principles and standards that govern deposit insurance regulation. In the area of money laundering and terrorist financing, the OECD's Financial Action Task Force ("FATF") has attained a high profile role in setting international standards (so-called recommendations) of disclosure and transparency for the regulation of banks, financial service providers, and other businesses in order to combat the global problem of financial crime.<sup>56</sup> The FATF and the Basel Committee have each played a much more prominent role in their respective international regulatory standard-setting functions as compared to the International Organization of Securities Commissions ("IOSCO") and the IAIS. In recent years, however, IOSCO and the IAIS have attracted much more policy attention since their standards and recommendations have been recognized by the IMF and World Bank as international benchmarks against which IMF and World Bank member countries are assessed for compliance in their financial sector assessment programs.

As discussed above, these international standard-setting bodies have been characterized as "networks" of international technical experts. But, it is submitted that their role is much larger than narrow technical experts, as they influence the development of broader economic policy and their negotiations and standard setting is more accurately characterized as a form of financial diplomacy. Although they are at the "coal face" of technical and regulatory standard setting, the goal of these regulatory technicians in international bodies is to devise broader international standards that govern the operations of financial markets and the many financial firms—banks, securities and insurance companies—in those markets with an important impact on the broader macroeconomy. These national regulators and supervisors—mainly from developed countries—use international standard-setting bodies to influence not only technical areas of regulation, but also broader areas of financial development. This

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56. Other important international standard setting bodies include the International Accounting Standards Board and the International Federation of Accountants, which are composed of non-state representatives that include professional accountants and academics who devise international accounting standards for the accounting industry. Similarly, the International Auditing and Assurance Standards Board sets standards for international financial reporting.

is especially the case with the creation of the G20 and the enhanced financial policy role of the FSB and the broader policy agenda for the Basel Committee with respect to the Core Principles of Banking Supervision. The G20, the FSB, and the G10 committees are all playing high profile roles in economic and financial policymaking and in influencing the development of international financial regulation.

In this vein, the Joint Forum on Financial Conglomerates (“Joint Forum”) and the FSB<sup>57</sup> have both been characterized as intergovernmental standard-setting bodies. They are composed of regulators and supervisors from the G10 and G20 countries and some large emerging market countries, and of representatives from other G10 standard-setting bodies. Established in 1996 under the aegis of the BCBS, IAIS, and IOSCO,<sup>58</sup> the Joint Forum issues legally nonbinding documents and principles. In contrast to its constituent international bodies, the Joint Forum has established a set of principles designed to assist regulated entities in determining the minimum steps they should take when considering outsourcing activities. These include creating a coherent policy and specific management plan for programs as well as deciding the types of issues that should be considered in contracts. The principles also contain some broad standards to help supervisors.<sup>59</sup> It develops its principles in conjunction with IOSCO, which produced the Objectives and Principles of Securities Regulation in 1998.<sup>60</sup> The Joint Forum’s principles are in its own words “high-level and cross-sectoral, designed to provide a minimum benchmark” for all financial institutions.<sup>61</sup> In contrast to the IOSCO principles, the Joint Forum minimum benchmarks are complementary and designed specifically for securities firms.

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57. The FSB, formerly the Financial Stability Forum, was “re-established” at the G20 Summit in London in April 2009. See G20, *Declaration on Strengthening the Financial System—London 1* (Apr. 2, 2009). The FSB will play a higher-profile role than its predecessor, the FSF, in monitoring global financial stability. Specifically, it will establish a supervisory college to monitor each of the largest international financial services firms. It will monitor a firm’s financial and operational structure, and any contingency funding arrangements, and will act as a clearing house for information sharing and contingency planning for the benefit of its member countries. *Id.*

58. ALEXANDER, *supra* note 17, at 50.

59. *Id.*

60. INT’L ORG. OF SEC. COMM’NS, OBJECTIVES AND PRINCIPLES OF SECURITIES REGULATION (1998), available at <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD82.pdf>.

61. Bank for Int’l Settlements, *Joint Forum Provides Outsourcing Guidance to the Financial Sector* (Aug. 2, 2004) <http://www.bis.org/press/p040802.htm>.

The FSB consists of the twenty countries that compose the G20.<sup>62</sup> It coordinates activities relating to issues common to the banking, securities, and insurance sectors. As the common body of three international financial bodies, the BCBS, the IAIS, and IOSCO, the FSB sets soft law in the form of guidance, and issues reports producing principles of prudential regulation, international cooperation between supervisors, executive compensation in financial firms, accounting standards, tax havens, and non-cooperative jurisdictions. It also collaborates with the IMF in conducting early warning exercises.

These international bodies lack the requisite attributes of an international organization, namely, they are not subject to international law, and do not have international personality, the capacity to conclude treaties, or international legal immunities. It is precisely because of these nonlegal attributes that these international standard-setting bodies—composed of state representatives and international organizations—have been praised for having a more flexible decision-making structure with a powerful normative component that significantly influences the development of national economic law and regulatory practices. Indeed, the type of international financial standard setting engaged in by the Basel Committee has been praised as an alternative form of international lawmaking without the burden of cumbersome treaty formation rules and the imprecise—and often politically impractical—requirements for the formation of customary international law. The international financial standard-setting bodies have been praised for being more effective in adopting economically beneficial regulatory norms and standards for most countries, while exercising far more influence over state economic and regulatory practice than the influence exerted by many formal international and regional economic organizations.<sup>63</sup> The worldwide credit crisis, however, has called the efficacy of this flexible and unstructured international decision-making process into question.

#### IV. THE BASEL COMMITTEE AND THE WORLDWIDE CREDIT CRISIS

Although the flexible and secretive manner in which the Basel Committee and the other G10 committees have conducted their deliberations and standard setting has generally been considered a strength in the effectiveness of their governance structures and decision-making processes,<sup>64</sup>

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62. The G20 countries are the same countries that are members of the Basel Committee. *See supra* note 39 and accompanying text.

63. *See* ALEXANDER, *supra* note 17, at 136–39.

64. The unstructured and secretive deliberations process has been praised because it allows regulators to respond quickly to rapidly changing developments in financial markets. *See* Jackson, *supra* note 38.

it has also had the unfortunate result of exposing them to special interest group pressure from major banks and international finance associations.<sup>65</sup> Most of the major international banks and their advocates used the more flexible institutional structure of the Basel Committee with its opaque decision-making processes to lobby regulators and central bankers to adopt more market-sensitive regulatory capital requirements. This led to weaker capital adequacy measurement processes for banks, which resulted in lower bank capital levels that did not cover the social costs (or negative externalities) of bank lending and overall risk-taking.<sup>66</sup> Moreover, Basel II did not address the serious liquidity risks which banks were exposed to through securitization and other forms of credit risk transfer. The combination of the banks' exposure to liquidity risk in securitization markets and to higher levels of credit risk and market risk, because the Basel II models permitted banks to hold far lower levels of regulatory capital than what was socially optimal, created serious systemic risk to the global financial system and contributed significantly to the causes of the global credit and financial market crisis of 2007–2009.<sup>67</sup> Essentially, Basel II permitted regulators to approve more market-risk sensitive capital models, which led to lower levels of regulatory capital and created an incentive for banks to increase their leverage levels in the structured finance and securitization markets.<sup>68</sup>

The failure of the Basel Committee and other international financial standard-setting bodies to anticipate the virulent risks created in the financial system over the last ten years has resulted in tremendous criticism of the bodies and the G10 committees for their failure to oversee adequately the international standard-setting process. The Basel Committee's failure to adopt regulatory capital standards that would require banks to manage their balance sheets in a more socially compatible manner resulted in high levels of leverage in the global financial system that contributed significantly to the causes of the worst financial crisis since the Great Depression of the 1930s. In other words, the lack of transparency and accountability in the Committee's decision-making structure, and the bankers' excessive influence on the regulators who were members of the Committee, resulted in the leading G10 countries adopting

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65. For example, the Institute for International Finance in Washington D.C.

66. Indeed, a major impetus for Basel II was the lobbying of major multinational banks and their trade associations, which wanted the eight-percent capital adequacy standard of the 1988 Capital Accord lowered significantly to reflect more approximately the economic capital levels that bank risk models suggested they hold to protect the investment capital of bank shareholders.

67. FINANCIAL SUPERVISION, *supra* note 34, at 2–7.

68. *Id.*

weak bank capital standards, thereby bringing about the world economy's fall into a serious economic recession.

#### CONCLUSION

The legal implications of the international financial standards produced by these bodies have raised important questions regarding the definition, relevance, and development of international economic law. The growing importance of the international financial standards, such as the Basel Capital Accord, and their acceptance by most countries for their domestic regulatory systems have demonstrated the importance of international financial soft law in influencing state practice. It has also shown that States in the financial regulatory arena have a certain disregard for using traditional public international law to govern state practice and the operations of global financial markets.

The current enthusiasm for international financial soft law standards has two disquieting implications. First, many governments not actively involved in the Basel standard-setting process are suffering an involuntary loss of sovereignty, as they have not been involved in the negotiation and design of the international standards. This loss is at odds with the general presumption in international law that governments are sovereign unless they decide to cede their sovereignty. Moreover, the growing obligation for States to adopt the Basel standards without representation in the standard-setting process calls into question the accountability and legitimacy of the Basel Committee. Perhaps, the G10's effective monopoly on decision making should be ended by allowing other countries that are also representative of the global financial system to have a seat at the table.

Second, as a matter of economic policy, if those designing the standards maintain the fiction that they are voluntary when in fact they are not, the content of the standards is likely to be suboptimal for economic growth and financial development, as is demonstrated with the recent financial crisis. Future research should elaborate what role international economic law should play in enhancing the institutional structure of decision making in order to achieve financial stability and development objectives. Moreover, the catastrophic financial crisis that has plagued Western financial markets from 2007 to the present raises important issues regarding the governance structure of the G10 committees and in particular the standard-setting competence of the Basel Committee, whose regulatory standards have completely failed in protecting the global financial system and in providing an efficacious, prudential regulatory model for future financial development.