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Golden Gate University

School of Law

S.J.D. Dissertation

A Just New World Order in the Global Finance

by

Insop Pak

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Insop Pak
San Francisco, California
May 2005

Introduction

Now that globalization is in the air, it is discernible in various forms and assuming varying contacts and ramifications. Globalization already affects national treatment and practice. It raises a number of questions that cannot be readily and easily answered. It may have to strengthen or weaken, in some respect or to some extent, the traditional concept of national boundary or territoriality, within which only one supreme authority exists without any external interference or interposition. Gradual and natural erosion of sovereign authority of a state is superseded by that of a global, supranational, or regional entity.

In particular, the globalization of finance has created a significant evolution of the international financial system in recent years. Very rapid increases in telecommunication and computer-based technologies have reduced the costs of borrowing and lending across traditional national boundaries, and thereby led to a dramatic expansion of cross-border financial flows entailed by the instantaneous transmission of information around the globe. Notably, the global financial integration has eroded economic and regulatory barriers to

competition across the marketplace for financial services. The growing global financial system is demonstrated to be far more efficient today than ever before in that it has significantly facilitated cross-border trade in goods and services, and thus substantially contributed to standards of living worldwide.

However, the world financial system has witnessed that the efficiency of the global system has exposed and punished underlying economic weakness swiftly and decisively, which has been accompanied by the effective transmission of financial disruptions as shown in considerable worldwide economic turbulence over the last decade, and the risks that internationally active banking and financial institutions have had to cope with have become more complex and challenging. As evidenced in recent financial crisis episodes, the world's financial regulators have been struggling with dealing with new and complex financial instruments and techniques driven by the financial innovation over the preceding decades. In particular, bank regulatory authorities have not succeeded in keeping pace with the dynamics of evolving international financial system, such as improvements in risk management in banking organizations, thereby failing to catch up with the market.

In the circumstances, the globalization of finance spurred by the information revolution has called for the integrated international regulation of banking organizations. At the same time, recent financial crises have raised a question of global governance as an agenda for rethinking about the rules and norms that underpin the world order, because the current global governance agenda emphasizes the universalization of understanding of global governance based on the efficiency and effectiveness through one-size-fits-all formulas, in which democratic accountability and participation is a secondary variable. Although implementing internationally acceptable financial standards is important, but remains problematic, because the national differences in financial systems and regulatory frameworks that underpin existing practices complicate the process of identifying and enforcing the standards. Despite strong pressures for the convergence of one-size-fits-all standards throughout the global system, the current global governance agenda has given little attention to the tension between harmonizing pressures of financial globalization led by advanced financial centers and prevailing diversity of financial systems and to their economic consequences. Prevailing variations in national financial practices continue to

complicate policy and regulatory cooperation through international institutions. Thus, the continued failure of national regulatory authorities to collaborate effectively attenuates prospects for the successful restructuring of the global financial regime through international cooperation based on harmonization. Here persistent national differences in financial market structures and institutions have significant implications for international cooperative efforts at global financial governance.

In order to restructure global governance toward a just new world order in the international finance, it needs to explore specific policy and regulatory options to national and international policy makers in devising patterns of regional and international cooperation. An important issue is how to enhance democracy, legitimacy, and accountability in the global financial regime dominated by the leading industrial states. Further, it needs to address what should be the appropriate national and international responses to the growing needs for regional cooperation through regional institutional coordination, as international regulatory cooperation continues to be difficult.

While the private sector activities have increasingly dominated global financial transactions, the wider public sector policy and regulatory objectives of financial governance have become more difficult. Further, there is a recognition that in light of ongoing global financial integration, emerging forms of governance and regulation involve a shift in power and authority from public sector institutions, across international layers, to forms of private sector and, increasingly, private interest governance and regulation. This situation pertains in both developed and emerging market economies. In particular, regulatory reform efforts on the part of national regulatory authorities and institutional institutions are important, but they are not sufficient for the effective governance of global finance. Notably, the role and influence of private sector actors in the elaboration of public policy with regard to financial regulation have been considerably enhanced at national, regional, and international levels. While the private sector is crucial to the governance of financial system at national, regional, and global levels, what should be the proper balance between public authority and private interests? To that end, the role of the state is deemed

to stand in need of reevaluation in an increasingly integrated global economy, as the private sector involvement is essential to the effective governance of global finance.

In line with the analyses above, this study attempts to address that in search of a just new world order in the global finance what should be the proper national, regional, and international responses to the global financial integration. At first glance, it analyzes the globalization of finance. The impact of globalization on state sovereignty is also demonstrated. In this regard, this study seeks to reconceptualize the traditional notion of state sovereignty. Here it highlights the increased interaction and interdependence between states and nonstate actors in the global economy. Then, this study moves on to the anatomy of the dynamics of global governance through government networks—independent national regulatory agencies—among states in terms of transgovernmentalism. In the context of an increasingly global economy, it acknowledges the rise of transgovernmental regulatory organizations in various areas and the achievements of these government networks, but it attempts to point to problems with the networks. With the investigation of the transgovernmental theory in light of global

governance, this study identifies the features of transgovernmental financial regulatory organizations.

Thereafter, the focus of this study shifts to the examination of international banking regulation and supervision under the auspices of the Basel Committee on Banking Supervision (Basel Committee). As noted, no other sector than banking has become more global in its operations, and thus more difficult to monitor and supervise it. As such, global convergence in banking has made greater strides than in any other financial sector. However, some skepticism has run over the argument that global standards in banking have been established by the international financial community's concerns about the safety and soundness of the global financial system. Arguably, hegemony of Western powers began a drive to move in terms of hegemonic stability more than their concerns about a global banking crisis. In this context, this study attempts to assess the Basel Committee's bank supervisory standards and capital adequacy rules, and thereby rethink whether global convergence in banking regulation is desirable and inevitable. To that end, it seeks to address the impetus for the creation of the Basel Committee, and explore driving forces

behind the internationalization of bank regulatory and supervisory standards. Following the theoretical analysis of systemic risk, historical experiences of bank failures are reviewed to answer the question about whether systemic risk has really played a key role in the internationalization of bank regulatory and supervisory standards.

More importantly, this study attempts to explore the origins of the Basel Accord on bank capital adequacy. To do so, it largely relies on current theories on the process of negotiating the capital adequacy standards in the areas of political science and international political economy. At this point, this study takes a position as a break against the force of international market failure logic that has enjoyed an exceptionally positive reception among economists, political scientists, and legal experts. Nonetheless, it does not intend to freeze the international coordination and cooperation of banking regulation.

Given the understanding of the politics behind the creation of the Basel Accord, this study evaluates the Basel Accord of 1988 and the new capital adequacy framework (Basel II), and then moves beyond the assessment of the capital adequacy standards. In doing so, it attempts to draw lessons from Basel toward a just world order in the global finance. In

search of a new international financial order, this study analyzes the dilemmas of international financial regulation. Then, the role of private regulation is examined. While this study stresses the importance of the private sector in the governance of financial system at national, regional, and international levels, it addresses what the proper balance should be between the public authority and private interests for the appropriate public-private partnership. Given the difficulties of institutional collaboration at the international level, this study emphasizes the importance of regional cooperation for global financial governance. In this way, it seeks to contribute to an assessment of proper balance between the market and regulatory discipline that would ensure that financial institutions have sufficient opportunities to compete fairly and profitably in a global marketplace. Finally, this study attempts to answer the question of what should be the appropriate national, regional, and international responses to global financial integration, and thus provide a new paradigm for the just world order in global finance.

I. The Globalization of Finance

A. Introduction

Globalization[1] has begun in various dimensions. Since the inception of the globalization process in numerous aspects, all our global neighbors are increasingly seeing the new issues and counter-effects that government and societies must confront. Amidst the enormous challenges driven by the process, it is worth noting that globalization propelled by information revolution[2] and technology innovation has created the increasing needs of cross-border relationships between countries, which extend across widely dispersed locations, transcending territorial borders. The global financial system has been evolving at ever-fast rates in the past decades. New technology has radically reduced the cost of borrowing and lending across national borders, facilitating the development of new

[1] Globalization commonly refers to the erosion of geographical borders between states in the form of cross-border exchange of goods, services and information technology along with cultural transfers. *See* Roman Terrill, *What does 'Globalization' mean?*, 9 TRNASNAT'L L. & CONTEMP. PROBS. 217, 218 (1999); Greenspan describes globalization as "the interaction of national economic systems." *See* Alan Greenspan, Opening Remarks presented at the symposium sponsored by the Federal Reserve Bank of Kansas City, titled Global Economic Integration: Opportunities and Challenges (August 24-26, 2000), at 1.

[2] The information revolution has raised the significance of the "back office operations" supporting other business activities, which were formerly considered as mere "plumbing," but now main operational process of business organizations seeking more profits. *See* Jane K. Winn, *Catalytic Impact of Information Technology on the New International Financial Architecture,* 34 INT'L L. 137, 146 (2000).

instruments and drawing in new players.[3] Indeed, computer and telecommunication technology has made it possible to use the integrated system and programmes for conducting highly complex financial transactions and for the immediate and systemic exploitation of the flood of available information that may be of relevance for financial operations.[4] The massive use of the Internet, therefore, has created not only a huge jump in transaction volumes but also the utilization of highly complex financial innovations, such as the whole range of ever more sophisticated derivative instruments[5] which are used to refine further the allocation of risk, and mostly traded in over the counter[6] markets.[7] As a result, electronic exchanges have been used around the globe for traditional stock-exchange

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[3] *See* Alan Greenspan, Testimony before the Committee on Banking and Financial Services, US House of Representatives (January 30, 1998), at 1.

[4] Mario Giovanoli, *Virtual Money and the Global Financial Market: Challenges for Lawyers*, 1 Y.B. INT'L FIN. & ECON. L. 3, 16 (1996).

[5] A derivative is a financial instrument whose value is based on (derived from) other assets or variable. Derivatives include options, swaps, and warrants. *See generally* Hal S. Scott & Philip A. Wellons, INTERNATIONAL FINANCE: TRANSACTIONS, POLICY, AND REGULATION 921-998 (5th ed. 1998).

[6] Securities transactions are conducted through a telephone and computer network connecting dealers in stocks and bonds rather than through an exchange. *See id.* at 800-801.

[7] *See* Giovanoli, *supra* note 4.

business, and for futures[8] thanks to the specific programmes along with modern data-processing techniques.

However, the growth of global networked information systems poses serious threats to the soundness of financial markets, and thus destabilizes markets around the world because financial information can be transmitted too quickly across borders.[9] It is argued that "excessive computerization has also tended to deform the financial services industry into a game driven by sheer lust for financial gain, without a broader sense of self-discipline or concern for the overall welfare of the economy or society."[10] The worldwide prevalence of greed among informed and sophisticated market participants of the money game creates a serious threat to the healthy development of financial markets because unsophisticated customers cannot access the accurate information rather than false rumors. As a consequence, a good number of gullible investors in a scam investment scheme can destabilize the safety of financial markets by rushing in and out of the market based on

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[8] Futures is an agreement to buy or sell a fixed quantity of a particular commodity, currency, or security for delivery at a fixed rate. Unlike an option, a future contract involves a definite purchase or sale and not an unlimited loss. *See generally* Scott & Wellons, *supra* note 5.

[9] *See* Winn, *supra* note 2, at 137.

[10] Toyoo Gyoten, *Global Financial Markets: The Past, The Future, and Public Policy, in* REGULATING INTERNATIONAL FINANCIAL MARKETS: ISSUES AND POLICIES 18 (Franklin R. Edwards et al. eds., 1991).

misperceptions.[11] Despite regulators' sustained efforts, serious violations in business ethics by the swindlers in the market through sophisticated technologies have brought about the exploitation of uninformed investors, and illegal actions such as securities fraud, which have a great impact on the global financial stability.

Undoubtedly, the global integration of information technology has become the challenges to the participants of the financial markets. On the one hand, financial services providers need to survive increasing competition with competitors through the prudent management of the risks entailed by acting on the opportunities offered by new technologies. On the other hand, regulatory and supervisory authorities should keep pace with the rapid financial innovation, and make endeavors in striking an appropriate balance in the midst of rapidly changing market environment since the evolution of the financial services industry driven by technological advances is not likely to stop. In short, the financial markets need to operate more efficiently and prudently to the extent that same degree of access is available to all of the participants of the market, and an appropriate

[11] *See* Winn, *supra* note 2, at 143.

balance between market and regulatory discipline ensures sufficient opportunities to both financial services providers to compete prudently and their unsophisticated clients to take advantage of advances in technology.

B. Financial Integration

Over the past decades, financial markets have tended to become more tightly linked across national boundaries. A notable example of capital market linkages among the countries is the introduction of Euro along with the advent of EMU (European Monetary Union), which represents a significant change since the breakdown of the Bretton Woods system in 1971 and the movement to floating exchange rates in 1973.[12] The EMU has eliminated exchange rate fluctuations among the eleven (11) participating countries, and reduced dramatically interest spreads and the volatility of the spreads.[13] The emergence of

[12] *See* Horst Koeler, *The Euro-An Emblem Success and Challenges of European Integration*, Remarks on the Occasion of the Informal Meeting of the ECOFIN Council (December 14, 2001), available at http://www.imf.org/external/np/speeches/2001/121401.htm (last visited January 10, 2003). *See also* Bertold Wahlig, *European Monetary Law: The Transition to the Euro and the scope of Lex Monetae, in* INTERNATIONAL MONETARY LAW: ISSUES FOR THE NEW MILLENNIUM 121 (Mario Giovanoli ed., 2000).

[13] The participating countries are Austria, Belgium, Finland, France, Germany, Greece, Iceland, Italy, Luxembourg, Portugal, and Spain. All the European countries are expected to join the EMU by 2010 under

a unified money market for liquidity with the rapid start of EMU has created a two-tiered structure. The first tier includes the large banks in each domestic market, which compete for the European Central Bank (ECB) funds at auction and trade liquidity among them, effectively distributing liquidity throughout the euro area. These large banks operate as hubs for distributing liquidity to a second-tier of smaller institutions in national markets.[14]

As for emerging market economies, a dramatic evidence of their linkage to global financial markets was drawn during the Asian financial crisis, which was preceded by a massive surge in gross private capital flows to emerging market countries and a deep compression of spreads for emerging market borrowers.[15] Notably, the five Asian crisis countries (Thailand, Malaysia, South Korea, Indonesia, and the Philippines) received $47.8 billion in foreign bank loans in 1996. This capital inflow turned into a $29.9 billion

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the condition that all goes well and the monetary union is prosperous. *See* Robert Mundell, *The Euro: How Important?,* 18 CATO J. 441, 444 (Winter 1999).

[14] *See* International Monetary Fund, International Capital Markets: Developments, Prospects, and Key Policy Issues 13 (September 2000).

[15] *See* Michael Mussa, *Factors Driving Global Economic Integration*, paper presented for the symposium sponsored by the Federal Reserve Bank of Kansas City, titled Global Economic Integration: Opportunities and Challenges (August 24-26, 2000), at 34-38. The Chart 5 in Mussa's paper illustrates the financing conditions for emerging markets between 1990 and 2000. According to Mussa, factors driving global economic integration fall into three categories: technological developments, social and individual for the benefits of globalization, and public policy. Mussa stresses that these factors have acted individually and interactively in driving integration.

outflow in 1997-a turnaround of almost $80 billion.[16] In this regard, one argues that these changes represent "a shift in tastes of global investors either toward lower assessment of the risks of investing in [Asian] emerging markets or toward greater acceptance of such risks."[17] Encouragingly, a recent annual data on net private capital flows to emerging markets show that net inflows stabilized in 1999 after large falls during 1997-1998.[18]

While with the financial globalization, international capital flows have increased markedly in the 1990s, some observers emphasize the need to determine if there has been a genuine increase in financial market integration because cross-border financial market linkages do not necessarily imply high degree of financial integration.[19] It is worth noting that according to the causes of the increase in financial market integration, the evaluation of degree of financial integration may be variably different. In short, this is because the

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[16] Martin N. Baily et al., *The Color of Hot Money,* 79 FOREIGN AFFAIRS, Mar.-Apr. 2000, at 101.
[17] *See* Mussa, *supra* note 15, at 34.
[18] *See* IMF, *supra* note 14, at 44-45 ("The stabilization of net private capital flows reflects continuing growth in foreign direct investment and a recovery in portfolio investment, which more than offset a continuing cutback in bank lending"). According to the report, net capital inflows to five Asian crisis countries have been broadly unchanged from 1998.
[19] *See* Juan Ayuso & Roberto Blanco, *Has financial market integration increased during the 1990s?,* BIS Conference Papers No. 8 (March 2000), International Financial Markets and the Implications for Monetary and Financial Stability, at 175-195. Ayuso and Blanco focus on stock markets and compute direct measures of the changes in market integration in 1990s. They argue that the main driving factor behind the increase in financial market linkages is the information globalization that affects financial prices rather than a higher degree of market integration.

welfare and policy implications of the apparent higher linkages depend on whether they are the outcome of greater market integration—fewer barriers to free financial trade in the context of financial services liberalization—or the globalization of information which still entails barriers.[20]

Here, there is still a need to investigate the persuasive evidence of growing international financial integration over the last decade. One adopts two indicators to support the evidence.[21] The first indicator is the sharp expansion in the scale of both gross and net capital flows between industrial countries, and between developed and emerging markets.[22] According to a balance-of-payments statistics, net inflows into emerging economies rose from virtually zero in 1989 to reach $307 billion in 1996 before falling half that level during 1997-1998.[23] Although the financial crisis has subdued the economic growth in

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[20] *See id.* at 192.

[21] *See* William R. White, *Evolving International Financial Markets: Some Implications for Central Banks,* BIS Working Papers No. 66 (April 1999) at 2.

[22] For the features of net and gross flows of capital, *see* International Monetary Fund, International Capital Markets: Developments, Prospects, and Key Policy Issues (August 2001) at 6-7 ("Although net capital flows provide useful insights about balance-of-payments financing and net funding requirements, they can considerably understate the volume and volatility of international portfolio rebalancing. Gross flows more closely reflect international transactions and are more relevant in terms of their impact on market prices and volatility").

[23] The Institute of International Finance, Inc., Near-Term Prospects for Emerging Market Economies (October 1998).

emerging economies and private capital flows to these markets, net capital inflows are expected to be about $160 billion in 2002, a significant increase from the $80.5 billion in 1999, and the $130 billion seen last year but well below the levels of the mid-1990s.[24] Nevertheless, gross capital inflows have risen sharply to about six times the level of net flows on a global basis since the mid-1980s.[25] As such, the growing global financial integration has occurred despite financial crises over the preceding decades.

In the meantime, it should be recognized that before strengthening the domestic financial system the increase in the volume and volatility of international capital flows driven by the capital account liberalization in light of financial liberalization has been a driving factor behind the recent costly financial crises.[26] That is, the financial integration as a process of the financial globalization has increased the potential risk of financial crisis. However, some argue that financial globalization along with the international financial

[24] *See* IMF, *supra* note 14, at 46. *See also* IIF, *Integrated Approach Proposed for a New Phase of Crisis Prevention and Crisis Management to Revive Emerging Market Capital Flows,* IIF Press Release (April 9, 2002).

[25] *See* IMF, *supra* note 22, at 7 ("The high level of gross flows relative to net flows suggests that countries and regions that have small net capital flows can nevertheless experience substantial gross inflows and outflows of capital").

[26] *See* Barry Eichengreen et al., Liberalizing Capital Movements: Some Analytical Issues, IMF Economic Issues No.17 (Feb. 1999) ("It is not financial liberalization that is at the root of the problem but rather weak management in the financial sector and inadequate supervision and regulation, whose consequences are magnified by liberalization.").

integration will eventually reduce the possibility of financial crisis since it is associated with the increasing direct investment, which is not so risky as portfolio investment.[27] By contrast, one argues that recent financial crises have been caused mainly by the financial market liberalization and deregulation rather than the global financial integration.[28] It is worth noting that the period between 1945 and 1973 was seemingly calm and prosperous since financial markets were operated by a stable system of pegged exchange rates under the Bretton Woods system, widespread controls over capital flows, and strict restrictions on banking activities.[29] Arguably, the relaxing of these financial regulations after 1974 brought about not only economic benefits but also potential risks of financial crisis.[30]

Another indicator of the increase in financial integration is the creation of new financial markets and instruments to facilitate diverse transactions around the world.[31] As noted, the

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[27] Paul Krugman, *Crises: The Price of Globalization,* paper presented at the symposium sponsored by the Federal Reserve Bank of Kansas City, titled Global Economic Integration: Opportunities and Challenges (Aug. 24-26, 2000) at 104. Krugman stresses although the process of globalization increased the risk of financial crisis, the increase in trade as tradeoffs of the policies reducing the risk of financial crisis via costly restrictions on capital flows may lead to a reduced likelihood of financial crisis in the long run because a depreciation of the currency is likely to have net explanatory effects with increased trade.

[28] Charles Goodhart, Commentary presented at the symposium sponsored by the Federal Reserve Bank of Kansas City, titled Global Economic Integration: Opportunities and Challenges (Aug. 24-26, 2000) at 108.

[29] *Id.* at 107.

[30] Goodhart stresses that there is a need to restructure the framework for regulating banking and financial sector s to restrict volatile short-term capital flows rather than as direct control. *Id.* at 110.

[31] *See* White, *supra* note 21.

forces of technological innovation and globalization have driven remarkable changes in financial services industry. The offshore markets—external markets located in a different political jurisdiction and only linked by the currency used to denominate the financial claims to the national market—have seen the rise of financial transactions in domestic currencies to be conducted abroad although it is argued that the markets generated by the providers' inducement on the users due to the financial regulatory discrepancies, and the differences in the investors' perceptions of markets[32] rather than the fair share of financial innovation.[33]

C. Financial Innovation

New financial instruments and financing techniques have rapidly developed and grown in response to the desire of market participants over the last decades. The advent of asset securitization, which links banking markets with capital markets has spread to meet the

[32] Movements of money from the national markets to offshore banking centers have been motivated by four factors: the profit incentive, financial privacy and secrecy, tax benefits (tax savings/avoidance), and protection of assets from lawsuits and other liabilities. *See* B. Chad Bungard, *Offshore Banking in the British Dependencies*, 9 TOURO INT'L L. REV. 141, 143-145 (2001).

[33] Gunter Dufey & T. Chung, *International Financial Markets: A Survey*, *in* INTERNATIONAL FINANCE AND INVESTING 3-29 (R. Kuhn ed., 1990), *cited in* Scott & Wellons, *supra* note 4, at 7.

needs of financial market participants. This new method of financing helps the financial institution, or corporation (originator) transform their illiquid financial assets into highly liquid securities to improve their financial situation and liquidity.[34] This new technique has been used to remodel all the assets such as home mortgages, credit card debt, student loans, car loans and equipment leases into asset-backed securities. As a result, credit has been expanded to consumers, and the liquidity (flexibility) for lenders and the modulation for investors have been getting greater.[35]

Likewise, derivative instruments have developed to meet the market participants' needs to repackage credit risk into discrete bundles and thus increase the debt market liquidity together with the improvement of the participants' balance sheets. According to the recent data, at the end of 2000, over-the-counter derivatives markets amounted to $95 trillion in

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[34] Securitization refers to the process by means of which primary creditors (originators) transfer a diversified, segregated illiquid income producing pool of assets (underlying assets) to a third party (special purpose vehicle) to transform and restructure these underlying assts and sell them into tradable equity or debt instruments. The means by which these transformation and restructuring are accomplished include pooling, unbundling, repackaging and refinancing of existing financial assets into securities or instruments that can be sold to and traded by investors in capital markets. *See* Tamar Frankel, SECURITIZATION, STRUCTURED FINANCING, FINANCIAL ASSETS POOLS, AND ASSET-BACKED SECURITIES, Sec. 1.1, at 3 (1999). For example, a special purpose vehicle (entity) purchases a pool of car loans from the creditor, using money it got by the sale of securities that are collateralized by the loans. As a result, interest and principal payments on the car loans are used to pay interest and principal on the asset-backed notes.

[35] *See* Diana B. Henriques, *The Brick Stood Up Before. But Now?,* The New York Times, Mar. 10, 2002, at Section 3, Page 1, Column 1.

notional principal, and daily aggregate global turnover rose to about $1.4 trillion.[36] As recognized, financial derivatives have created considerable benefits by allowing investors to unbundle and redistribute diverse risks—foreign exchange, interest rate, market and default risks—, and thereby contributed to the improvement of market liquidity and increase in the capacity of the financial system to bear the risk and intermediate capital.[37] However, there is a concern that heavy reliance on new and innovative financial techniques and instruments can cause a serious turbulence resulting in financial panics and banking crises[38]

Although asset backed securitization can create several benefits in the financial market, it also raises some potential risks, particularly to the banking system. Most importantly, a financial institution may be in trouble when the originator could not achieve a true sale of the assets, but recognize the incurred losses when the assets cease to perform subsequently.[39] Also, potential risks arise when banks in pursuit of a favorable market

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[36] *See* IMF, *supra* note 22, at 30.
[37] *See* IMF, *supra* note 14, at 79.
[38] Id. at 83.
[39] *See* Basel Committee on Banking on Supervision, Asset Transfers and Securitization (Sept. 1992), at 6.

reception for the securitized assets may tend to sell off the highest quality assets despite their retention of lower quality assets, and thereby increase the average risk in the remaining portfolio.[40] Securitization may also raise systemic risks leading to the increase in the fragility of the financial system in both national and international contexts as long as it reduces the proportion of financial assets and liabilities held by banks in countries where the variable minimum reserve requirement system control the central bank's operation.[41] Moreover, various securitization plans have been introduced to reduce the third world debt,[42] which arose by the loan of unprecedented sums of money from commercial banks in industrial countries to developing countries of the third world in the 1970s due to the increase in the reserves resulting from an influx of oil-generated deposits by the Organization of Petroleum Exporting Countries (OPEC).[43] As highlighted in the third world debt crisis of the 1980s, arguably securitization plans may be inadequate measures of

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[40] *Id.*

[41] Under the system, a country's central bank can control the domestic money supply by raising or lowering the level of minimum reserves, which banks should maintain. The effectiveness is reduced with the decrease in the overall level of assets and liabilities held by financial institutions. *Id.* at 7.

[42] Mostly, these plans entail repackaging of debts into a negotiable instrument, such as bond, which creditor banks may thereafter sell on the secondary markets to private investors. *See* Robert Plehn, *Securitization of Third World Debt,* 23 INT'L LAW, 161, 162 (1989).

[43] *See* Alfred J. Puchala, Jr., *Securitizing the Third World Debt,* 1989 COLUM. BUS. L. REV. 137 (1989).

alleviating the debt problem so far as the plans cannot address the debt nation's major problem of simply having too much external debt to service in the near or medium-term future.[44]

Similarly, derivatives activities can cause the build up of financial system fragilities and adverse market dynamics in some cases as demonstrated in the recent events of near collapse of the U.S. hedge fund, Long-Term Capital Management (LTCM),[45] and the Enron debacle[46] in the mature financial markets. The turbulence of the near-failure of LTCM in

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[44] It is argued what the debtor nations really need is for creators to forgive and write down a portion of the debt until the situation stabilizes and only thereafter, should securitization of the debt be considered. *See* David W. Leebron, *First Things First: A comment on Securitizing Third World Debt,* 1989 COLUM. BUS. L. REV. 173 (1989).

[45] Between January and September 1998, LTCM, one of the largest U.S. hedge funds and most important market-makers and providers of liquidation in securities markets, lost almost 90 percent of its capital. By August 1998, with less than $5 billion of equity capital, LTCM had earned a very highly valued counterparty status and highly leveraged trading positions through assembling of a trading book that involved about 60,000 trades, including on-balance-sheet positions totaling $125 billion and off-balance-sheet positions including about $1 trillion of notional OTC derivative positions. In September 1998, the Federal Reserve determined that rapid liquidation of LTCM's trading positions and related positions of other market participants might raise a serious threat to already unsettled international financial markets. As a consequence, the Federal Reserve facilitated a private sector recapitalization to prevent the collapse of LTCM. *See* United States General Accounting Office (GAO), Long-Term Capital Management: Regulators Need to Focus Greater Attention on Systemic Risk, Doc. No. GAO/GGD-00-03 (Oct. 29, 1998), at 1. *See also* IMF, *supra* note 14, at 85.

[46] Enron was the main dealer, market-maker, and liquidity provider in major segments of the OTC energy derivatives markets, and at end-September 2001, its overall derivatives trading liabilities stood at nearly $19 billion. However, its non-recurring charges amounted to $1.01 billion for the third quarter of 2001, and net income was reduced back to 1997 by $586 million, or 20%. The collapse resulting from the aggressive use of accounting techniques to mask the Enron's excessive leverage and weak earning caused important volatility in financial markets, and considerable losses for market participants, which may lead to the risk of systemic consequences for financial markets. The plummeting of Enron's shares and credit rating in October 2001 resulted in its filing for bankruptcy in two months. Arguably, the Enron case raised three capital market issues: inadequate oversight of financial activities of nonfinancial institutions, ineffective private market discipline, disclosure, corporate governance and auditing, and misallocation of retirement savings. *See* IMF,

late 1998 was preceded by the accumulation of a complex network of derivatives counterparty exposures, encompassing a high degree of leverage in the major markets through late summer 1998, and the adverse shift in market sentiment following the Russian crisis in mid-August 1998.[47] In short, the near-collapse raised concerns that heavy reliance on innovative financial techniques and undue reliance on historical information got the market participants into serious trouble.[48] As such the severity of the LTCM turbulence posed the risk of systemic impact on the global financial system and real economic activities.

Meanwhile, the collapse of Enron, interestingly a nonfinancial institution as an energy trading and distribution corporation in late 2001 highlights uncertainties about the effective

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Global Financial Stability Report (March 2002) at 41-42. *See also,*John R. Emshwiller, Rebecca Smith & Jonathan Weil, *Enron Slashes Profits Since 1997 by 20%,*WALL ST. J., Nov. 9, 2001, at A3; Enron Corporation, Press Release, *Enron Reports Recurring Third Quarter Earnings of $0.43 per Diluted Share; Reports Non-Recurring Charges of $1.01 Billion After-Tax; Reaffirms Recurring Earnings Estimates of $1.80 for 2001 and $2.15 for 2002 and Expands Financial Reporting* (Oct. 16, 2001), available at http://www.enron.com/corp/ pressroom/release/2001/ene/68-3QEarningsLtr.html (last visited January 15, 2003).

[47] The Russian turmoil due to Russia's devaluation and unilateral debt restructuring sparked a broad-based reassessment and repricing of risk and large scale deleveraging and portfolio rebalancing that cut across a range of global financial markets. *See* IMF, *supra* note 14, at 85.

[48] The Russian crisis deprived the LTCM of its engaging in highly leveraged bets on the historical interest rate spread between riskier debt instruments and US Treasury bonds, and thereby drove investors' worldwide flight of high risk investments to safety. *See* Steve Lipin, Matt Murray & Jacob M. Schleginger, *Bailout Blues: How a Big Hedge Fund Marketed its Expertise And Shrouded Its Risks,* WALL ST. J., Sep. 25, 1998, at A1.

functioning of credit-risk transfer vehicles[49] used to hedge or take on credit exposures across markets and sectors.[50] Even though these financial instruments and markets, which are usually driven by regulatory arbitrage offer some benefits to the market participants including nontraditional players, the complexity of financial transactions and markets have posed new challenges to the market.[51] As demonstrated in the Enron case, the vast use of derivatives by way of credit risk transfers raised concerns over potential systemic risks.[52] Moreover, the Enron case called for "much greater transparency and the increased completeness in the accounting treatment of derivatives"[53] since it seemingly engaged in manipulative accounting transactions to minimize financial-statement losses and volatility,

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[49] Notably, credit risk transfers can foster the efficiency and stability of credit markets overall the allocation of capital with the growth of the markets by the separation of credit institution from credit risk bearing. Also, they can reduce the concentration of credit risk in financial systems by helping nonfinancial corporations take on the credit risks held by banks. Additionally, credit risk transfers create the diversification of financial institutions' credit exposures across markets and sectors, and facilitate the trading of credit risk, and thus, financial and nonfinancial institutions can flexibly manage their credit exposures. Moreover, liquid credit risk transfer markets can enhance price discovery and provide price information. *See* Global Financial Stability Report *supra* note 46, at 38-39.

[50] *Id.* at 41.

[51] Arguably, there are some concerns about these instruments and markets. First, they reduce transparency regarding the institutional distribution of credit risk and its concentration. Second, they may create or magnify channels, which help credit events-associated distress spread across institutions and markets. Third, these instruments are not seemingly regulated as well as banks, and not necessarily have the experience required to price properly and manage these risks. Finally, the mechanism of credit risk transfer augments the potential for mispricing and misallocation of capital by adding the leveraged instruments to the total amount of credit. *Id.* at 39.

[52] Greenspan stresses that despite providing of greater flexibility to the financial system, due to the complexity, the counterparties could get vulnerable to serious risk that "they do not currently recognize, and hence these instruments potentially expose the overall system if mistakes are large." *See* Allan Greenspan, Testimony Before the Committee on Financial Services, U.S. House of Representatives (Feb. 27, 2002) at 8.

[53] *See id.*

augment profits, and avoid adding debt to its balance sheet.[54] There were no requirements to disclose information about its risks to counterparties, and the market prices or conditions, and thus the derivatives activities have not been regulated in spite of the size of derivatives market, complexity, and pivotal role in the energy derivatives markets under the 2000 Commodity Futures Act.[55]

In these circumstances, same financial techniques used for the asset securitization were arguably applied to "construct the elaborately camouflaged and boody trapped partnerships" resulting in the Enron's collapse.[56] That is, non-consolidated special purpose entities (vehicles) were used to hedge certain Enron investments in its manipulations. However, it should be recognized that the problem in Enron case is not the securitization, the process of creating asset-backed securities but the more Enronic uses of structured

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[54] As a consequence, the Enron's credit rating was damaged, and thus its credibility in energy trading business was hurt. *See* Report of Investigation by the Special Investigation Committee of the Board of Directors of Enron Corporation 4, 36, 68, 78, 97 (Feb. 1, 2002).

[55] *See* Global Financial Stability Report, *supra* note 46, at 41. However, the U.S. Congressional Hearings have affirmed that certain energy derivatives activities do not fall into the categories that are exempted from key regulatory provisions under the act.

[56] *See* Henriques, *supra* note 35.

finance.[57] Arguably, the Enron's abuse of special purpose vehicles posed fundamental questions whether its SPV transactions transferred risks of the hedged assets owned by the Enron to others[58] because of the SPVs' inability to perform their hedges resulting from the simultaneous fall in Enron's asset and stock values.[59] In this sense, the Enron collapse has not been caused directly by the new financial techniques and instruments. Rather, partly ineffective private market discipline, disclosure, corporate governance, and inadequate accounting rules should be blamed for the Enron case.[60]

Consequently, financial regulatory and supervisory authorities should catch up with the financial innovation and new instruments to improve robust financial system. Any regulatory re-evaluation needs to take a long-term perspective so that market participants can take advantage of the ever-lasting financial innovation in the age of the information economy. Also, financial institutions need to strengthen their credit risk management

[57] *Id.* (quoting law professor Ronald Gilson that "Enron gives a very useful tool a bad name for no reason. Structured finance is used for a zillion different and worthwhile purposes. The problem is Enron used it to create a structure that was genuinely not transparent, to hide things.").

[58] Steven L. Schwarcz, *Enron, and the Use and Abuse of Special Purpose Entities in Corporate Structures,* 7 (July 2002), available at http://ssrn.com/abstract_id=306820 (last visited Dec. 19, 2003); *see also* Henriques, *supra* note 35 (quoting law firm partner David Eisenberg that "securitization is about transferring risk to others – and Enron only appeared to be doing that, when in reality they were retaining the risk themselves").

[59] *See* Steven L. Schwarcz, STRUCTURED FINANCE, A GUIDE TO THE PRINCIPLES OF ASSET SECURITIZATION Sec. 1:1 (3[d] ed. 2002); *see also* Schwarcz, *supra* note 58, at 7 n.41.

[60] *See* Global Financial Stability Report, *supra* note 46, at 41.

practices to foster their review of new financial instruments. Needless to say, the market participants' attention to the lessons from the recent episodes, and adoption of the adequate policies and controls will substantially prevent or minimize the risks of repeating similar excess in the near future.[61]

D. Financial Deregulation

As noted, the regulatory authorities are continuously getting behind the structural changes in the financial services industry, and thereby cannot but react to immense pressures by relaxing the financial regulations or implementing new regulations. Despite regulators' sustained efforts, the increasing complexity of financial services transactions involving the cross-institutional and cross-border activities has reduced the effectiveness of financial regulation, and thus eroded statutory and physical barriers between financial sectors and jurisdictions, which led to regulatory changes and convergence of financial regulatory standards in response to the regulatory arbitrage.

[61] Richard Spillenkothen, Testimony Before the Permanent Subcommittee on Investigations of the Committee on Government Affairs, U.S. Senate (Dec. 11, 2002), at 6.

These structural trends have blurred traditional distinctions between banking and other types of financial activities resulting in "one-stop" shopping for the customers of the financial services industry, and a concentration of financial services in larger institutions through merges and acquisitions. As such, there has been a remarkable convergence of banking and financial sectors. The recent repealing of the Glass-Steagall Act (Section 20), which prohibited banks from engaging in securities underwriting, under the Financial Modernization Act of 1999 (the Gramme-Leach-Bliley Act) in the U.S.,[62] and the dismantling of Japan's statutory separation of banks, securities firms, and trust banks[63] are examples of the new regulatory approach to the structural trends.[64]

Moreover, the international competition between national regulatory authorities based on regulatory discrepancies[65] has intensified the pressure for deregulation of financial

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[62] Glass-Steagall Act, 12 U.S.C. sec. 377 (repealed 1999); and Gramme-Leach-Bliley Act section 101(a).

[63] In light of the financial "Big Bang," the Law Amending related laws for Financial System Reform amended over 21 laws including the Securities and Exchange Law, Banking Law, and Insurance Law (Law No. 107 of 1997). *See* Mamiko Yokoi-Arai, *The Japanese Banking Crisis: Some Historical and Regulatory Aspects,* Y.B. INT'L FIN. & ECON. L., 205, 217 (1999).

[64] At the extreme, the regulatory trends are toward the German-style "universal banking," in which banks are allowed directly to underwrite securities and invest in equities of nonblank institutions. *See* Richard J. Herring & Robert E. Litan, FINANCIAL REGULATION IN THE GLOBAL REGULATION 10-11(1995).

[65] Differences in regulatory constraints between national financial systems have driven the shift of financial activities from one location to another than to accomplish their intended goals in some cases. *See id.* at 20. Such cases demonstrate that the regulators need to anticipate to the providers' circumvention of the regulation through the financial innovation, and thereby react by new regulation or deregulation. In particular,

markets in the domestic arena. As a result, international pressures along with the globalization of financial markets spurred the domestic financial liberalization.[66] Also, this competitive deregulation and liberalization process have removed anti-competitive regulatory restrictions, and brought the increased competition for the financial market industry, which resulted in efficiency and lowered costs in the financial services sector.[67] That is, financial market participants have enjoyed net benefits from both lower prices for financial services and the improvements in quality and access to new financial instruments through deregulation and liberalization.[68]

In the meantime, there are some concerns about the potential risks and other shortcomings raised by financial deregulation.[69] In short, the issues fall into the broad categories: the financial market volatility resulting from the large swings in financial

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deregulation has played an important role in stimulating financial innovation while innovation has spurred financial deregulation. In short, financial innovation and regulation are mutually reinforcing.

[66] For example, Japan's financial liberalization in the early 1980s resulted from the United States' pressures for Japan to make its financial services industry effective. *See* K. Osugi, *Japan's Experience of Financial Deregulation Since 1984 in an International Perspective* (Basle: Bank for International Settlements, Jan. 1990), cited in OECD, *Regulatory Reform in the Financial Services Industry: Where Have We Been? Where Are We Going?*, FIN. MKT. TRENDS, June 1997, at 36.

[67] *See* OECD, *supra* note 57, at 53. While financial deregulation has created gains from efficient resource allocation such as the improved capacity of consumers and private businesses to allocate their spending over time thanks to increased capital mobility, it has also raised extensive changes in the financial and macro-economic environment. *Id.* at 59-63.

[68] *Id.* at 56.

[69] *Id.* at 63-75.

market prices, debt build-ups and asset price bubbles preceded by the flexibility of available financial instruments and the increased access to credit, banking sector problems, and recent international debt problems due to international capital flows. However, it is argued that the costs and risks of deregulation can be outweighed by its benefits if only deregulation is appropriately implemented and entailed by necessary policy reforms affecting financial incentives.[70] More importantly, the financial deregulation process should be accompanied by proper reform efforts such as prudential supervision and regulation of financial markets to ensure the financial stability. In this regard, the regulatory competition can focus on the quality of regulation such as its ability to deliver results in terms of the financial efficiency and stability rather than the regulatory laxity.[71] In sum, the financial deregulation and liberalization should not be inappropriately implemented to bring about the laissez-faire activities or functions free of the prudential regulation and supervision of financial markets in the wake of recent financial crises around the globe.

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[70] *Id.* at 75.
[71] *See* Wendy Dobson & Pierre Jacquet, FINANCIAL SERVICES LIBERALIZATION IN THE WTO 112 (1998).

E. The Convergence of Regulatory Standards

There have been some debates over whether the cross-national convergence of regulatory policy is desirable by the pressure of globalization. Arguably, globalization pushing the elimination of all barriers and differences[72] among states and cultures has brought sharing same values accompanied by the convergence[73] of economic and political systems despite differences between countries with market economies.[74] In particular, the financial globalization has caused policy convergence,[75] that is, a general convergence of policy goals, policy instruments, and policy style. Namely, in response to the financial globalization, the international cooperation has produced the widespread adoption of

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[72] However, some argue that globalization is misunderstood as "the promotion of homogeneity across the face of the earth...as a bulldozer....[G]lobalization is a technological and telecommunications revolution, a phenomenon of the information age, which will not necessarily erase all differences and barriers between nations and cultures." *See* Douglas M. Branson, *The Very Uncertain Prospect of "Global Convergence" in Corporate Governance,* 34 CORNELL INT'L L. J. 321, 326-327 (2001).

[73] As for the meaning of convergence, one defines it as "the process of applying increasingly similar rules to a given situation in different jurisdictions, and is closely related to the harmonization and approximation of laws." *See* Andrew M. Whittaker, *Tackling Systemic Risk on Markets: Barings and Beyond, in* THE FUTURE FOR THE GLOBAL SECURITIES MARKET 259, 261 (F. Oditah ed. 1996). Similarly, convergence is described as "the process by which the rules, regulations, or political institutions governing economic activity in different countries become more similar." *See* Henry Laurence, *Spawning the SEC,* 6 IND. J. GLOBAL LEGAL STUD.647, 649 (1999).

[74] *See* Alex Y. Seita, *Globalization and the Convergence of Values,* CORNELL INT'L L. J. 429, 465-469 (1997) (arguing that sharing the same values promotes "similar expectations and a common ground for understanding" and thereby creating the closer relationship in human society).

[75] Policy convergence is composed of different dimensions including policy goals, "a coming together of intent to deal with common policy problems," policy instruments, "the institutional tools available to administer policy, whether regulatory, administrative or judicial," and policy style, "a more diffuse notion signifying the process by which policy responses are formulated." *See* C.J. Bennett, *What is Policy Convergence and What Causes it?,* 21 BRIT. J. POL. SCI. 215, 219 (1991).

similar regulatory technique and harmonized global standards by way of negotiated and multinational agreements among different national regulatory authorities.[76]

While the convergence advocates note that the global convergence does not necessarily imply the convergence of identical regulatory standards and structures among different nations, they emphasize the convergence of basic values and fundamental systems to promote the reliance on market forces, and thus attracting international businesses and increasing economic benefits.[77] At this point, there is a growing cognizance of the need to evaluate the international cooperative efforts at the harmonization and unification of regulatory standards.

In this regard, one of the most controversial debates in the field of international economic law concerns the desirability of international cooperation. By explaining the relationship between internationalization and public choice, one of the proponents for international cooperation advocates that "international cooperation is likely to be welfare-

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[76] One describes this convergence process as "negotiated convergence" because it is the byproduct of extensive negotiation among different regulatory authorities and the usual compromises and trade-offs inherent in bargaining. *See* Heidi Mandanis Schooner & Michael Taylor, *Convergence and Competition: The Case of Bank Regulation in Britain and the United States,* 20 MICH. J. INT'L L. 595, 597-598 (1999).

[77] *See* Laurence, *supra* note 73, at 649-650; Seita, *supra* note 73, at 466-469.

improving in the majority of contexts, though the exact nature of that cooperation must vary from one subject to another."[78] The defender identifies several reasons why international cooperative efforts should be encouraged.[79] First, as the ability of national authorities to regulate transnational activities is eroding, and noncooperarive strategies become less successful, international cooperation will become more attractive. Second, international cooperation is desirable and successful because of the increase in welfare associated with the cooperation in trade liberalization under the WTO despite it's the value-subtracting cooperation. Third, even if international cooperation can be welfare-reducing, the argument for cooperation may be strengthened since the cooperation allowed nations to consider a broader range of interests and thus producing a remarkable growth in trade and welfare.

[78] *See* Andrew T. Guzman, *Public Choice and International Regulatory Competition,* 90 GEO. L. J. 971, 972-974 (2002). By contrast, Stephan and O'Hara's skepticism identifies about the potential hazards of international cooperation resulting from the probability and the costs of welfare-reducing international agreements through facilitating transfer payments and logrolling. *See* Paul B. Stephan, *The Political Economy of Choice of Law,* 90 GEO. L. J. 957, 960-961 (2002); Erin A. O'Hara, *Economics, Public Choice, and the Perennial Conflict of Law,* 90 GEO. L. J. 941, 948-956 (2002).

[79] *See* Guzman, *supra* note 78, at 978-979.

To support the argument, the international cooperation advocates assert the determination of the appropriate level of cooperation when it should be used.[80] In particular, it is worth noting that when the other levels of cooperation fail, supranational standards and regulations should be alternatively taken into account because of their potential to reduce the cost of transfers among nations, which makes it easier to reach an agreement.[81]

In contrast to the international cooperation advocates, some argue that international cooperative efforts have faced a great degree of skepticism at the national level because the efforts lack the political accountability of elected and appointed officials at national and local levels.[82] That is, the domestic decisionmakers or bureaucrats face severe constraints on their behavior as opposed to international lawmakers, and thereby bears some political

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[80] *See* Guzman, *supra* note 78, at 980-983 (providing several levels of cooperation that are available: first, a laissez-faire system as the lowest level of cooperation, second, a nation's setting of the terms of its interactions with other nations through a unilateral selection of choice-of-law rules, third, an agreement on choice-of-law rules without any comments on substantive rules, fourth, harmonization of substantive laws as a higher level of cooperation, alternatively, supranational standards and regulations as the highest level of cooperation).

[81] *See* Guzman, *supra* note 78, at 983 (taking as the best examples of this strategy, international trade and international intellectual property under the WTO, and international banking regulation through the Basle Accord).

[82] *See* Paul B. Stephan, *The Futility of Unification and Harmonization in International Commercial Law,* 39 VA. J. INT'L L. 743, 752 (1999) (arguing that this is because "[n]o mechanism exists for voters to pass judgment on the international lawmakers. At best, they can vote for the domestic governments that in turn choose the drafters of international agreements.").

accountability for their choices.[83] Also, international cooperative efforts have brought about skepticism because they lack the transparency of local lawmaking.[84] Due to the lack of transparency, a substantial amount of economic rent—returns in excess of what is necessary to keep a given resource from transferring to other occupation—have been sought all over the world. As such, bureaucrats may foil the cooperative efforts unless they have chances to engage in rent seeking, thereby decreasing transparency and engaging in turf protection.[85] Furthermore, the pessimistic perspective on cooperative efforts classifies into two categories the reasons why international cooperation may produce undesirable outcomes:

> First, negotiators may give excessive weight to the preferences of private groups with unrepresentative preferences but especially low organizational costs....Second, persons with an interest in the institutions established or promoted by international cooperation may

[83] Paul B. Stephan, *Rules, Rents and Legitimacy,* 17 NW. J. INT'L L. & BUS. 681, 682, 732 (1997)
[84] *See id.* at 689 ("interest groups tend to have somewhat lower costs of expressing their preferences to executives engaged in international lawmaking than in conveying their wishes to domestic legislators, and ... the general public has higher monitoring costs with respect to international lawmaking").
[85] *See* id. at 706.

seek the adoption of agreements that expand the competence, discretion, and authority of those institutions at the expense of desirable regulatory outcomes.[86]

More importantly, this pessimistic point of view on the cooperative efforts points out the costs of cooperation and welfare-reducing agreements.[87] The grounds for welfare-reducing international cooperation fall into three categories:

> First, [the negotiators] have powerful incentives to achieve some kind of agreement regardless of substantive outcome.[88] Association with a concluded agreement brings prestige opportunities to offer interpretation, and invitation to participate in subsequent negotiations. Second, the legislatures…face take-it-or-leave-it choices that limit their power to shape what gets adopted. Thus they are [unlikely] to reject agreements that may reduce overall welfare.[89] Third, the difficulty of reaching the sustained level of agreement

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[86] *See* Stephan, *supra* note 78, at 960-961.

[87] In general, the costs incurred by a potentially undesirable agreement, discounted by the likelihood of the structure producing such an agreement is greater than the benefits of a potentially desirable agreement, discounted by the likelihood of a particular institutional structure achieving it. *See id.* at 960.

[88] In response to this argument, Guzman advocates that this does not show an important ground to resist international cooperation for three reasons. First, as long as a pro-agreement bias exists among the negotiators as agents for the nations, the principals have a incentive to correct for this through a change in the negotiators. Second, there are many ways to "reach a deal" without imposing important commitments on a nation under international law. Third, despite a bias toward some kind of agreement, the bias may be helpful rather than harmful in light of the overall negotiating structure of international law, under which the consent of every participating nation is required for international agreements in accordance with the unanimity rule. *See id.* at 974-975.

[89] As for this argument, Guzman casts doubts for two reasons. First, the negotiators are controlled by the executive, and thus the nation has a chance to shape the content of the agreement. Second, the legislature's

necessary to permit frequent updates of existing agreements pushes negotiators toward delegations of lawmaking authority to international institutions.[90]

Even if international cooperative efforts have been remarkably increasing over the last decades, there is still a concern that the international cooperation has pitfalls and should be approached cautiously.[91] As noted, the lack of transparency, the lack of political accountability and the rent-seeking may impede convergence.[92] Here, it should be noted that there is no trend to homogeneity in world economics as asserted by globalization advocates the globalization thesis. Moreover, modernization and Westernization are not converging trends, as the underlying premise of global convergence scholarship implies.[93] With respect to the convergence thesis, some argue that states still pursue diverse policy choices. In this regard, one examines the hypothesis that the Keynsian welfare policies of

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decision to accept a tale-it-or-leave-it offer does not imply that it is not likely to approve a welfare-reducing agreement. *See id.* at 975-976.

[90] *Id.* at 961. In contrast to this concern of entrenchment by international bureaucrats, Guzman claims that the concern is a concern about the form of cooperation rather than its merit since many forms of cooperation can proceed without formal institutions. *See* id. at 975.

[91] Paul B. Stephan, *Accountability and International Lawmaking: Rules, Rents and Legitimacy,* 17 NW. J. INT'L L. BUS. 681 (1996-1997).

[92] In addition, one indicates as one of the grounds the pretentious "we know better" tone of much of the convergence advocacy. *See* Branson, *supra* note 72, at 339.

[93] John Gray, FALSE DAWN: THE DELUSIONS OF GLOBAL CAPITALISM 169-170 (1998), cited in Branson, *supra* note 72, at 349. It is argued that for much of the world, modernization and Westernization have become diverging trends or, indeed, anathema to one another.

West European states will be eroded by the international financial integration and concludes that notwithstanding the increased exertion of capital integration over the past two decades, "powerful pressures for convergence in economic policies,"[94] such convergence has not happened, and that "the evidence on fiscal policy conflicts sharply with the convergence thesis."[95] The other argues that "the international outcome [of the financial integration] is solidly rooted in domestic policy dilemmas and distributional debates," and that "[financial] markets remained distinctively national."[96]

Nevertheless, global convergence fueled by the process of globalization has grown significantly in international economic affairs. As a matter of fact, international efforts at regulatory cooperation have resulted in global convergence of regulatory standards. Notably, global convergence of financial regulatory standards propelled by the globalization of finance has recently attracted a considerable attention around the globe. In particular, it deserves noting that global convergence in banking regulation has made

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[94] *See* Geoffrey Garrett, *Capital Mobility, Trade, and the Domestic Politics of Economic Policy,* 49 INT'L ORG. 657, 657 (1995)

[95] *See id.* at 659.

[96] Andrew C. Sobel, *Domestic Choices,* INTERNATIONAL MARKETS 19, 143 (1994), cited in Laurence, *supra* note 73 at 652-653.

greater strides than in any other financial sector law and regulation. In this regard, most regulators and academics seem to believe that global convergence of the Basel Committee's bank supervisory standards and capital adequacy principles is desirable and more would be better. However, there is a strong need to examine this global, one-size-fits-all-standards setting process and thus to enhance the more prudential bank supervisory and regulatory framework in the wake of recent financial crises.

II. The State in the Global Era

A. The Status of the State Under International Law and in a Globalizing World

After the World War II, the realization that global problems need international regulatory regimes to cope with cross-border and inter-state activities has driven the creation of international organizations, such as the United Nations (UN), the North Atlantic Treaty Organization (NATO) and the World Trade Organization (WTO) that have international administrative jurisdictions ensuing contravention of the territorial sovereignties of states. Globalization has also played a key role in eroding states' geographical borders thanks to the rapid economic integration, and the growth of regionalism. The birth of European Union despite member states' national differences shows that the reciprocal benefit derived from the correlative restriction on another state's power makes the loss of one's power acceptable, and the state's boundaries insignificant.

As mentioned, globalization has played an important role in reshaping the world order since the end of the Cold War. Dramatically, remarkable innovative changes in the linked technologies of computing and communication as a result of the information revolution, so

called the third industrial revolution, are influencing the nature of the state institutions, and increasing the role of non-state actors.[97]

The process of globalization has transformed the traditional view of international law for the state sovereignty that is associated with exclusive territorial jurisdiction since the Treaty of Westphalia in 1648, ending the Thirty Years War.[98] This Westphalian

[97] It deserves noting Joseph Nye's remark in the context of information revolution, although the focus is on the importance of soft power of the American foreign policy. According to Nye, "we can get some idea of where we are heading by looking back at the past. In the first industrial revolution, around the turn of the nineteenth century, the application of steam to mills and transportation had a powerful effect on the economy, society and government.... The second industrial revolution, around the turn of the twentieth century, introduced electricity, synthetics, and internal combustion engine and brought similar economic and social changes. The historical analogies help us understand some of the forces that will shape world politics in the twenty-first century. Economies and information networks have changed more rapidly than governments have, with their scale having grown much faster than that of sovereignty and authority. [T]he building blocks of world politics are being transformed by the new technology, and our politics will have to adjust accordingly. If we focus solely on the hard power of nation-states, we will miss the new reality and fail to advance our interests and our values." *See* Joseph Nye, The Paradox of American Power: Why the World's only Superpower can't go it alone 43-44 (2002).

[98] Since the 17th century, the modern state has been the dominant entity in domestic and international affairs both in terms of power and regulatory authority. *See* John Ruggie, *Territoriality and Beyond: Problematizing Modernity in International Relations,* 47 INT'L ORG. 139, 174 (1993); Kalevi Holsti, Peace and War: Armed Conflict and International Order 1648-1989 25 (1998) (noting that [t]he Peace of Westphalia organized Europe on the principle of particularism. It represented a diplomatic arrangement—an order created by states, for states—and replaced most of the legal vestiges of hierarchy, at the pinnacle of which were the Pope and the Holy Roman Empire."); Jessica T. Mathews, Power Shift, Foreign Affairs, Jan-Feb. 1997, at 50 (arguing that the Westphalia thesis is not universally endorsed); Christian Reus-Smit, The Moral Purpose of the State: Culture, Social Identity and Institutional Rationality in International Relations 88 (1999) (pointing out that "[I]t was not until the middle of the nineteenth century, when a new set of constitutional value has emerged to justify the authority of [a] sovereign state, the fundamental institutions of multilateralism and contractual international law took off."); *see also* Andreas Osiander, Sovereignty, International Relations, and the Westphalian Myth, 55 Int'l Org. 250, 268 (2001) (remarking that "the prevalence of the Westphalian Myth ... is the result of the nineteenth- and twentieth-century historians adopting a certain standard account of 1648, influenced by ideas that can be traced to anti-Habsburg propaganda of the Thirty Year' War.").

Historically, the modern state system has its origin in the medieval European feudalism. One conceives the state as the outcome of chance and history in that the state developed by defeating all other contesting forms of authority. *See* Bart Driessen, A Concept of Nation in International Law 33 (1992). Since the Westphalia pact in 1648, the concept of state sovereignty has established the territorial state as governing system for a specific territory with a stable population and a functioning government, and the capacity to

sovereignty has been subject to critical scrutiny due to the rapid globalization in the world economy, the growth of regionalism around the globe, and the advent of international regulatory regimes.[99]

In recent years, the impact of globalization on the dominance and autonomy of the state has increasingly been the subject of heated debate cutting across various disciplines. Globalization has played a significant role in eroding states' geographical boundaries thanks to the rapid economic integration, and the growth of regionalism. Dramatically, innovative changes in the linked technologies of computing and communication are influencing the nature of state institutions, and enhancing the role of nonstate actors. In this regard, some observers stress a need for relocation of authority, both to the international level for problems for which the state is too small to operate effectively, and

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engage in foreign relations despite the persistence of ethnic and religious identities as reaffirmed in Article 1 of the 1933 Montevideo Convention on the Rights and duties of States regarding four requirements for de facto status as a state. A defined territory is one characteristic of statehood, whereas an attachment to lands may or may not be a feature of nationhood. Here, a state can be defined as a territory built by conquest in which one culture, one set of ideas and laws have been enforced over diverse nations. By contrast, a nation may be defined as a self-identifying people who share a common history, a common culture, language and a homeland, but not necessarily installed on a given territory. *See* Suzan D. Balz, Essay: A Country within a Country: Rewarding Borders on the post-Colonial Sovereign State, 2 Mich. J. Race & L. 537, 541 n.13 (1997).

[99] *See* Kanishka Jayasuriya, *Globalization, Law, and the Transformation of Sovereignty: The Emergence of Global Regulatory Governance,* 6 GLOBAL LEGAL STUD. J. 425, 426 (1999) (arguing that "[t]he notion of a single unified system of internal sovereignty has become increasingly problematic in a global political economy surrounded by islands of sovereignty, rather than by a single, central decisionmaking authority"). Jayasuriya claims that the development of this "complex sovereignty" reflects the transformation and reconstitution of the notion of the state sovereignty in the face of globalization in the world economy. *Id.*

to the sub-state level, for tasks for which it is too big.[100] Others acknowledge the gradual ending of the primacy of the state.[101] This is due to "the alleged loss of functions to international institutions, to pressure to develop power to regional movements demanding autonomy or secession, and to the difficulty of effectively controlling large multinational enterprises, the flows of international finance and of information and ideas."[102]

The new medievalists proclaiming the end of the state emphasizes the role of non-state actors with multiple allegiances and a global network[103] while liberal internationalists adhere to the primacy of the state, but recognize a need for international rules and institutions, constituted by a legally binding treaty, with expanding powers of governance to solve governmental problems.[104] The adherents of new medievalism conceive the development of a complex and varied world order with multiple layers and actors that is

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[100] *See* Paul Kennedy, PREPARING THE TWENTY-FIRST CENTURY 131 (1993).

[101] *See* Ali. Khan, The Extinction of Nation-States: A World without Borders 193 (1996); *see also* Jan A. Scholte, *Global Capitalism and the State,* 73 INT'L AFFAIRS 427, 444-45(1997) (noting the states' loss of sovereign authority in the face of independent regulatory activities by business association; arguing that the end of state sovereignty does not mean the end of the state; recognizing the more powerful states have retained important influence in contemporary global finance).

[102] *See* Peter Malanczuk, *Globalization and the Future Role of Sovereign State, in* INTERNATIONAL ECONOMIC LAW WITH A HUMAN FACE 46-47 (Friedl Weiss et al. eds., 1998).

[103] *See* Jessica T. Mathews, *supra note* 98 (describing a shift away from the state—up, down, and sideways—to supra-state, sub-state, and above all, nonstate actors).

[104] *See* Michael Zuern, *From Independence to Globalization, in* THE HANDBOOK OF INTERNATIONAL RELATIONS 235 (Walter Carlsnaes et al. eds., 2000). The liberal internationalism requires a centralized rule-making authority, a hierarchy of organizations, and universal membership: the United Nations is one of the standard or classical model of international institutions.

more akin to the order of medieval times.[105] In this sense, this view is construed as a back-to-the-future model of the twenty-first century.[106]

Another view of chaos paradigm specifically addresses the decline of the state as an institution.[107] This view highlights the sharp rise in tribal, ethnic and religious conflict, the rapid increase in the activities of international criminal mafia organizations, the proliferation of biological, chemical and nuclear weapons, the increase of international terrorism, the problem of massive refugee flows and the appearance of acts of genocide and ethnic cleansing.[108] This is an anarchic and chaotic world characterized by the breakdown of governmental authority, the dismemberment and fragmentation of states and the appearance of failed states: Somalia, Liberia, Rwanda, Burundi, Afghanistan, and Yugoslavia.[109]

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[105] For a summary of this view, *see* Samuel Huntington, *The Clash of Civilizations and the Remaking of World Order* 35 (1996).

[106] *See* Anne-Marie Slaughter, *The Real New World Order,* FOREIGN AFFAIRS, Sept.-Oct. 1997, at 183. Slaughter pointed out two central weak points of the new medievalism: first, private power does not take the place of state power; second, "the power shift is not a zero-sum game [because] [a] gain in power by nonstate actors does not necessarily translate into a loss of power for the state." *See id.* at 184.

[107] *See* Huntington, *supra* note 105.

[108] *See* Zbigniew Brzezinski, OUT OF CONTROL (1993); *see also* Daniel Moynihan PANDAEMONIUM: ETHNICITY IN INTERNATIONAL POLITICS, cited in Huntington, *supra* note 105, at 35. .

[109] *See* generally G.B. Helman et al., *Saving Failed States*, 89 FOREIGN POLICY 21(1992); for the analysis of failed states and illegal regimes, *see also* Oscar Schachter, *The Erosion of State Authority and its*

At the other extreme, advocates of the realism in international relations stress the primacy of the states as the central actors in world affairs, that is the primary units of analysis in social science terms, and the states' activities in a single-minded pursuit of political and military security in accordance with their own self-interest.[110] This realism's narrow focus on power and military might have encountered challenges from other schools of international relations theory since the collapse of Communism and the end of the Cold War. As the most dominant theory of these schools, the regime theory shares a number of

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Implications for equitable Development, in International Economic Law with a Human Face 40-42 (F.Weiss et al. eds., 1998) at 40-42.

[110] The perspectives of realists Hans Morganthau and George Kennan builds on the experience of World War II, the Cold War, and the alleged utopianism of Wilsonian internationalism in the interwar years. *See* Claude E. Barfield, Free Trade, Sovereignty, Democracy: The Future of the World Trade Organization 150-152 (2001). Mogenthau argues that the science of international politics does not lie at the interstices of realism and utopianism, but in the realm of realism alone. Its dual purposes are "to detect and understand the forces that determine political relations among nations, and to comprehend the ways in which those forces act upon each other and upon international political relations and institutions." *See* Hans J. Morgenthau, Politics Among Nations: The Struggle for Power and Peace 18 (6th ed. 1985). For the relationship between realism and utopianism, *see* E. H. Carr, The Twenty Years' Crisis: 1919-1939 (2nd ed. 1946). The realists consider the international relations anarchic and often compare to a state of war, specifically "a competition of units in the kind of state of nature that knows no restraints other than those which the changing necessities of the game and the shallow conveniences of the players impose." *See* Robert O. Keohane, After Hegemony: Cooperations and Discord in the World Political Economy 7 (1984). Kenneth Waltz shifted the focus in realist theory, particularly the powerful redefinition and refinement of realism. According to Waltz's neorealist reformation of realist international theory based on the economic theory of the firm, the anarchical nature of the international system—its lack of a central authority with effective sanctioning powers—gives states a powerful survival motive. *See* Kenneth Waltz, Theory of International Politics (1979) preface; for the analysis of the Watz's theory; *see also* Anne-Marie Burley, International Law and International Relations Theory: A Dual Agenda, 87 American J. of Int'l L. 205, 208-218 (1993). The advocates of the realist tradition of international economy continue to stress the primacy of the state as the central actor. In this context, one points out, in some cases, globalization has brought about the expansion of government authority and government spending rather than diminishing the state authority. *See* Robert Gilpin, THE POLITICAL ECONOMY OF DIRECT FOREIGN INVESTMENT (1975).

assumptions with realism, but regime theorists often modify them substantially. Although like realists, the regime theorists view the state as the primary actor in the international affairs, they acknowledge that "internal economic, social, and political pressures buffet governments before they reach a unified national position."[111]

In recent years, the proponents of transgovernmentalism recognize that the information revolution and globalization are changing world politics, and entailing selutory effects on the evolution of international law, but they believe that the state is resilient and will remain the centerpiece of the international system, thereby continuing to exercise its power in a disaggregated, more flexible fashion.[112] That is, the transgovernmentalism notes the frequent interaction among decentralized government agencies—global networks—all over the world rather than formal negotiation. This point of view argues that "[r]egular interaction with foreign colleagues offers new channels for spreading democratic

[111] For the distinction between the realism and regime theory, *see* Claude E. Barfield, Free Trade, Sovereignty, Democracy: The Future of the World Trade Organization, 152-153 (2001). *See generally* International Regimes (Stephen D. Krasner ed., 1983).

[112] *See* Slaughter, *supra* note 106 at 184. Slaughter asserts that "[d]isaggregating the state permits the disaggregation of sovereignty as well, ensuring that specific state institutions derive strength and status from participation in transgovernmental order." *Id.* at 196.

accountability, governmental integrity, and the rule of law."[113] The advocate claims that transgovernmental networks represent "a blueprint for the international architecture of the 21st century."[114]

Although it is beyond the scope of this study, exploring the relationship of the state and nation due to the increase in the nation and state conflicts is noteworthy while traditional international law doctrine is still based on the presumption of fictional nation-states. With the demise of Communism across Eastern and Central Europe that has propelled us into the post-Cold War era, international community has confronted the ever-increasing claims to autonomy and outright independence by minority nations that are seeking a greater recognition of their cultural and political identities within their existing states in the name of self-determination or national liberation.[115] Arguably, since current international law

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[113] *See id.* at 186. Slaughter asserts that transgovernmentalism is more effective and potentially more accountable than any other alternatives since it leaves the control of government agencies in the hands of national citizens rather than supranational bureaucracies answerable to no one in the liberal internationalism. Slaughter also argues that although new medievalism attracts states' rights enthusiasts and superanationalists, it could easily reflect the worst of both worlds. *Id.*

[114] *See id.* at 197.

[115] See Ved P. Nanda, Revisiting Self-Determination as an International Law Concept: A Major Challenge in the post-Cold War Era, 3 Ilsa. J. Int'l & Comp. L. 443, 444 (1997); see also Ravi Mahalingam, The Compatibility of the Principle of Nonintervention with the Right of Humanitarian Intervention, 1 UCLA J. Int'l L. 223, 225 (1993). For the concept of self-determination, see generally Eric Kolodner, The Future of the Right to Self-Determination, 10 Conn. J. Int'l L. 153, 155 (1994).

still excessively based on the presumption of fictional nation-states has not evolved sufficiently to handle this postmodern global disorder of the tumult of ethnicity as witnessed in the fragmentation of the former Yugoslavia, the paradigm of international legal discourse needs to be adapted to real nature of states and nations.[116]

Arguably, a nation cannot be defined in international law while sticking to the positive, while ignoring the concept of morality in international society.[117] One focuses on the issues of self-determination and rights of nations in international law to solve problems between states and nations.[118] The past centuries saw the problem of the moral justification of the state-centric conception while the state system could not prevent hundreds of wars. It can arguably be assumed that the order or authoritative association between states has little moral value in itself. In short, state borders are not borders of morality, and thus the state system cannot be adapted to be harmonious with the nations system.[119] In this regard,

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[116] See Bart Driessen, *A Concept of Nation in International Law* 5 (1992)
[117] See id. at 4.
[118] Id. at chapter 5.
[119] Id. at 34.

it is asserted that the real moral collectivity is not the state but the nation, which should be recognized under international law.[120]

The decolonization in 1950s has formed numerous new states that housed different peoples with different cultural backgrounds between their borders. Since new sates' borders were often drawn arbitrarily, based on previous wars fought by the colonial powers, and on compromises reached between them, yet unmatured democracies were also anticipated to accommodate several peoples in their territory, to protect minorities against the majority and to build one nation out of several ones, and thus the post-Colonization era has witnessed a side effect of failed states.[121]

Although it is difficult to attempt a definite normative assessment of so complicated and many-sided phenomenon as that discussed above, the state will be unlikely to disappear in

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[120] Id. at chapter 4.

[121] See Ruud Lubbers & Jolanda Koorevaar, Nation state and democracy in the globalizing world, Paper presented at a Tilburg University seminar (Nov. 26, 1998), at 3; see also Suzan D. Balz, A Country within a Country: Redrawing Borders on the Post-Colonial Sovereign State, 2 Mich. J. Race & L. 537, 561-563 (1997) (arguing that territory is no longer necessarily the characteristic of political entity in the international arena, and therefore stateless nations should be recognized as subjects of international law. The best way to achieve this is to make room in international law for minority nations that are self-defining in accordance with their own criteria to be recognized as political entities within the concept of the sovereign state, co-exist in arrangements with states, and further serve as members of international organizations. In order for Colonialism to be ended, a room in international law for non-Western concepts should be made, and stateless nations should be recognized, they should be heard, and they should be allowed to contribute to its shape. This will strengthen the state, whose legitimacy and continued survival hinge on its representation of the peoples.).

the foreseeable future. The key issue is not the continuous existence of the sovereign state, but how its centrality and functions are being modified. As the past decades have witnessed, all the states on the globe are struggling to solve the problems that are beyond their control within their national boundaries—financial flow, drug trade, AIDS, terrorism, and so forth—. In these circumstances, the state actors and institutions need to adapt. As such, they modify the meaning of sovereign authority, control, and the role of private actors.[122] In short, while the state's powers are not what they once were, the state remains sovereign.[123]

B. The Emergence of Global Civil Society: Implications for the State

The changing role of the state is often associated with the increased participation of global civil society in domestic and international affairs. Notably, the state has been

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[122] *See* Joseph S. Nye, The Paradox of American Power, supra note 97, at 56 (2002)

[123] *See id.* at 74. Observers remark that "[I]f the state remains at the center of governance in the world, what has changed? In a word everything. Never have so many different nonstate actors competed for the authority and influence that once belonged to the state alone." *See* Gordon Smith et al., Altered States: Globalization, Sovereignty and Governance 10 (2000).

increasingly challenged by the proliferation of nongovernmental organizations (NGOs).[124] The information revolution has enabled NGOs to engage in the large scale-activity across national borders because NGOs are particularly effective in penetrating states without regard to borders.[125] As a result, NGOs operating transnationally have much greater opportunities to organize and propagate their views in response to new demands.[126] The prospect of a civil society is attractive to liberals, who envisage it as enabling and empowering independent self-organized groups to participate politically and to counter the abuses of state power.[127] One notes that "the revitalization of civil society was portrayed,

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[124] Thanks to the information revolution, the number of NGOs increased from 6,000 to approximately 26,000 during the 1990s alone. *See* The Third Force: The Rise of Transnational Civil Society (Ann Florini ed. 2000). It deserves noting the importance of in particular NGOs, such as Human Rights Watch, Amnesty International, the International Red Cross, Greenpeace, the World Economic Forum, Doctors without Borders, and Transparency International. Multinational enterprises (MNEs) play a key role in an increasingly global economy. At the end of 2001, the gross product of all foreign affiliates of MNEs was estimated at $3.5 trillion, or roughly one tenth of the world's domestic product. About two thirds of world trade is conducted by MNEs, and about a third takes place within MNEs. *See* United Nations Conference on Trade and Development (UNCTAD), World Investment Report 2002: Transnational Corporations and Export Competitiveness 4-5, U.N. Doc. UNCTAD/WIR/2002 (2002). Gross Product is defined as the total value of all goods and services produced by MNEs.

[125] See Joseph S. Nye, Soft Power: The Means to Success in World Politics 91(2004).

[126] In this regard, new perspectives on governance highlight the potential role of civil society. Nye notes the need for a diffusion of governance activities in several directions at the same time instead of centralization or decentralization when there is imbalance between the state's problem-solving capacity and the problems of life. *See* Nye, The Paradox of American Power, supra note 97, at 45. Nye illustrates the possible diffusion of activities away from central governments—vertically to other levels of government and horizontally to market and private nonmarket actors. See id. at 45-46.

[127] *See* John Clark, *Democratizing Development: The Role of Voluntary Organizations* (1991); *see also* Andrew Hurrell et al., Globalization and Inequality, 24 Int'l Studies 447, 467 (1995) ("the idea of 'civil society' has long been considered in liberal thought as something defined in contradiction to the state and as valuable precisely as a means of checking the power of states. Confirming this view in the evidence of NGOs

at least by conservatives, as a solution to the social and political side of public well-being, one that could make the state politically obsolete, just as global markets made the state economically obsolete."[128]

Many NGOs assert to act as a global conscience representing broad public interests beyond the domain of states, or interests that states are used to ignoring.[129] In this way, a large number of NGOs have played a key role in the official institutions concerned with the creation of international law and legal policy, and in pressing for the implementation and enforcement of law.[130] NGOs' work ranges over their broad interests.[131] Some note that

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which have given voice to the weak and vulnerable and to those who are deemed to be non-members of a particular state or political community, or who fall between the cracks of the state system ...").

[128] *See* Peter Evans, *The Eclipse of the State?: Reflections on Stateness in an Era of Globalizations,* WORLD POLITICS, Vol. 50, No. 1 (Oct. 1997), at 78-79. Evans points out that the political triumph of the stateless Anglo-American world order was a crucial driving force behind the charisma of civil society. *Id.* at 78.

[129] *See* Nye, The Paradox of American Power, supra note 97, at 60. Thanks to the expansive use of the Internet, NGOs are able to share information with state institutions, thereby pressing governments directly, or indirectly by mobilizing their publics through focusing the attention of the media and governments on their preferred issues. In this way, they create a new type of transnational political coalitions, such as a coalition to ban land mines brought together NGOs, celebrities, and politicians in many countries. Meanwhile, there is a need to rethink about NGOs' use of the Internet to plan the disruption of the WTO summit in 1999 that became known as the battle of Seattle. *See* Nye, Soft Power, supra note 125, at 90-92.

[130] *See* Oscar Schachter, *The Erosion of State Authority and its Implications for Equitable Development, supra* note 109, at 36. For a recent survey of NGOs, *see* Thomas G.Weiss et al., *NGOs, the UN and Global Governance* (1996).

[131] Multinational enterprises are also the target of NGO activities. In short, as the technology of the cheap communications enable NGOs to conduct campaigns to name and shame transnational companies that pay low wages to laborers in poor countries. Such campaigns sometimes work since they are credibly able to threaten to deprive the corporations of the soft power of their valuable brand names. *See* Nye, Soft Power, supra note 125, at 93. Indeed, multinational enterprises (MNEs) play a key role in an increasingly global economy. At the end of 2001, the gross product of all foreign affiliates of MNEs was estimated at $3.5 trillion, or roughly one tenth of the world's domestic product. About two thirds of world trade is conducted by MNEs,

"[NGOs] breed new ideas; advocate, protest, and mobilize public support; do legal, scientific, technical, and policy analysis; provide services; shape, implement, and monitor national and international commitments; and change institutions and norms."[132]

Needless to say that NGOs have played a critical role in supporting human rights, thereby improving the status of women and environmental regulation. Despite their dedication to higher aims, their efforts are widely viewed as a desirable addition to international political and legal structures.[133] Their power in mobilizing public opinion and bringing pressure on government is construed as participatory democracy.[134] The information revolution and global communication networks have contributed to the growth and effectiveness of the NGOs on the international stage. As a result, NGOs are able to challenge states or compete with them in important areas. In this regard, governments

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and about a third takes place within MNEs. *See* United Nations Conference on Trade and Development (UNCTAD), World Investment Report 2002: Transnational Corporations and Export Competitiveness 4-5, U.N. Doc. UNCTAD/WIR/2002 (2002). Gross Product is defined as the total value of all goods and services produced by MNEs.

[132] *See* Mathews, *supra* note 98, at 53.

[133] *See* Schachter, *supra* note 109, at 35.

[134] *Id.* at 37.

have to consider NGOs as both allies and adversaries because of their ability to attract followers.[135]

However, NGOs are barely recognized under international law, and their juridicial status and rights are still governed by national law constituted by the state authority. Under the special circumstances, they are granted privileges and immunities similar to the public bodies.[136] A provision of the U.N. Charter (Article 71) provides a basis for granting consultative status in the U.N. Economic and Social Council (ECOSOC) to both international and national NGOs with regard to economic and social issues. The text of this provision is commonly viewed as a compromise among those who advocate NGO participation in the United Nations' work and those who oppose such participation.[137] A reading of Article 71 of the U.N. Charter may cause some doubts as to any entitlement of nongovernmental organizations in the context of a legal subject.[138] Nevertheless, the

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[135] *See* Nye, The Paradox of American Power, supra note 97, at 90.
[136] *See* Schachter, at 37..
[137] *See* Rainer Lagoni, *Article 71, in* The Charter of the United Nations, A Commentary (Bruno Simma et al. eds., 1994).
[138] Article 71 provides: " The Economic and Social Council may make suitable arrangements for consultation with nongovernmental organizations which are concerned with matters within its competence. Such arrangements may be made with international organizations and, where appropriate, with national organizations after consultation with the Member of the United Nations concerned." For the analysis of the

provision created the unprecedented formal relationship between interest groups and an intergovernmental body (ECOSOC).

Since the U.N. Conference on Environment and Development in Rio de Janeiro held in 1992, a lot of members of NGOs served on government delegations, and they penetrated deeply into official decision-making in international authorities with independent regulatory powers.[139] The Rio Declaration itself does not mention nongovernmental organizations. However, Agenda 21 underlines that such organizations possess "well-established and diverse experience, expertise and capacity infields which will be of particular importance to the implementation and review of environmentally sound and socially responsible sustainable development"(Section 27.3). It is therefore concluded that the role of such organizations is to be strengthened. Apart from promoting the fullest possible communication and co-operation between international organizations, national and local governments and NGOs, one specific method of enlarging the role of NGOs is "to

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role of NGOs, *see* Stephan Hobe, *Global Challenges to Statehood: The Increasingly Important Role of Nongovernmental Organizations*, 5 INDIANA J. GLOBAL LEGAL STUD. 191(1997).

139 *See* Mathews, *supra* note 98, at 55.

ensure the right of nongovernmental organizations to protect the public interest through legal action"(Section 27.13).

Moreover, it is important to note NGOs and states' collaborating ad hoc in large-scale humanitarian relief operations that involve both military and civilian forces.[140] Also, it is noteworthy that whereas NGOs as observers of the World Bank have done, they may also file *amicus curiae* briefs in WTO dispute-settlement cases depending on the transparency of their own membership and finances.[141] Another group of NGOs engage directly in development activities under contractual agreements with governments or international agencies such as the World Bank.[142] More importantly, there is an increasing role of NGOs to play in a hybrid network of organizations that combine governmental, intergovernmental, and nongovernmental representatives, such as the World Commission on Dam or Kofi Annan's Global Compact, the International Telecommunications Union,

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[140] *See id.* at 62-63.

[141] *See* Nye, The Paradox of American Power, supra note 97, at 167.

[142] In that way, international financial institutions have also more engaged in states' domestic affairs. Beyond their engagement in domestic economic and social decisionmaking, under the new policies,the World Bank, the International Monetary Fund, and other international financial institutions are forced to be allied with business, NGOs, and civil society if they are to accomplish broad changes in target countries. In the process, they have exposed themselves to the same needs they are asking their clients: broader public participation and greater openness in decision-making. *See* Mathews, Power Shift, supra note 98, at 60.

and the International Union for the Conservation of Nature to enhance global governance.[143]

Since a number of groups within civil society are the direct or indirect product of state action, and cannot be understood outside their relationship to states, the politics of transnational civil society mainly concerns the way of certain groups' emergence, and their legitimacy by governments, institutions, or other groups.[144] NGOs' environmental and development activities which are not operated for profit are also influenced by scientific and technical community of like-minded experts acting through their associations or consulting companies. A benefit of these epistemic communities, in addition to their specialized competence, is their avoidance of defects of centralization, and the hierarchies' characteristic of both state and international public bodies.[145] One observer notes that epistemic communities bring up knowledge and consensus providing basis for effective

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143 *See* Nye, The Paradox of American Power, supra note 97, at 167; see also Mathews, supra note 98, at 62.
144 Andrew Hurrell & Ngaire Woods, *Globalization and Inequality*, 24 MILLENNIUM 447, 467-468(1995).
145 *See* Peter. Haas, *Do Regimes matter?: Epistemic Communities and Mediterranean Pollution Control,* 43 INT'L ORG. 377 (1989).

cooperation through framing issues of ozone depletion or global climate changes.[146] Although the cross-border transmission of knowledge and ideas is often viewed as the diffusion of knowledge through epistemic communities, this neglects the issue of whose scientific knowledge becomes critical through what channels, and with what relationship to states and state power.[147] Arguably, there is a need to examine the links between influential epistemic communities, particular institutions and particular groups within society are often unexamined

In the meantime, there are increasing concerns over the rise in transnational criminal organizations' illegal activities of drug-traffic, money laundering, terror, and so on. In particular, international terrorist groups have become the center of attention around the globe in the aftermath of 9/11 tragedy. As for the empowering terrorist groups in an uncritical way, there are two further problems. First, these transnational terrorist organizations are not necessarily representative, nor politically accountable. Second, the

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[146] Peter M. Haas, Introduction: Epistemic Communities and International policy Coordination, 46 Int'l Org. 1 (Winter 1992).

[147] *See* Karen Litfin, *Framing Science: Precautionary Discourse and the Ozone Treaties*, 24 MILLENNIUM 251(1995).

probability of demonstration for better and for worse. In this regard, the same standards of transparency should be applied to NGOs themselves as the increased transparency, that is curtailing secrecy of procedures is required for international institutions to be held accountable.[153] Furthermore, NGOs do not hesitate to use their soft-power resources in calling to storm the barricades evidenced in Seattle and Doha if the lack of political accountability and legitimacy came to a head.

Despite problems of empowering NGOs, they have worked their way into the core of international negotiations and the operations of international institutions bringing new priorities and demands for procedures that give a voice to groups outside governments.[154] Fostering civil society does not necessarily require the demise of the state. That is to say, it is not a zero-sum relation between robustness of the state and the vibrancy of civil society.[155] Thus, the relationship of the state to civil society is more productively viewed in the context of mutual empowerment or synergy.[156] Likewise, by assisting to solve

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[153] See Nye, The Paradox of American Power, supra note 97, at 166-167.
[154] See Mathews, supra note 98, at 56.
[155] See Evans, supra note 128, at 79.
[156] See id. at 80

probability of demonstration for better and for worse. In this regard, the same standards of transparency should be applied to NGOs themselves as the increased transparency, that is curtailing secrecy of procedures is required for international institutions to be held accountable.[153] Furthermore, NGOs do not hesitate to use their soft-power resources in calling to storm the barricades evidenced in Seattle and Doha if the lack of political accountability and legitimacy came to a head.

Despite problems of empowering NGOs, they have worked their way into the core of international negotiations and the operations of international institutions bringing new priorities and demands for procedures that give a voice to groups outside governments.[154] Fostering civil society does not necessarily require the demise of the state. That is to say, it is not a zero-sum relation between robustness of the state and the vibrancy of civil society.[155] Thus, the relationship of the state to civil society is more productively viewed in the context of mutual empowerment or synergy.[156] Likewise, by assisting to solve

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153 See Nye, The Paradox of American Power, supra note 97, at 166-167.
154 See Mathews, supra note 98, at 56.
155 See Evans, supra note 128, at 79.
156 See id. at 80

problems governments cannot cope with, private sectors, NGOs, and international institutions may find themselves actually strengthening the state system.[157]

C. The Reconceptualization of State Sovereignty

The traditional conceptions of sovereignty have been problematic due to the changing nature of sovereignty. Finding a workable definition of sovereignty has been an everlasting challenge for academics. As a result, the notion of sovereignty is meant by different definitions.[158] Moreover, the concept of sovereignty has been attacked as obsolete,[159] a dead duck[160] or extinct,[161] but has not been abandoned.

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[157] One observer argues that "NGOs are no more successful now in driving outcomes than they were in the past. The most powerful of these organizations originated and are headquartered in Europe or the United States—territories that have driven international policies for at least the last fifty years. To the extent that these NGOs have been able to prevail in domestic processes of interest intermediation in the most powerful states, they have long been able to influence international negotiations and outcomes. When NGOs have not prevailed in powerful countries, they have sometimes tried to effect change by going around the their powerful home states, prevailing instead upon weaker states to support their positions in international negotiations. Such strategy, however, has not reversed their fortunes in the powerful states where they were unable to prevail initially. The net result has been a series of recent treaties that have been limited effectiveness due to lack of support from powerful states—the Kyoto Protocol, the Antipersonnel Landmines Convention, and the Rome Statute, to name a few." *See* Richard H. Steinberg, Who is Sovereign?, 40 Stan. J. Int'l L. 329, 335 (2004).

[158] Stephen Krasner conceptualizes four different dimensions of sovereignty—international legal sovereignty, Westphalian sovereignty, domestic sovereignty, and interdependence sovereignty. According to Krasner, in particular Westphalian sovereignty refers to the exclusion of foreign actors from domestic decision-making, and interdependence sovereignty refers to a state's control over the cross-border movement of goods, services, capital, labor, and information. *See* Stephen D. Krasner, Sovereignty: Organized Hypocrisy 9-25 (1999). Krasner's study was initiated to respond to observers who assert that the state sovereignty was once exclusive and absolute, but has been eroded by transportation and communication advances, globalism in general, and

The term "sovereignty" has had a long history of the concept in philosophical and historical lexicons as the word's meaning changes with each passing era. The conceptualization of sovereignty varies with the context and objectives of the use of the word among legal scholars, political theorists, and policymakers. As remarked earlier, the concept of sovereignty has been defined as absolute control of territorial state since the 17th century, first in Europe and then elsewhere. As the term "territorial state" denotes a governing system for a specific territory with a stable population and a functional government, the rise of the territorial state was entailed by the notion that the state was sovereign.[162] Hence, the sovereignty of all social groupings regardless of ethnic and religious identities within a state's borders was legally subordinated to the sovereignty of the state. This was the situation at the earliest stages in the development of the concept of sovereignty. Thereafter, sovereignty has become a widely accepted notion as the ultimate authority to make policy within a state's boundaries. Therefore, sovereignty is perceived

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the rise of NGOs. Notably, Krasner remarks that sovereignty was never absolute and always frail as a legal principle. *See* id.

[159] See Hans J. Morgenthau, The Intellectual and Political Functions of a Theory of International Relations, *in* the Role of Theory in International Relations 116 (Horace V. Harrison ed., 1964).

[160] See J.P. Nettle The State as a Conceptual Variable, 20 World Politics 560 (1968).

[161] See Ali Khan, The Extinction of Nation-States 193 (1996).

[162] See Thomas G. Weiss et al., The United Nations and Changing World Politics 4-9 (1997).

as an authority to enhance the power of peoples constituting the government that represent the state.

As a legal concept, the doctrine of sovereignty and the legal fiction of the sovereign equality of states is the independence of states. In the doctrine of international law, state sovereignty itself denotes not only the power of an independent state, but the ultimate authority of the state, which is absolute within its territory and equal in its relations with other sovereigns. That is to say, the state is granted the right freely to exercise its power within its territory, and the right to exclude from its territory the exercise of power by any other state without any voluntary invitation to do so. Accordingly, the sovereign's will is the only legally relevant one, and thus the power of sovereigns and their political authority must be respected, that is no outside rules and institutions are held to be superior to the state.

The eclipse of established empires after World War I and the creation of international institutions following World War II posed challenges to the traditional notions of state sovereignty as absolute territorial control over all people in a state. Moreover, the

breakdown of the communist regimes in Eastern and Central Europe which led to the end of the Cold War has propelled the emergence of a new world order. The traditional and ideological conflict in politics has encountered a new stage of the world politics and global cooperation. In particular, the economic integration in the European Community[163] leading to the prominence of the European Union[164] has become an inspiration for the regional cooperation movement aiming at the growth of domestic economy. It is very crucial to note what the transformation of Europe means in the context of the state sovereignty in that the transformation makes states' boundaries insignificant. The European integration toward Europe as unity and Europe as community raised a question

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[163] The European Community (hereinafter EC) is opposed to the European Union (hereinafter EU), from a legal point of view, the European Communities in that the European Communities and their Member States are members of the WTO. That is because the area of trade is governed by the three Community treaties: the Treaty establishing the European Community (EC), formerly the European Economic Community (EEC); the Treaty establishing the European Coal and Steel Community (ECSC); and the Treaty establishing the European Atomic Energy Community (Euratom). These treaties were amended but not replaced by the Treaty on European Union (the Maastricht Treaty). The tree supranational European Commnuties make up the first of so-called three pillars on which the EU, which does not have legal personality, is founded. The two othr pillars—foreign and security policy and justice and home affairs—are intergovernmental EC as opposed to European Communities. *See* Sydney J. Key, Financial Services in Uruguay Round and the WTO, Group of Thirty Occasional Papers 54 (1997) at 53 n.2.

[164] Thanks to the success of the 1992 initiative, followed by the Masastricht Treaty and plans for further integration in the near future, the European Union has come into being. *See* Treaty on European Union, Feb. 7, 1992, O.J.C. 224/1 (1992), [1992] 1 C.M.L.R. 719, 31 I.L.M. 247 (1992) [hereinafter TEU]. The TEU, also known as the Maastricht Treaty, officially adopted the name "European Union" for the former "European Communities." The European Coal and Steel Community, which was born during the devastation wrought by Hitler has come a long way to breed the prominence of the EU. As of May 1, 2004, the European Union has grown to an organization with 25 member states and 450 million people from 6 member sates in 1951. For the detail, see http://www.europa.eu.int/abc-en.htm.

whether the reciprocal benefit derived from correlative restriction on the sovereignty of a state renders the surrender of the sovereignty of another state, because the EU has to become as much a union of citizens as it is of states. In other words, there was a concern over the loss of sovereignty by the EU member states because the EU accession required significant changes in the local legislation and direct infringement on the domestic control of tax and other matters, although it was permanent, and did not include a right of secession.[165]

However, the EU member states do not conceive the growing power of the EU and its rulemaking commissions as a loss of sovereignty, although public suspicion of the sudden prominence of the EU became painfully obvious during national ratification of the Maastricht Treaty.[166] Likewise, the EU member states were expected to surrender more sovereignty to the EU, but even the smaller states of Europe consider the EU's progress and

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[165] *See* Jenik Radon, Sovereignty: A Political Emotion, not a Concept, 40 Stan. J. Int'l L. 195, 199-202 (2004).

[166] Notably, a referendum on the Maastricht Treaty in Denmark, British parliamentary support was questionable, and even in traditionally pro-EC France a referendum passed by the narrowest of margins. *See* e.g., Half-Maastricht, Economist, Sept. 26, 1992, at 15; The Danes say No, Economist, June 6, 1992; See also David Arter, The Politics of European Integration in the Twentieth Century 212-216 (1993). Public suspicion of the creation of the EU arose due to the concern over the legitimacy of EU institutions themselves in terms of the democratic deficit, and the threat the EU posed to the independence and survival of the member states. For the democratic deficit, see Peter Lindseth, Democratic Legitimacy and Administrative Character of Supranationalism: The Example of The European Community, 99 Colum. L. Rev. 628 (1999).

growth as an exercise of expansion of their sovereignty.[167] Accordingly, each EU member state still enjoys its dignity as a sovereign in international law. Hence, the prominence of the EU casts some hints on defining a contemporary concept of state sovereignty in the expectation of new geographic and functional entities' birth.

With the acceptance of the Charter of the United Nations (UN), none of the original fifty-one member states raised the issue of UN membership as a threat to the sovereignty, but perceived it as a confirmation of their sovereignty.[168] However, competing conceptualizations of sovereignty arise even in the Charter of the United Nations. According to the Article 2 (7) of the Charter, "Nothing in the present Charter shall authorize the United Nations to intervene in matters which are essentially within the domestic jurisdiction of any State."[169] By contrast, the UN Member States, in virtue of their acceptance of the UN Charter, have agreed to the ensuing restrictions on their

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[167] Estonia and the other Baltic States became the EU members to protect their sovereignty because they considered joining the Euro Zone as a means to increase sovereignty. See Askel Kirch et al., Changes in EU-Consciousness in Estonia 1995-2000: Discussion and Public Union (IES Proceedings 2002).

[168] See Radon, supra note 165, at 201 (remarking "the creation of the United Nations also sanctified the concept of state sovereignty, as only recognized states could be members of this new global club").

[169] U.N. Charter art. 2, para. 7.

sovereignty according to the Article 2 (1) of the Charter.[170] The coexistence of human rights provisions in the UN Charter since 1945 has made the issue of conceptualization of sovereignty complicated. In particular, the NATO intervention of in Kosovo was the subject of hot debate among international legal experts, with asserting illegality because it was not explicitly authorized by the UN Security Council, and others claiming its legality under the evolving body of international humanitarian law.[171] The issue lies at the center of the justification of states' interference in the affairs of other sates. One arguably attributes such interferences to governments' understanding of the unavailability of no other alternatives to them, and fundamental threats to their security derived from conditions once thought to be within a state's exclusive domestic jurisdiction.[172]

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[170] U.N. Charter art. 1, para. 2 (embedding the principle of self-determination in the mission of the UN). One observer argues that "[r]ecent attemps in the international legal literature to declare incompatible with state sovereignty, and therefore illegal, the binding decisions of the UN Security Council authorizing enforcement measures under Chapter VII, are flawed and simply false.". See Jost Delbruck, Prospects for a "World (International) Law?": Legal Developments in a Changing International System, 9 Ind. J. Global Legal Stud. 401, 428 (2002). Delbruck continues asserting that "the concept of sovereignty with which the UN actions are supposed to be incompatible is an extraneous notion revived from pre-World War I times, not the concept on which the UN are based on according to the article 2 (1) of the Charter." See id. at 428 n.78.

[171] See Adam Roberts, "The So-called 'Right' of Humanitarian Intervention", Yearbook of International Humanitarian Law, summer 2001.

[172] See Anne-Marie Slaughter, Sovereignty and Power in a Networked World Order, 40 Stan. J. Int'l L. 283, 284-285 (2004).

According to the International Commission on Intervention and State Sovereignty (ICISS),[173] participating in international organizations, such as the UN itself, ensues the participating states' acceptance of the fellow member states to intervene in their domestic affairs in case of their failure in their primary responsibility to protect their citizens.[174] In December 2001, the ICISS issued a significant report, "The Responsibility to Protect," as a call for updating the UN Charter to incorporate a new conceptualization of sovereignty.[175] The ICISS insists that "there is a necessary re-characterization involved: from sovereignty as control to sovereignty as responsibility in both internal functions and external duties.[176] That is, whereas internally, a government has an obligation to respect the dignity and fundamental rights of its citizens, externally, it has an obligation to respect other states' sovereignty.

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[173] In September 1999, the UN Secretary General Kofi Annan issued a challenge to all the UN member states on the humanitarian area at the opening of the General Assembly to "reach consensus—not only on the principle that massive and systematic violations of human rights must be checked, wherever they take place, but also on ways of deciding what action is necessary, and when, and by whom." In response to this challenge, a distinguished global group of diplomats, politicians, scholars, and nongovernmental activists established the International Commission on Intervention and state Sovereignty. *See id.* at 286-287.

[174] Id. at 286.

[175] ICIS, The Responsibility to Protect, Report of the Commission on Intervention and State Sovereignty (2001). See also Slaughter, supra note 172, at 287 & n. 12.

[176] See ICIS, supra note 175, at para. 2.14.

As a matter of fact, states have difficulty governing effectively as long as they are left alone and they leave other states alone.[177] It is arguably because governments' ability to accomplish their objectives through individual action has been impeded by international political and economic interdependence.[178] Conversely, "[s]tates can only govern effectively by actively cooperating with other states and by collectively reserving the power to intervene in other states' affairs."[179] Here, a modern notion of sovereignty formed by the paradigms of cooperation and compliance with the international legal order needs to be reconceptualized.

In the words of Chayes and Chayes , "the new sovereignty" is the right and the capacity to participate in the international organizations of all types that authorize their members cooperating with one another, to attain the objectives that could once be achieved by governments themselves.[180] According to Chayes and Chayes, the international system

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[177] See Abram Chayes & Antonia H. Chayes, The New Sovereignty: Compliance with International Regulatory Agreements 27 (1995) (arguing that "[I]t is that for all but a few self-isolated nations, sovereignty no longer consists in the freedom of states to act independently, in their perceived self-interest, but in membership in reasonably good standing in the regimes that make up the substance of international life.").

[178] See Robert O. Keohane, Sovereignty, Interdependence, and International Institutions, *in* Ideas and Ideals: Essays on Politics in Honor of Stanley Hoffmann 91,92 (Linda B. Miller et al. eds.,1993).

[179] See Slaughter, supra note 172, at 285.

[180] See Chayes & Chayes, supra note 177, at 4.

itself has moved beyond interdependence, and it has become a "tightly woven fabric of international agreements, organizations and institutions that shape [states'] relations with one another and penetrate deeply into their internal economics and politics."[181] In this regard, one argues that state sovereignty does not mean the autonomy of the state any more as long as the background features of international system are connection rather than separation, interaction rather than isolation, and institutions rather than free space.[182] In this sense, the new sovereignty is conceived as status, membership, "connection to the rest of the world and the political ability to be an actor within it."[183]

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[181] See id. at 26. For the relationship of globalization to interdependence, see Wolfgang Reinicke, Global Public Policy: Governing without Government 52-74 (1998).

[182] See Slaughter, supra note 172, at 286.

[183] See Chayes & Chayes, supra note 177, at 26. However, Slaughter paradoxically remarks that "the measure of a stae's capacity to act as an independent unit within the international system—the condition that "sovereignty" purports both to grant and describe—depends on the breadth and depth of its links to other states." See Slaughter, supra note 172, at 286. Despite a need for the reconceptualization of the traditional notion of sovereignty, there is a variance in the extent to which states exercise their sovereignty. In this regard, some observer argues that "all states are legally sovereign, but they vary in the extent to which they are behaviorally sovereign." See Steinberg, supra note 157, at 329 (distinguishing legal from behavioral sovereignty: legal sovereignty confers each state the legal competence to participate in the international system on an equal footing with other states, conclude treatise on the basis of consent, exclude other states from interfering in its internal affairs; behavioral sovereignty is an evaluation of the extent to which states indeed exercise the authority granted by legal sovereignty). This variance arises because the state's capacity to exercise both domestic and international dimensions of legal sovereignty is contingent. See id. at 333. Furthermore, states are entitled to a right to exclude other states, nonstate actors, and international organizations from interference in their internal affairs in international system under international law, but few states are able to do so in fact. As noted, the IMF's conditionality arrangements imposed on loans and other measures to help developing countries prevent financial disaster drive the target countries' domestic policy and institutional changes. See Lawrence L.C. Lee, The Basle Accords as Soft Law: Strengthening International Banking Supervision, 39 Va. J. Int'l L. J. 1, 36-39 (1998) (noting that the Basel Committee's bank regulatory and supervisory standards have been enforced in emerging economies through considerably

As noted above, state sovereignty is deemed to be an evolutionary rather than a static concept because both the international system and state-society relations have been transformed by globalization and interdependence. As such, sovereignty encounters the transformation and evolution in its nature. Consequently, state sovereignty is redefined by its responsibility to protect its nationals as well as its capacity to participate in international regimes.

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more coercive means. Under the conditionality, the IMF has insisted on compliance with the Basel Accord and the Core Principles as a condition of aid.). In contrast to the sovereign equality of states, powerful states actually have a dominant voice in the decision-making processes, thereby driving international rules and consequences of in these settings. See Articles of Agreement of the IMF, Dec. 27, 1945, art. XIL, section 5, 60 Stat 1401, 1418-1419, 2 U.N.T.S. 39, 86-88 (In the IMF, votes are weighted to reflect some measure of underlying power). In this sense, international environmental changes have strengthened in particular the behavioral sovereignty of powerful states.

III. Skepticism on Governing the Global Economy Through Government Networks

A. Restructuring Global Governance

The ongoing economic integration in the world economy raises significant questions concerning the structure of global governance[184] systems intended to safeguard markets where globalization entails the erosion of national boundaries. Some observers argue that international institutions threaten state sovereignty.[185] The other advocates that traditional

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[184] As David Kennedy mentions in a particularly informative discussion, governance "has emerged as a distinctive motto for international public order, consciously distinguished from 'government' and consciously identified with the group of phenomena that are thought to define the late twentieth-century international condition: globalization, interdependence, the demise of sovereignty, the apparent futility of further United Nations institution building, and the emergence of international civil society. These writers identify governance as a new, distinct phenomenon: either a defining characteristic of the new world order or a prescriptive for resolving its pragmatic challenge, or both. 'Governance' in this literature, as opposed to 'government' is the complex of more or less formalized bundles of rules, roles, and relationships that define the social practices of the state and non-state actors interacting in various issue areas, rather than formal interstate organizations[.]" *See* David Kennedy, *New Approaches to Comparative Law: Comparativism and International Governance,* 2 UTAH L.REV. 545, 548 n.4 (1997).

[185] *See e.g.,* Susan George, The Problem isn't Beef, Bananas, Cultural Diversity or the Patenting of Life. The Problem is the WTO, The Guardian (London), November 24, 1999 (claiming that "[w]ithout the WTO has created an international court of "justice" that is making law and establishing case law in which existing national laws are all "barriers" to trade, and is sweeping aside all environmental, social or public health considerations."); *see also* Patrick Buchanan, The Great Betrayal (1998) (arguing that "the World Trade Organization exercises a supranational authority in conflict with our forefathers' vision of an American forever sovereign and independent"). Kal Raustialla classifies the conventional sovereignty-based critiques of international institutions into three categorizes; first, sovereign power is absolute power and thus reallocations of power represents a zero-sum game; second, reallocations of sovereignty, especially reallocations of upwards to international institutions are presumptively bad, and the retention of sovereignty is presumptively good; third, sovereignty is nearly synonymous with the notion of democracy. This premise claims that power allocations to international institutions not simply erode sovereignty but harm democracy, because democratic processes work better the closer the people are to the government. As a result, international organizations are perceived as unaccountable and distant, thereby creating or strengthening the democratic deficits. *See* Kal Raustiala, Rethinking the Sovereignty Debate in International Economic Law, 6 J. Int'l Econ. L. 841, 853 (2003).

notions of state sovereignty are being eroded by globalization itself rather than international institutions.[186] Further, one claims that international institutions at least under some conditions actually enhance sovereignty.[187] The sovereignty question at international institutions is related to the level of political support and concerns over democracy.[188]

In particular, the third premise represents American notions of sovereignty adopting the pre-War concept of sovereignty. The invocation of patriotism arisen from the association of sovereignty in the U.S. with the domestic democratic process, complete with checks and balances and political accountability is hard to be reconciled with the global interdependence other states have embraced in their efforts to accomplish sovereignty. Accordingly, the U.S. entrance in to the International Criminal Court (ICC) like the accession into the WTO was met with opposition and suspicion. The U.S. sovereigntists argues that the U.S. acceptance of the ICC would allow politically motivated prosecutors of Americans by nonaccountable actors without granting Americans their constitutional rights. In this context, Jenik Radon highlights that "[w]ithin the United States, the word "sovereignty" has found a separate and independent footing almost adrift from its historical origins. In effect, it has become an emotion flag. In contrast to the growing trend of interdependence between nations and ready acceptance of negotiated limits on sovereignty, American notions of sovereignty adopt the pre-War concept of sovereignty that reconciles both absolute control and popular sovereignty in its singular brand of democracy." *See* Radon, Sovereignty: A Political Emotion, not a Concept, supra note 165, at 202-206; John R. Bolton, The United States and the International Criminal Courtfrom America's Perspective, 64 Law & Contemp. Prob. 167, 173 (2001) (remarking several U.S. objections to the ICC); *see also* John H. Jackson, The Great 1994 Sovereignty Debate: United States Acceptance and Implementation of the Uruguay Round Results, 36 Colum. J. Transnat'l L. 157, 160 (1997) (arguing that "[w]hen [sovereignty is] viewed as a question of allocation of power, however, the debate only begins with the "sovereignty objection; it must continue with an analysis demonstrating why it is better or worse for such a power shift to occur in certain circumstances.... [T]his is rarely done, but ought to be done if the argument is to be persuasive.").

[186] *See* Andrew Guzman, Global Governance and the WTO, 45 Harv. Int'l L. J. 303, 348 (2004). For the sovereignty question at the WTO, Guzman asserts that "[it] can be viewed through the lens of contract. Domestic legal systems allow individuals to make binding agreements. These contracts limit the future actions of each party, but we do not criticize them as infringements on individual autonomy. In fact, we view them as tools to further individual autonomy, because they allow individuals to advance their interests more effectively than would be possible in a world without binding contracts. International agreements can be viewed as contracts among sovereign states. Like domestic contracts, they restrict (or seek to restrict) future behavior, but like contracts, they should be viewed as serving rather than undermining the interests of states." *See id.* at 346.

[187] See Kal Raustiala, Rethinking the Sovereignty Debate in International Economic Law, supra note 185, at 843.

[188] See e.g., John O. McGinnis & Mark L. Movesesian, The World Trade Constitution, 114 Harv. L. Rev. 511 (2000). In response to the concern over democratic deficit, Raustiala point out that contemporary critiques of global governance often embrace the retention of state sovereignty in that sovereignty protects democratic processes from external influence. Further, he argues that the expansion of governance beyond the state strengthens sovereignty and democracy. *See* Raustiala, supra note 185, at 854-855. The major reactions responding to the conventional sovereignty-based critique of international organizations can be fallen into

Sovereignty issues emerge due to the institution's success in limiting the policy options of national governments and its impact on the state behavior despite no enforcement mechanism within the institution.[189]

three categories. *See generally* Robert O. Keohane & Joseph S. Nye, Jr., Democracy, Accountability, and Global Governance, Kennedy School of Government, Harvard University (June 27, 2001), *cited in* Raustialla, supra note 185, at 855, n.52. According to Keohane and Nye, the first reaction is to withdraw; to suggest that reliance should be curtailed as shown in the U.S. rejection of the ICC. The second reaction is to continue to employ international organizations but to strive to reform them through institutional design to enhance the accountability and legitimacy of international institutions and networks. *See* Nye, The Paradox of American Power, supra note 97, at 165. This reaction is embedded in the current practice of subsidiarity, that is all political issues to the lowest possible level for resolution in the EU as a response to the critique of democratic deficit in global governance in European context. *See* Peter L. Lindseth, democratic Legitimacy and the Administrative Character of Supranationalism: The Example of the European Community, 99 Colum. L. Rev. 628 (1999). The third reaction is realist: to dismiss the whole problem as a misguided category because "world politics are is inherently undemocratic and there is little point in lamenting the obvious." *See* Keohane & Nye, Democracy, Accountability, and Global Governance, at 2. This reaction is closely associated with realist theory in international relations theory under which international institutions do not act in world politics directly, and states would never agree to institutions that diminish their sovereignty unless it is their interests to do so. *See id.*

As a conceptual alternative, Raustiala presents the sovereignty-strengthening claim that views international institutions as a positive force for sovereignty. There are two varied ideas about this claim. The first variant is that states declared sovereignty as autonomy in the past due to the dramatic change of the nature of sovereignty and international relations, but international institutions are the tools through which sovereignty is reasserted thanks to the increased interdependence in world affairs. The second variant based on public choice theory asserts that international organizations can enhance sovereignty for two related but distinct reasons stressing the centrality of rent-seeking by individuals and private actors. Raustiala points out that "[I]nternational institutions may help to circumvent domestic rent-seeking interests which have captured the state, or international institutions may be used as tools to preserve the sovereign power, and associated rents, of government officials whose regulatory powers are challenged by globalization." *See* Raustialla, Rethinking the Sovereignty Debate in international Economic Law, supra note 185, at 856-857. For the detail, *see id.* at 857-874.

[189] For example, borrowing countries are required to accept the more forceful conditions, so called conditionality on the loan agreement imposed by the IMF. In short, due to the imbalance of power between the IMF and the client countries, the countries are put on strict targets. As a result, the countries' congress should pass pertinent laws in order to meet IMF requirements and targets by a specific date. As for the conditionality, one argues that "conditions that might weaken the economy in the short run, whatever their merits in the long, run the risk of exacerbating the downturn and thus making it more difficult for the country to repay the short-term IMF loans[,]" although at a minimum, every loan agreement specifies basic conditions designed to increase the likelihood that they will be paid. *See* Joseph E. Stiglitz, Globalization and its Discontents 43-44 (2002). Stiglitz notes several reasons for the failure of conditionality. *See id.* at 46-48. Further, Stiglitz argues that the conditionality has little to do with the welfare of less developed country peoples and more to do with the concerns of powerful states. Id. at 18.

Moreover, the increasing interdependence among states has posed formidable challenges for the predominating post-War mechanism of international cooperation, so called liberal internationalism based on multilateral treaties, mainly creating international institutions. In this context, some critics assert that the traditional statist foundation of liberal internationalism has increasingly been waning due to globalization and the growth of nonstate actors.[190] As a leading alternative to liberal internationalism, the new medievalists assert that information revolution has driven the power shift from hierarchies to networks in the structure of organization with the eclipse of the state, whereas liberal internationalists still view international rules and institutions as crucial mechanisms to solve governmental problems.[191] In response to the debate, one observer argues that transgovernmental networks can be substituting for sovereign or unitary state interaction in several regulatory fields due to the demise of regulator's power to implement national

[190] See Mathews, supra note 98, at 50-52.

[191] See id. at 52 (arguing that "[b]usiness, citizens' organizations, ethnic groups, and crime cartels have all readily adopted the network model [while] [g]overnments...are quintessential hierarchies, wedded to an organizational form from incompatible with all that the new technologies make possible."). Some argue that the future is one of new-medievalism, meaning a return to the overlapping sovereignties of that era. *See generally* Philip G. Cerny, Globalization and the Changing Logic of Collective Action, 49 Int'l Org. 595, 624 (1995)("[G]overnment per se will essentially become privatized, losing much of its public character. The world will be a neo-feudal one, [w]ith overlapping and democratically unaccountable private regimes..."). The term originated in a classic work of international relations by Hedley Bull. *See* Hedley Bull, The Anarchical Society: A Study of Order in World Politics 264-281 (1977).

regulations within those boundaries both because of their citizens' flight for regulatory laxity, and financial flows are too great and sudden for one regulator to control.[192] In contrast, the liberal internationalist response to concerns about the erosion of state regulatory power is to build a larger international apparatus, such as the United Nations system—the paradigmatic example of liberal internationalism— constituted by a legally binding treaty, with expanding powers of governance to deal with governmental problems.[193] However, these attempts to reconstruct global governance have encountered the limits and strains of liberal internationalism.[194]

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[192] *See* Slaughter, *supra* note 106, at 189-192. Slaughter argues that "[a] new world order is emerging, which less fanfare but more substance than either the liberal internationalist or new medievalist vision." See id. at 184. According to Slaughter, "[g]lobal governance, [from the transgovernmentalist perspective], is not a matter of regulating states the way states regulate their citizens, but rather of addressing the issues and resolving the problems that result from citizens going global—from crime to commerce to civic engagement." *See* Slaughter, A New World Order 16 (2004).

[193] *See* Zuern, *supra* note 104, at 241. Slaughter notes that "[g]lobalization thus leads to internationalization, or the transfer of regulatory authority from the national level to an international institution... Liberals are likely to support expanding the power of international institutions to guard against the global dismantling of the regulatory state." *See* Slaughter, The Real New World Order, *supra* note 106, at 192-193. Although Slaughter acknowledge the importance of international rules and institutions described by liberal internationalism for the creation and maintenance of international order, she argues that "they apply to part only, and arguably a diminishing part, of the rules and institutions that are generated outside any one national legal system but that directly regulate individuals and groups in both their domestic and foreign interactions. *See* Anne-Marie Slaughter, Governing the Global Economy Through Government Networks, *in* The Role of Law in International Politics: Essays in International Relations and International Law 178 (Michael Byers ed., 2000).

[194] *See* Sol Picciotto, Networks in International Economic Integration: Fragmented States and the Dilemmas of Neo-Liberalism, 17 Nw. J. Int'l L. & Bus. 1014, 1019-1020 (1996-97). For detail, *see id.* at 1022-1035. While liberal internationalism is still robust, it faces increasing challenges. Recently, the formidable challenges have been posed to unaccountable and undemocratic international bureaucrats. The slow pace, formal procedures, and high bargaining costs of multilateral organizations may impede the negotiation of new

A notable response is the decline of liberal internationalism, and the disaggregation of the state into its component legislative, executive, administrative and judicial parts, and the positing of a complex of transnational connections between these component parts in different states.[195] This perspective asserts that contemporary international cooperation is being undertaken among discrete and specialized agencies of governments to coordinate their policies and enhance the enforcement of laws, in a fashion which, by comparison to formal inter-state cooperation is fast, flexible and effective.[196] That is, these constituent institutions are all networking with their foreign counterparts, thereby sharing information, ideas, resources, and policies. This new paradigm of peer-to-peer cooperation adopts the adaptable and decentralized network model instead of traditional international institutions and treaties for their enforcement.[197] However, as discussed later, some critics

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treaties and institutions. *See* Kal Raustiala, The Architecture of International Cooperation: Governmental Networks and the Future of International Law, 43 Va. J. Int'l L. 1, 17 (2002).

[195] See Slaughter, supra note 106, at 184, 188-189. One observer argues that "there has been a shift from "government" to "governance," as the central political institutions of the state have found it increasingly difficult to resolve social conflicts or to reconcile the diversity of social interests ... Internationally, the arrangements for allocating competence between states have also tended to break down, evidenced by the increased salience and frequency of inter-jurisdictional conflicts." *See* Picciotto, supra note 194, at 1018-1019.

[196] See id.

[197] For the term "transgovernmental networks," see Raustiala, supra note 194, at 4 ("They are "transgovernmental" because they involve specialized domestic officials directly interacting with each other, often with minimal supervision by foreign ministries. They are "networks" because this cooperation is based

acknowledge the significance of networks, but hold them accountable for their role in reducing transparency and impeding political accountability.[198] Others fear that networks may reinforce the dominance of the major economic powers, particularly inequalities between advanced industrial countries and less developed economy because of networks' club-like feature.[199] Nonetheless, transgovernmental networks are on the rapid rise, and their growth is visible in regulatory cooperation.[200]

In these circumstances, the complex issue of how to govern the global economy comes into question. That is to say, how states can regulate properly the global economy. Even

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on loosely-structured, peer-to-peer ties developed through frequent interaction rather than formal negotiation.")

[198] *See generally* Robert Howse, *Regulatory Cooperation and the Problem of Democracy, in* TRANSATLANTIC REGULATORY COOPERATION 469 (George A. Bermann et al. eds., 2000).

[199] See Stephen Toope, Emerging Patterns of Governance and International Law, *in* The Role of Law in International Politics, supra note 193, at 96-97 ("Networks , like regimes and regardless of their membership, are sites of power, and potentially of exclusion and inequality."); *see also* David Kennedy, *When Renewal Repeats: Thinking Against the Box,* 32 N.Y.U. J. Int'l L. & Pol. 335, 412 (2000) (questioning whether exploring the "disaggregation of the state and the empowerment of diverse actors in an international civil society without asking who will win and who will lose by such an arrangement" is prudent).

[200] See generally Paul B. Stephan, Regulatory Cooperation and Competition: The Search for Virtue, supra note 198, at 202; see also Kalypso Nicolsidis, Regulatory Cooperation and Managed Mutual recognition: Elements of a Strategic Model, supra note 198, at 571 (remarking that "[r]egulatory cooperation deservers analytical attention both in own right and a forerunner for the effect of interdependence on other policy areas and international governance in general."). One observer identifies three chief factors behind the recent rise of networks: technological innovation, the expansion of domestic rerulation, and the rise of globalization. *See* Raustialla, supra note 194, at 11-16. Moreover, Slaughter lauds that transgovernmental networks are "the optimal form of organization for the Information Age." *See* Slaughter, Governing the Global Economy Through Government Networks, supra note 193, at 204. Needless to say, since Robert Keohane and Joseph Nye first observed its emergence, transgovernmentalism has rapidly become the most widespread and distinctive system of global governance. *See* Robert O. Keohane & Joseph S. Nye, Jr., Transgovernmental Relations and International Organizations, 27 World Pol. 39 (1974) (wondering "whether the common interests of central bankers in a stable currency system have been implemented as fully by trangovernmental contracts as they might have been."). Id. at 51.

if the answer is through international cooperation, there are still some concerns over governing the global economy through government networks.

B. The Rise of Transgovernmental Financial Regulatory Organizations

The growing economic interdependence has urged economic regulators to work with their counterparts abroad. Furthermore, burgeoning financial disturbances of the past few decades have called for international cooperation among domestic financial regulatory agencies. As a result, networks of finance ministers and central bankers have played a central role in responding to domestic and regional financial turbulences. As the finance ministers, the G8 that is as much a network of finance ministers as of heads of state is taking key decisions on how to respond to calls for debt relief for the most highly indebted countries.[201] In response to the East Asian financial crisis in 1997 and the Russian crisis in 1998, the finance ministers and central bank governors hold separate news conferences to

[201] Since 1994 Russia has been included in the annual summit of the G7, now meeting as G8 thanks to Boris Yeltsin's efforts to join it as evidence that Russian was now part of the West. See Slaughter, A New World Order, supra note 192, at 2, 37. The G7 was set up in Tokyo in May 1996 to strengthen the effective coordination of international economic policy. It consists of Canada, France, Germany, Italy, Japan, the United Kingdom and the United States. See R. Fraser & Long, The World Financial System 199 (1993).

announce policy.[202] In order to help prevent future financial crises, the creation of a network of G20 was led by the Indian finance minister and consists of the finance ministers of twenty industrialized and underdeveloped states.[203] Notably, the Financial Stability Forum as a networked network comprising three organizations, and other domestic and international authorities was established in 1999 to provide a coherent strategy to achieve and to maintain financial stability.[204] The key characteristic of government networks in

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[202] Recent meetings of G7/G10 finance ministers and central bankers are significant in that the practical agenda of the regulatory fora is decided in these monthly and annual meetings. Its framework is set out by G7 financial ministers, whereas the actual technical deliberation of financial regulation is conducted by the technocrats of domestic regulators. *See* Mamiko Yokoi-Arai, Regional Financial Institutionalization and the Creation of a Zone of Law: The Content of Financial Stability/Regulation in East Asia, 35 Int'l Law. 1627, 1636 (2001). The G10 comprises Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, the United Kingdom, and the United States. *See* Long, The World Financial System, supra note 201, at 31.

[203] The G20 was created by created by the G7 on September 25, 1999 in Washington D.C. The extension of the membership attributes to the increase in the role of the emerging economies' in banking and financial service markets. *See* George Alexander Walker, International Banking Regulation: Law, Policy and Practice 152 (2001). Walker asserts that"[t]he importance of the G20 adds political credibility and authority arguably to an otherwise politically deficient process. A democratic or political deficit or gap must necessarily exist in the area of international policy construction. ... The desire [to be involved in all immediate decision-taking bodies or agencies] must clearly be to make them as inclusive and credible but at the same time as operationally efficient and effective as possible."). *See* id. at.152. For the relative inclusiveness of the G20, Canadian Finance Minister Paul Martin remarked that "[w]hat makes [the G20] unique is the fact that it brings together a cross-section of national economies at different stages of economic maturity, thereby providing the diversity needed to address the wide range of human needs." *See* Notes for an address by Honorable Paul Martin to Royal Institute of International Affairs, London, U.K., January 24, 2001, on Department of Finance Canada. However, the G20 has certainly not replaced the G8 nor ever been invited to meet and consult with the G8 on a regular basis. *See* Salughter, A New World Order, supra note 192, at 144 ("How inclusive specific networks can be will ultimately depend in part on their particular functions.").

[204] The Financial Stability Forum was led by the finance ministers and central bankers of the G7 industrial countries in February 1999 preceded by a report on international occupation and coordination in the area of financial market supervision and surveillance by the President of the Deutsche Bundesbank. The Forum consists of six representatives from the Basel Committee, the International Organization of Securities Commissioners (IOSCO), and the International Association of Insurance Supervisors along with senior representatives from domestic authorities responsible for financial stability in significant international finance centers. Also, the Forum comprises traditional international institutions, such as the IMF and the World Bank, and the OECD. *See* Financial Stability Forum website, at http://www.fsforum.org.

particular, in financial sector is the cross-border interaction of government agencies with similar functions and encountering similar problems. The result of this identifying feature has led to the establishment of transgovernmental financial regulatory organizations.[205] In order to understand how these organizations exemplify international financial regulatory cooperation, it is necessary to explore how they actually work in the sense of the increasing economic interdependence and achieving financial stability.

1. The Basel Committee on Banking Supervision

The Basel Committee on Banking Supervision (Basel Committee) prompted by two large international bank failures in 1974 was established by a simple agreement among the twelve central bank governors of the G10 countries, Luxembourg, and Switzerland.[206] Its founding mandate was a press communiqué from the central bank governors issued through

[205] Slaughter divides government networks into three broad categories: harmonization networks, enforcement networks, and information networks. According to Slaughter, transgovernmental financial regulatory organizations are generally considered as information networks in that they exchange information, and further actively collect and distill information about how their members do business. The standard product of this distillation is a code of best practice. For detail, *see* Slaughter, A New World Order, supra note 192, at 50- 64.

[206] *See* Walker, supra note 203, at 17-81. The Basel Committee was established in 1975 by the Group of Ten, which were the ten member countries of the IMF plus Luxembourg and Switzerland.

the Bank for International Settlements (BIS).[207] As an oldest and most active committee under the BIS,[208] the Basel Committee seeks to create common standards of banking supervision.[209] The Basel Committee has no formal constitution or by-law, and operates without its own staff or facilities.[210] The charter membership of the BIS and the Basel Committee overlaps, but the BIS does not formally participate in the Basel Committee. Nevertheless, a small staff of the BIS—four professional supervisors on temporary

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[207] See Joseph Norton, Trends in International Bank Supervision and the Basle Committee on Banking Supervision, 48 Consumer Fin. L.Q. 415, 415 n.1 (1994).

[208] The BIS was formally created on January 30, 1930 at the Hague Convention of 1930 with the main purpose of processing settlements of international payments associated with Germany's reparations as part of the 1929 Young Plan. Convention respecting the Bank for International Settlements, Jan. 20, 1930, 104 L.N.T.S. 441 (Hague Convention of 1930), available at http://www. bis.org/about/convention.htm#P21_2653 (last visited Sept. 30, 2004). As a commercial bank, the BIS holds deposits for other central banks, engages in capital market activities, and provides lending facilities to its central bank members. As an international institution with legal personality, the BIS seeks to promote international monetary cooperation by hosting meetings among central bank experts, conducting statistical research, and publishing some of its results periodically. See Mario Giovanoli, The role of the BIS in Monetary Cooperation and its Tasks Relating to the ECU, *in* Current Legal Issues Affecting Central Banks 1, 39 (1994) (comparing the BIS with other financial institutions). For the profile of the BIS, *see* Carl Felsenfeld et al., The Role of the Bank for International Settlements in Shaping the World Financial System, 25 U. Pa. J. Int'l Econ. L. 945, 954-977 (2004). For more information about the BIS, see Bank for International Settlements, About BIS, available at http://www. bis.org/about/index.htm (last visited August 25, 2004).

[209] In response to two large international bank crises, such as the Herstatt, and the Franklin National's Failure in 1974, the Basel Committee's aim was to strengthen collaboration among domestic authorities in their supervision of international banking. *See* C. J. Thompson, The Basle Concordat: International Collaboration in Banking Supervision, *in* 1Current legal issues Affecting Central Banks 331, 333 (Robert C. Effrose ed., 1992). While the bank failure in 1974 was a driving force behind the creation of the Basel Committee, other factors arguably contributed to the legitimacy and solidity of the Basel Committee. Two key events were the collapse of the fixed international exchange system established by the Bretton Woods agreement in 1945, which caused much more speculative investment and a general movement of funds in the currency markets, and the need for international banks to absorb and invest these funds. *See* Ethan B. Kapstein, Governing the Global Economy: International Finance and the State 30, 58 (1994). This issue will be discussed in detail in terms of systemic risk in the next chapter.

[210] See Joseph Norton, Devising International Bank Supervisory Standards 177 (1995)

secondment from member institutions, and a member of the Basel Committee—serve as the Basel Committee's secretariat, and the Committee meets four times per year in Basel.[211]

The Basel Committee is not a public organization in that it operates informally and by consensus.[212] The Committee operates secretly and seeks to maintain a low profile.[213] Further, membership is strictly limited to the world's most highly industrialized countries and will be unlikely extended.[214] In 1988, capital adequacy requirements for all banks were adopted by the central bankers of the world's major financial powers under their supervision. Its members follow their own rules. Decisions are made by consensus and are not formally binding; however, members do implement these decisions within their own systems. The Basel Committee's authority is often cited as an argument for taking domestic action.

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[211] *See* Charles Freeland, The Work of the Basle Committee, *in* 2 Current Legal Issues affecting Central Banks 231-232 (Robert C. Effros ed., 1994).

[212] See United States General Accounting Office, Report to Congressional Committee, International Banking: Strengthening the Framework for Supervising International Banks (Mar. 1994), at 37. The Committee's operations are characterized by an emphasis of close personal contacts, insistence, and an interactive and decentralized method of ensuring compliance. The Committee operates through a rotating chair and makes recommendations based on consensus. *See* Huib J. Muller, Address to the 5th International Conference of Bank Supervisors (May 16, 1988), *cited in* Tony Porter, States, Markets, and regimes in Global Finance 66 (1993). The Committee seeks these contacts within its membership and pursued to develop others with outside banking regulators. *See* General Accounting Office, International Banking, at 64-67.

[213] A former chairman Huib J. Muller noted that"[w]e don't like publicity. We prefer, I might say, our hidden secret world of the supervisory continent." *See* Norton, Supervisory Standards, supra note 210, at 177.

[214] See id.

The Basel Committee's stated objectives are too broad. The Committee describes itself as a "forum for ongoing cooperation among member countries on banking supervisory matters" that aims to "strengthen international cooperation, improve the overall quality of banking supervision worldwide, and ensure that no foreign banking establishment escapes supervision.'"[215] In practice, the Committee publishes some of its recommendations ranging from short documents to technical, mathematical regulations used to provide guidance for the implementation of the promulgations. After a comment period, the Committee reconsiders and reissues a final version of its work, which the Central Bank Governors are then supposed to implement within their own national systems. Even if the Committee's formal authority has arisen exclusively from the support of the central bankers, its recommendations have been implemented by both member and nonmember countries.[216]

As one observer argues, "[t]he Basel Committee's recommendation-making process exemplifies the distinctive nature of transgovernmenatl regulatory cooperation."[217] One of the recommendations, the Committee's 1988 Capital Accord exemplifies the Basel

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[215] Basel Committee on Banking Supervision, Annexure C (1995), para. 3.
[216] Nonmember banking states' adoption of the 1988 Basel Capital Accord is a good example.
[217] See Slaughter, Governing the Global Economy Through Government Networks, supra note 193, at 182.

Committee's informal procedure, and demonstrates the Committee's expansive understanding of consensus.[218] The Accord, setting minimum capitalization standards for international banks regulated by the member countries, provides an instructive example to understand how the Committee operates as a transgovernmental network. After several meetings, the Basel Committee announced that agreement on a proposal had been reached. There was a six month comment period , during which the Committee received comments on its draft agreement from private bankers and other interested parties. The final version of the Accord was released on July 15, 1988, after which the central bankers of member banks implemented the agreed standards. Following frequent amendments of the Accord since its promulgation, the Basel Committee recently released the document, "International Convergence of Capital Measurement and Capital Standards, a Revised Framework" (widely known as Basel II) on June 26, 2004.[219]

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[218] For the detail, *see* Kapstein, supra note 209, at 103-128.
[219] The Bank for International Settlement, Implementation of Basel I: Practical Considerations, available at http://www.bis.org/bcbs109.htm (last visited on August 1, 2004). Unlike most treaties or other legal agreements the Basel Capital Accord is intended to evolve over time.

As the BIS notes, the Basel Committee does not possess any formal supranational supervisory authority, and its conclusions do not, and were never intended to have legal force.[220] The use of more informal language or no legalese is not unusual in products of Committee agreements.

It is a significant task to the Basel Committee itself and members to insure the compliance with agreements due to their informality and lack of authority. In this regard, the Basel Committee members view the agreements binding even if they do not resort to the legal status of treaty.[221] In fact, the Basel Committee's attempts to reach consensus among domestic regulatory authorities are part of a broader harmonization process that relies on national implementation of internationally agreed upon standards for insuring that over time and under the pressure of market forces and the desire of national regulators to give their institutions a competitive edge, harmonization objectives are met.[222] Given the absence of an independent mechanism for monitoring non-compliance, the job belongs to

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[220] Bank for International Settlement, The Basel Committee on Banking Supervision, available at http://www.bis.org/bcbs/aboutbcbs.htm (describing the structure of the Basel Committee) (last visited Oct. 1. 2004)

[221] See Charles Freeland, The work of the Basle Committee, *in* 2 Current Legal Issues Affecting Central Banks 233 (Robert C. Effros ed., 1994).

[222] See Cynthia Liechtenstein,, Bank for International Settlements: Committee on Banking Regulation and Supervisory Practices, Consultative Paper on International Convergence of Capital Measurement and Capital Standards, 30 I.L.M. 967, 969 (1991).

the Committee themselves and their staff, with pressure from their colleagues[223]. In this regard, specific meetings review the implementation and consistency of the agreements. Originally signed by the G10 countries, Luxembourg, and Switzerland, the 1988 Accord has been implemented by over one hundred countries.[224] In this context, one observer arguably attributes the result to the effectiveness of the Committee's informal enforcement[225] despite suspicions that the resulting deceleration in bank lending intensified the recession of the early 1990s in the United States, and other industrialized countries.[226] Arguably, the implementation of the Accord by national governments illustrates the degree of autonomy and influence over domestic governments that the Basel Committee has achieved.[227]

Here, the effectiveness of the Committee's distinctive system needs to be examined. One claims that the key factor of success is seemingly the Committee's facilitation of close

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[223] *See* United States General Accounting Office, supra note 45, at 36.
[224] *See* Patricia Jackson, Basle Committee on Banking Supervision, Capital Requirements and Bank Behavior: The Impact of the Basle Accord, Working Paper, No.1 (Apr. 1999) (reviewing capital adequacy literature).
[225] See Slaughter, Governing the Global Economy Through Government Networks, supra note , at 183 ("In fact, the adoption of the capital adequacy standards has been so effective that governments did not withdraw their support of the Accord ...).
[226] See generally Robert Litan, *Nightmare in* Basle, The International Economy, Nov.-Dec. 1992, at 7.
[227] See Slaughter, supra note 193, at 183.

personal contacts among the central bankers.[228] In this regard, the Committee itself acknowledges the significance of its role, declaring "the development of close personal contacts between supervisors in different countries has greatly helped in the handling and resolution of problems affecting individual banks ...[t]his is an important, though necessarily unpublicized element in the Committee's regular work."[229] The Committee's efforts are still underway to pursue to organize and facilitate networking among the rest of the world's central bankers and other financial regulators. Among them, the Committee supported the establishment of the Offshore Supervisors Group, the South East Asia, New Zealand and Australia Forum of Banking Supervisors, and the Caribbean Banking Supervisors Group. As discussed below, the Basel Committee has also established links with other financial sector regulators through groups.[230]

Over time the Basel Committee has played a key role in international financial regulation on the ground that it has effectively promulgated binding international standards

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[228] See id.

[229] Bank for International Settlements, Compendium of Document produced by the Basle Committee on Banking Supervision (Apr. 1995), at 14.

[230] See Walker, supra note 203, at 60-68.

despite the expense of implementing such standards and burden for member states.[231] The Committee's competency in developing more theoretical principles of banking supervision has led to its adoption of consolidated supervision derived from the Basel Concordat in 1975, which expands the regulatory responsibilities of committee member governors beyond their borders as a matter of their first principle. National securities commissioners and insurance regulators have followed the Basle Committee's example. Moreover, the Committee has issued the Core Principles comprising twenty-five area of banking supervision in 1995.

Needless to say the global community view the Basel Committee as a crucial player in international banking arena. However, the Committee is a government network with a variation of traditional international organization. As a result, the Committee has necessarily been accompanied by its strength and its weakness.

[231] See Slaughter, Governing the Global economy Through Government Networks, supra note 193, at 184.

2. The International Organization of Securities

The International Organization of Securities Commissioners (IOSCO) is a global network of securities regulators.[232] The IOSCO consists of over 150 representatives from ordinary members comprising national securities commissions or self-regulatory organizations such as stock exchanges from countries with no official government regulatory agency; associate members comprising provincial or regional securities regulators when the national regulator is already a member; and affiliate members comprising international or regional organizations charged with the regulation or development of capital or other organizations recommended by the Executive Committee.[233] Although the Basel Committee has limited its membership to the major industrialized countries, the IOSCO follows a more inclusive policy of seeking to attract the regulators of developing and emerging market economies.[234] In some

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[232] The IOSCO is a private organization originated in the Inter-American Association of Securities Commission and Similar Agencies in 198, when the Associations' members passed bylaws transforming it from a regional group to a global association of securities regulators. *See* Paul Guy, Regulatory Harmonization to Achieve Effective International Competition, *in* Regulating International Financial Markets: Issues and Policies 291 (F.R. Edwards et al. eds., 1992).

[233] For a list of IOSCO members, see http://www.iosco.org/index4.html.

[234] The IOSCO's membership covers eighty-five percent of the world's capital markets. See IOSCO, IOSCO Annual Report 1994, at 26-32.

instances, he IOSCO may even offer membership to non-governmental regulators such as private stock exchanges.[235] The IOSCO is not a formal international institution because it has no formal charter or founding treaty. It was formed through incorporation by a private bill of the Quebec national Assembly.[236]The organization's stated principles are "improving cooperation, and coordinating and harmonizing securities and futures regulations on the international level.[237] Its primary purpose is to solve problems affecting international securities markets by creating a consensus for the enactment of national legislation.[238] That is, in a similar manner to the Basel Committee, the IOSCO seeks to achieve regulatory harmonization through consensus. Unlike the Basel Committee, however, and perhaps in recognition of its inability to achieve consensus on specific issues, the IOSCO defines harmonization broadly. This reflected in the comments of some IOSCO members who acknowledge that, whatever the merits of harmonization, "value should be attached to the possibility of giving

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[235] See IOSCO Annual Report, at 4.

[236] See an Act Respecting the International Organization of Securities Commissioners, Ch. 143, 1987 S.Q. 2437 (Can.) (incorporated under a private act as non-profit corporation). It has created and funded a permanent secretariat in Montreal.

[237] See Guy, supra note 232, at 295.

[238] *See* Geofferey Underhill, *Keeping Governments Out of Politics: Transnational Securities Market, Regulatory Cooperation, and Political Legitimacy,* 21 REV. INT'L STUD 251 (1995).

issuers and investors a choice between quite different rules and regulations."[239]

Similarly, IOSCO officials have recognized that "harmonization does not necessarily mean that regulation must be identical."[240] Rather, it ensures that the organization has adopted a cautious consensus-based approach. The IOSCO monitors whether its members have employed and implemented its standards through methods of self-reporting. Although its principle and rules are not legally binding, the organization often seeks to ensure compliance through moral suasion applied to nonconforming regulators.[241]

The IOSCO has notably contributed to the development of information-sharing and enforcement agreements. All reciprocal information-sharing Memoranda of Understanding (MOUs) were initially issued by the IOSCO in 1986 as a Resolution on Reciprocal Assistance,[242] and has been signed by forty agencies.[243] The Organization

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239 See Guy, supra note 232, at 299-301 (quoting German Stock Exchange Federation Executive Vice President Ruedieger von Rosen who emphasized this point).

240 See id. at 297.

241 *See* David Zaring, *International Law by Other Means: The Twilight Existence of International Financial Regulatory Organizations,* 33 TEXAS INT'L L. J. 281, 295 (1998).

242 IOSCO Annual Report 1990.

243 See Michael D. Mann & Lise A. Lustgarten, Internationalization of Insider Trading Enforcement: A Guide to Regulation and Cooperation, 7 PLI/Corp 798 (1993).

has also issued widely used Principles for Memoranda of Understanding as basic guidelines to create enforcement MOUs for securities law violations.[244] In 1989, the IOSCO employed a set of principles for the negotiation and implementation of information-sharing MOUs, which was led by its resolution proposal for members to enter into such MOUs.[245] Along with a combination of some factors, this groundwork has been a driving force behind a whole network of bilateral MOUs that regulate insider trading and information exchange.[246] Its members have also entered into information-sharing agreements on their own initiative.

However, the IOSCO has not achieved the regulatory success of the Basel Committee in implementing global standards for securities regulators. Its efforts to develop and implement minimum capital requirements for securities firms failed in 1992 after opposition arose from the U.S. securities regulators against the capital adequacy formulas that were developed by the Basel Committee and endorsed by

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[244] See generally Michael Mann et al., The Establishment of International Mechanisms for Enforcing Provisional Orders and Final Judgments Arising From Securities Law Violations, 55 Law & Contemporary Problems 303 (1992).

[245] See id.

[246] See Slaughter, Governing the Global Economy Through Government Networks, supra note193, at 189-193.

European securities regulators. The IOSCO, subsequently, abandoned its efforts to reach a compromise on the issue. Additionally, many resolutions passed by the IOSCO are not implemented at the domestic arena. These failures highlight that government networks are lacking in the ability to exercise any coercive power over their members, and have less degree of independence from their national legislature.[247]

3. The International Association of Insurance Supervisors

The International Association of Insurance Supervisors (IAIS), created in 1994 as an Illinois nonprofit corporation, is the leading transgovernmental regulatory organization for state agencies that supervise and regulate the insurance industry.[248] The IAIS consists of two membership classes: (1) the charter members, who include the insurance regulators from sixty-seven countries and seventeen U.S. states, joined the organization by the completion of its first annual meeting on June 16, 1994.[249]; (2) the second class consists of new members, which can be admitted to the organization so long as they are an insurance

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[247] See Slaughter, supra note 193, at 185.
[248] See IAIS, 1994 Annual Report.
[249] See IAIS By-Laws, app. A.

industry supervisor or agency, or an association of the public regulatory bodies with jurisdiction over insurance in a country.[250] Whereas one of the objectives of the Basel Committee and the IOSCO is the establishment of uniform standards through the work of the organization, the IAIS currently acts only as a forum for the exchange of information and experiences by insurance supervisors around the world. As such, the organization's goals include engendering awareness of common interests, and encouraging wide international personal and official contacts. The IAIS's eight-page long governing document is a set of bylaws that do not impose legal obligations on members or the countries or members that they represent.[251] In a similar manner to the Basel Committee and the IOSCO, the IAIS maintains only a tiny centralized bureaucracy, and has subcontracted the role of its general secretariat to the American National Association of Insurance Commissioners.

Yet the IAIS has the power to promote minimum standards or multinational regulations. However, it has approved the Recommendation Concerning Mutual Assistance,

250 See id. pt. 2, paras. 4-5.
251 See IAIS Annual Report, at 2.

Cooperation, and Sharing of Information which has been signed by fifty-one members.[252] In spite of its brevity—one-half page in length—it has been applauded by some insurance regulators.[253]

The IAIS seems to be viewed as a talking shop rather than a genuine government network on the ground that it does not appear to exercise any kind of power that could be described as governmental.[254] Its value depends on providing regular channels for communication and cross-fertilization among national regulators often striving to regulate the same entities across national lines, or simply encountering the same problems within their national jurisdictions. Despite the IAIS's struggling to develop standards,[255] one argues that "the IAIS is likely to evolve in ways that will give it more influence over its

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[252] See IAIS, Recommendation Concerning Mutual Assistance, Cooperation, and Sharing of Information, reprinted in IAIS Newsletter (Summer 1995), at 5.

[253] The US insurance regulator David Walsh claims that '[the IAIS] is a very good vehicle for regulators to get to know one another and develop the kind of relationship where you just pick up the phone and say, 'What's going on here?" ' See IAIS News 1, Summer 1995, at 1.

[254] See Slaughter, supra note 193, at 186.

[255] Id. ("Within a spectrum of government networks, the Basel Committee would fall at one end and the IAIS at the other.").

member and eventually power.... it at least provides insurance regulators around the world with the possibility of being a 'node' in a more important network."[256]

4. Common Features

The transgoevrnmental financial regulatory organizations have much in common in the way of their organizing themselves and the manner of their seeking to achieve their objectives.[257] The membership of these organizations is composed of state regulatory agencies, not states. Their establishment is generally *ad hoc,* and they tend to have only minimal structural components such as founding treaties, by-laws, and staff. The founding documents that establish organizations emphasize the flexibility in structure and encourage new members who are willing to adopt their principles. The internal operations and deliberations of these organizations are normally not open to the public.

Consensus among the members is a key factor behind the agreements phrased in no legalese, which are reached by these organizations. Significantly, the lack of legal force in

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[256] Id.
[257] See Zaring, supra note 241, at 301-304.

the agreements reached is insisted by the member states' regulators of these organizations.[258] In this regard, the resolution, MOUs, or communiqués reached by these organizations are not viewed as treaties by the member of the organizations.[259] As a result, the implementation on the domestic level occurs without any domestic legislation and ratification.[260] As an additional feature, the absence of formal mechanisms to monitor compliance with standards is in need of creating a formal peer view process to access compliance, thereby achieving ever greater consistency.

The characteristics of their apparent *ad hoc* formation and self-proclaimed lack of legal force do not prevent the members of these organizations from regarding them as generally effective in performing their self-appointed functions.[261] The regulatory agreements reached are considered pledges of good faith that are self-enforcing, in the sense that one

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[258] Interview with Paul Leder, Deputy Director, Office of International Affairs (Jan. 19,1996), *quoted in* Zaring, supra note 241, at 303.

[259] As for the Basel Committee's extra-legal status, one observer remarks the Basel Accord as a "gentlemen's agreement among central banks." See Hal Scott, The Competitive Implications of the Basle Capital Accord, 39 St. Louis U. L.J. 885, 885 (1995). In contrast, another notes that the Committee's pronouncements, which are generally enforced in twelve member states, have assumed normative standards and may be viewed as international soft law. See Norton, Supervisory standards, supra note 210, at 261-262.

[260] With respect to this quasi-legality, one observer notes that "although [these organization] promulgations lack formal international legal authority when implemented at the domestic level, they gain at least local legitimacy. In this way the promulgations are legal more in a multinational, rather than an informational, sense." See Zaring, supra note 241, at 304.

[261] See Slaughter, supra note 193, at 189.

state's ability to enforce its national law by implementing the agreement depends on other state's enforcement on the domestic level in the same manner.[262] For this, one emphasizes that the strong interconnection between these organizations has led to the creation of an interlocking web of financial regulators.[263]

It is worth noting the observation that the nationalization of international law produces the effectiveness of these organizations.[264] According to one observer, the purpose of these organizations is not to exercise power in the international system but to help domestic regulators protect the interests of their citizens, or enhance the enforcement of national laws by working together across states' borders or promulgating common solutions to problems existing in their boundaries.[265]

Although the Basel Committee, the IOSCO, and the IAIS have different features, they possess a number of commonalities in the way in which they are organized, and in the

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[262] See id.

[263] See Zaring, supra note 241, at 304. The degree of international regulatory cooperation in financial sector is intensifying through the Basel Committee, IOSCO, IAIS, and the Financial Stability Forum. See George Walker, A New International Architecture and the Financial Stability Forum, Studies in International Finance and Economic Law, No. 24 (1999).

[264] See Slaughter, supra note 193, at 189.

[265] See id. ("The result is an international rule-making process that directly engages national officials and national promulgation and enforcement mechanisms, without formal translation and implementation mechanisms from the international to the national.").

manner in which they seek to achieve their objectives. All are not traditional international organizations per se, and therefore have no legal personality. They are informally formed, containing flexible internal organization and decentralized bureaucracies. These organizations often operate in secrecy and informality, but they manage to attain influence through a kind of decentralized enforcement of their agreements that utilizes their links with various international, regional and national financial regulators. Featuring tiny central bureaucracies and small annual budgets, the organizations rely on their members to enforce any regulations issued by the groups and to monitor the compliance of other members. Their regulations have no legal force, but at least in the case of the Basel Committee, have enjoyed full compliance.

C. Assessing Government Networks

1. The Advantages of Government Networks

The adherents of transgovernmetalism argue that transgovernmental networks provide a new vision of global governance at the most general level: horizontal rather than vertical,

decentralized rather than centralized, and comprised of national government agencies rather than supranational bureaucrats.[266] They believe that the networks build trust and create relationships among their participants, thereby establishing incentives to create a good reputation and avoid a bad one.[267] That is, such peer-to-peer cooperation among the world's agencies is arguably self-enforcing since each agency is in a better position to implement its domestic mandate as a product of the network due to the predominance of common interests over the incentives to violate obligations.[268] In this way, the networks arguably offer technical assistance and training to underdeveloped country members, assistance resulting in replication of regulatory models from developed countries.[269] In the process, the networks arguably take advantage of soft power, that is persuasion and attraction rather than hard power of compulsion and coercion in that supranational entities need to use everything from expertise to endearments: information, persuasion, socialization when they have no actual means to enforce the obligations due to their formal

[266] See Slaughter, Governing the Global Economy Through Government Networks, supra note 193, at 193.
[267] See Slaughter, Sovereignty and Power in a Networked World Order, supra note 172, at 290.
[268] See, The Real New World Order, supra note 106, at 217.
[269] See Raustiala, The Architecture of International Cooperation, supra note 193, at 7. (noting that networks promote regulatory export from stronger to weaker states, and that this transfer of rules, and practices promotes policy convergence among states).

legal authority over its national counterparts.[270] Further, the transgovernmentalists assert that the networks' reliance on various forms of soft power leads to the hard impact of soft law.[271]

The proponents claim that the networks are potentially both more effective and accountable than traditional international organizations whereas the liberal internationalism is cumbersome, inflexible, and incapable of dealing with new challenges on the global agenda in that it is based on the juridicial equality and the time consuming formality of traditional international organizations.[272] They advocate that the networks are adaptable to the technology of the Information Age. The networks arguably strengthen states' power

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[270] See Slaughter, Sovereignty and Power in a Networked World Order, supra note 172, at 291. According to Nye, soft power flows from the ability to convince others that others want what you want. It is exercised through setting agendas and holding up examples that other nations seek to flow. "It co-opts people rather than coerces them." By contrast, hard power is command power that can be used to induce others to change their position. It works through both carrots and sticks, rewards and threats. See Nye, The Paradox of American Power, supra note 97, at 8-9.

[271] See Slaughter, A New World Order, supra note 192, at 178-181. Traditional international lawmaking has come in the form of hard law: treaties and other international agreements. By contrast, soft law provided in the form of international guidance and nonlegal instruments is emerging as an equally powerful form of regulation. See id. at 179.

[272] See id.; see also Slaughter, The Real New World Order, supra note 106, at 183; see also Raustiala, The Architecture of International Cooperation, supra note 194, at 24. In response, critics who criticize the networks for being mere talking shops explain that "[t]he enormous increase in transnational activities as a result of globalization highlights the legislative void at the international level. The activities described ... respond, sometimes unconventionally, to the need to fill this gap. Traditional means of treaty making are too cumbersome for the tasks at hand and too time consuming. There may also not be the need for full agreement in all the details that a treaty requires, but simpler and more expeditious means to provide guidance may be sufficient." See Andre Rigo, Law Harmonization Resulting from the Policies of International Financial Institutions: The Case of the World Bank, Speech delivered at a conference on Globalization and the Evolution of Legal Systems, University of Ottawa (October 2000).

and provide state actors to interact with other state or any kind of nonstate actors at the domestic, regional and international levels.[273] Most importantly, transgovernmentalism is arguably all about bringing the state back in as a significant international actor in the real new world order, which offers a governance alternative to both traditional international organizations and new medievalist networks of nonstate, regional, local, and supranational actors.[274]

2. The Problems with Government Networks

Yet the transgovernmentalism is unquestionably controversial. The networks are encountering sharp criticisms from many different perspectives. The sharpest charge

[273] See Slaughter, Governing the Global Economy Through Government Networks, supra note 193, at 193, 204.

[274] Slaughter asserts that another major advantage of the networks is associated with the ways in which they can be used to strengthen individual state institutions. See id. For a proposal for the model of world order, Slaughter summarizes in several terms: "The State is not the only actor in the international system, but it is a still the most important actor; The state is not disappearing into its component institutions, which are increasingly interacting principally with their foreign counterparts across borders; These institutions still represent distinct national or state interests, even as they also recognize common professional identities and substantive experience as judges, regulators, ministers, and legislators; Different states have evolved and will continue to evolve mechanisms for reaggregating the interests of their distinct institutions when necessary. In many circumstances, therefore states will still interact with one another as unitary actors in more traditional ways; Government networks exist alongside and sometimes within more traditional international organizations." See Slaughter, A New World Order, supra note 192, at 18.

against the networks is their lack of accountability[275] in that they are networks of the world's technocrats. As noted, the adherents of transgovernmentalism advocate that separate, functionally distinct disaggeregated networks are models for the next generations of international institutions which are more likely to look like the Basel Committee or, more formally the OECD[276] than traditional international organizations.[277] In response, some critics charge the proponents' oversimplification of its actual and potential impact resulting in the emphasis of only one artificial stratum out of a complex set of layers.[278]

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[275] The term accountability is illustrated as "A is accountable to B when A is obliged to inform B about A's (past or future) actions and decisions, to justify them, and to suffer punishment in the case of eventual misconduct." See Andreas Schedler, Conceptualizing Accountability, *in the* Self-Restraining State: Power, and Accountability in New Democracies 17 (Andreas Shedler et al. eds., 1999). Some observers note that "[t]he concept of accountability implies that the actors being held accountable have obligations to act in ways that are consistent with accepted standards of behavior and that they will be sanctioned for failures to do so." See Ruth W. Grant & Robert O. Keohane, Accountability and Abuses of Power in World Politics, American Political Science Review, Vol. 99, No. 1 (Feb. 2005), at.1.

[276] Although the Organization for Economic Cooperation and Development (OECD) is characterized as one of the international governmental organizations in the international system, it has played a critical role in shaping the architecture of global governance despite its feature of "low-profile institution." See James Salzman, Labor Rights, Globalization and Institutions: The Role and Influence of the Organization for Economic Cooperation and development, 21 Mich. J. Int'l L. 769, 772-773 (2000). As the successor to the organization to the Organization for European Economic Cooperation, the OECD was initially established to strengthen the economies of it's member states, and thereafter expanded its mission to identify common issues and coordinate national and worldwide policies. See id. at 773. Because the OECD offers a closed setting for its member states through the closed-door meetings, this feature of restricted membership and transparency makes difference from conventional international organizations. As a result, the OECD provides a "restricted forum on virtually unrestricted topics." Id. at 776-777.

[277] See Slaughter, The Real New World Order, supra note 106, at 196. Slaughter asserts that "[w]all street looks to the Basle Committee rather that the World Bank." See id. at 185.

[278] See Philip Alston, The Myopia of the Handmaiden: International Lawyers and Globalization, 3 Eur. J. Int'l L. 435, 441 (1996). With respect to a question of the nature of the global agenda in a globalized world, Alston observes that the formulation of the transgovernmental policy agenda focuses on issues that are essentially spillovers from the domestic policy agendas of the industrialized world, leaving out global poverty, malnutrition, human rights, refugees, the persecution of minority groups, and disease. See id. at 439.

Further, in the context that who sets and implements the global agenda, one claims that the transgovernmental theory disregards the multiple points of interaction between decision-makers which takes place within a variety of public, private and transgovernmental fora.[279] In this context, there is still a need to examine the transgovernmentalist's argument that regulation by small, unaccountable, self-selected, non-transparent elite groups (which are, more often than not, wholly US-centered)[280] is preferable to classical international regulation through horizontally enforced treaties and traditional international institutions. In response to an argument about networks among national and international bureaucrats, some critics charges that the networks adopt Platonic Guardianship as a mode of transnational governance, an open move toward technocratic elitism.[281] Others note "a

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[279] See id. ("Multilateral organizations cannot be simply sifted out of the picture like lumps in flour. To suggest that the real action lies in the Basle rather than Washington in the case of banking, or with transnational litigation strategies in national courts rather than with the UN Human Rights Committee in the case of human rights, is to oversimplify the complex, essential and continuing interaction among different levels or fora that continues to characterize international relations in these areas.").

[280] See Alston, supra note 278, at 443 (1996) ("If [Slaughter's analysis] is correct ..., [I]t implies the marginalization of governments as such and their replacement by special interest groups, which might sometimes include the relevant government bureaucrats. It suggests a definitive move away from arenas of relative transparency into the back rooms, the emergence of what she terms a 'real new world order' in which those with power consolidate it and make the decisions which will continue to determine the fate of the excluded, and the bypassing of the national political arenas to which the United States and other proponents of the importance of healthy democratic institutions attach so much importance.').

[281] See Antonio Perez, Who Killed Sovereignty? Or: Changing Norms Concerning Sovereignty, 14 Wis. Int'l L. J. 463, 476 (1996). A good example of the alleged global technocracy is the Basel Committee's creation and enforcement of capital adequacy accords among its members. Whereas other members' regulators played

chronic lack of legitimacy plagues direct international contacts at the sub-state level among national officials and administrators."[282] Critics also argue that problems with the undemocratic, unaccountable nature of regulation by transgovernmental bureaucrats arise from the proponents' hasty dismissal on the basis that forms of international regulation in contrast to traditional international law sources are nonbinding, that such transgovernmental regulation has been pre-approved by legislative processes at the domestic level, or that transgovernmental bureaucrats need only make their activities transparent via the websites.[283]

In contrast to proponents' arguments,[284] transgovernmentalists' interests in transnational regulation arise because, or to the extent that these networks are not mere

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a key role in employing the Basel Accords to protect their autonomy in the face of international competition, the Japanese represented a 'hands-tying strategy' that allowed "the Japanese bureaucrats ... to collude with bureaucrats from other countries in order to obtain more discretionary authority." See Jonathan Macey, The 'Demand' for International Regulatory Cooperation: A Public Choice Perspective, *in* Transatlantic Regulatory Cooperation, supra note 198, at 159-160.

[282] See Picciotto, supra note 194 , at 1047.

[283] See Jose E. Alvarez, Do Liberal States Behave Better? A Critique of Slaughter's Liberal Theory, 12 Eur. J. Int'l L. 183, 229 (2001) Alvarez claims that liberal internationalism is normatively superior because "democratic legitimacy often requires turning to treaty formally ratified by domestic legislative processes." See id. at 228; see also Anne-Marie Slaughter, Agencies on the Loose? Holding Government Networks Accountable, *in* Transatlantic Regulatory Cooperation 521 (George A. Bermann et al. eds., 2000).

[284] Slaughter remarks that "many governmental networks remain primarily talking shops, dedicated to the sharing of information .... But in giving and receiving this information, even in ways that may significantly affect their thinking, government officials are not exercising power in the traditional ways which polities find

talking shops but sites of power of effective norm-making among relevant policy-makers.[285] In this sense, transgovernmental networks may not be considered soft for the purposes of accountability nor hard vehicles for more effective and integrated modes of cooperation than are usually possible under traditional international law sources.[286]

Other critics assert that the networks may be even less accountable than some states in that the form of accountability provided by the diversity of membership is not assured because power differentials within the network may distort negotiated solutions, and there is no guarantee that all relevant interests will actually have a voice within the network. [287] Still critics accuse the networks of assuming and exaggerating to make the accountability

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it necessary to hold them accountable." See Slaughter, Governing Through Government Networks, supra note 193, at 195.

[285] See Alvarez, supra note 283, at 229; see also Stephen Toope, supra note 199, at 96-97 ("Networks, like regimes, and regardless of their membership, are sites of power, and potentially of exclusion and inequality.").

[286] See id. ("If transnational networks such as the Basle Committee come to exercise real power, those affected are bound to notice eventually and to begin to ask questions about accountability strikingly similar to those that are now being asked of those international organizations whose regulatory effect are becoming too prominent to ignore. Nor can the accountability issues raised by transnational networks be deflected by pointing to the domestic legitimacy of executive agency power. Whatever authority US citizens might have delegated to their own central bank, it is not clear that such delegation was meant to extend to other central bankers' powers to regulate US banks."). It is also unclear how the Basle process has been pre-approved by citizens of states whose central bankers are among those represented on the Basle Committee. See id. at 229 n.219.

[287] See Toope, supra note 199, at 97. Moreover, the clubby feature of networks may widen inequalities between North and South. See David Kennedy, When Renewal Repeats: Thinking Against the Box, supra note 199 (questioning whether exploring the "disaggregation of the state and the empowerment of diverse actors in an international civil society without asking who will win and who will lose by such an arrangement" is prudent); see also Steinberg, supra note 157, at 336 (arguing that "actors from the most powerful states dominate interactions within their network ...In this way, policymaking by transgovernmental actors merely replicate the capacity of powerful states to coerce weaker states into accepting particular international rules or norms.").

benefits of information available via the Internet.[288] Even though those who have become accustomed to the exercise of power without transparency will not struggle to cede to the general public relevant information, it is unclear that Internet access will serve all relevant constituencies.[289] Further, this Internet access to information without the incorporation of other procedures for outside input into decision-making processes leads to meeting process concerns.[290] As critics remark, "[w]ithout knowing what questions to ask—what information among the mass that may be available is relevant—and without the ability to influence what these networks do, Internet access may not seriously ameliorate accountability concerns."[291]

In addition, it deserves noting that the proponent borrows and incorporates the tools and sources of traditional international law to solve the accountability dilemmas. As traced by one observer, the proposals help to accountability concerns at the expense of claims that

[288] See Alvarez, supra note 283, at 229.
[289] See id. Alvarez claims that "[t]o the extent the accountability objection relates to fear of 'neo-colonialism' or US dominion via technocratic rule, Internet access may only aggravate these concerns given the wide gap between rich and poor (nations as well as between individuals) with respect to access to the web itself." See id. at 228-229.
[290] See id. at 230.
[291] See id.

transgovernmental networks are distinctive tools of international law-making that remain outside of and are superior to the coercive structure of international law.[292] In this context, trangovernmentalists are not ready to declare that transgovernmental regulation is more flexible, expeditious, more capable of deploying technical expertise, more compliant with domestic implementation and forms of deep cooperation than is the ordinary treaty as they acknowledge.[293]

A relevant concern is lack of transparency resulting from the informality and flexibility of networks. The proponents argue that "[g]overnment networks are necessarily informal because separate government institutions have no formal standing in the international system under international law."[294] That is, these organizations do not exist from the lens of the law, and thereby they cannot establish organizations that do.[295] As a

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[292] See Alvarez, supra note 283, at 230. Proposals include bringing network decisions before legislative oversight committees or having them approved by legislative processes, nestling the networks or their work products within international organizations, having the network norms or codes enforced by private investors or by international organizations such as the IMF, and the World Bank, or expanding the representation of countries within these networks. See Slaughter, Agencies on the Loose, supra note 283, at 528-535.

[293] See Alvarez, supra note 283, at 230 ("Treaty regimes vary, coming in all shapes and styles of discourse, covering a multitude of subjects ... Some such agreements come in forms that are not clearly distinguishable from liberals' transnational networks to the extent that they establish mere mechanisms for the application of technical expertise ..., while others anticipate ... domestic implementation and very deep cooperation indeed.")

[294] See Slaughter, A New World Order, supra note 192, at 152.

[295] See id.

consequence, these institutions can exist both within and alongside the formal sector of international organizations comprised of states interacting as unitary actors.[296] Ironically, this claim contradicts the transgovernmental theory that the networks are the most distinctive vehicles of international law-making in the disaggeregated world order.[297] As such the networks control more significant resources and values, it is natural that demands for transparency and more direct participation increase. Increased transparency is essential if the networks are to be held accountable.

A final response to the transgovernmental theory is that its claim of the 'nationalization of international law' that take place through the action of transgovernmental regulatoy networks is based on a false dichotomy between the issues of traditional international law coping with the global commons and inter-State relations, versus the issues, such as crime, monopoly, securities fraud, pollution, tax evasion coped with by transgovrernmental

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[296] Slaughter highlights that the reinvention, or the reconceptualization of existing international organizations are necessary for the coexistence of the networks and traditional international organizations. Id.

[297] *cf.* Slaughter, The Real New World Order, supra note 106, at 196.

networks.[298] As one proponent argues, if the networks coexist and interact with traditional international agreements, and thereby cooperate on the administration of anti-trust policy, securities regulation, environmental policy, criminal law enforcement and banking and insurance supervision, much of this activities originate in the shadow of an intricate web of obligations ensuing from obligations assumed under treaties and traditional international institutions.[299] Even though the subject matter of treaties and traditional international institutions, accompanied by the often soft products of both has been in its proliferation no less than transgovernmental networks in the global age.[300] As one argues, it is not easy to understand why "accurate description requires reordering the priorities of international law such that non-treaty sources of law demand more attention."[301]

The proponents' attempt to nationalize international law is arguably missing a more significant point about the nature of norm-setting itself. It is very important to note that

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[298] See Anne-Marie Slaughter, Government Networks: The Heart of the Liberal Democratic Order, *in* Democratic Governance and International Law 217 (Gregory H. Fox et al. eds., 2000).
[299] See Alvarez, supra note 283, at 212. ("While it is true that the Basle Committee itself operates in an regulatory area not traditional regarded as 'international', without benefit of treaty or intergovernmental organization, and through the medium of non-binding recommendations, its success is very much dependent on other treaty regimes and the work of more traditional forms of international organization, including the Bretton Woods institutions. ... neither its subject matter nor its style of regulation really distinguishes the Basle Committee from a wide number of traditional treaty regimes and institutions.").
[300] See id.
[301] See id.

contemporary international law cannot be distinguished in terms of subject matter, from domestic policy.[302] Nevertheless, one oversimplifies how international norms are nationalized under the classic sources of international law.[303] The suggested dichotomy that whereas the traditional international law is coercive and top-down, transgovernmental regulation is soft and bottom-up fails to describe accurately either approach to norm-making or the complex interplay between the two.[304] Indeed, there are many treaties that are viewed as promotional, and contain purposefully ambiguous commitments.[305] Other treaties even with more definitive textual commitments are hard to classify as coercive due to the lack of enforcement provisions or ambiguities within the enforcement schemes provided. In contrast to the proponent's interpretation, the UN Convention on the Law of

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[302] See id. at 212-213.

[303] See Slaughter, Government Networks, supra note 298, at 217 ("Traditional international law requires States to implement the international obligations they incur through national law where necessary, either through legislation or regulation. Thus, for instance, if States agree to a twelve-mile territorial sea, they must change the domestic legislation concerning the interdiction of vessels in territorial waters accordingly. However, the subject of such legislation would be international... Bilateral and plurilateral regulatory cooperation does not seek to create obligations between nations and enforceable at international law. Rather, the agreements reached are pledges of good faith that are essentially self-enforcing, in the sense that each nation will be better able to enforce its national law by implementing the agreement reached if all other nations do likewise. The binding or coercive dimension of law emerges only at the national law.").

[304] See id.

[305] These commitments are not different from Slaughter's pledge of good faith. Like the soft products of transgovernmental networks, they also become self-enforcing only when domestic laws enable reciprocal enforcement to be exercised or when other forms of interpretation provide them the concreteness that they were originally in need of. See id. Many ILO conventions and recommendations are good examples.

the Sea does not explicitly require changes in national law or regulations concerning the breadth of the territorial sea.[306] As most treaties do, the agreement reached among member states leaves states considerable direction as to how to attain compliance with its terms.[307]

D. Concluding Remarks

The transgovernmental theory is overly optimistic with respect to the prospects of the networks as an effective governance alternative in the international system and under international law. The transgovernmentalists do not look to the empowerment of traditional international organizations as the way for governance. Rather, they do to the evolving practice of formal and informal transgovernmental regulatory networks as the most realistic hope for governing the global economy. Indeed, the direct transnational interaction between the diffuse states' agencies of the world's regulators has remarkably proliferated in the global era. The transgovernmental theory based on the disaggregation of state sovereignty stresses the active participation of the world's independent government

[306] See id. at 213-214.
[307] Id. at 214.

agencies rather than supra international regimes, which reflects regulators' compliance with broad regulatory standards constituting international soft law instead of direct enforcement. In this context, transgovernmentalism highlights nationalization of international law toward the regulatory harmonization. However, this claim is still controversial even though transgovernmental regulatory organizations are on the rise in the international system. In order for all the undeveloped and industrialized countries to benefit from the transgovernmental regulatory governance, various types of realistic measures should be taken to reduce inequalities between North and South. Otherwise, global standards as international soft law will not be apparently welcome to developing and transitional countries.

Furthermore, this process is still a host of hot debate due to concerns over the lack of accountability in the networks. The deficiencies of traditional forms of cooperation through regional organizations can be assessed against the scope and the goals of their constitutional documents, but the impact of informal arrangements is far more difficult to evaluate. As there is no formal acknowledgement of the role of the networks,

accountability still remains a concern. If transparency over the impact of such processes is not present, the networks may reinforce the traditional undemocratic features of international law by consolidating the state's position over the individual.[308] In this perspective process, the benefits of greater plurality will disappear.[309] Consequently, an "all-or-nothing" perspective for the analysis of desirable forum of global governance ignores exploring each component of it, as it is at present in the international system. In this sense, emphasis should be put on the cooperation between all the state and non-state actors in the international system and under international law. It deserves noting some observer's remark that "[g]lobal governance will come not at the expense of the state but rather as an expression of the interests that the state embodies. As the source of order and basis of governance, the state will remain in the future as effective, and will be essential, as it has ever been."[310]

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[308] See Richard A. Barnes, Book Review: Democratic Governance and International Law, 8 Ind. J. Global Legal Stud. 281, 284 (2000).
[309] See id.
[310] *See* Martin Wolf, *Will the Nation-State survive Globalization?,* FOREIGN AFFAIRS, Jan.-Feb. 2001, at 190.

IV. Second Thoughts on the Inevitability and Desirability of Global Convergence in Banking Regulation: The Case for the Basel Bank Supervisory Standards and Capital Adequacy Rules

While the prudential supervision and regulation[311] of banking and financial markets were not preceding the globalization of finance, the bank supervision and regulation remained the province of national regulatory authorities until the mid-1970s.[312] As a result, some historical incidents such as bank failures and financial disruptions over the past decades, which are illustrated below, have drawn a considerable attention to the need for the global regulation of banking markets. The internationalization of bank regulatory standards has been essentially reactive in nature. Since no other sector than banking has become more global in its operations, and thus more difficult to monitor and supervise it, national regulatory authorities have adjusted domestic regulations to keep abreast of global

[311] There are two approaches to distinguish regulation and supervision in terms of function and content. Under the distinction based on function, regulation refers to 'the body of legal rules, regulations or administrative requirements established by financial authorities or financial market participants to limit or control the risks assumed by financial institutions." Supervision refers to "the associated or complimentary process of monitoring or reviewing compliance by financial institutions with specific regulatory provisions or general standards of prudent or proper behavior in any particular market." By contrast, a distinction based on content or degree of control is drawn between "particular systems having regard to the degree of control or statutory direction imposed as against the level of discretion left to be exercised by the authorities concerned." *See* Walker, supra note 203, at 1 n.1. Walker argues that neither the Bank for International Settlements (BIS) nor the Basel Committee has ever defined the terms. See *Id.* at 17 n.1. This study follows the more complete distinction based on function rather than content as long as both approaches impose some degree of control which implies a compliance or review function.

[312] Moreover, bank supervision has been traditionally "subject to no direct legal direction or, until recently relied upon the exercise of often uncontrolled administrative direction." *See id.* at 2.

bank regulatory standards. As such, global convergence in banking has made greater strides than in any other financial sector.

However, some skepticism has run over the argument that global standards in banking have been established by the international financial community's concerns about the safety and soundness of the global financial system. Arguably, hegemony of Western powers began a drive to move in terms of hegemonic stability more than their concerns about a global banking crisis. In this context, this chapter attempts to assess the Basel Committee's bank supervisory standards and capital adequacy rules, and thereby rethink whether global convergence in banking regulation is desirable and inevitable. To that end, it examines how bank supervisory and regulatory standards have been internationalized toward global convergence in banking regulation. In this regard, this study attempts to address driving forces behind the creation of the Basel Committee on Banking Supervision and its establishment of uniform international banking standards. In doing so, it addresses the question of whether systemic risk in banking has really played a key role in the establishment of international bank regulatory and supervisory standards. In this context,

this study analyzes a comprehensive view of systemic risk in the banking sector. Moreover, historical experiences of bank failures in terms of systemic risk are demonstrated.

More importantly, this study attempts to explore the origins of the Basel Accord on bank capital adequacy. To do so, it largely relies on current theories on the process of negotiating the capital adequacy standards in the areas of political science and international political economy. At this point, this study takes a position as a break against the force of international market failure logic that has enjoyed an exceptionally positive reception among economists, political scientists, and legal experts. Nonetheless, it does not intend to freeze the international coordination and cooperation of banking regulation. Given the understanding of the politics behind the establishment of the Basel Accord, this study evaluates the Basel Accord of 1988 and the new capital adequacy framework (Basel II), and then moves beyond the assessment of the capital adequacy standards. In doing so, it attempts to draw lessons from Basel toward a just world order in the global finance.

A. The Internationalization of Bank Regulatory Standards

1. The Historical and Theoretical Background

Although international finance has a long history of involvement with foreign trade, shipping, and investments, the international financial markets expanded remarkably after the post-world War period of construction and recovery.[313] In particular, the substantial expansion of bank overseas operation played a significant role in the growth of international financial markets. The creation of Eurodollar[314] accounts pioneered by British banking has increased the amounts of liquidity to finance multinational business, and expanded the deposits and lending operations for many clients including corporations

[313] It is worth noting that European financial institutions have already conducted overseas activities for centuries. Italian banks dominated international finance during the Middle Ages and Renaissance. With the establishments of colonial empires, British and Dutch banking have become conspicuously international by their worldwide presence. During the 19th century, London took the strong position as the center of international finance until after the World War II. Although U.S. banking began to flow abroad earlier in the 20th century, especially during the World War I, the big involvement began after World War II. In last generation, U.S. multinational banking system has been rapidly created as resulting from greater affluence, thriving trade and commerce, foreign investment, and increasing use of multinational channels for tax avoidance, enhanced profits, and flight of capital to escape regulation. *See* William A. Lovett, BANKING AND FINANCIAL INSTITUTIONS LAW (3d ed. 1992) at 215, 217-218: David S. Kidwell, Richard L. Peterson & David W. Blackwell, FINANCIAL INSTITUTIONS, MARKETS, AND MONEY 449-450 (5th ed. 1993).

[314] The term Eurodollar was initially used to refer to the lending of U.S. dollars out of London by the foreign branches of U.S. banks mainly located in U.K. The Eurodollar market is the foreign location of the banks that distinguishes Eurodollars from ordinary dollar deposits in U.S. banks. In this sense, the Eurodollar market is an offshore market in contrast to domestic onshore markets. *See* Franklin R. Root, INTERNATIONAL TRADE AND INVESTMENT 502 (7th ed. 1994). Walker, *supra* note 203, at 19 n.3. The role of the dollar as a preferred reserve currency with less inflation than most countries to gather increasing amounts of liquidity to finance multinational business had been influential between the later 1940's-late 1960's. *See* Lovett, *supra* note 313, at 218.

and even governments, drawn from around the world.[315] In particular, the post-World War II brought up the big involvement of the U.S. banking to service the needs of American corporations expanding their business and activities into worldwide.[316] Moreover, U.K. banking regulation and tax policy fostered the retention of earnings abroad by foreign clients, especially American corporations in London.[317] That is because U.S. restrictions on leakage of capital in the 1960's, with its interest equalization tax to be imposed on the purchase of foreign bonds by U.S. investors stimulated the early development of the Eurobond markets.[318] In addition, oil-rich exporters placed a large volume of their liquid earnings into Eurocurrency deposits with the demise of OPEC and the "petrodollar" recycling of 1974-75.[319] In all this rapid expansion of overseas banking activities, more corporations and governments placed liquidity deposits in multinational banks to maximize earnings and tax evasion.[320]

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[315] *See* Lovett, Banking and Financial Institutions Law, *supra* note 313, at 218.
[316] *Id.* at 217-218; *see also* William A. Lovett, WORLD TRADE RIVALRY: TRADE EQUITY AND COMPETING INDUSTRIAL POLICIES (1987) at 39 (noting that … "U.S. industrial, financial, and naval dominance was much like Britain's leadership after the Napoleon Wars").
[317] *Id.*
[318] *See* Walker, *supra* note 203, at 21.
[319] *See* Lovett, *supra* note 313, at 218.
[320] *See id.* at 219.

However, the internationalization of financial markets has entailed the complexity of financial markets and thereby posing new levels of financial risks. To begin, the breakdown of the Bretton Woods fixed exchange rate system between 1971 and 1973 put an end to the period of substantial growth and stability of international financial markets.[321] The collapse of Bretton Woods system forced all of the participants in international

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[321] The international monetary system, known as the Bretton Woods system has existed for 25 years since the Agreement was signed at a conference attended by 44 countries in Bretton Woods, New Hampshire in July 1944. The objective of the conference was to create a fixed exchange rate system to replace the formerly existed foreign exchange market under the international gold standard. The delegates to the conference including John M. Keynes from the U.K. and Harry D. White from the U.S were sure that only an unprecedented degree of international monetary cooperation could anticipate a repetition of the Global Depression in the 1930s. The result of their negotiations was the establishment of the International Monetary Fund (IMF), and the International Bank for Reconstruction and Development (now known as World Bank). The IMF was created as a mutual lending institution (facilitating short- and medium-term loans) for member countries, with potential to create multinational liquidity over the long run. The IMF's mandate was to assist in stabilizing currency relationships, as described in terms of gold-dollar exchange standard. The International Bank for Reconstruction and Development (Word Bank) was designed to complete the IMF's role as a means for long-term lending above and beyond the support provided by private investors, international banks, traditional export finance, and the IMF.

Under the circumstances, the Bretton Woods international monetary system was sustained by two institutions: the IMF, and the central reserve role of the U.S. dollar due to the emergence of the U.S. as the prime reserve nation, with the dollar increasingly taking over the function of gold as an international reserve asset during the 1950s. Notably, the U.S. dollar was the only currency for convertible into gold at a fixed price of $35 per ounce for official monetary purposes in that all IMF nations were required to maintain stable par values of their currencies defined in terms of gold or the 1944 U.S. dollar under the Bretton Woods system. This international monetary system had both benefits, and drawbacks that brought about the replacement with a regime of floating exchange rates. Arguably, the poor performance of the Bretton Woods system in the 1960s attributes mainly to three interconnected causes: (1) the problem of international liquidity formation centered on the dollar, (2) delays in balance of payments adjustments, and (3) disequilibrating short-term capital movements. In response to widespread concern over the adequacy of international liquidity, agreement was reached in the late 1960s on facilities to create a new international reserve asset, the special drawing right (SDRs) which was first activated in the beginning of the 1970s. More significantly, in the early 1970s, serious complexity of dollar devaluation, currency realignment, and major commodity price inflation inspired the international monetary crisis of 1971, which forced the U.S. to suspend the gold convertibility of the dollar on August 15 and thereby brought the closure of the Bretton Woods fixed exchange rate system in March 1973. As a consequence, the floating exchange rate system has been accepted as the basis for valuing currencies. The basic difference from the Bretton Woods system is the floatation of the U.S. dollar against other key currencies. *See* Lovett, World Trade Rivalry, *supra* note 316, at 37-49; *see also* Root, *supra* note 314, at 456-485.

financial markets to expose to new levels of currency and interest rate risk.[322] Most of the financial institutions had never experiences in managing currency risk before and thereby suffered a considerable amount of losses either in direct trading foreign currency or by failing to hedge against foreign currency exposures. The losses are attributable to the provision of forward cover by banks for existing clients and reckless trading to cover existing losses.[323] In short, the elimination of fixed exchange rate parity with gold led the privatization, which created the pressure to release the restraints on cross-border capital movements, and the further deregulation in financial markets.[324] The privatization of financial risk in the post-Bretton Woods age intensified the pressure on governments to liberalize their national restriction on transborder capital flows so that financial

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[322] *See* Walker, *supra* note 203, at 25. Currency risk is associated with currency value changes and exchange controls. Since many world currencies do not have well-established foreign currency markets, international loans cannot always be hedged to reduce the risk if the currency in which the loan is made loses the values against the dollar during the course of the loan. The exchange risk may occur due to difficulties in convertibility into dollars for repayment. Some form of exchange control may be established by a country in case of its large balance-of-payments deficit and its inability to make current payments of its sizable international loans. Interest risk concerns the risk of fluctuations in a bond's price or reinvestment caused by changes in market interest rates. The volatile interest rate environment of the late 1970s and early 1980s caused the failure of many savings and loans association industry (S&Ls) because of the faster increase in interest rates of their payment on deposits (liabilities) than the decline in yields of earnings on their mortgage loans (assets). *See* Kidwell, Peterson & Blackwell, *supra* note 313, at 124-126, 344, 467.

[323] *See* E. P. Davis, DEBT, FINANCIAL FRAGILITY AND SYSTEMIC RISK (1992) at 154, cited in Walker, *supra* note 203, at 26.

[324] *See* Kern Alexander, *The Need ForEfficient International Financial Regulation and the Role of a Global Supervisor, in* REGULATING FINANCIAL SERVICES AND MARKETS IN THE TWENTY FIRST CENTURY 273-274 (Eilis Ferran et al. eds., 2001).

organizations could spread their risks to foreign assts and transactions. As a consequence, the remarkable increase in short-term cross-border portfolio investment has posed systemic risk due to the volatility of cross-border capital flows in many capital-importing countries.[325] In these circumstances, the stability of financial markets has become a serious concern in the era of volatility since historical bank failures and financial disruptions. Unquestionably, national regulatory authorities began to recognize the necessity to promote sound banking systems through the efficient management of systemic risks in domestic markets.

Meanwhile, the extraordinarily large budget and trade deficit since 1981 transformed the United States from the world's largest creditor in 1980 to the world's largest debtor in 1988.[326] As the U.S. suffered from the increasing trade deficit, Japan emerged as an significant creditor country thanks to the growing strength of the yen, and the nation's

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[325] *Id.* at 274.

[326] *See* Kidwell et al., *supra* note 313, at 332 (noting the purely financial impact of this phenomenon that "[f]irst, since corporate capital spending actually rose as the budget and trade deficits mushroomed, the United States had to borrow money from foreigners on a scale never imagined, [which] caused the world's most sophisticated financial system become even larger, more efficient, more innovative[;]....[second,] [a]s the national debt zoomed past $2 trillion, a truly global bond market (for U.S. Treasury securities) of immense size and liquidity came into being[;] [t]hird, foreigners accumulated massive holdings of U.S. dollars, which they either invested in dollar-dominated financial assets or repatriated to the United States as direct investment").

burgeoning foreign reserves.[327] Notably, Japanese banks and securities firms became a driving force in international financial markets as a result of the liquidity provided by the huge foreign currency accumulations along with a high national savings rate and a slowing domestic economic growth.[328] That is, the relatively lower Japanese interest rates than those of other industrial nations enabled the financial firms to bid aggressively for multinational financing business, and dominate in financial commodity markets.[329]

In these circumstances, the prosperity enjoyed by industrialized globe during the 1980s promoted the internationalization.[330] Meanwhile, a major industrial countries' argument about their competitive disadvantages due to the discrepancies in the bank capital adequacy regulations posed the pressure to establish a set of common regulatory standards, eliminating disparities, creating a level playing field in international finance. Furthermore, the Third World debt-overload crisis of 1982-84, and financial disruptions over the past two

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[327] *See* Scott & Wellons, *supra* note 5, at 491.
[328] The ten largest banks in the world were Japanese by the mid-1980s. They held almost 40% of international bank assets. *See* id.
[329] *See* Kidwell et al., *supra* note 313, at 333.
[330] *See id* (noting that international capital flows were propelled by the need for companies expanding their multinational operations to fund expansion in efficient capital markets, and the explosive growth in valuation and trading volume in stock markets around world during the 1980s as investors pursued diversification objectives, and corporations pursued low-cost financing).

decades around the glove have called an attention to the need for global regulation of financial markets. The major underlying factors of the internationalization of bank regulatory standards will be demonstrated below.

2. The Impetus for the Internationalization of Bank Regulatory Standards: Systemic Risk

Notably, the internationalization of regulatory standards in banking has made greater strides than in any other financial sectors. The greater headway with which international standards converged in banking law lies in the concerns over the uniqueness in the financial services industry such as worldwide spillover problems in financial markets, and fears about entailing political, economic and social disruption as shown in financial crises over the decades since the collapse of Bretton Woods system.[331] Historically, it was not until the banking collapses due to the privatization of financial risks in the 1970s that international community has paid attention to the need for the global banking supervision

[331] *See* Patricia A. McCoy, *Musings on the Seeming Inevitability of Global Convergence in Banking Law,* 7 CONNECTICUT INSURANCE L. J. 433, 436 (2001).

and regulation.[332] In short, the major banking collapse at U.K., West Germany, and the U.S.A. in the post-Bretton Woods era has led national regulatory authorities to improve the supervision of financial institutions, and promote safe and sound financial systems through the taking of the increased risk of systemic financial destabilization.[333]

As a matter of fact, the increased cross-border linkages among the financial markets have brought a remarkable expansion in financial activities and efficiency to capital markets around the globe. However, the increasing complexity in financial activities of financial institutions has caused systemic and other financial risks at the same time. Especially, systemic risk is critical issues in the bank regulation because of the capital structure and mutual interdependence of banks.[334] That is to say, banks are special due to the characteristics of bank funds comprised of debt in the form of demand deposits, and banks' short-term borrowing and long-term lending resulting in a fundamental mismatch in

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[332] *See* Kern Alexander, *supra note* 324, at 276.
[333] *Id.* at 274.
[334] *See* McCoy, *supra note* 331, at 442.

the maturities of their assets and liabilities.[335] Upon borrowing, a bank invests in riskier and safer assets, that is, a bank has an incentive to take on excessive risks in making loans or investments, or to operate with insufficient capital, because accepting those risks may greatly reward the bank's owners and managers, while the possible adverse consequences may be borne by depositors, other lenders, and government guarantees and bailouts such as deposit insurance.[336]

Moreover, banks' choice of industry in which they undertake riskier investments determines the correlation of their portfolio returns. When banks prefer to lend to similar industries in equilibrium, systemic risk occurs as an endogenous consequence.[337] Namely, the severe deterioration in bank balance sheets may lead to bank panics in case of multiple

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[335] *Id.* Traditionally, banking business involves borrowing short and lending long, that is, taking deposits which can be withdrawn on demand or certificates of deposit that can be withdrawn in a matter of months, and making loans that will be repaid over periods of years. As such, the assets of a bank have typically longer duration than its liabilities.

[336] Here is a crucial issue of "moral hazard," meaning that loss may arise from a person's character, habits, and circumstances, a sin of omission. In short, all but the largest depositors tend to indifferent to the safety and soundness of their banks because the government guarantees their deposits, and their funds are not really at risk. Major sources of moral hazard in banking are leverage and deposit insurance. Some notes the moral hazard arising from government guarantees as a justification for bank regulation. *See* Stephen C. Cecchetti, *The Future of Financial Intermediation and Regulation: An Overview,* Federal Reserve Bank of New York Current Issues in Economics and Finance, Vol. 5 No. 8 (May 1999) at 3-4.

[337] *See* Viral A. Acharya, *A Theory of Systemic Risk and Design of Prudential Bank Regulation* 2 (January 9, 2001), available at http://papers.ssrn.com/sol3/papers.cfm?/abstract=236401 (last visited Jan. 10, 2003). Acharya notes that in practice, joint failure risk of banks may be determined by a more complicated pattern of inter-bank loans, derivatives, and other transactions. *See id.* at 2 n.2.

and simultaneous failures of banking institutions. In this context, systemic risk arises arguably from a high interconnection of returns on the asset side of their balance sheets.[338] In addition, the linkages of banks to one another through the payments system and inter-banking lending may cause a ripple effect throughout the banking system.[339] Since deposit contract is not explicitly subject to bank characteristics, the depositor losses due to bank failures are not internalized by the bankowners.[340] As such, bank failures and panics are considered to involve huge externalities. That is, individual bank failures produce harmful effects on other banks.[341] The aggregate investment may be reduced due to a decrease in the aggregate supply of deposits. As a result, a recessionary spillover (a negative

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[338] *See id.* at 5-11.
[339] *See* McCoy, supra note 331, at 443.
[340] *See* Acharya, *supra* note 337, at 2.
[341] Acharya notes two conflicting effects of individual bank failures on other banks. According to Acharya, in contrast to a negative externality, surviving banks have a strategic benefit (a positive externality) from other bank's failure because of an increase in scale or an expansion caused by the migration of depositors from the failed banks to the surviving banks, or due to a reduction of operation cost resulting from acquisition of the failed bank's lending facilities. Meanwhile, if the negative externality effect is greater than the positive externality effect, banking institutions recognize it optimal to increase the probability of surviving together, and hence failing together by choosing asset portfolios with greater correlation of returns. This phenomenon would arise where (i) the decrease in aggregate investment is substantial on a bank's failure, for example, banks are large; or (ii) depositors of the failed bank's depositors do not migrate to the surviving banks, for example, banks are essential; or (iii) other banks cannot benefit from the acquisition of the failed banks' business facilities, for example, banks are unique, or such acquisitions are prohibited by anti-trust regulations. This preference occurs as a joint outcome of the limited liability of the banks' equityholders and the nature of the externalities. Acharya calls this equilibrium characterization behavior of systemic risk as "systemic risk-shifting." In this context, bank regulator attempts to reduce systemic and individual risk-shifting incentives of bankowners through its design of bank closure policy and capital requirements. However, these regulatory mechanisms based only on a bank's own risk fail to minimize aggregate risk-shifting incentives, and thus accentuating systemic risk. *See id.*

externality) spreads to the surviving banks because of an increase in scale or an expansion, and hence reducing the profitability of banks. More importantly, as long as banks are levers of monetary policy, ensuing bank panic can have negative macroeconomic effects resulting in the decrease in the money supply, and an economic downturn.[342] As such, systemic risk causes a negative externality of banks, since failed banks and their owners (shareholders) do not have to pay for systemic harms they posed to other banks and other economies.[343] In the global context, the domestic repercussions of cross-border banking crises that national bank regulators cannot individually control have brought up concerns over the danger of contagion stemming from the risk of systemic crisis. Accordingly, most banking systems around the globe are heavily regulated, because bank regulators are concerned about the social and economic costs of systemic risk.[344] In this regard, the

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[342] *See* McCoy, *supra* note 331, at 443. Since the losses to both depositors and the economies from a joint bank failure exceed those from individual bank failures, different banks undertake investments in assets with lower correlation of returns, and thereby resulting in a greater decrease in aggregate investment. *See id.* at 3.

[343] *See id.*

[344] Nevertheless, there is still no consensus on whether bank regulation is necessary, and if so, how banks should be regulated. One notes this is partly caused by the lack of consensus on the nature of the market failure that makes free banking not optimal. *See* George Benston & George Kaufman, *The Appropriate Role of Bank Regulation,* ECONOMIC JOURNAL, Vol. 106, No. 4, at 688-697, cited in Joao A C Santos, BANK CAPITAL REGULATION IN CONTEMPORARY BANKING THEORY: A REVIEW OF THE LITERATURE, BIS Working Paper No. 90 (Sept. 2000), at 5. For the rationale of banking regulation, *see* Charles Goodhart et al., FINANCIAL REGULATION: WHY, HOW AND WHERE NOW? 10-12 (1998) (outlining the traditional rational bank regulation on the basis of four main considerations: (i) the critical status of banks in the financial system,

objective of prudential bank regulation is considered to ensure the stability and soundness of the financial system as a whole. Consequently, systemic risk has been one of the most powerful forces behind the internationalization of bank regulatory standards as it is one of the critical justifications for bank regulation. In these circumstances, deep skepticism is running over the efficiency of the current bank regulatory mechanism to prevent or retard systemic risk. In this context, it is worth analyzing the concept of systemic risk.

a. Concepts of Systemic Risk

In general, systemic risk is not a phenomenon limited to economics and the financial system. Historically, the concept has been well illustrated in the field of health and epidemic diseases. That is, Black Death of the Great Plague in the Middle Age, which broke out in 1348-50, and beset Europe until the 1730s, was immediately fatal and spread rapidly from southern to northern Europe resulting in by 1400 a remarkable decrease in the population to about a half or two-thirds of its total a century before. Most recently, the

particularly in clearing and payments systems; (ii) the potential systemic dangers resulting from bank runs; (iii) the nature of bank contracts; (iv) moral hazard associated with the lender-of-last-resort role and other safety net arrangements that apply to banks.

outbreak of SARS (severe acute respiratory syndrome) in China in November 2002 has rapidly brought about a devastating infectious disease around the globe. Systemic risk is arguably a particular characteristic of financial system in the area of economics. Whereas contamination (contagion) effects may also take place in other sectors of the economy, the probability and danger is accounted as considerably higher.[345] An entire systemic crisis in the financial system may have strong adverse impacts on the real economy and general economic welfare.[346]

Systemic risk is defined as "the risk or probability of breakdowns (losses) in an entire system as opposed to breakdowns in individual parts or components and is evidenced by comovements (correlation) among most or all parts."[347] Systemic risk in banking sector is proved by a high correlation and ensuing of bank failures in a nation, in a number of

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[345] However, some challenges the existence of systemic risk in the financial system. *See* G. Sheldon & M. Mauer, *Interbank Lending and Systemic Risk: An Empirical Analysis of for Switzerland,* SWISS JOURNAL OF ECONOMICS AND STATISTICS, Vol. 134, No. 2 (1998), at 685 (asserting that "[s]ystemic risks are for financial market participants what Nessie, the monster of Loch Ness, is for the Scots (and not only for them): Everyone knows and is aware of the danger. Evereyone can accurately describe the threat Nessie, like systemic risk, is omnipresent, but nobody knows when and where it might strike. There is no proof that anyone has really encountered it, but there is no doubt that it exists").

[346] *See* Olivier De Bandt & Philipp Hartman, SYSTEMIC RISK: A SURVEY, European Bank Working Paper Series, Working Paper No. 35 (November 2000,) at 10.

[347] *See* George G. Kaufman, *Banking and Currency Crises and Systemic Risk: Lessons from Recent Events,* Federal Reserve Bank of Chicago Economic Perspectives (3rd Quarter 2000) at 9, 14.

nations, or all over the globe. In this sense, systemic risk may arise either or both in the domestic dimension and/or in the transnational arena.[348]

Meanwhile, systemic risk is meant by different description, especially with respect to its causation.[349] The first refers to a macro shock that causes near simultaneous adverse effects on the most or all the domestic economy. In other words, systemic "refers to an event having effects on the entire banking, financial, or economic system, rather than just one or a

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[348] *See id.* Systemic risk is also evidenced in the other financial sectors. In particular, the size of big securities firms is now so great as to cause genuine systemic concerns in case of a market failure. Since the dramatic collapse of Barings plc in 1995, the understanding to cope with systemic risk has been widely spread to securities regulators and supervisors because of the negative effect on financial systems resulting from the simultaneous decline in the prices of a number of securities in single or several markets in a nation or across nations. For an analysis of the Barings Collapse, *see generally* Joseph J. Norton & Christopher D. Olive, *Globalization of Financial Risks and International Supervision of Banks and Securities Firms: Lessons from the Barings Debacle,* 30 INT'L LAW. 301 (1996).

[349] For the review of various description of systemic risk, *see* Kaufman, *supra* note 347, at 14-15; *see also* De Bandt & Hartman, *supra note* 346, at 10-13. De Bandt and Hartman specified some concepts to define systemic risk. They refer to "a systemic event in the narrow sense as an event, where the release of "bad news" about a financial institution, or even its future, or the crash of a financial market leads in a sequential fashion to considerable adverse effects on one or several other financial institutions or markets ... Essential is the "domino effect" from one institution to the other or from one market to the other emanating from a limited ("idiosyncratic") shock." According to them, a systemic risk in the broad sense includes both the event defined above and "simultaneous adverse effects on a large number of institutions or markets as a consequence of severe and widespread ("systematic") shocks." They also describe a systemic crisis in the narrow and broad sense as a systemic event that produces effects on a considerable number of institutions and markets in a strong sense, thus "severely impairing the general well-functioning ... of the financial system relatin[g] to the effectiveness and efficiency with which savings are channeled into the real investments promising the highest returns. They assert that the distinction between the distinction between the narrow and the broad concept of systemic events is significant because "crisis management measures, tackling the source of the problem, might be different in the case of an idiosyncratic shock that risks causing contagion compared to the case of a systematic shock that might have a broad simultaneous destabilization effect." As for systemic risk, they describe it as 'the risk of experiencing systemic events in the strong sense ... the spectrum of systemic risk ranges from the second-round effect on a single institution or market ... to the risk of having a crisis affecting most of the financial system at the upper extreme ..."

few institutions."[350] Arguably, this definition does not clarify how the effects transmit from a macro shock to individual units.[351]

Two other definitions emphasize potential spillover from one unit to others. One refers to systemic risk as the "probability that cumulative losses will accrue from an event that sets in motion a series of successive losses along a chain of institutions or markets comprising a system ... That is, systemic risk is the risk of a chain reaction of falling interconnected dominos."[352] This definition focuses on "causation as well as correlation (correlation with causation) and requires strong direct interconnections or linkages among

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[350] *See* Philip F. Bartholomew & Gary W. Whalen, *Fundamentals of Systemic Risk, in* RESEARCH IN FINANCIAL SERVICES: BANKING, FINANCIAL MARKETS, AND SYSTEMIC RISK, Vol. 7, at 4 (George G. Kaufman ed., 1995). *See also* Frederic S. Mishkin, *Comment on Systemic Risk, in* RESEARCH IN FINANCIAL SERVICES: BANKING, FINANCIAL MARKETS, AND SYSTEMIC RISK, Vol. 7, at 32 (George G. Kaufman ed., 1995) (defining systemic risk as "the likelihood of a sudden, usually unexpected, even that disrupts information in financial markets, making them unable to effectively channel funds to those parties with the most productive investment opportunities").

[351] *See* Kaufman, *supra* note 347, at 14.

[352] *See* George G. Kaufman, *Comment on Systemic Risk,* supra note 350, at 47; *see also* Bank for International Settlements, 64th ANNUAL REPORT (June 1994), at 177 (defining systemic risk as "the risk that the failure of a participant to meet its contractual obligations may in turn cause other participants to default with a chain reaction leading to broader financial difficulties"). This domino phenomenon is remarkable in banking sector. Since banks have claims on each other through the payment system and the interbank market, financial difficulties of an individual bank can spread to others as it defaults on its obligation. *See* Stephen R. Gallen, *Regulating the Modern Financial Firm: Implications of Disintermediation and Conglomeration,* University of St. Gallen Discussion Paper No. 2000-21 (September 2000) at 5. Recently, some study and research have dealt with this type of financial contagion. *See* Jean-Charles Rochet & Jean Tirole, *Interbank Lending and Systemic Risk,* JOURNAL OF MONEY, CREDIT AND BANKING, Vol. 28, No. 4 (1996) at733-762 (developing a model of the interbank market where interbank lending produces a trade-off between increased peer monitoring and higher systemic risk resulting from larger interbank linkages); *see also* Franklin Allen & Douglas Gale, *Financial Contagion,* JOURNAL OF POLITICAL ECONOMY, Vol. 108, No. 1 (2000) at 1-33 (analyzing the completeness of the interbank deposit market affects the extent to which individual shocks spread throughout the system). Meanwhile, this perspective emphasizes some type of government intervention either through guarantees or last resort lending. However, there are still many significant issues in dealing with contagion left.

institutions and markets, sectors, or countries involved, … when the first domino falls, it falls on others causing them to fall and in turn knock down others in a chain of "knock-on" reaction."[353]

A third definition of systemic risk also emphasizes spillover from an initial shock.[354]

> [B]ut, [it] does not involve direct causation, and depends on weaker and more indirect interconnections. It focuses on similarities in third-party risk exposures among the units involved. When one unit experiences an adverse shock generating severe losses, uncertainty is produced about the values of other units potentially subject to same shock. To minimize additional losses, market participants will examine other units, such as banks, in which they have economic interests to see whether and to what extent they are at risk. The more similar the risk exposure profile with that of the initial unit economically, politically, or otherwise, the greater is the probability of loss and the participants to withdraw funds as soon as possible. The response may cause liquidity and even more fundamental solvency problems. This may be defined as a "common shock" or

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[353] *See* Kaufman, *supra* note 352, at 47.
[354] Kaufman, *supra* note 347, at 14.

"reassessment shock" effect, and represents correlation without direct causation (indirect causation).

In the periods of uncertainty due to the asymmetric information problems, market participants need time and resources to sort out the other units at risk and the magnitudes of any potential losses, and increasingly tend to make their portfolio adjustments in quantities (runs) rather than prices (interest rates).[355] As a consequence, there seems to be "an immediate flight or run to quality away from all units that appear potentially at risk, regardless of whether further analysis would identify them as ex-post as having similar exposures that actually put them at risk (guilty) or not (innocent)."[356]

The runs are likely to put a strong downward pressure on the prices (upward pressure on interest rates) of the securities of financially affected institutions and markets. Simultaneously, many of the affected countries are likely to increase their interest rates up

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[355] *Id.* at 15.
[356] *See Id.* Since runs are concurrent and widespread in this period, where common shock contagion appears indiscriminate, potentially affecting the entire universe and reflecting a general loss of confidence in all units, such behavior by investors is referred to as "herding" behavior. This definition of systemic risk does not differentiate between innocent parties and guilty parties. *Id.*

to diminish additional capital outflows and encourage inflows.[357] Thus, any resulting liquidity problems are likely to temporarily spill over to units indirectly affected by the initial shock.[358] That is, the initial domino falls indirectly on other dominos, however, its fall forces market participants to examine nearby dominos until they can see if they are subject to the same destabilizing forces as forced to fall.[359]

In addition, systemic risk is often distinguished between rational or information-based systemic risk and irrational, noninformation-based random, or pure contagious systemic risk.[360] According to this distinction, rational contagion assumes that investors (depositors) can differentiate among market participants based on their fundamentals.[361] Random contagion, on the basis of the actions of uniformed agents, is considered more dangerous as it does not differentiate among participants, affecting and spilling over to both

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[357] *See id.*

[358] *See* George Kaufman & Kenneth Scott, *Does Bank Regulation Retard or Contribute to Systemic Risk?,* Stanford Law School John M. Olin Program in Law and Economics Working Paper No. 211 (December 2000) at 3-4 , available at http:papers.ssrn.com/paper.taf?abstact-id=257927 (last visited Jan. 15, 2004).

[359] *Id.* at 4.

[360] *Id.* Under common shock contagion systemic risk, innocent parties are likely to be affected immediately during the sorting out period, however, in time will be sorted out by investors (depositors) from guilty parties. As a consequence, the empirical borderline between rational and irrational contagion is unclear and depends partially on the time horizon applied. Likewise, the distinction between "innocent" and "guilty" is not always clear even though innocent parties may be referred to as units that are widely perceived to be economically well-behaved, and guilty parties as economically insolvent, near-insolvent, or excessively leveraged units. *See id.* at 6.

[361] *Id.* at 5.

guilty and innocent parties, and thus seems to be broader and more difficult to contain.[362] Although random contagious systemic risk is relatively easy to discriminate between the innocent and the guilty ex-post the crisis, it is practically difficult to distinguish the one from the other ex-ante a crisis, because ex-ante information is frequently insufficiently available, timely, or reliable to make the distinction with confidence.[363]

b. The Financial Fragility Proposition

It is worthwhile to reexamine why systemic risk poses a special concern to the financial system. As noted briefly above, in a broad sense there are three interrelated characteristics of financial system for the driving forces behind the financial fragility proposition. That is, the features are the structure of banks, the interconnection of financial organizations through direct exposures and settlement systems, and the information intensity of financial contracts and related credibility problems.[364]

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[362] *Id.*
[363] *See id.* at 7.
[364] *See* De Bandt & Hartman, *supra note* 346, at 13-14.

First, as financial intermediaries banks engage in deposit-taking and loan-extension at the same time.[365] Traditionally, banks take fixed-value deposits that can be unconditionally withdrawn at any time with a very short notice, and lend long term to industrial firms.[366] Since banks provide liquidity services, and act as a delegated monitors for depositors, a bank collects demand deposits, invests in illiquid long-term projects, and provides liquidity insurance to consumers facing uncertainty about the exact timing of their consumption.[367] As a consequence, projects are illiquid because they can earn higher returns only if they remain funded until maturity, whereas premature liquidation reduces their value substantially.[368] In this way, banks add value since they allow depositors to pool their resources, and indirectly invest in high yield investment projects.[369] However, in transforming short-maturity liabilities to long-maturity assets, banks become susceptible

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[365] There has always been a need for some mechanism for channeling the savings of households into the investments of industrial companies. From the viewpoint of financial markets, businesses demand capital, and will supply assets to the market to get this capital. Households are the final holders of these assets either directly or via engaging in various types of investments pools, and thus provide ultimate demand. In this way, a bank as the financial intermediary distributes resources between these two units of businesses and households. This is the fundamental role of a financial intermediary.

[366] *See* Douglas Diamond & Philip Dybvig, *Bank Runs, Deposit Insurance and Liquidity,* JOURNAL OF POLITICAL ECONOMY, Vol. 91, No. 3 (June 1983) at 401-419.

[367] *See id.*

[368] *See* Gallen, *supra* note 352, at 4.

[369] *Id.*

to runs, during which all depositors lose confidence and withdraw their funds prematurely. That is to say, only a small fraction of assets are required to be held in liquid reserves to encounter deposit withdrawals, thereby leading to illiquidity and even default when exceptionally high withdrawals occur and long term loans cannot be liquidated.[370] In short, this feature shows that the health and soundness of bank is both subject to the confidence of depositors in the value of the loan book, and their confidence that other depositors will not run the banks as well as to its success in picking profitable investment projects for lending.[371] This special characteristic has brought up a shift from a good equilibrium with bank intermediation to a bad bank run equilibrium, which has justified banking regulation.[372]

Second feature is a complex network of exposures among banks and other financial intermediaries through the interbank money market, the large-value (wholesale) payments

[370] *See* De Bandt & Hartman, *supra* note 346, at 13.
[371] *See id.*
[372] *See* Gallen, *supra* note 352, at 4. This special feature of banks is not applicable to other financial intermediaries, such as insurance companies and securities corporations unless banks and other intermediaries belong to the same financial conglomerate. *See* Goodhart et al., *supra* note 344, at 1-37.

and security settlement systems.[373] That is, systemic risk arises from inter-locking exposures among financial institutions, whether through equity, debt or participation in a common payments system. Since these exposures may be very large to banks at certain points during the business day, the financial difficulties at one bank may spread to other banks as they default on their payment obligations. As long as bank deposits are part of narrow money, banks create money.[374] In this context, widespread bank failures have the potential to affect the money supply if depositors rather withdraw their funds in order to hold cash than shift their funds from one bank to another.[375] This type of externality through the money supply emphasizes the specific nature of bank liabilities in serving as a method of payment.[376] Banks play a key role in wholesale and retail payment, and

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[373] *See* De Bandt & Hartman, *supra* note 346, at 14.

[374] When the bank makes a loan to a customer, the bank can supply the funds by giving the customer cash from the vault or a check on another bank, or by selling investment securities and giving the customer the proceeds. Any of these actions simply changes one kind of asset into another kind, cash for example, into a loan. The totals on the bank's balance sheet (its "footings") remain the same. Much more often, however, a bank makes a loan by crediting the amount of the loan to the customer's checking account. On the bank's books, this increases both assets and deposits, and consequently both assets and liabilities. The initial increase affects only the bank making the loan, but ultimately it affects the banking system as a whole. If we accept the fact that checkable deposits are money, or money substitutes, it is clear that banks, and banking system create money.

[375] *See* Kaufman, *supra* note 352, at 6.

[376] *See id.*

settlement, thereby arising relevant externalities on the rest of economy.[377] No doubt securities or insurance subsidiaries can play a role in the tight network of financial linkages among institutions to the extent financial conglomerates encompass banks and other financial intermediaries as was discovered in the case of Barings debacle[378] In short, the failure of one institution may have "knock-on" effects on the balance sheet of other institutions.[379]

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[377] Immediate negative externalities throughout the economy, which bank failures may generate, are one of the main concerns about the possible effects of the millennium bug or Y2K problem.

[378] Since many deposit-taking institutions are major players in the securities market, their soundness can be affected by securities losses. That is, the failure of big securities firm encompassing banks and other financial intermediaries may bring about the disruption in the payment system resulting in a chain reaction of liquidity problems at other institutions. The collapse of Barings in early 1995 provides an illustration of such intragroup contagion. The Barings failure due to rapidly accumulated trading losses in exchange-traded derivatives called attention the need to recast the form of external regulation dealing with risks associated with derivatives trading. Namely, the greater use of derivatives fro financial management and speculation has attracted considerable attention on their risks and led to several initiatives regarding regulation and supervision, firms' internal controls, and reporting and disclosure. *See* Andrew Cornford, *Risks and Derivatives Markets: Selected Issues,* UNCTAD REVIEW 1995, at 189-212; *see also* Goodhart, et al., *supra* note 344, at 39-43. Various risk management techniques used in securities and derivative markets, such as margin requirements and portfolio insurance, which are intended to limit ex ante risk, put an emphasis on large and immediate payments demands by banks and other financial intermediaries ex post, that is at times of big asset price changes, thereby applying usually to limit the potential of contagion in payment and settlement systems. *See* De Bandt & Hartman, *supra* note 346, at 32-36 for the financial intermediaries' interconnection through payment and settlement systems.

[379] *See* David Humphrey, *Payments Finality and Risk of Settlement Failure, in* TECHNOLOGY AND THE REGULATION OF FINANCIAL MARKETS: SECURITIES, FUTURES AND BANKING 97-120 (Anthony Saunders & Lawrence White eds., 1986).

The third character is asymmetric information and control intensity of incomplete financial contracts.[380] According to the information economics, there would be little role for financial markets and financial market regulation if information were perfect and markets were complete.[381] The asymmetries of information-the differences in information, which are pervasive in all economies, between the lender and the borrower, the insurance company and the insured have shown the foundations for realistic theory of financial markets, explaining why those most in need of credit often cannot get the credit-rationing.[382] Generally speaking, financial decisions aiming at the intertemporal allocation of purchasing power for consumption are derived from expectations on what the value of

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[380] According to the free market ideology based on the economic theory attributed to Adam Smith, market forces-the profit motive-arguably drive the economy to efficient outcomes as if by an invisible hand. However, recent crucial researches do not agree with Adam Smith's idea that markets by themselves lead to efficient outcomes asserted in his book, THE WEALTH OF NATIONS written in 1776. That is, whenever information is perfect or markets are incomplete, the invisible hand works most imperfectly and competitive equilibrium (constrained Pareto) is not efficient. Here come desirable government interventions, which improve in principle on the efficiency of the markets so that main activities of government can account for responses to the market failures. *See* Joseph E. Stiglitz, supra note 189, at 73-74, 254 n. 2.

[381] *See id* at 74.

[382] *Id* at xi. With regard to the evaluation of various systemic events, the information and intensity of financial contracts highlight the significance of the distribution of information among the agents playing in the financial sector. In short, general uncertainty and agents' awareness of potential asymmetries of information stress the fact that the occurrence or nonoccurrence of systemic events are based on expectations. In this context, some distinguish three potential causes of narrow systemic events related to asymmetric information and expectations: (i) the full revelation of new information about the health of financial institutions to the public; (ii) the release of a noisy signal (imperfect information) from outside sources about the health of financial institutions to the public; (iii) the occurrence of an imperfect signal which coordinates the expectations of the public without being actually related to the health of financial institutions. *See* D. Cass & K. Shell, *Do Sunspots Matter?*, JOURNAL OF POLITICAL ECONOMY, Vol. 91 (1983) at 193-227; *see also* De Bandt & Hartman, *supra* note 131, at 14-15.

respective assets will be in the future or whether the future cash flows guaranteed in a financial contract would be satisfied. As a consequence, the increasing uncertainty or lack of credibility of financial commitments may cause market expectations, investment and divestment decisions to shift substantially and individually rationally in short periods of time.[383] Furthermore, the asymmetric information problems can demonstrate how financial problems arise over an extended period of time before an efficient or inefficient crisis occurs. Namely, the systemic event is just the effect of a more fundamental underlying problem, which has been unrevealed from policymakers or the general public for some time.

As noted above, these three characters can be referred to as the major factors behind higher vulnerability of financial systems to systemic risk than other sectors in the economy. Furthermore, the increased linkages across markets and volatility in capital flows on the international platform may create rapid intermarket contagion and systemic events around

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[383] This may result in large asset price fluctuations, whose sizes and directions cannot sometimes virtually explain through fundamental analysis alone, which attempts to predict asset price changes driven by the factors influencing the intrinsic values of assets, such as corporations' earnings influencing shares, and inflation rates influencing exchange rates. *See* R. Shiller, MARKET VOLATILITY, (1986), *cited in* De Bandt & Hartman, *supra* note 131, at 14, n.16.

the globe. In this context, one argues that bank regulators need to address four principal non-traditional areas of potential systemic risk present in the international financial system today.[384] First, there is the threat of occurrence of a second sovereign debt crisis due to developing countries default on securitized debt obligations.[385] Second, there is the threat that the remarkably increased exposure to foreign exchange and settlement risk as shown in the collapse of Bankhaus Herstatt in 1974. The concerns over this type of systemic risk arise from the fact that the current multicurrency clearing systems are not subject to regulatory oversight.[386] Third, the money laundering contagion can pose a systemic risk to the international financial system when financial institutions or communities are influenced by laundered funds of international criminal syndicates.[387] Fourth, there is non-sovereign-

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[384] *See* Joseph J. Norton, *International Financial Law, " An International Important Component of International Economic Law": A Tribute of Professor John H. Jackson,* 20 MICH. J. INT'L L. 133, 142 (1999) (asserting that "[t]hese risks can only be addressed appropriately by financial institutions and international regulators working together in quasi-symbiotic "partnerships"...).

[385] These concerns are arguably aggravated by the widely disseminated holdings of these obligations among institutional investors and by the fact that the terms and conditions on instruments such as Brady Bonds do not benefit sovereign debt reschedulings or restructurings. *See generally* Philip R. Power, Sovereign Debt: The Rise of the Secondary Market and its Implications, 64 FORDHAM L. REV. 2701 (1996).

[386] *See* Norton, *supra* note 384, at 142. The collapse of Bankhaus Herstatt in 1974, known as "Herstatt Risk" is analyzed below.

[387] *See id.*

related cross-border financial crises contagion risk as evidenced by the East Asian financial crises in 1997.[388]

Along with addressing the threat of systemic risk, there is a need for further research to identify whether historical bank failures and financial crises reflect systemic risk. In short, the evidence on systemic risk and historical experience should be addressed prior to searching for mechanisms dealing with systemic risk in terms of ex ante (preemptive) measures, such as prudential supervision and regulation to prevent inefficient and negative systemic events from arising and ex post policies in the form of crisis management as well.

c. The Evidence on Systemic Risk

Historically, there have been concerns that an individual bank run can trigger other banks' runs through depositors' reassessment of their bank's soundness and withdrawal of their funds. That is to say, do bank failures reflect systemic risk? In this context, there is a strong need to make an empirical analysis of systemic risk resulting from the classical

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[388] *Id.*

bank run models and extensions of these models of single banks' fragility to models of multiple bank systems leading to the modern bank contagion in different countries and on the international platform.[389]

To begin with, classical bank runs are not currently viewed as a major threat to the financial system in the industrialized country. This accrues from the adoption of deposit insurance schemes reducing incentive for depositors to withdraw their funds, and the fact that non-bank financial intermediation and financing through the capital markets give a reason for an increasing portion of the financial system.[390] As a consequence, the risk of contagious bank failures may be considered as the classical case of systemic risk. Here is an introduction of econometric papers attempting to identify contagion effects although the full analysis of this issue is outside the scope of this study.[391] A first approach tries to link bank failures with subsequent other bank failures directly by autocorrelation in terms of

[389] Some argues that the empirical evidence of contagious systemic risk depends on the definition as used. When systemic risk is defined as a broad big shock, systemic risk is observed more frequently. However, this definition is silent on the transmission of contagion. *See* Kaufman & Scott, *supra* note 358, at 8.

[390] *See* Kaufman, *supra* note 138, at 16. Nonetheless, the modern version of bank runs still poses a threat to the financial system since panics resulting from adverse events such as a default or failure are likely to occur in the wholesale markets and may cause solvency-threatening liquidity crises. *See id.*

[391] For the review of papers, *see* De Bandt & Hartman, *supra* note 436, at 36-42.

intertemporal correlation of bank failures.[392] A second group tests whether the survival time of banks decrease during historically identified episodes of panics or through other banks' failures with the application of a macroeconomic duration model in which bank survival is explained by a host of economic fundamentals such as individual bank balance sheet items, regional and national macroeconomic variables.[393] Third, a most popular approach appraises the relationship between bank failures or news and other banks' stock market value in terms of event studies of bank stock price reactions in response to bad news.[394] A fourth group focuses on the link between news or failures and deposit withdrawals at

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[392] Some provide more evidence of intertemporal failure clustering in free banking markets through applying an analysis to data from the US Free Banking Era (1837 through 1863). *See* I. Hassan & G. Dwyer, *Bank Runs in the Free Banking Period,* JOURNAL OF MONEY, CREDIT, AND BANKING , Vol. 26 (1994), at 271-288. However, it is argued that this approach has some disadvantages: first, the negligence of macroeconomic factors exhibiting autocorrelation would discredit any evidence of contagion; second, the intertemporal contagion cannot be detected at shorter time intervals but only at the frequencies of macroeconomic data through this approach. *See* de Bandt & Hartman, *supra* note 346, at 37.

[393] Calomiris and Mason estimates the average survival time of thousand Fed member banks between January 1930 and March 1933 during the Great Depression through an application of a macroeconomic duration model in which bank survival is explained by a host of economic fundamentals and some proxies of contagion, panics, or liquidity crises. *See* C.W. Calomiris & J.R. Mason, *Causes of U.S. Bank Distress During the Depression,* NBER Working Paper, No. 7919 (2000). Although this approach could indicate the presence of some bank contagion effects in specific episodes during the Great Depression, most of these episodes have been contained remaining limited to a specific region of the U.S., and some of the reductions in survival duration this study observed might still be related to some unobservable regional or national fundamentals. *See* de Bandt & Hartman, *supra* note 346, at 38.

[394] According to this approach, contagion effects are identified by comparing the normal return of a bank stock, as proclaimed by a standard capital market equilibrium model estimated with historical data, to the actually observed returns at the announcement date or during a window around this date. Bad news (such as the announcement of an unexpected increase in loan-loss reserves or the failure of a commercial bank or a country to serve its debt) for a bank leading to significantly negative abnormal returns of another bank can be interpreted as evidence of contagious systemic risk. *See* de Bant & Hartman, *supra* note 346, at 38.

other banks, thereby keeping track of and analyzing deposit flows.[395] A fifth approach analyzes the effect of news or failures on the probability of other banks' defaults as perceived by market participants and reflected in risk premiums in interbank lending in the context of examinations of bank debt risk premiums.[396] A final approach measures the

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Aharony and Swary addresses the effects of three largest bank failures in the U.S. before 1980: United States National Bank of San Diego in 1973, Franklin National bank of New York in 1974, and the Hamilton National Bank of Chattanooga in 1976. These three failures might arise from an idiosyncratic nature related to in-house fraud, illegal real-estate loans, or foreign exchange losses after the switch to floating exchange rates. This study shows that the Franklin National case, the failure of the 12th largest US bank at the time, brought about substantial negative abnormal returns in money-center, medium-size, and small banks while no external effects of the smaller two other cases occurred. *See* J. Aharony & I. Swary, *Contagion Effects of Failures: Evidence from Capital Markets,* JOURNAL OF BUSINESS, Vol. 56, No. 3 (1983), at 305-317.

The results of adverse external stock market reactions to bad news have been subject to critical scrutiny. Some argues that this results can be interpreted as evidence of pure contagion effects, whereas others claim that they rather reflect rational investor choices in response to the revelation of new information. The general outcome of this hot debate is that abnormal returns varied in proportion as banks exposed to problem countries, which is consistent with the hypothesis of rational investor choice. Since most of these results are obtained through US data, they cannot apply to other financial systems. Moreover, the concept this study developed indicates weak systemic events, because stock price fluctuations do not imply failures. Although this approach may be efficient in proportion to actual exposures, it shows systemic repercussions in the broad sense. *See* De Bandt & Hartman, *supra* note 131, at 39-40.

[395] According to this approach, there is a contagion of bank run, if depositors withdraw funds from another bank in response to financial difficulties of a bank or a group of banks. Saunders addresses whether two key anoouncements regarding the shape of Continental Illinois Bank in April and May 1984 had any noticeable effect on other banks' US or overseas deposits. Whereas the April 18th announcement of a US$400 million increase in the Continenetal's problem loans did not affect US depositors noticeably, the May 10th denial of rumors by the US Office of Comptroller Currency have seemingly triggered flight to quality (such as shifts to safer banks and more secure deposits) by big banks but not a general run. *See* A. Saunders, *The Inter-bank Market, Contagion Effects and International Financial Crises, in* THREATS TO INTERNATIONAL FINANCIAL STABILITY 196-232 (R. Portes et al. eds., 1987). However, this approach can only address the occurrence of narrow systemic events in the weak sense.

[396] Carron shows that the Franklin National failure in New York in mid-1974 caused an increase in the quarterly average spread between US certificates of deposits (CDs) and three-month Treasury bills by a factor of at least six, which is consistent with systemic events via risk premiums. *See* A.S. Carron, *Financial Crises: Recent Experience in U.S. and International Markets,* BROOKINGS PAPERS ON ECONOMIC ACTIVITY, No. 2 (1982), at 395-418. Jayanti and Whyte estimate statistically significant increase in the average certificate of deposit (CD) rates for both UK and Canadian banks after the Continental Illinois failure in May 1984. They show that the result is consistent with the international contagion effect visible in equity returns. *See* S.V. Jayanti & A.M. Whyte, *Global Contagion Effects of the Continental Illinois Failure,* JOURNAL OF INTERNATIONAL FINANCIAL MARKETS, INSTITUTIONS AND MONEY, Vol. 6, No. 1, at 87-99 (1996).According to Saunders, the Continental Illinois failure did not lead to a decrease in the total of non-sterling deposits at

physical exposures among operating banks (or between those and banks which have been bailed out by the government) to assess whether a default would render other banks insolvent.[397]

According to the empirical studies on banking crises in the United States, there seems little empirical evidence of contagious systemic risk that renders economically solvent banks economically or legally insolvent either before or after the presence of federal government guarantees and deposit insurance schemes.[398] The evidence shows that

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either American, Japanese or other overseas abnks in London in April or May, but an increase in risk premiums on the deposits generally. Saunders also concedes that the average spread between 3-month Euro-dollar deposits and T-bills doubled during the Continental Illinois failure in April and May 1984, which is consistent with international systemic risk in the weak sense. *See* Saunders, *supra* note 395.

As a test for contagion effects, this approach is similar to the application to equity returns in that it applies to risk premiums in debt rates. As a consequence, this study cannot usually address the occurrence of systemic events in the strong sense. Also, it does not occasionally clarify whether the effects measured originate in an aggregate shock (potentially revealed by a specific event) or are a reflection of a successive transmission. *See* De Bandt & Hartman, *supra* note 346, at 42.

[397] This approach measures directly whether exposures to certain (potentially or effectively failing) banks are larger than capital. Very Large exposures may occur temporarily vis-a-vis core institutions (large clearing banks), whereas in principle, banks are not permitted to lend more than a small share of their capital to a single borrower in accordance with prudential rules restricting large exposures. Kaufman finds some results from the US inquiry into the Continental Illinois case, one of the core institutions at the time. Notably, 65 financial institutions had uninsured exposures larger than their capital to the bank shortly before the Continental Illinois failure. The Congressional study estimated that if the Continental's losses would have been 60 per cent, then 27 banks would have been legally insolvent, and 56 banks would have suffered to below 5 per cent, so that none of its correspondents suffered solvency-threatening losses. *See* George G. Kaufman, *Bank Contagion: A Review of the Theory and Evidence,* JOURNAL OF FINANCIAL SERVICES RESEARCH, Vol. 7 (1994), at 123-150.

This approach is strongly linked to empirical research on the impact of failures in payment and settlement systems. However, it cannot address the actual occurrence of systemic events, and it can just shows the ex ante risks as potential events in the future. *See* de Bandt & Hartman, *supra* note 346, at 42.

[398] *See id.* Some review a number of non-quantitative studies on the banking crises in US history between 1873 and 1933, as well as quote a number of contemporaneous observers (arguing that "systemwide contagious bank runs were not a frequent occurrence in US history (probably occurring at most only in 1878,

financial difficulties at one bank or a group of banks spread to other banks, but they spill over almost exclusively only to banks with the same or similar portfolio risk exposures and subject to same shock.[399] That is to say, there seems little empirical evidence on the insolvency of a bank which directly leads to the insolvency of other economically solvent banks, or deposit withdrawals at economically insolvent banks resulting in bank runs and the insolvency of the banks.[400]

Even though the empirical assessment of the systemic risk potential on the international platform is undoubtedly essential in shaping and evaluating the future supervisory and regulatory framework, there is the lack of appropriate data, and empirical studies on systemic risk in other countries and financial systems. Furthermore, even bank equity

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1893, 1908, and 1931-1933 and doing major damage probably only in 1893 and 1931-1933), and that fear of widespread ripple effects did not appear to be of major concern to most students of U.S. banking before1932"). *See* George J. Benston et al., PERSPECTIVES ON SAFE AND SOUND BANKING: PAST, PRESENT, AND FUTURE 70 (1986). For final comments, they concluded in asserting that "U.S. history suggests that runs on individual banks or groups of banks only rarely spread to other banks that are not subject to the same conditions that started the runs, and that most banks runs have been contained by appropriate action, with only minimal or short-lived effects on national financial stability and economic activity. Generally, the instability of individual banks or groups of banks has not translated into instability in the banking system as a whole. The major exception was the run on all banks in late 1932 through early 1933, which caused the banking system to grind to almost a complete halt and substantially reinforced the economic crisis at the time. Although an exception, this event was so traumatic that it has colored analysis of bank runs and failures ever since." *See id.* at 77. With respect to the bank runs in Chicago, in June 1932 during the Great Depression, Benston et al. asserted that "these failures occurred primarily because of adverse local business conditions rather than because of spillover from other failed banks outside their market areas." *Id.* at 62.

[399] *See* Kaufman, *supra* note 347 at 8.

[400] *Id.*

returns, debt risk premiums, deposit flows or physical exposures for European, Japanese or emerging market countries have not been studied thoroughly. In the circumstances, there seems little empirical evidence on the potential for systemic risk in Europe. This may account for the fact that the appropriate data such as interbank lending for Europe is rare or virtually absent. Recent studies attempt to evaluate the threat of systemic risk in European banking employing correlations between stock returns of European banks and bank stock indexes, respectively, as interdependencies between banks.[401] Arguably, the results of these empirical studies show that the systemic risk potential has increased at the European arena, and that there exists a threat of systemic risk in European countries.[402] Nonetheless, to support this argument, further empirical and theoretical studies are needed.

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[401] *See* Martin. Schueler, *The Threat of Risk in Banking-Evidence for Europe,* ZEW Discussion Paper, No. 02-21 (2002) (calculating rolling-window correlations between bank stock returns of the 60 largest European banks, after controlling for national influences in bank stock returns); *see also* M. Schroeder & M. Schueler, *Systemic Risk in European Banking-Evidence from Bivariate GARCH Models* ZEW Discussion Paper (2003) (estimating bivariate GARCH models between excess returns of bank stock indexes of 13 European countries: first, testing for structural banks in 1994, as a consequence of the second banking directive, and the introduction of the euro in 1999, second, testing for the significance of a trend variable in the covariance equation of the GARCH model).

[402] *See* Martin Schueler, *How do Banking Supervisors Deal with Europe-wide Systemic Risk?,* ZEW Discussion Paper, No. 03-03, at 5 (July 21, 2003), available at http://papers.ssrn.com/abstact_id=412460 (last visited Feb. 1, 2004).

As noted above, the results of existing econometric tests for bank contagion effects are still limited to data for the United States. Thus, there is a need for more empirical research on other financial systems to identify the significance and character of bank contagion in terms of systemic risks, but this agenda may encounter any challenges on account of the adoption of safety nets in a number of countries. Historical experiences of bank failures in terms of systemic risk are demonstrated below.

d. Historical Experiences

i. The Collapse of Bankhaus Herstatt in 1974

In 1974, the world economy experienced a traumatic distress due to a catastrophic combination of the sharp increase in oil price, a sharp rise in interest rates on the sovereign loans, a global recession, and exchange rate volatility. In particular, the new regime of floating exchange rates brought about a new problem: exchange or currency risk.[403] Since

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[403] *See* Kapstein, GOVERNING THE GLOBAL ECONOMY: INTERNATIONAL FINANCE AND THE STATE, supra note 209, at 38 (noting that "[i]ndeed, it is somewhat ironic that flexible exchange rates increased [the] mutual sensitivity to bank failures…"). That is to say, economists and central bankers expected that the new regime did the opposite when it came to macroeconomic policy: under fixed rates, central bankers had little

the early 1970s and the collapse of Bretton Woods, banks and all other players in the international financial market have been exposed to new levels of exchange rate or currency risk.[404] That is, all the entities participating in the international financial markets have been necessitated to catch up with the probability of unforeseen changes in exchange rates such as sharp changes in the value of domestic and foreign money in the foreign exchange markets. In particular, bank traders sometimes responded to unanticipated exchange-rate changes by taking further positions in the hope of recouping losses. Moreover, the creation of innovative financial instruments has driven international financial markets toward the direction of a tremendous foreign currency movement. In order to satisfy the worldwide currency needs of their clients facilitating their international trade and business transactions, banks borrowed needed funds from other banks, both foreign and

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autonomy; their policies had to be formulated with respect to those being set abroad, in order to maintain the value of the currency; By contrast, under floating rates, it appeared that economic policies could be set independently, as long as the government and central bank were willing to accept the change rate consequences. In this context, one argues that interdependence has crucial implications for both macroeconomic and banking policy. *See generally* Robert M. Dunn Jr., *The Many Disappointments of Flexible Exchange* Rates, Princeton Essays in International Finance (1983).

[404] Kapstein notes that foreign exchange trading paused two risks to banks: credit risk and currency risk. The former arises when a purchaser of foreign exchange contract, usually a bank would not pay after receiving foreign exchange, as shown in the collapse of the Herstatt Bank of Germany in 1974. The latter arises from unhedged currency movements. That is, a bank suffers tremendous losses when it is in an unhedged position in a currency with a bad bet as was the Franklin National Franklin Bank in 1974. *See* Ethan B. Kapstein, *Resolving the Regulator's Dilemma: International Coordination of Banking Regulations,* INT'L ORG. Vol. 43, No. 2 (Spring 1989), at 334.

domestic through interbank market because they kept little foreign exchange in their vaults.[405] In this context, the growth of foreign exchange trading has propelled the international interdependence of banking industry. [406]

Whereas banks recognized the potential profits in the sharp currency movement, thereby playing a more speculative game with a bad bet, a number of banks and financial institutions suffered tremendous losses by failing to hedge against foreign exchange exposures or in direct foreign currency tradings due to their inexperience to manage currency risk. As a result, bank failures at the domestic level would spread overseas and led to the financial problems at the regional and international arenas, because bank supervisors and regulators were not aware of the remedies coping with this type of risks.[407]

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[405] *See* Kapstein, Governing the Global Economy, *supra* note 209, at 38.

[406] *See id.*

[407] In dealing with this unprecedented risk, three types of controls were implemented by responsible management of a bank to restrict the excessive speculation of its foreign exchange department and to ensure its fulfillment of careful analysis of borrowers. Firstly, establishing definite limits on the bank's position in various foreign currencies; secondly, internal controls to ensure such limits were honored; finally, a credit analysis system to ensure borrowers' repayment of their foreign exchange loans. However, these seemingly simple measures to design in theory were not successfully executed in practice. This was due to the facts that bank managers could not but respect account officers' efforts to increase their foreign exchange limits to satisfy the demands of clients, and that during the early 1970s, bank managers could not get real-time data on the institution's foreign exchange position under the internal accounting and operating systems of banks. Furthermore, banks could not easily protect themselves from fraudulent attempts by some account officers and traders to benefit from the bank's foreign exchange book. *See* Kapstein, *supra* note 209, at 38-39.

It took only one year to draw global attention to focus on the need to deal with a bank failure driven by this risk after the adoption of floating exchange rate system.

The collapse of Bankhaus Herstatt in Cologne, Germany in June 1974 due to the severe changes in foreign exchange trading conditions had the most significant impact on the rest of world, whereas a number of banks suffered the heavy foreign exchange losses.[408] Herstatt, a medium-sized commercial bank in Cologne, West Germany, was founded in 1955, and had over 50,000 customers and assets over DM2 billion after less than 20 years. As a major player in the foreign exchange market, Herstatt had been notorious for overtrading, taking foreign exchange trades that were very large relative to its capital. In particular, Herstatt had been wildly speculating on the direction of a currency movement in the foreign exchange markets, borrowing in different currencies from banks around the globe, and it had lost the speculative game. As a consequence, Herstatt had suffered tremendous losses in foreign exchange tradings, which the bank's foreign exchange

[408] *See* John Cooper, THE MANAGEMENT AND REGULATION OF BANKS 6, 23, 241 (1984); *see also* Richard Dale, THE REGULATION OF INTERNATIONAL BANKING 156-157(1984).

department had concealed with its fraudulent bookkeeping.[409] In short, Herstatt's fraud, and incompetence to deal with the risks it took in the foreign exchange market led to the huge losses that expedited its collapse.

Upon discovering Herstatt's fraudulent concealing of exchange losses[410] exceeding half the book value of its assets, and its insolvency, the German Banking authorities abruptly revoked Herstatt's license, stopped clearing payments for Herstatt's accounts, and closed the bank on June 26, 1974 at the close of business (4:00 PM). The timing of the closure left uncompleted a large number of payment commitments in the amount of millions of dollars of spot foreign exchange transactions, which had been entered into two days earlier,[411] thereby taking several months to unravel the ensuing tangle.[412] By the time the

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[409] *See id.*

[410] Herr Daniel Dattel, the Chief Foreign Exchange Dealer at Herstatt was responsible for the exchange losses that exceeded $200 million at the time of the closure. *See Outrageous Consequences of Bundesbank's Over-hasty Reaction,* International Currency Review, Vol. 6, No. 4 (July-August 1974), at 21.

[411] Herstatt's capital losses were estimated to be in excess of DM 1.2 billion as a consequence of excessive uncovered foreign exchange conditions and bad debts. *See* H.J. Muller, *The Concordat: A Model for International Cooperation,* Paper presented for the International Conference of Banking Supervisors (London, July 5-6, 1979), at 65.

[412] Due to the lack of clarity in several legal issues, the number of parties involved, and the complexity of the transactions, it took approximately 11 months of negotiations among all the pertinent creditors to reach an agreement and distribute available funds. Notably, all the pertinent parties sought an out-of-court settlement although legal actions also aimed at the establishment of who owed to what to whom, and thereby disbursing of Herstatt funds held in New York. Interestingly, authority to close a bank in West Germany rests with the Bundesbankaufsichtsampt fuer das Kreditwesen rather than the Bundesbank, the Gernan central bank. Even though the Bundesbank did not apparently played any role in the Herstatt's debacle, it was the target of

bank was closed in Germany, it was still during business hours in New York (10:00 AM), and London (3:00 PM). Herstatt's global correspondents had paid Deutschemarks to Herstatt to fulfill maturing foreign exchange contracts at the end of German business day in the expectation that they would receive US dollars later that day at the close of business in New York. When Chase Manhattan, Herstatt's New York correspondent received a notice of the closure, Herstatt declined to honor $620 million in payment orders and checks drawn on its account. The German banking authorities' abrupt closure of the bank aborted the settlement of millions of dollars of foreign exchange contracts caused the New York's counterparties' exposure to the full value of DM deliveries made, and thereby leading to the collapse of the United States clearing and international banking systems.[413] As it is known

litigation on charges negligence for clearing for Herstatt during the few hours between the closure of negotiations between Herstatt and the Bundesbankaufsichtsampt fuer das Kreditwesen and the actual revocation of the bank's license. The litigation was not successful since the Bundesbank owed no particular duty to the plaintiffs. All creditors, including depositors with accounts over $7,500 lost money as a result of the collapse, since the deposit insurance scheme did not exist in Germany at this time. *See* E. Gerald Corrigan, The Statement Before the U.S. Senate Committee on Banking, Housing and Urban Affairs (May 3, 1990), at 17-18, 20-21.

[413] The international financial community experienced payment problems. The problems are dislocations in the Clearing House Interbank Payments System (CHIPS), which is the most significant large dollar clearing system had to be shut down while Herstatt's settlemt debts were declined to cover by German authorities. That is, New York's corresponding banks, for their own or customers' accounts, would decline to make payments until they received confirmation that countervalues had been received. As a result, large balances held in New York's correspondents were not covered. Since large international payments are made through the mechanism of the CHIPS in New York, the incompletion of payments led to in a chain of reaction of

as "Herstatt Risk"—the time lapse between payment of foreign currencies and the receipt of US dollars in foreign exchange transactions: cross-border settlement risks for banks—, the corresponding dollar payments were left unsettled in New York, while the DM portion of these transactions had been transferred to Herstatt.

Also, the Herstatt failure triggered the crucial tiering of interbank interest rates, with premiums as high as 200 basis points charged to even the largest banks and less credit-worthy borrowers excluded from the market effectively. As a consequence, the international liquidity was reduced sharply due to the mobility of funds from the Euromarket to domestic markets and lenders discriminated against borrowers. Moreover, the global economy encountered dislocations in the international interbank sector of the Eurocurrency market because of the lack of information about the allocation of spot transaction losses and the expectation of prospective losses on forward transactions with Herstatt. This credit crisis caused by the absence of reliable information regarding the exact nature and extent of losses incurred to Herstatt and the counterparties triggered

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nonpayment under a tightly linked system. The daily clearing drop was estimated to be $24 billion from the usual $60 billion to average $36 billion over the three days after the collapse.

market participants' withdrawal of credit lines from banks that could sustain counterparty losses involved whether they had dealt with Herstatt directly or not. A number of banks had to pay far above the current London Interbank Offer Rate whereas others could not borrow at all.[414]

In the meantime, the German banking authorities faced harsh criticism in the wake of the Herstatt debacle.[415] The controversies ran over the negligence of the German regulatory authorities. It is argued that the German central bank, the Deutche Bundesbank should have honored Herstatt's debts, and intervened in the foreign exchange markets in order to support less credit-worthy banks, which had been shut out. That is to say, if the German authorities had waited to the closure of business in New York before closing the Herstatt, the counterparty losses would have been greatly reduced. Thus, the counterparty losses arose from the asynchronous exchange in payment systems due to differences in time zones rather than Herstatt's exchange losses.[416] It deserves noting "much of the spillover form the Herstatt Bank to other banks from these transactions represents more of a

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[414] *See* Herring & Litan, *supra note* 64, at 96.
[415] *See* Kapstein, Governing the Global Economy, *supra* note 209, at 40.
[416] *See* Kaufman, *supra* note 347, at 10.

government risk than a market risk."[417] In this respect, there was arguably no other bank's failure as a consequence of the Herstatt collapse.[418] In response to the critics, the German authorities justified their actions by stating their intent to give a lesson to both bank dealing with speculators and speculators.[419] Ironically, the Germans established subsequently a new set of regulations coping with foreign exchange trading, which reflected some self-criticism on the part of the German banking authorities.[420]

The Herstatt failure highlighted the need for bank regulators and supervisors cooperative efforts toward keeping pace with the expansion of international banking and the growing interdependence of financial markets. In this regard, the Herstatt collapse compelled banking supervisors in different countries to regularly correspond with one another, and share necessary information, which would soon become the formalized process by the

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[417] *See id.* at 11. Notably, in a number of countries, evidence of contagious systemic risk in banking is frequently confused with crises arising from the freezing, confiscation or devaluation of deposits (either in domestic or foreign currency) or the defaulting on bank held government securities by governments. That is to say, the bank problems frequently arise from the use of the banks by the governments to pursue their nonbanking policies rather than from the actions of the banks themselves in their banking activities. These crises may be referred to as government created crises rather than bank created crises. *See* Kaufman & Scott, *supra* note 358, at 14. As shown in the recent Russian crisis, the crises almost always reflect notorious abuses that were permitted if not endorsed by government, and the government's incompetence to resolve banks' insolvency in a timely and efficient manner. *See* Mark Whitehouse, *Frustration soars for Russian bank depositors.,* Wall Street Journal, April 8, 1999, at A14.

[418] *See id.*

[419] *See* E. P. Davis, *Instability in the Euromarkets and the Economic Theory of Financial Crisis,* Bank of England Discussion Papers 43 (October 1983), at 3.

[420] *See* Kapstein, Governing the Global Economy, *supra* note 209, at 40.

Group of Ten central bank governors.[421] The aftermath of the foreign exchange related losses suffered by the Herstatt debacle and the closure of Franklin National in New York in 1974[422] triggered the establishment of the Basel Committee on Banking Supervision.[423] That is, it is widely recognized that the establishment of the Basel Committee resulted from

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[421] *See id.* at 41. In spite of banking crises of the Herstatt failure and the Frankilin National's collapse, and the growing interdependence of financial markets, the Group of Ten central bank governors' meeting in July 1974 at the Bank for International Settlement (BIS) could not answer the troubling question of whether emergency liquidity assistance would be available to banks active in the international interbank market. The meeting could not reach an agreement on which central bank would provide lender-of last-resort assistance to banks, in what amount, and under what condition. By contrast with the United States, the Germans would not explicitly state for some reasons: firstly, the Deutsche Bundesbank did not have the formal lender-of-last-resort powers, which were authorized by a Liquidity Consortium Bank established in response to the Herstatt failure; secondly the Bundesbank declined any commitments to providing emergency liquidity assistance to failed banks due to illegal or highly risky activities because it considered central bankers' making explicit commitments as moral hazard. *See* Joan Spero, THE FAILURE OF THE FRANKLIN NATIONAL BANK 154 (1980). Under the circumstances, the uncertainty over whether the lender of last resort would operate can also destabilize and precipitate the systemic crisis, whereas it may intensify market discipline over some banks. Otherwise, market discipline is weakened in proportion with market participants' expectation of the central banks to come to the rescue. Shortly, the vagueness cannot accomplish the two apparently designed objectives: ensuring market discipline and reducing systemic risk. *See* Herring & Litan, *supra* note 64, at 97-98. Despite the disagreement on emergency liquidity assistance for international banks, the central bank governors recognized the growing interdependence of financial markets, the necessity of cooperation among bank regulators and supervisors around the globe.

[422] On May 10, 1974, the twentieth largest bank in the Unites States, the Franklin National suffered a series of deposit runs following substantial losses in foreign exchange trading entailed by its book-keeping malpractices. Owing to the bank's aggressive expansion, the bank encountered a number of difficulties including excessive gearing, aggressive maturity mismatching, and bond trading, speculation on interest rate movements, poor asset quality, over-dependence on purchase funds and foreign exchange losses. The Federal Reserve authorities' fear that the failure of the Franklin National could drive a nationwide depositor run, and an international banking crisis led to support the ailing institution. However, the bank was closed on October 8, 1974 although as lender of last resort the Fed provided the bank with more than $1.7 billion in funds. The Fed took over the bank's foreign exchange operations under the guarantee that the Franklin National would not leave its foreign creditors unpaid as did the Herstatt. The Federal Reserve also acted to prop up the bank's London branch, extending the lender-of-last-resort provision overseas. In the meantime, it must be noted that the bank was already in big trouble as to its domestic and international operations. At the domestic level, the Franklin National had suffered from weak management, a weak loan portfolio, poor investments and heavy reliance on short-term funding. At the international level, the bank faced a remarkable decrease in its earnings, and a massive liquidity problem resulting from the heavy foreign exchange losses. *See* Kapstein, *supra* note 209, at 41-42; *see also* Walker, *supra* note 203, at 26-28.

[423] *See* Kapstein, *supra* note 209, at 44-48; Herring & Litan, *supra* note 64, at 98-101; *see also* Walker, *supra* note 203, at 35-39, 155-156.

the aftereffect of the Herstatt and Franklin National's fraud, and incompetence to deal with foreign exchange risk and the fear of contagious systemic risk leading to a global banking crisis. However, as pointed out in the next sub-chapter, the crucial point to note is that the creation of the Basel Committee arguably resulted more from hegemony of the most highly industrialized countries in terms of hegemonic stability than from their concerns over systemic risk leading to a global banking crisis.

ii. The Failure of Continental Illinois Bank in 1984

The collapse of the Continental Illinois Bank, the seventh biggest bank in the United States, with total assets in excess of $40 billion in May 1984 provides a model case of a bank that had combined high leverage with a risky portfolio in its reckless pursuit of market share, and also provides some measures of the potential for financial knock-on effects.[424] Prior to the failure, 2,299 banks had credit exposures to the Continental Illinois, the largest correspondent bank in the country. The bank management's failure in its job of asset and

[424] *See* Kapstein, *supra* note 209, at 108-109.

liability management brought about rumors about asset quality leading to institutional investors' withdrawals of their deposits.[425] Despite the emergency infusion of Federal Reserve cash in response to the bank's request for a $6 billion injection of the Fed funds to meet its immediate obligations, the bank collapsed, and a federal bailout followed.[426]

Since the Federal Deposit Insurance Corporation (FDIC) fully protected the creditors at the time, no bank suffered any losses.[427] Even though all creditors had not been fully

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[425] *See id.* at 109. Public announcements of millions of dollars of losses due to bad domestic oil loans triggered depositors and creditors into a run on the bank. That is to say, the Continental Illinois' problems were traceable to large anticipated loan losses in the bank's loan portfolios for energy, agriculture, and heavy industry. What is worse, a senior loan officer had purchased many bad loan participations from Penn Square Bank after receiving a large personal loan from that bank. As a consequence, rumors about the bank's problems started to circulate within the financial community, which caused the bank to lose $4billion in deposits in three days. *See* Kidwell et. al., *supra* note 313, at 379, 493.

[426] *See* Kapstein, *supra* note 209, at 109. In the aftermath of the Continental Illinois debacle, the Federal Reserve wanted the banks to make their every effort to strengthen their balance sheets though the financial markets before any of them had to ask for the federal government's assistance. One source of the Continental Illinois problems at this time is that the off-balance-sheet items accumulating in big institutions were not considered under the fixed capital-to-asset ratio scheme which required banks to hold $5.50 of capital (defined as shareholders' equity and the loan-loss reserve) for every 100 of assets regardless of the asset quality or the type of asset held. As a consequence, U.S. bank regulators and supervisors began to search for a new capital adequacy standard as illustrated in detail in the next chapter. *See id.* at 110. Also, the debacle led to a wide scale reexamination of the management practices of large money-center banks. *See* Kidwell at. al., *supra* note 313, at 379.

[427] *See* Kaufman & Scott, *supra* note 358, at 10. Bank regulators responded promptly to the problems: firstly, the Federal Reserve provided the bank with discount-window loans. Next, the Federal Deposit Insurance Cooperation (FDIC) guaranteed all the deposits of the bank's depositors and creditors (not just those with deposits up to $100.000). Thirdly, $1.5 billion was added to the bank's declining capital base by the FDIC. As the bank's subsequent bailout, the FDIC provided open bank assistance with a full protection of all the bank's creditors and depositors, but left the original stockholders with practically nothing. However, deep criticism has run on these regulatory measures. In short, the FDIC seemingly preferred the arrangement of purchase and assumption transactions at the time of a large bank's failure to liquidate it for many years. Then, at the time of the Continental Illinois debacle in 1984, the "too big to fail" policy produced a two-tiered banking system. Thus, federal regulators guaranteed 100 percent of deposits of all the bank's depositors to be paid irrespective of how large the deposit size was or how poorly the bank performed. This policy to resolve the Continental Illinois failure was also implemented in conjunction with other large banks' failures. *See* Kidwell et. al., *supra* note 313, at 486, 493-494.

protected, the losses would not have been very much.[428] That is, some 1,325 banks exposed to less than $100,000, and were thus fully insured by the FDIC. In spite of the remainder's exposure to some risk, according to a study of the staff of the House Banking Committee, only 27 banks would have suffered losses in excess of their reported capital and insolvent, if the Continental Illinois' loss had been as large as 60 cents on the dollar (a recovery rate on assets of only 40 percent), which was more than ten times either the estimated loss or the actual loss as of the time of its resolution.[429] These losses would have been just $137 million. Another 56 banks would have suffered losses equal to between 50 and 99 percent of their total capital in an amount totaling $237 million. According to the study, no bank would have suffered a loss greater than its capital, and only two banks would have suffered losses in excess of 50 percent of their capital, if the Continental Illinois' loss had been as large as 10 cents on the dollar, more than twice the actual loss.[430] This study shows that banks had apparently acted for the protection of themselves through

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[428] *See id.*
[429] *See* U.S. Congress, House of Representatives, Subcommittee on Financial Institutions, Supervision, Regulation, and Insurance, Hearing (1984), Inquiry into the Continental Illinois Corp. and Continental Illinois National Bank (98-11), 98th Cong. 2nd Sess., September 18-19.
[430] *See id.*

limiting their uninsured exposures to their capital and monitoring their positions carefully.[431] Moreover, it seemed that no bank with insured deposits at the Continental Illinois would have collapsed if these deposits had been uninsured.[432] Arguably, with regard to banks, at least in the United States, there is little evidence of contagious systemic risk that causes economically solvent banks to become economically or legally insolvent, either before or after the introduction of federal government guarantees and insurance.[433]

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[431] *See* Kaufman & Scott, *supra* note 358, at 10.

[432] *Id.* The Continental Illinois case required regulators to note more strict regulations for two reasons: Firstly, as a result of the bank failures of the 1970s and early 1980s, Congress was losing confidence in their supervisory capacities, given their recent track record, and would demand new regulations; secondly, otherwise, an undesirable message might be transmitted throughout the banking community. The regulators did not want bankers to misunderstand that the Federal Reserve's saving the seventh-largest bank would be extended to save any large institution irrespective of the quality of its management and the standard of its loan portfolio. Moreover, they did not want observers to infer that the United States was now willing to provide emergency liquidity assistance for the banks out of their third world debts without any satisfactory adjustment on the part of banks because they were apparently concerned about the moral hazard problem. *See* Kapstein, *supra* note 209, at 109.

[433] *See* Kaufman & Scott, *supra* note 358, at 8. According to Kaufman and Scott, the evidence strongly suggests that "in the absence of de-jure deposit insurance, depositors and other bank creditors take sufficient protective action on their own to greatly reduce the probability both of losses to themselves and of spillover to other banks. The externality of contagion appears to be price by the market. This conclusion holds even when there appears to be some positive probability that some or all the effected claimants may be ex-post partially or totally protected de-facto. It is also likely that the event stronger protective actions would have been taken by most bank stakeholders in the absence of regulations or other regulatory actions that project a perception of safety." *See id.* at 14. In this context, it should be noted that the financial safety net usually exists de facto, if not de jure, even in countries with no formal deposit insurance scheme in place nor an official discount window facility at the central bank. Under the protection of a government safety net, a number of countries have adopted deposit insurance schemes to protect depositors from losses resulting from bank failures. Furthermore, central banks operate as a lender of last resort either by giving liquidity assistance to an individual bank or by maintaining liquidity to the system as a whole. Some highlight that the safety net has its reason for being in reducing the likelihood of bank runs. *See* Douglas Diamond & Philip Dybvig, *Bank Runs, Deposit Insurance, and Liquidity,* JOURNAL OF POLITICAL ECONOMY, Vol. 91, No. 3 (1994), at 401-419. However, the scheme has a negative side-effect because of its creation of incentives for excessive risk taking by bank managers. Meanwhile, it should be note the difference between deposit insurance and bank bailout policies on a bank's risk-taking incentives. Under the deposit insurance scheme, a bank failure causes loss of shareholders' entire investment and managers' jobs. By contrast, a bank bailout with taxpayers' funds or

The Continental Illinois debacle is a significant case in both the international banking regulation and bank management practices in that a new regulatory approach with regard to bank capital was forming within the U.S. Federal Reserve system, whereas the debate over international banking supervision continued. In that context, some argue that "...an international agenda to strengthen the banking system emerged in 1983-84, not as collective solution to the third world debt crisis on the part of central-bank governors, but as an outcome of domestic politics in the United States."[434] At the time, bank capital was subject to critical scrutiny as a domestic political issue in the United States. In particular, the issue of bank capital had been an ongoing agenda item for the U.S. Congress as it

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through a last-lender-of-resort facility causes managers and shareholders to lose their stake in the bank only to the extent that this is required as a part of the rescue package (through management package or recapitalization). As a consequence, the point to note is that both deposit insurance and bank bailouts protect depositors, thereby eliminating their incentives to monitor and impose discipline on the bank, whereas expected rescues may provide bank mangers with incentives for risk-taking. Namely, bank managers will tend to take more risk than the creditors would accept if they were uninsured, because banks do not encounter the outcomes of investing in projects with highly expected returns other than high risks. As a consequence, the safety net can be a source of moral hazard. *See* George Berger, *Reforming Insurance and the Regulatory System: the Failure of the Middle Way,* THE CATO JOURNAL, Vol. 14, No. 2 (Fall 1994). Most governments are inclined to rescue a troubled bank, because the political pressure for the rescue is usually very strong. In this respect, the moral hazard tends to exist even without an official safety net scheme. Although limiting the size and scope of the safety net can reduce moral hazard problem in banking, moral hazard appears almost inherent to banking unless governments are expected to commit not to bailout failed banks despite the scheme. Moreover, some note that a positive level of moral hazard resulting from safety net schemes might be unavoidable or optimal to contain the systemic costs or monetary disturbances associated with financial crises. *See* Charles Goodhart & H. Huang, *A Model of the Lender of Last Resort,* L.S.E. Financial Markets Group Discussion Paper, No. 313 (1999), cited in De Bandt & Hartmann, *supra* note 346, at 25.

[434] *See* Ethan B. Kapstein, *Supervising International Banks: Origin and Implications of the Basle Accord,* Princeton Essays in International Finance, No. 185 (December 1991) at 12.

debated what to do about increasing the International Monetary Fund's quota since the debt crisis in 1982.[435] In the circumstances, the failure of Continental Illinois compelled American regulators to recognize the inadequacy of existing prudential regulations in the context of the myriad risks that banks encountered, and brought them the urgent attention on the need for a more comprehensive capital adequacy framework.[436] As discussed below, it must be noted that the U.S. Congress' concern over the competitiveness in response to U.S. commercial banks' argument of their loss in a relative competitiveness in relation both to foreign banks and nonblank financial institutions rather than their concern about the safety and soundness of the international financial system drove the internationalization of bank regulatory standards, particularly capital adequacy standards.

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[435] *See id.* at 14.

[436] *See* Glenn Tobin, INTERNATIONAL CAPITAL ADEQUACY NEGOTIATION: A CASE STUDY (1989), cited in Ethan Kapstein, *Between Power and Purpose: Central Bankers and the Politics of Regulatory Convergence,* INTERNATIONAL ORGANIZATION, Vol. 46, No. 1 (Winter 1992) at 277.

B. The Movement Toward Global Standards in Banking

As noted above, in the aftermath of financial disruption in international currency and banking markets suffered by the failure of the Bankhaus Herstatt and the closure of the Franklin National Bank in 1974, concerns over the need for uniformity in global banking standards began to spread among industrialized countries' bank regulators in the mid-1970s. The rationale for the standardization of unitary global banking standards was that even though banks were increasingly multinational and deregulated, monitoring and regulating cross-border banking practices remained the province of national regulatory and supervisory authorities. That is to say, it is widely recognized that a dramatic expansion and diversification of global banking activities posed challenges to national authorities in dealing with systemic risk, and maintaining the stability and soundness of banks incorporated in their home countries through domestic bank regulation, and thereby drove a movement toward uniform global standards in banking.

However, the significant point to note is that hegemony of the Western powers began a drive to move for the internationalization of bank regulatory standards in terms of

hegemonic stability more than their concerns about systemic risk leading to a global banking crisis. That is, the United Kingdom's concern over how to supervise a number of foreign banks active on her territory in the early 1970s was the most powerful driving force behind the uniformity of standards in banking. As a matter of fact, by the early 1970s, London had become a host to a group of multinational banks in search of regulatory refuge, particularly from the United States, thereby reestablishing itself as a hub of global finance, partly thanks to the financial deregulation that attracted foreign banks' activities with branches and subsidiaries in the city.[437] The presence of over two hundred foreign banks with branches in London raised a host of supervisory issue concerning who would become a lender of last resort in the event of financial disturbances.[438] Namely, the Bank of England wanted to make sure that these branches active in London would be rescued by their home country's central bank when the one of these branches failed. Furthermore, London confronted the increasing challenges from other financial centers for fresh

[437] *See* Kapstein, *Resolving the Regulator's Dilemma*, *supra* note 404, at 329; Kapstein, Supervising International Banks, *supra note* 434, at 5; *see also* Kapstein, Governing the Global Economy, *supra* note 209, at 44.
[438] *See id.*

investment from other banks in reestablishing itself as an offshore financial center, and unilateral regulation would have eroded this effort.[439]

In the circumstances, the United Kingdom as one of the international financial market powers played a key role in initiating a drive to move for the unitary global bank regulatory standards.[440]

1. The Creation of the Basel Committee

The aftereffect of banking crises of 1974 fueled the United Kingdom's drive to search for the regulatory and supervisory mechanism monitoring and regulating the complex cross-border lending and borrowing activities of multinational banks. That is, at that time the Bank of England's first concern was to address problems with the current domestic

[439] *See* Kapstein, *supra* note 404 at 329, n.16.

[440] The Bank of England had already witnessed financial disturbances of the fringe banking crisis in Britain resulting from a number of virtually unregulated regional banks' borrowing hot money (short-term funds with floating interest rates) and long-term lending at fixed rates to support various real estate projects. *See* Kapstein, *supra* note 209, at 42, 44.

bank regulation that could not cope with the regulatory avoidance and evasion by foreign bank branches and subsidiaries.[441]

At the same time, capital-exporting countries were concerned about the potential threat to international financial systems in the aftermath of financial disturbances in 1974. In this regard, the central bank Governors of the Group of Ten industrialized countries undertook two courses of corrective action. The Governors initially issued a support Communique to attempt to stabilize the markets while a separate standing committee on regulatory and supervisory practices was formed to report to the Governors on the development of possible preventive measures against the repercussion of similar crises in the future. The Governors at their meeting in July 1974 at the Bank for International Settlements (BIS) in Basel raised concerns about the stability of foreign exchanges and Euro dollar markets, and

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[441] With respect to the allocation of supervisory responsibility, the position of the United Kingdom was that the Bank of England was concerned with its unaccountability for the costs of having to extend support operations to all foreign banks operating out of London or elsewhere within the United Kingdom, whereas the Bank of England was prepared to support the UK banks' activities at home and overseas despite limited resources. By 1974, the Bank of England adopted an express policy of parent undertaking and parent country responsibility, which applied both to the branches of overseas banks operating within the United Kingdom and to wholly owned subsidiaries and consortia. With the presence of a number of foreign banks in London, the Bank was concerned to ensure that the parent undertakings and parent authorities assumed a certain degree of responsibility in connection with the overseas operations of their banks, and that the Bank did not have to bear sole responsibility for the financial support of such institutions in the event of difficulties. Due to the lack of a cost allocation mechanism, the Bank had to attempt to develop this combined parent undertaking and parent country control argument in that it could not assume an unlimited liability associated with the foreign banks to which it was host in the event of a number of large foreign operations in the UK. *See* Walker, *supra* note 203, at 33-34, 94-97.

bank liquidity. However, the disagreement between the United States and West Germany over central banks' provision of lender-of-last-resort to troubled banks caused smaller banks and consortia banks to lose access to funds in the interbank market. In response to the national market operators' pressure on them for a stronger support commitment, the Governors declared their commitment to maintaining the stability of the markets in order to recover the market order and prevent further bank failures in the Communique of September 1974.[442] Although the statement did not expressly mention the establishment of new international lender of last resort facility, it seemed that the Governors acknowledged the effect.[443] In that context, one observer highlights the coordinated action among states for the effective and stable operation of the new financial markets.[444]

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[442] The content of the Communique is as follows: "At their regular meeting in Basel on September 9th, 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 noted recent improvements in these fields in a number of major countries. They agreed to intensify the exchange of information between central banks on the activities of banks operating in the international markets and, where appropriate, to tighten further the regulations governing exchange positions. The Governors also had an exchange of views on the problems of 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." *See* Joan Spero, THE FAILURE OF THE FRANKLIN NATIONAL BANK 154 (1980); S. Solomon, THE CONFIDENCE GAME : HOW UNELCTED CENTRAL BANKERS ARE GOVERNING THE CHANGED WORLD ECONOMY 117 (1995).

[443] *See* E. P. Davis, *Instability in the Euromarkets and the Economic Theory of Financial Crisis,* Bank of England Discussion Papers 43 (October 1989) at 19 (noting that this move did not guarantee the automatic lender of last resort intervention but indicated the central bankers' willingness of intervention in a crisis). *See*

In addition to the issuance of the September 1974 Communique, the G10 governors reached an agreement to form a working group of supervisors to develop appropriate rule and guidelines for the supervision of international banking markets.[445] As a matter of fact, the establishment of the new working group was initiated by the Governor of the Bank of England Gordon Richardson who recognized the need for greater cooperation among bank supervisors and the Bank's requirement for more information from home country supervisors as to the activities of foreign banks with branches and subsidiaries in London.[446] Richardson's idea of establishing the Standing Committee on Banking Regulation and Supervisory Practices, now known as "the Basel Committee" which was comprised of representatives from G10 countries along with Luxembourg and Switzerland

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also Kapstein, *supra* note 209, at 43 (arguing that "[y]et it is by no means clear that all the central bankers present had agreed to provide what their commercial bankers saw as a lender-of-last-resort facilities").

[444] *See* Walker, *supra* note 203, at 33 (noting that "[a]s this was a carefully drafted compromise statement of no specific intent, it could not be regarded as representing the conclusion of any clear agreement between all of the parties concerned. It did, however, confirm that countries could no longer act in isolation with regard to such matters and that, in future, more considered and co-ordinated action would be required in such an important area of national and international concern as the effective and stable operation of the new financial markets which had emerged during the 1960s and 1970s").

[445] Understandably, the Governors agreed as follows: "The Governors of the Group of Ten at their December Meeting at the BIS, discussed the problem of assuring the solvency and liquidity of banks, basing themselves on a summary report prepared by the BIS... To carry further the work in this field, and to prepare for future discussions among themselves, the Governors decided to establish a new Committee to be made up of two experts from each country, one from the supervisory and one from the foreign exchange side. The Committee will take as its starting point the BIS Summary Report and will give particular attention to the need for an early warning system. It was noted that from this point of view the quality of supervision is at least as important as the regulations themselves." *See id.* at 35-36 n.82.

[446] At that time, bank supervisors in any country had difficulty assessing a bank as a whole because banks did not provide the consolidated statements of their activities. *See* Kapstein, *supra* note 209, at 44.

was accepted by the G10 bank central governors at their meeting in December 1974.[447] That is, the initiative for the creation of the Basel Committee had arisen from the city of London. As a consequence, the Bank of England took the lead role in arranging the secretariat for the Committee, and providing senior officials of the Bank for the first two Chairman of the Committee (George Blunden 1974-76, Peter Cooke 1977-88).[448]

As noted above, since London's financial system had been dominated by international banks, particularly the US banks by the early 1970s, British regulatory and supervisory had good reasons to be concerned about systemic risk in the aftermath of banking crises in 1974. Moreover, any unilateral regulatory attempt to cope with international banks would plunder London of its reputation as a good place for banking activities.[449] As one observer notes, London's two apparently irreconcilable objectives had to be accomplished: first, the maintenance of London's reputation for regulatory flexibility and the competitive

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[447] *See id.* It deserves noting George Blunden's statement that the Basel Committee "was established in 1974 by the Governors of Group of Ten, shortly after they had agreed that it was the duty of central banks to provide lender-of-last-resort facilities to their national banks to support their euro-currency operations." *See* George Blunden, *International Co-operation in Banking Supervision,* Bank of England Quarterly (Sep. 1977), at 326.

[448] *See* Kapstein, *supra* note 404, at 329 (noting the Bank of England's lead role in formation of the Standing Committee in terms of hegemonic stability).

[449] *See id.*

advantages arising from that, second, the reduction of systemic risk.[450] As a result, "[t]he solution lay in a multilaterally coordinated approach that could produce a set of standards all could live with."[451] In the circumstances, the bank of England was concerned to ensure the allocation of responsibility in the market support operations and appropriate division of supervisory and regulatory liabilities. Without any formal allocation rule, the Bank would have been responsible for the supervision of all domestic and foreign banks' activities in the United Kingdom and the costs of any necessary support operations as well. In this regard, it is noteworthy the efforts toward the agreement on allocation rules for supervisory responsibility and lender of last resort liability. A basic principle of shared responsibility based on the principle of parent country control with an enhanced role for the host authorities was adopted instead of the espousal of a pure home or host country control.[452] As reviewed below, the Basel Committee formulated its first major initiative known as the Basel Cocordat of 1975, concerning guidelines for consolidated supervision by home

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[450] *See* John Braithwaite & Peter Drahos, GLOBAL BUSINESS REGULATION 104 (2000).
[451] *See id.*
[452] *See* Walker, *supra* note 203, at 84-136. As pointed out below, under the original 1975 Basel provisions, the host rather than the parent country was to be responsible for the solvency of a subsidiary although this was subsequently reversed in 1983. *See id.* at 86-109.

countries and host countries of the foreign activities of banks in response to the Herstatt Collapse.[453]

Indeed, by the early 1970s, the G10 central bank governors developed a highly sophisticated but essentially personal network of consultation and cooperation. However, this had been traditionally based on contact related to purely monetary and economic matters.[454] Furthermore, the Governors meetings did not pay heed to national bank supervision whereas national regulatory and supervisory authorities considered developments unfolding in international financial markets to be irrelevant.[455] In this context, arguably, not until the establishment of the Basel Committee in 1974, would bank regulatory and supervisory issues be emerging as the issue of national and international issue.[456]

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[453] *See id.* at 86-100. Walker stresses the evidence of coordinated activity secured in relation to the management of the Franklin National failure although the major catalyst for establishing the Basel Committee was the collapse of the Bankhaus Herstatt and the Committee's supervisory model, the European Community Contact Group (the Contact Group). At the time of the National Franklin's difficulties, the Western financial community has already coordinated on an *ad hoc* basis between particular national agencies and through the meetings of the Governors of G10 countries in Basel with regard to the coordination of monetary and economic matters. *See id.* at 38.
[454] *See id.*
[455] *Id.*
[456] *See id.*

2. The Establishment of Bank Supervisory Standards

a. The Basel Concordat

Following the Herstatt collapse in 1974 and the Franklin National failure of 1975, the Basel Committee issued a paper, subsequently known as the Basel Concordat outlining some principles in the form of recommended guidelines of best practice regarding the supervision of banks operating internationally through branches, subsidiaries, and joint ventures.[457] The Committee's aim was that no international banking establishment should escape adequate supervision. The Concordat specifieses five basic principles[458]

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[457] See Basel Committee on Banking Supervision, Basel Concordat on Principles for the Supervision of Bank's Foreign Establishments. The original Basel Concordat was not released to the public until March 1981. It was reproduced by the IMF as an Annex ("Supervision of Banks' Foreign Establishments") to William and Johnson's paper, "International capital Markets: Recent developments and Short-term prospects." See IMF Occasional Paper No. 7 (1981); see also R. C. William & G. G. Johnson, International Capital Markets: Recent Developments and Short-Term Prospects 29-32 (Aug. 1981). The Basel Concordat was a set of guidelines on bank supervision reached by consensus among the banking regulators of the Committee's member states. The Basel Committee titled the document a 'concordat' to indicate the agreement had no legal force of the treaty. See id.

[458] The Basel Concordat of 1975 provided five basic principles to bank regulatory authorities for international banking supervision:
(1) The supervision of foreign banking establishments should be the joint responsibility of host and parent (home) authorities; (2) No foreign banking establishment should escape supervision, each country should ensure that foreign banking establishments are supervised, and supervision should be adequate as judged by both host and parent authorities; (3) The supervision of liquidity should be the primary responsibility of host authorities since foreign establishments generally have to conform to local practices for their liquidity management and must comply with local regulations; (4) The supervision of solvency of foreign branches should be essentially a matter for the parent authority. In the case of subsidiaries, while primary responsibility lies with the host authority, parent authorities should take account of the exposure of their domestic banks' moral commitment in this regard; and (5) Practical cooperation would be facilitated by transfers of information between host and parent authorities and by the granting of permission for inspections by or on behalf of parent authorities on the territory of the host authority. Every effort should be made to

delineating the supervisory responsibilities of home and host countries' bank regulators in overseeing banking institutions that operate on a transnational basis. It emphasized that all banks operating in host countries should be supervised by both the home country's and host country's supervisory authorities.[459] The Concordat mainly concerns liquidity, solvency, and foreign exchange positions. That is, it recommended that the host country's authority is primarily responsible for the adequacy of the foreign bank's liquidity.[460] In turn, the home country's supervisory authority should take primary responsibility for the solvency of home country's bank operating in a foreign country.[461] Under the Concordat foreign subsidiaries were to be primarily subject to the host authorities whereas foreign braches were considered as indistinguishable from a parent bank as a whole.[462] Its final principle emphasizes the need for cooperation between home and host country regulatory authorities in removing existing legal restrictions on the transfer of confidential information for

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remove any legal restraints (particularly in the field of professional secrecy or national sovereignty) which might hinder these forms of cooperation. See id.

[459] See Basel Committee on Banking Supervision, Report to the Governors on the Supervision of Bank's Foreign Establishments (September 1995).

[460] See id.

[461] Id.

[462] See id.

effective supervision.[463] Despite its making a positive step toward international cooperation of banking supervision, the Concordat failed in keeping up with various international banking activities, thereby being revised in 1983.

b. 1983 Revised Concordat

In response to financial crises arisen from the Latin American sovereign Debt Crisis and the Banco Ambrosiano failure,[464] the Basel Committee issued a revision of the 1975 Concordat in 1983 for the purpose of promoting consolidated supervision on a transnational basis. The 1983 Revised Concordat adopted new principles for the allocation of bank regulatory responsibilities between home and host authorities provided in the Principles for

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[463] Id.

[464] In 1983 Italy's largest private bank, Banco Ambrosiano SpA failed. As Ambrosiano was on the verge of a liquidity crisis, the parent regulatory authority (the Bank of Italy) initially honored the Ambrosianos's financial difficulties with the support of the state's largest commercial banks. However, the bank's illegal activities spurred the authority to move to close the bank due to the authority's inability to control loss of confidence. The problem arose because the 1975 Concordat applied only to 'banks'. Indeed, Ambrosiano had a financial holding company called Banco Ambrosiano Holdings SA that was incorporated in Luxembourg. Even if the holding company conducted the business of banking, it was beyond the reach of Luxembourg's banking regulations, because it was not considered as banks. To make matters complicated, Luxembourg's secrecy laws veiled Banco Ambrosiano Holdings' operation from the Bank of Itlaly. For the detail, see Kapstein, Governing the Global Economy, supra note 209, at 53-57.

the Supervision of Bank's Foreign Establishments.[465] The Revised Concordat focused on ensuring that no bank operating in a foreign country could escape adequate supervision, thereby developing the approaches of 'consolidated supervision'[466] and 'dual key'[467] supervision. Consolidated supervision expands the responsibilities of the home country's regulatory authority by requiring the home country's regulatory authority to monitor the total risk exposure and capital adequacy of the home country's bank.[468] The home country regulator is able to do so by reviewing the bank's total operations.[469]

When a host country sees a home country's supervision inadequate, the revised Concordat proposes two options. First, the host country could deny entry approval to an organization from a country that does not adequately supervise its own organizations.[470] Alternatively, it could impose specific conditions governing the conduct of the business of

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[465] Basel Committee, Principles for the Supervision of Bank's Foreign Establishments (May 1983), reprinted in (1993) 22 ILM 900, 901.

[466] 'Consolidated supervision' represents monitoring the risk exposure (including the concentration of risk, the quality of assets, and the capital adequacy) of the banking groups for which the home country authority takes responsibility on the basis of the totality of the business carried on. See id. at 905.

[467] 'Dual key' supervision represents that the regulatory authority of each country concurrently evaluate the ability of other national authorities to supervise and carry out their respective responsibilities. See id.

[468] See id. at 905.

[469] Id. 904.

[470] Under the Revised Concordat the Basel Committee's key aim is to examine the totality of each bank's world-wide business on the basis of consolidated supervision. See Revised Concordat, 22 ILM 901.

foreign banks to operate in the host jurisdiction.[471] Where a host country does not have an adequate supervision, the Revised Concordat urges the home country's regulatory authorities to discourage the home country's bank from expanding its operations into the proposed host country.[472] The rationale behind the dual key approach is to prevent countries from lowering supervisory practices in order to attract foreign investment and foreign capital.[473] Additionally, the Revised Concordat seeks to prevent structural features of international banking groups, such as holding companies from facilitating the evasion of supervision through lenient regulatory arrangements.[474] In response to the Ambrosiano failure, the Revised Concordat recommended that "where host authority supervision (Luxembourg) is inadequate, the parent authority (Bank of Italy) should either extend its supervision … or it should be prepared to discourage the parent bank (Banco Ambrosiano SpA) from continuing to operate the establishment (Baco Ambrosiano Holdings SA) in

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[471] See id.
[472] Id.
[473] See Duncan E. Alford, Basle Committee Minimum Standards, International Regulatory Response to the Failure of BCCI, 26 Geo. Wash. J. Int'l L. & Econ. 241, 253 (1992).
[474] Id. at 904.

question."[475] In 1990, the Basel Committee issued a supplementary document called Information Flows between banking Supervisory Authorities (Supplement) dealing with the practical aspects of implementing the 1975 Concordat, such as its authorization, information flows, bank secrecy, and external audit.[476]

c. The Response to BCCI: Minimum Standards for International Banking Groups and Their Crossborder Establishments

Although the Revised Concordat and the 1990 Supplement contributed to improving the bank supervisory standards that were initially set forth in the Basel Concordat of 1975, the existing significant gaps in the allocation of supervisory responsibilities led to the collapse of the Bank of Credit and Commerce International (BCCI)[477] in July 1991. The

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[475] See Basel Committee, Principles for the Supervision of Bank's Foreign Establishments 3 (May 1983). In this regard, the 1983 revisions to the Basel Concordat of 1975 appeared to be fueled by the Ambrosiano collapse. See Herring & Litan, supra note 64, at 103.

[476] See Basel Committee on Banking Supervision, Information Flows between Banking Supervisory Authorities 1 (April 1990).

[477] In 1972 BCCI was founded with a view to financing trade with the third world. BCCI was incorporated in Luxembourg, and its headquarters were in London. Through widespread fraud, deception and money laundering, BCCI was able to conceal its insolvency for decades, thereby evading supervision and eluding regulatory authorities for a number of years by incorporating a holding company in Luxembourg. As a result, the BCCI conglomerate held two parent (home) banks: BCCI SA, incorporated in Luxembourg, and BCCI Overseas, incorporated in Cayman Islands. Each of these banks had subsidiaries in foreign countries, such as the United Kingdom. This complex corporate structure enabled BCCI to evade consolidated supervision. Although BCCI had two parent banks for which two countries held overall regulatory responsibilities, neither of the parent banks carried on its primary operations in those countries. Consequently, the lack of

BCCI collapse resulted, in part, from BCCI's ability to evade supervision by both home and host countries, and demonstrated the difficulties of adequately supervising banks which operate in more than one jurisdiction.[478] The BCCI case raised significant issues over the regulation of financial institutions established across states' territorial borders. The BCCI story also shows that the smart money had long left BCCI by the time BCCI went under because the financial elites of the West were well wired into the work and concerns of the Basel Committee.[479] Those who lost were thousands of poorly informed investors from developing countries. One of BCCI's legacies was to wipe out the social security fund of Gabon.[480] While BCCI was a tragedy for Gabon, it never posed any systemic risk to the financial centers of industrialized countries which under other conditions it might have done.

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comprehensive regulation over much of BCCI's operations and the secrecy laws in Cayman Islands and Luxembourg prevented earlier diagnosis and led to the insolvency of a $20 billion bank with sustained losses estimated at $10 billion. See Peter Truell & Larry Gurwin, False Profits: The Inside Story of BCCI, The World's Most Corrupt Financial Empire 31-35 (1992).

[478] See id. at 67-94.

[479] The BCCI story shows that the existence of the Basel Committee serves as a warning system for those who move in elite financial circles. During the early 1980s the Basel Committee noticed BCCI's evasion of consolidated supervision. See Herring & Litan, supra note 64, at 103.

[480] Brent Fisse & John Braithwaite, Corporations, Crime and Accountability 222 (1993).

As the BCCI case shows, under the Basel Committee's guidelines no one supervisory authority was able to put BCCI under the lens of consolidated supervision. The BCCI crisis urged the Basel Committee to issue the 1992 Report on Minimum Standards for the Supervision of International Banking Groups and their Crossborder Establishments (Minimum Standards).[481] The Minimum Standards represent no departure from the prior agreements in terms of consolidated supervision, dual key supervision and communications between supervisory authorities except the guidelines for the implementation of these principles. In response to the increased need for consolidated supervision, the Minimum Standards recommend that the host country regulatory authorities make sure that the home country receives consolidated financial statements of the bank's global operations. Furthermore, the Minimum Standards advise that the home country's regulatory authorities have the means to satisfy themselves concerning the completeness and validity of all

[481] The Basel Committee's 1992 Report on Minimum Standards for the Supervision of International Banking Groups and their Crossborder Establishment were summarized by the Basel Committee in its own terms: (1) all international banking groups and international banks should be supervised by a home-country authority that capably performs consolidated supervision; (2) the creation of a crossborder banking establishment should receive the prior consent of both the host country supervisory authority and the bank's , and if different, the banking group's home country supervisor; (3) if a host country authority determines that any one of the foregoing minimum standards has not been met to its satisfaction, that authority could impose restrictive measures necessary to satisfy its prudential concerns with these minimum standards, including the prohibition of the creation of banking establishment. See Basel Committee on Banking Supervision, Minimum Standards for the supervision of International banking Groups and Their Crossborder Establishment 3-7 (July 1992).

financial reports.[482] The Minimum Standards also recommend that the host country make sure that the home country's supervisory authorities have consented to the establishment of foreign banks.[483] Additionally, the host country's regulatory authorities should assure themselves that the home country's regulators have the authority to prevent banks under their jurisdiction from establishing organizational structures that circumvent supervision.[484]

d. The Core Principles for Effective Banking Supervision

In 1997, the Basel Committee issued the Basel Core Principles for Effective Banking Supervision (Core Principles), which comprises twenty-five key areas of banking supervision.[485] The Core Principles were designed to present the essential elements of a regulatory banking structure that will stimulate confidence in the international banking market. Its purpose is to serve as a basic reference for the world's supervisory authorities in supervision of all banks within their jurisdictions. The Core Principles cover the

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[482] See id.
[483] Id. at 6.
[484] Id.
[485] See Basel Committee on Banking Supervision, Core Principles for Effective Banking Supervision (Sept. 1997) at 1.

significant preconditions for effective banking supervision, licensing of banking institutions, capital standards, and other prudential guidelines for risk management and internal control, methods of ongoing banking supervision, information requirements, formal powers of supervision and crossborder banking.[486] In response to the Asian financial crisis, the IMF and the World Bank have engaged in technical assistance work to improve the quality of banking regulation in the emerging and transition markets by using the Core Principles as a guideline. This technical assistance work involves to design incentive compatible deposit insurance schemes, and to set forth provision for the orderly exit of unsound banking organizations. Each feature of a regulatory regime is evaluated under the Core Principles. In this context, one argues that important motivations for encouraging adoption of the Core Principles benefit both those countries in helping make a serious banking crisis unlikely and other market economies through preventing the danger of spillover into others.[487] In

[486] See id. In order to harmonize international banking supervision, the Basel Committee also worked with non-Basel representatives from Chile, China, the Czech Republic, Hong Kong, Mexico, Russia, and Thailand. Eight other countries—Brazil, Hungary, India, Indonesia, Korea, Malaysia, Poland, and Singapore—were also closely associated with the work of the Basel Committee. Id.

[487] See Michael Taylor, International Financial Standards and the Transition Economies, *in* Y. B. Int'l Fin.& Econ. L. 348 (1999) (arguing that increased interlinkages between banks urge bank regulators to make sure the compliance of all countries' bank regulators and supervisors with a set of common standards under the Core Principles).

October 1999, the Basel Committee, in cooperation with the IMF and the World Bank, produced a follow-up document called the Core Principles Methodology (Methodology).[488] This report was initiated to respond to requests from a number of countries for additional guidance on how to interpret and implement the Core Principles.[489] The Methodology document covers specific criteria for assessing and implementing each Core Principle.[490] While one set of criteria focus on issues viewed essential for the minimum implementation of the Core Principles, the other focuses on those issues deemed to represent best practice.[491] Currently, the IMF and the World Bank use the methodology to evaluate the banking sectors in individual countries.[492]

Nonetheless, the Core Principles have faced criticisms from various directions for failing to pay sufficient attention to the varying conditions of emerging markets compared

[488] See The Basel Committee, Core Principles Methodology (Oct. 1999).
[489] See id. Notably, some observer has compared the Core Principles to the United States Constitution, and argues that the Core Principles can only be applied to the circumstances of individual countries through the interpretative efforts of numerous experts and advisers. See Bill McDonough, Interview, 3 The Financial Regulator 3, 32 (1998).
[490] Id.
[491] William J. McDonough, Remaks before the Eleventh International Conference of Banking Supervisors (Sept. 2000).
[492] The methodology can be used in multiple contexts: (1) self-assessment performed by bank supervisors themselves; (2) peer review conducted for instance within regional groupings of bank supervisors; (3) revies conducted by private third parties such as consulting firms; or (4) reviews performed in the context of the IMF surveillance or World Bank lending operations. See Basel Committee on Banking Supervision, Core Principles Methodology (Oct. 1999), at 5.

with the developed markets.[493] The more important issue is that the Core Principles presume an infrastructure of regulation that is usually shared in common in the developed economies but is often lacking from emerging markets and transition economies.[494] Even though the Basel Committee, in cooperation with a number of emerging market regulators formulated the Core Principles, it remained a predominantly developed world grouping.[495] Hence, if a set of basic principles needs to be recognized as global standards, the document is required to balance the desire to set high standards for supervisory practices with the pragmatic recognition that specific supervisory arrangements, practices and techniques vary from country to country depending on differences in culture, financial system structure and internal political realities. In addition, the Basel Committee needs to consult particularly with supervisors from emerging market states in order to produce a document with the legitimacy unless the Committee's membership is expected to expand in the near future. Here, a point to note is the anti-globalization argument that the process of establishment

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[493] See Morris Goldstein, Towards an International Banking Standards, 2 The Financial Regulator 2 (1997).
[494] See Taylor, International Financial Standards, supra note 487, at 354.
[495] See id. at 354-355. Taylor notes that "[the Basel Committee] has tended to make assumptions which reflect the conditions in the developed markets, especially concerning the availability of adequate and accurate accounting information and the existence of a legal system through which regulators can enforce their decisions." Id. at 355.

and implementation of global standards are under the Western industrial states' dominance, and represents the transgovernmentalism that threaten undeveloped countries' state sovereignty and takes away their freedom of action as sovereign states.[496] In this context, it deserves noting the emphasis of a democratization of the legislative process by which global standards as international soft law are established, a flexibility in implementation of the standards reflecting local legal tradition and practice, a full incorporation of the majority of states into the legislative process concerning the development of the standards, and a priortization of the implementation of global standards on a country-by-country basis.[497] Undeveloped countries will apparently resist in complying with global standards unless they have a realistic chance to absorb and accept the standards. In this sense, the development of new standards needs to be treated as an evolutionary and educational process.[498]

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[496] For the detail, *see* Herbert Morais, *The Quest for International Standards: Global Governance vs. Sovereignty,* 50 U. KAN. L. REV. 779, 779-780 (2002).
[497] *See id.* at 806-820.
[498] *Id.* at 820.

3. The Establishment of Capital Adequacy Standards

Following the Latin American sovereign debt crisis[499] of the 1980s, bank regulatory authorities in the major industrialized countries were concerned about the decline in the capital strength of their banks and the exposure of several large international banks to the underdeveloped countries. In response to the deterioration in the levels of bank capital,[500] particularly the U.S. regulators' efforts to strengthen their capital adequacy framework encountered a sharp industry resistance on competition grounds, and thus shifted to the establishment of capital adequacy guidelines by the Basel Committee. In July 1988, the Basel Committee issued uniform risk- based capital adequacy standards for internationally

[499] The debt crisis for the developed countries was incurred by too many loans too few high-risk borrowers. By 1982, Mexico alone owed U.S. banks $23 billion, estimated to be approximately 46 percent of the capital of America's seventeen largest banks. Once Brazilian and Argentinean loans are added, the nine largest U.S. banks had lent more than 140 percent of their capital to these three countries, all of which subsequently became incapable of servicing their loans. See Wolfgang H. Reinicke, Banking, Politics and Global Politics: American Commercial Banks and Regulatory Change, 1980-1990, 142 (1995). The dozen largest American banks lent between 83 percent and 263 percent of their capital to five heavily indebted Latin American countries that later announced they were not able to service their debts. Due to the lack of prudential oversight by American regulatory authorities, U.S. commercial banks were able to conduct unsound lending practices, and thus they were in trouble to the extent that the stability of U.S. financial system was threatened. See Thomas Oatley & Robert Nabros, Redistributive Cooperation: Market Failure, Wealth Transfers, and the Basel Accord, 52 Int'l Org. 35, 42 (1998).

[500] The deterioration of the level of capital in international banks arises because bank capital serves as a cushion to absorb unexpected losses that cannot be paid with current earnings, and because capital also give depositors confidence in the safety and soundness of the bank. See Ethan B. Kapstein, Resolving the Regulator's Dilemma, supra note 404, at 335. In the United States, the average level of capital in money center banks in 1980 had dropped to a postwar low of 4.5 percent of assets that was deemed inadequate in light of the risks encountering domestic and international loan portfolio. See International Monetary Fund, International Capital Markets (Dec. 1986) at 42; see also Andrew S. Caron, Financial Crises: Recent Experience in U.S. and International Markets, Brookings Papers on Economic Activity, No. 2 (1982), at 395-419.

active banks (Basel Accord).[501] Under the Basel Accord all banks that actively engaged in international transactions are required to hold capital equal to at least 8 percent of their risk-weighted assets plus off-balance-sheet commitments.[502]

Basel Accord aims two goals: first, to require banks to maintain higher levels of capital reserves by maintaining capital-to-asset ratios that are risk-based, and thus improve the safety and soundness of banks;[503] and second, to establish a level playing field by requiring uniform regulation so that a bank based in one country would not receive a competitive advantage by enjoying a lower capital adequacy requirement than a bank based in another country.[504] Although the Basel Accord has no legal force, the G-10 countries have

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[501] The guidelines are reprinted in Bank for International Settlements: Committee on Banking Regulations and Supervisory Practices, International Convergence of Capital Measurement and Capital Standards, reprinted in 30 I.L.M. 980-1008 (1991) (with introductory note by Cynthia C. Lichtenstein, 30 I.L.M. 967 (1991)).

[502] Bank capital (equity) is traditionally referred to as assets (loans) minus liabilities (deposits). See Peter R. Krugman & Maurice Obstfeld, International Economics: Theory and Policy 659-667 (5th ed. 2000). The Basel Accords divides capital into two tiers: Tier 1, defined as paid-up share capital/common stock and published reserves from post-tax retained earnings, must comprise at least 5 percent of a bank's capital base; Tier 2, defined as undisclosed reserves, asset revaluation reserves, general provisions/general loan-loss-reserves, hybrid (debt/equity) capital instruments, and subordinated debt, is limited to 10 percent of Tier1 and combined with Tier 1 must comprise 8 percent of the risk-weighted assets. See Basel Accord, supra note 501, Annex 17. On-balance sheet assets are assigned to one of four risk buckets as part of the risk-weighting procedure.

[503] See Hal S. Scott & Shinsaku Iwahara, In Search of a Level Playing Field: The Implementation of the Basel Capital Accord in Japan and the United States 2 (1994).

[504] See id. at 3.

incorporated it into their national banking regulations.[505] Unlike other studies focusing on its implementation and compliance with Basel Accord, this study mainly explores the origins of the Basel Accord. That is, it seeks to examine when and how national regulatory authorities pursue international regulatory harmonization or convergence as shown by the case of Basel Accord.

a. International Regulatory Harmonization

The globalization of financial markets has attracted a considerable amount of attention to the prudential regulation of financial institutions. Under the market volatility and competitive pressure, regulatory authorities from the industrialized countries initiated their efforts toward the harmonization of their prudential regulation.[506] In particular, bank

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[505] A number of non-G10 countries have implemented the Basel Accord into their national banking laws: Australia, Austria, Finland, Hong Kong, Israel, Korea, Mexico, and Taiwan. See Klaus P. Follak, International Harmonization of Regulatory and Supervisory Frameworks, *in* International Monetary Law: Issues for the New Millennium 307 (Mario Giovanoli ed. 2000). One views the Basel Accord as a gentleman's agreement among central banks from the Basel Committee member states. See Hal S. Scott, The Competitive Implications of the Basel Capital Accord, supra note 259, at 885. By contrast, the Basel Accord is deemed as international soft law. See Mario Giovanoli, A New Architecture for the Global Financial Market: Legal Aspects of International Financial Standard Setting in International Monetary Law, *in* International Monetary Law: Issues for the New Millennium 33-44 (2000).

[506] One refers this situation to as the regulator's dilemma. See Kapstein, Resolving the Regulator's Dilemma, supra note 404.

regulators from these countries recognized a need for the creation of international standards for the stability of banking organizations. To that end, the regulators negotiated to harmonize their prudential regulations, thereby establishing an international agreement on international banking regulation. In this context, some observers recognize the Basel Accord as an effective response to international market failure arisen from international financial integration.[507] That is, arguably global economic integration in the international financial markets, which caused a market failure as evidenced by the debt crisis[508] through raising systemic risk and impeding regulators to ensure the safety and soundness of national banking systems has led to international financial regulation.[509] This view argues that the Basel Accord was established as a result of regulators' consensus knowledge of the

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[507] See Kapstein, Governing the Global Economy, supra note 209, Ch. 5.

[508] Some observers note that its shocks lead to a crisis of confidence in a state's regulatory environment. See David A. Singer, Capital Rules: The Domestic Politics of International Regulatory Harmonization, 58 Int'l Org. 531, 531 (2004).

[509] See id. Kapstein remarks policy challenges posed by the debt crisis to all the actors involved—the banks, the creditor states' regulators, and the relevant international institutions, and the debtors themselves. In short, the crisis threatened the payment system in two ways: (1) it threatened to bring trade, investment, and financial flows between the developed and developing countries, choking the world economy; (2) it threatened the solvency of the banks, which did not have sufficient capital to absorb the losses from unpaid debts. If their depositors became aware of this shortfall, a run on the banks would begin. See Kapstein, Supervising International Banks, supra note 434, at 9.

systemic risks of undercapitalized banks.[510] As bank's capital levels deteriorated throughout the 1970s and 1980s, they became more vulnerable to losses from loan defaults and exogenous shocks. This argument, which has enjoyed an extraordinarily positive reception among economists and political scientists, is that the adoption of minimum capital standards by the G-10 countries provided that the global public good of financial stability to regulators' collective interests.[511] Beyond the application of this perspective to the Basel Accord, this view implies that harmonization will take place whenever an international regulatory standard is necessary for addressing systemic risk including financial instability.[512]

In response, others charge this functionalist logic by claiming that the Basel Accord is an example of redistributive cooperation: "the creation of an international instituion that

[510] See Kapstein, Resolving the regulator's Dilemmas, supra note 404, at 341-342.(remarking the Basel Accord from a public goods perspective whereby leadership of the U.K. and U.S. learned from the 1982 debt crisis).
[511] See Frederic S. Mishkin, Prudential Supervision: Why is it Important and What are the Issues?, *in* Prudential Supervision: What Works and What Doesn't 1-30 (Frederie S. Mishkin ed., 2001); Herring & Litan, supra note 414; see also Tony Porte, States, Markets, and Regimes in Banking: The Policy Issues (1983). On the global public good, see Wolfgang H. Reinicke, Global Public Policy: Governing Without Government, supra note 181. From the lens of this perspective, Kapstein assumes that regulatory authorities is playing the most significant role in mitigating global systemic risk. See Kapstein, Resolving the Regulator's Dilemmas, supra note 404.
[512] See Robert O. Keohane, After Hegemony: Cooperation and Discord in the World Political Economy, supra note 110.

internationally reduces at least one other government's welfare compared to the status quo."[513] They advocate that the U.S. Congress legislated stricter capital adequacy requirements domestically in 1983,[514] and urged U.S. regulators to impose these regulations on foreign competitors, especially the Japanese through an international agreement.[515] In contrast to functionalists, they assert that legislators lead the international regulatory harmonization process, that is, electoral incentives drive politicians to shift the costs of their policies to other states. Thus, international regulatory harmonization represents the special interests of a state's legislators to satisfy competing interest group and voter pressures rather than a jointly provided public good. This view implies that regulators are significant simply in that they carry out the directives of the legislature.

[513] See Oatley & Nabros, Redistributive Cooperation, supra note 499, at 36 (arguing that the U.S. proposals for capital adequacy regulation emerged from the U.S. congressional efforts to reconcile competing demands from their commercial banks and voters rather than an optimal response to international market failure).

[514] In 1983 the U.S. Congress acted the International Lending Supervision Act (ILSA), which provides the regulators to "establish examination and supervisory procedures to assure that factors such as foreign currency exposure and transfer risk are taken into account in evaluating the adequacy of the capital of banking institutions." 12 U.S.C. 3903 (b). Additionally, the act required the regulators to encourage the regulators from other major banking countries to cooperate toward maintaining and strengthening the capital bases of banks involved in international lending. 12 U.S.C. 3903 (b) (3) (c).

[515] The U.S. banks argued that relatively high capital requirements in they had been placed at a competitive disadvantage to the Japanese and French banks and nonbanking financial institutions. See Kapstein, Supervising International Banks, supra note 434, at 13.

For a more general model of the politics of international regulatory harmonization, a study examines the process of regulatory harmonization in four financial areas, but uses a country's incentives to emulate as an independent variable rather than specifying systemically what those incentives are and how they vary.[516] It deserves noting this study's explanation that the circumstances under which financial regulatory authorities will seek to harmonize with their foreign counterparts or, to explain precisely what the incentives are leading a regulator to press for harmonization.[517]

A more recent study proposes an analytical framework that satisfies the competing domestic pressures on regulatory authorities, and the role of international regulatory harmonization in addressing these pressures.[518] To that end, this framework assumes a

[516] See Beth A. Simmons, The International Politics of Harmonization: The Case of Capital Market Regulation, 55 Int'l Org. 589, 601-615 (2001).

[517] See id. Applying Simmon's framework to the transgovernmental theory, Raustiala argues that for the case of the Basel Accord, transgovernmental "networks become a vehicle for cooperation alongside some weak forms of liberal internationalism by facilitating information flow and technical assistance among jurisdictions." See id. at 601-605; see also Raustiala, The Architecture of International Cooperation, supra note 194, at 74. Raustiala claims that the "incentives to create networks or to negotiate treatise vary across the spectrum of regulatory power, and in turn appear to interact with liberal internationalism differently. When regulatory power is highly asymmetric, as in securities law, liberal internationalism tends to be shunned and networks primarily fill gaps in cooperation. Conversely, when regulatory power is diffuse, and therefore treaties are an essential cooperative tool, the domestic capacity building that networks promote may increase compliance with, and the effectiveness of, treaty law. When regulatory power is moderately concentrated, networks may help smooth the path to a liberal internationlist solution by promoting convergence in regulatory approach." See id. at 73.

[518] See Singer, supra note 508, at 532.

principal-agent relationship between a legislature and a regulator in order to analyze regulator behavior.[519] Put simply, the legislature, as the principal, delegates the responsibility for implementing financial regulations to a regulatory agency, and prescribes limits on that agency's policymaking by the threat of legislative intervention.[520] In such circumstances, the framework predicts that regulatory authorities are more likely to seek international regulatory harmonization as a means of increasing the size of its win-set and safeguarding its autonomy where confidence in the stability of financial institutions is deteriorating, and where competitive pressures are increasing from foreign firms confronting less strict regulations.[521] In short, the regulatory authority's domestic political environment spurs an international solution.[522] As this view argues, this "confidence-competitiveness" framework synthesizes elements of both of functionalist and

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[519] See id.
[520] As Singer notes, in this process the legislature maximizes a combination of campaign contributions and aggregate welfare, while the regulatory authority is only concerned with maintaining its decision-making autonomy. Also, the legislature enjoys a range of policy options at its disposal, but the regulator is limited to a single policy tool of regulatory stringency. According to Singer, the regulatory authority chooses a degree of regulatory strictness that falls within its "win-set"—the range of policy choices that do not result in legislative intervention. Furthermore, exogenous shocks to international competitiveness or voter confidence in financial stability can lead to the decrease in the size of the win-set and make intervention more likely. Id. at 532-533. For the analysis of the analytical framework, see id. at 535-544.
[521] See id. at 533.
[522] Id.

redistributive logics, but seek to offer an explanation of regulator preferences.[523] In similar manner to the functionalists, this view incorporates regulators as important actors in international regulatory harmonization in that they have considerable discretion in coordinating with their foreign counterparts.[524] Here, a significant note is the functionalist and confidence-competitiveness frameworks, and transgovernmentalism are in agreement with on the significance of regulators in the process of international regulatory harmonization.[525] Similarly to the transgovernmental theory, they highlight regulators as key actors in all the modes of international regulatory harmonization. In contrast, they incorporate the focus of redistributive logic on legislatures and domestic politics more

[523] See id. at 534. Singer argues that "[u]nderstanding preferences is the first step in a more theoretically complete analysis of circumstances under which regulators will create international standards. Once one understands who wants what and why, one is in a much better position to explain harmonization outcomes using variables such as market power and international institutions." See id. at 544. Kapstein, Oatley and Nabors are in accord with on the significance of market power in explaining the emergence of a multilateral agreement for bank capital adequacy. See Kapstein, Resolving the Regulator's Dilemma, supra note 404, at 338; Oatley & Nabors, Redistributive Cooperation, supra note 499, at 49-52. On the role of international institutions in the process of harmonization, see Simmons, The International Politics of Harmonization, supra note 516.

[524] Id. at 534-535.

[525] Like the transgovernmentalists, they emphasizes that unlike traditional international agreements, such as treaties, regulatory agreements are usually not ratified by legislatures, nor have they legal force on signatories, and that these agreements are important, and thus under market forces and pressure from international organizations, which correspond to transgovernmental regulatory networks, help to ensure compliance with global regulatory standards. See Singer, supra note 508, at 535. On market pressures, see Kapstein, Governing the Global Economy, supra note 209. On compliance with the Basel Accord, see David Ho, Compliance and International Soft Law: Why do Countries Implement the Basel Accord?, 5 J. Int'l Econ. L. 647 (2002).

generally.[526] In this sense, both theories and liberal internationalism are in accord with on the importance of legislatures in the process of international harmonization. In this context, one stresses an integrative approach considering the incentives of both regulators and legislatures for a complete analysis of international regulatory harmonization.[527]

As noted, there is still a need to reevaluate the views introduced above in the context of the Basel Accord To that end, this study moves on to the examination of the perspectives in pursuit of a more adequate framework responding to the demands for international regulatory harmonization.

b. The Establishment of the Basel Accord

i. Capital Regulation

As financial intermediaries, banks take many specific risks. Upon lending money to customers, banks incur credit risk that a borrower will default on a loan.[528] On a bank's

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[526] See Singer, supra note 508, at 535.
[527] Id.
[528] "Credit risk is most simply defined as the potential that a bank borrower or counterparty will fail to meet its obligations in accordance with agreed terms." See The Basel Committee, Principles for the Management of

balance sheet, a loan appears as assets because it represents an entitlement of the bank to receive a certain amount of money (plus periodic interest payments) on a specified date from a borrower. The major liabilities on a bank's balance sheet are its deposits, or obligations to reimburse savers either on demand or at a time agreed. The amount of net assets (assets minus liabilities) is thus the bank's capital. Capital provides a cushion against losses resulting from borrower default or changes in asset prices.[529] Banks view capital reserves as necessary for their prosperity and stability. [530] In the event of severe trouble, bank regulators' goal is to enable the bank to survive trouble, thereby protecting depositors' funds and public confidence in banking system. Capital levels are required to be sufficient to absorb losses and enable the bank to continue as a going concern. It is important to note that capital requirements are designed to prevent insolvency and default for banks. In this context, one points to the significance of the capital requirements for

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Credit Risk (Sept. 2000), available at http://www.bis.org/publ/index.htm (last visited Jan. 10, 2003). When the bank makes a loan to a customer the bank could supply the funds by giving the customer cash from the vault or a check on another bank, or by selling investment securities and giving the customer the ;proceeds. Any of these actions simply changes one kind of asset into another kind, cash for example, into a loan. The totals on the bank's balance sheet remain the same.

[529] See Singer, supra note 508, at 544.

[530] See Gray Haberman, Capital Requirements of Commercial and Investment Banks : Constraints in Regulation, Federal Reserve Bank of New York Quarterly Review, Vol. 12 (Autumn 1987) at 1-10.

three reasons.[531] First, capital requirements influence the price and availability of credit, and thereby affect the efficiency of the financial system in all economies. Second, capital is a key determinant of the strength and competitiveness of the banking system. "Too little capital, and crises become uncomfortably frequent. Too much, and the financial intermediation moves away from banks and into other, less regulated channels." Third, capital regulation influences the fairness of the international playing field. "Banks is a global business, one in which some institutions may have an unjustified advantage through their treatment by national regulators."

ii. The Backdrop

As some observers note, initially, capital adequacy was an entirely domestic issue.[532] Although bank regulators had expressed the concern over the deterioration of the levels of capital, this concern did not emerge until the early 1980s. The key event that captured the attention of bank regulators on levels of bank capital was the outbreak of the debt crisis in

[531] See Andrew Crockett, Banking Needs a New Basel Accord, Financial Times, Jan. 27, 2004, at 19.
[532] See Singer, supra note 508, at 545.

1982.[533] Since banking institutions in the world's financial centers such as London, New York, and Tokyo confronted financial difficulties arising from substantial losses on their lending portfolios, the debt crisis of 1982 served as a wake-up call to regulators about the dangers of low capital levels.[534] The Basel Committee initiated to work on a set of guidelines for capital adequacy, but its progress was delayed. With a general understanding that levels of capital were too low to support the riskiness of bank portfolios, central bankers launched their negotiations for improving bank safety and soundness.[535] Nevertheless, the regulators could not decide how to properly define capital nor agree on an appropriate minimum level that banks are required to hold.[536] Also, Japanese banks were operating with substantially lower levels of capital than Western banks, which have placed them at a competitive advantage to especially U.S. banks through offering more favorable pricing than their competitors.[537] French banks also had relatively low levels of capital and

[533] In the early 1980s, the Basel Committee initiated to investigate the wide-scale deterioration of capital levels in internationally active banks.
[534] See Singer, supra note 508, at 546.
[535] See Kapstein, Resolving the Regulator's Dilemma, supra note 404, at 337.
[536] See id.
[537] Id. at 339.

were resistant to any movement toward more stringent regulations.[538] Japanese bank regulators resisted the creation of an international standard that would incur high cost to their banking markets.[539]

In January 1987, the U.S. Federal Reserve and the Bank of England announced a bilateral agreement on common standards for capital adequacy.[540] This Anglo-American agreement established a risk-weighed standard in which capital requirements would increase with the degree of risk of a bank's portfolio.[541] From the outset it was clear that "the agreement was not intended to last in isolation; rather it was a strategy to force the Basel Committee into multilateral agreement favorable to U.S. and U.K. regulators."[542] This Anglo-American "zone of cooperation" implies the warning of excluding noncompliant countries' banks from British and American markets.[543] On December 10, 1987, the Basel Committee issued the Basel Accord as a global standard for minimum

[538] See id. at 341.
[539] Id.
[540] Id. at 339.
[541] Id. at 339-340.
[542] See Singer, supra note 508, at 546.
[543] See Kapstein, Resolving the Regulator's Dilemma, supra note 404, at 340. Kapstein argues that "[t]he tacit threat of preventing foreign banks from expanding operations or establishing new ones within that zone was apparently credible enough to move discussions to the multilateral level." See id. at 344.

capital levels which superseded the U.S./U.K. accord after several months of negotiations to mitigate the discrepancies between the U.S./U.K. coalition and the nonmembers of the Committee.

iii. The Origins of the Basel Accord

Under what conditions did the regulators seek to establish the Basel Accord? This study attempts to answer this question through reviewing the current literature on the Basel Accord.

a) Functionalist Theory

Functionalists claim that the creation of the Basel Accord was led by international "consensual knowledge" of the systemic risks of bank lending, combined with the leadership of the United States and the U.K.[544] This theory highlights that the Herstatt collapse and the Franklin failure of 1974 triggered the creation of the Basel Committee in emphasizing the significance of consensual knowledge. This view asserts that these

[544] See Kapstein, Resolving the Regulator's Dilemma, supra note 404, at 341-342.

prominent banking institution collapses followed by the debt crisis of less developed countries (LDC debt crisis) in 1982 led to a consensus among regulators of the systemic risks of global financial markets.[545] In particular, the failure of Continental Illinois bank in 1984 caused the U.S. regulators to acknowledge the inadequacy of existing prudential regulations in the context of risks confronted by banks, and attracted an increasing attention of the urgent need for a more comprehensive capital adequacy framework.[546] In this regard, this view argues that crisis acted as an impetus for the introduction of new ideas in policy circle.[547] This claim acknowledges that consensual knowledge of systemic risk was necessary but insufficient to produce an international agreement. With respect to the creation of the U.K./U.S. accord leading to the establishment of the Basel Accord, this view implies that although all the G-10 states wanted to create a global standard, it took a demonstration of market power to move the negotiations along.

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[545] See Kastein, Between Power and Purpose, supra note 436, at 277. In this regard, one argues that the issue of capital adequacy emerged by the supervisors, but not in a multilateral context. Further, an international agenda to strengthen the safety and soundness of banking system emerged as a result of domestic politics in the United States rather than a collective solution to the debt crisis on the part of central bankers. See Kapstein, Supervising International Banks, supra note 434, at 12.

[546] See Kapstein, Between Power and Purpose, supra note 436, at 277.

[547] See Kapstein, Resolving the Regulator's Dilemma, supra note 404, at 338.

Some critics charge its inability to explain the dynamics of the Basel negotiations.[548] The point to note is that capital adequacy regulations cost too mush, as they influence bank's profit margins.[549] If regulators are rational, there are a great number of incentives for countries to free ride, and let other states suppose the costs of global financial stability.[550] Systemic risk is not a helpful variant because it cannot provide an answer to the question of why U.S. and U.K. regulators made their efforts to produce an agreement, while Japanese regulators were resistant to an increase in capital standards.

b) Redistributive Cooperation

Some observers charge the functionalist logic by arguing that the Basel Accord was an instance of redistributive cooperation.[551] With the Mexican announcement of their inability to meet their upcoming interest payment obligations to foreign banks, the industrialized countries tried to address the LDC debt crisis through the IMF in order to

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548 See Singer, supra note 508, at 550.
549 See id.
550 Id.
551 See Oatley & Nabors, Redistributive Cooperation, supra note 499, at 36.

bail out large Western banks struggling due to the crisis.[552] In particular, the U.S. regulators initially sought to cope with the debt crisis through a wealth transfer from voters to commercial banks and a risk transfer from commercial banks to voters rather than by enacting stricter regulations governing international lending.[553] The IMF was deemed to achieve both objectives.[554] That is, with additional capital the IMF was to provide Latin American debtor governments with new credits that could then be used to service their loans. This process led to the transfer of the ownership of a portion of developing countries' debt to the public sector.[555] As part of this arrangement, commercial banks were required to restructure their existing commitments and extend additional loans.[556] Since implementing this strategy required the IMF to boost its resources by 47 percent, and thus part of this revenue was to come from a $4.7 billion

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[552] See Kapstein, Supervising International Banks, supra note 434, at 12.
[553] See Oatley & Nabors, Redistributive Cooperation, supra note 499, at 42. In this sense, the weakness of commercial banks was not sufficient to bring about a demand for international financial regulation. See id.
[554] See id. at 43.
[555] Id. ("Through this process, "society as a whole," rather than the commercial banks, would bear the risk of default by less-developed countries . . .").
[556] See Thomas Oatley, *The Dilemmas of International Financial Regulation*, Regulation, Vol. 23, No. 4 (Spring 2001) at 37.

outlay from the United States. The U.S. Congress approved the expenditure,[557] but requested tightening of domestic banking regulations and an increase in commercial banks' levels of capital.[558] In response, the U.S. banks protested this unilateral measure in arguing that the proposal could lead to both a decrease in international and domestic lending, and an exacerbation of their competitive difficulties in relation to foreign, particularly less-regulated Japanese banks and nonblank financial institutions due to cross-national differences in existing capital adequacy regulations.[559]

In addressing the competing pressures from voters and commercial banks, Congress synthesized the IMF quota increase, regulatory concerns about capital levels, and the banks' concerns over unilateral regulation in the International Lending Supervision Act (ILSA) of 1983. The ILSA required the U.S. regulators to increase domestic capital adequacy standards, and it encouraged other major banking countries' regulators to

[557] With a deepest recession in the 1980s, voters opposed to using of taxpayer dollars to rescue a number of commercial banks. See Oatley & Nabros, Redistributive Cooperation, supra note 499, at 43. In response to this analysis, one argues that additional government spending or taxes are not required for an IMF quota increase. See Singer, supra note 508, at 551.

[558] See Oatley, The Dilemmas, supra note 556, at 37. From the perspective of Congress, its advantage to raise new capital would be a demonstration that taxpayers (voters) would not bear the full costs of the debt crisis. See id.

[559] See Kapstein, Supervising International Banks, supra note 434, at 13; see also Oatley & Nabors, Redistributive Cooperation, supra note 499, at 44.

work toward strengthening the capital bases of banks involved in international lending.[560] The redistributive theory contends that the ILSA met voter demands by forcing banks to raise new capital and take at least part of the responsibility for their unsound lending practices.[561] Concurrently, it claims that an international agreement mitigated the banks' concerns over the loss of market share due to their potential placement at a competitive disadvantage to other competitors.[562] In other words, an international agreement on capital adequacy provided American legislators a means to satisfy both demands: the voters would get regulations to prevent their responsibility for unsound bank lending practices; the commercial banks would be compensated by mitigating the regulatory advantage enjoyed by foreign banks.[563] In this way, Congress linked stricter capital standards in the U.S. to the successful competition of an international agreement.[564] More importantly, this theory argues that there was no evidence of international market failure once capital adequacy reached the G-10

[560] 12 U.S.C. 1280, 1281.
[561] See Oatley & Nabors, supra note 499, at 45.
[562] See id.
[563] Id. at 45-46.
[564] See Oatley, The Dilemmas, supra note 556, at 37. To the contrary, one argues that "[I]f the banks were going to be forced to raise, at least it would be done on a multilateral rather than a unilateral basis." See Kapstein, Supervising International Banks, supra note 434, at 14.

agenda.[565] Moreover, widespread commercial bank weakness was not evident, nor did all G-10 regulators believe that harmonized capital adequacy regulations would create benefits relative to the regulatory status quo.[566] Finally, this view asserts that the exercise of U.S. financial market power led to a multilateral agreement of the Basel Accord.[567] The Basel Accord is arguably a case of redistributive cooperation.[568]

In response to the redistributive theory, some observers acknowledge the significance of the U.S. market power in the creation of the Basel Accord, but point to the inconsistency of congressional view on the Basel Accord. Thus, this perspective emphasizes that a principal-agent framework is necessary for a full explanation of the preferences of U.S. regulators during the Basel negotiations.[569]

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[565] See Oatley & Nabors, supra note 499, at 48. Oatley and Nabors argue that "even if we accept the premise that the debt crisis revealed an international financial market failure, this was not sufficient to generate a demand for international regulation." See id. at 45.
[566] Id.
[567] See id. at 49.
[568] Id. at 52.
[569] See Singer, supra note 508, at 552.

c) The Confidence-Competitiveness Framework[570]

During the 1980s both the United States and the U.K. confronted an increased threat from Japanese banks.[571] Moreover, U.S. markets were home to a rising proportion of Japanese bank assets.[572] By 1988, more than 38 percent of the assets of the Japanese banks were held in overseas branches, mostly in the United States and the U.K.[573] In 1985, Japanese international lending surpassed U.S. lending for the first time.[574] As a result, both the United States and the U.K. experienced an exogenous shock to competitiveness in the mid-1980s.[575] Some observers argue that if Japanese banks were to hold the same capital level as their competitors in the United States and the U.K., their competitive advantage would be severely lowered.[576] Exogenous shocks to

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[570] The assumption of the confidence-competitiveness framework is that regulators choose policies that defend their decision-making from direct political intervention. See id. at 553. As a result, regulators can strike a balance between the competitiveness of regulated firms and voter confidence in the stability of financial institutions. Id. Accordingly, regulators are more likely to seek international regulatory harmonization when confidence is declining, or when less-regulated foreign firms impinge on the market share of domestic firms. Id.

[571] See id. at 554. The data for the total assets of the ten largest banks in the world for 1974, 1984, and 1994 shows the remarkable growth of Japanese banks at the expense of U.S. and U.K. banks. See id. at 555.

[572] See id. at 554.

[573] See Henry S. Terrell, The Activities of Japanese Banks in the United Kingdom and in the United States, 1980-88, Federal Reserve Bulletin (Feb. 1990).

[574] See Financial Times, January 31, 1986, at 24.

[575] See Singer, supra note 508, at 554.

[576] See Devesh Kapur, Reforming the International Financial International System: Key Issues, *in* Global Financial Reform: How, Why and When? (2000). In 1986, Citicorp and Barclays (U.K.) had capital-to-asset

confidence were also remarkable in the Basel Accord case. As witnessed by the debt crisis of 1982, despite an IMF quota increase to deal with the crisis in the short term, market confidence was badly shaken by the imprudent lending practices of a number of U.S. commercial banks.[577] The failures of Continental Illinois and John Matthey Bankers (U.K.) in 1984 were distressing to regulatory authorities, and called into question the stability of their countries' banking system.[578] Due to a tremendous number of bank failures in both countries during the 1980s, voter confidence was badly shaken in both countries.[579]

While the United States and the U.K. were experiencing simultaneous shocks to competitiveness and confidence, regulators in each country were in agreement on the

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ratios of 4.73 and 4.71, respectively, whereas Japan's Dai-Ichi Kangyo, Sumitomo, and Fuji had ratios of 2.38, 2.89 and 2.95. See Herve De Carmoy, Global Banking Strategy: Financial Markets and Industrial Decay (1996).

[577] See Singer, supra note 508, at 554. Exposure among the dozen largest American banks in the five most indebted Latin American countries ranged from a low of 82.7 percent to a high of 262.8 percent, with most banks falling between 140 and 180 percent. See Oatley & Nabors, supra note 499, at 42.

[578] See Arturo Estella, Dealing with Financial Instability: The Central Bank's Toolkit, New York Federal Reserve Bank Discussion Paper (Jan. 23, 2001).

[579] See Singer, supra note 508, at556. By contrast, Japanese banks were not much exposed to LDCs during the debt crisis, and there were no high-profile bank insolvencies throughout the 1980s. Because of a close linkage between banking industry and government in Japan, and implicit guarantees of government support to business in difficult times, exogenous shocks to confidence are rare. Id. at 557.

urgent need for international regulatory harmonization.[580] These regulators recognized that sufficient levels of confidence and competition could not be obtained without a change to Japanese regulations.[581] This view argues that regulators from the United States and the U.K. made their sustained efforts to establish international capital adequacy standards, thereby creating a variable win-set for regulatory policy, as evidenced by the Anglo-American Accord in 1987.[582]

d) Concluding Remarks

The dynamics underlying the creation of the Basel Accord imply that a more general negotiating process lies at the heart of international financial regulation. Regulatory authorities shift regulation from the domestic arena to international arena in order to avoid domestic battle with their banking institutions. As a consequence, international financial regulation has little with rectifying market failures resulting from international

[580] See id.
[581] See id. ("More stringent regulations were necessary to bolster stability, but the resulting loss of competitiveness was too great to bear.").
[582] Id.

financial integration. Rather, regulators adopt international regulations to minimize the distributional outcomes of regulatory reform in an increasingly integrated international financial system.[583]

The principal-agent relationship between legislatures and regulators is significant to understanding when and why states seek global financial standards. As such, regulators as well as legislatures are deemed crucial players in the negotiating process. Thus, the regulator's incentives derive from the possibility of legislative intervention. In turn, the legislature's incentives arise from the need to choose an optimal trade-off between confidence and competitiveness. In particular, regulators are required to use regulatory policy as the only tool at their disposal to strike a balance between confidence and competitiveness. In the event of an exogenous shock to competitiveness, or confidence regulatory policy may be ineffective in maintaining this balance unilaterally, in which case regulators have incentives to seek an international regulatory agreement to maintain their autonomy.

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[583] See Oatley, supra note 556, at 37.

Here the issue of the Basel Accord needs to be addressed by focusing on the varying preferences of national regulators in the context of legislative constraints rather than on systemic concepts such as international market failures and global public goods. In addition, it is significant to note the trade-off between voter confidence and financial sector competitiveness.

c. Evaluating the Basel Accord

i. The Basel Accord of 1988

The Basel Accord of 1988 (Basel I) set forth minimum standards for internationally active banks pegged at eight percent of risk-weighted assets.[584] Since its inception, Basel I is still the basis for the requirements of the size and the structure of the capital banking institutions in more than 100 countries all over the world.[585] Basel I goes further on the

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[584] Basel Committee on Banking Supervision, International Convergence of Capital Measurement and Capital Standards, Publications (July 1988), available at http://www.bis.org/publ/index.htm (last visited January 10, 2003).

[585] See Patricia Jackson et al., Capital Requirements and Bank Behavior, supra note 224, at 1; see also Mamiko Yokoi-Arai, Regional Financial Institutionalization and the Creation of a Zone of Law: The Context of Financial Stability/Regulation in East Asia, 35 Int'l Law. 1627, 1647 (2001) ("While many countries have adopted the Basel principles, they are not necessarily rigorously enforced due to the high threshold for an emerging economy and the low compliance rate of the regulations. This reflects an acceptance of principles

premise that a single capital structure, based on minimum capital ratio of eight percent, was universally optimal for banks both in terms of return on equity and adequate protection for depositors and their insurers.[586] As such, a determinist notion of economic efficiency is embedded in Basel I as in the Core Principles. As the unintended outcomes led by regulations often get regulators away from their goals, the Basel 8 percent standard, based on a single, lockstep model of economic efficiency, has inevitably brought about its adverse consequences. In short, due to its simplicity of the "one-size-fits-all" standard, the Basel I framework could not catch up with the ongoing evolution of banking fueled by the emergence of new complex financial instruments and techniques in banking. Accordingly, banking institutions have learned to exploit its loopholes, that is, they can evade higher standards through regulatory capital arbitrage,[587] which is not strictly cheating but lawful

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because otherwise they would not be able to attract foreign investment or finance in the international financial market.").

[586] See McCoy, supra note 331, at 439.

[587] Regulatory capital arbitrage refers to the gaming of the capital standards, that is, the exploitation of loopholes that allows banking institutions to lower the amount of capital for a given level of risk. It is not necessarily undesirable, because in many cases, regulatory capital arbitrage acts as a safety valve, preventing the capital rules from distorting bank behavior in noneconomic ways. Put differently, regulatory capital arbitrage serves to reduce the adverse effects that are in excess of the levels warranted by a specific activity's underlying economic risk. In this way, arbitrage may appropriately lower the effective capital requirements against safe activities that banks would otherwise be forced to drop by the effects of regulations. See Alan Greenspan, The Role of Capital in Optimal Banking Supervision and Regulation, Federal Reserve Bank of New York Economic Policy Review (Oct. 1998) at 164-165.

exploitation of intentional and unintentional regulatory loopholes in contravention of the objectives of the standards.

Despite its desirable effects, arbitrage may undermine the effectiveness of the capital rules and cause some economic distortions in that it is not costless and thus not without implications for resource allocation.[588] Because regulators did not interestingly want to influence banks' resource allocation decision, the formal capital standards do not include very many risk buckets.[589] As a consequence, the "one-size-fits-all" standard does that by forcing the bank to strive to negate the capital standard, or exploit it in case of a significant disparity between the arbitrary standard and internal, economic capital requirement.[590] The disparities between internally required economic capital and the regulatory capital standard create another problem of the possibility that normally high regulatory capital ratios may mask the true level of insolvency probability.[591] This possibility becomes more acute as banks arbitrage away inappropriately high capital

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[588] See id. at 166.
[589] See id.
[590] Id.
[591] Id.

requirements on their safest assets by removing these high quality assets from the balance sheet via securitization.[592] Through securitizing assets, banks can unbundle and repackage risks to transform on-balance sheet assets into off-balance sheet assets that fall into lower risk weight categories.[593] The issue is not only the appropriateness of the capital requirements on the bank's residual risk in the securitized assets, but the sufficiency of regulatory capital requirements on the assets remaining on the book.[594] Such "cherry picking" goes further to leave on the balance sheet only low quality assets for which economic capital allocations are greater than the 8 percent regulatory standard.[595] In other words, against this lower quality balance sheet, the Basel Accord's eight percent capital requirement may be insufficient, and thus the bank's capital ratios may not offer an appropriate measure of the bank's true financial condition.[596] Thus,

[592] Id.
[593] See Oatley, supra note 556, at 38.
[594] See Greenspan, The Role of Capital, supra note 587, at 166.
[595] See id.
[596] See Oatley, supra note 556, at 38.

banks can sell off loans to avoid higher capital requirements that otherwise would apply if those loans would remain on the books.[597]

Moreover, the Basel Accord's simple risk classification scheme has called into question. Under the Basel Accord's relatively crude system of weighting risk, according to its supposed level of risk, assets are divided into four broad categories, referred to as buckets: a zero risk weight to governments of states in the OECD, a 20 percent risk weight to OECD banks and non-OECD governments, a 50 percent risk for mortgage lending, and a 100 percent risk to all other loans.[598] Under this system, nearly all private sector loans are dealt with as equivalent from a risk standpoint, with identical capital holding requirements. Banks have taken advantage of this simple risk-weighted capital system, thereby altering their lending practice in ways that they evade regulatory oversight. For example, the risk classification offers incentive to bank to hold riskier loan portfolios than they would have otherwise. Moreover, banks have incentives to shift toward higher-risk, higher-interest assets within each category, because the

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[597] See id.
[598] See id. at 38.

regulations assign the same risk weighting and capital costs to all loans within a given category. For example, a loan to a AAA-rated company receives the same risk weighting as a loan to a junk-rated company, even though the loan to the junk has a much higher probability of default. Because the banks charge higher interest to the junk, they are more likely to make that loan than to lend money at a lower interest rate to the secure company. In classifying sovereign debt, the four-bucket system assumes that assets with higher weights have higher risks than lower-weighted assets, but that is not always the case. For example, relatively risky loans to Mexican banks require four-fifths less capital than loans to secure corporations with AAA credit, simply because Mexico is a member of the OECD.[599] This problem of simplification has created increasing distortions over the years.

Given these difficulties with one-size-fits-all nature of the capital regulations, it is understandable that calls have arisen for the reform of the Basel Accord of 1988. The

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[599] It is widely acknowledged that assigning a 20 percent weight to short-term bank lending, as opposed to the 100 percent that lending to most private nonblank institutions carries caused an increase in lending to Asian banks, which in turn contributed to the Asian crisis of 1997. Sixty percent of the $380 billion in international bank lending to Asia at the end of 1997 had a maturity of one year or less. See Z. Minton-Beddoes, A Survey of Global Finance: Time for a Redesign?, The Economist, Jan. 30, 1999.

last decade have witnessed considerable economic turbulence and the increased new complex financial instruments and techniques in banking sector. Under the circumstances, banking institutions have made significant improvements in risk management, and thus there has been a need for the reform of the Basel Accord to keep pace with market developments. In response, The Basel Accord has been modified twice.

As the 1988 Basel Accord's focus on credit risk was too narrow, it could not adequately address the complexities and risks inherent in the growth of international bank participation in swaps and OTC derivative activities.[600] That is, understandably the Basel Accord ignored market risk as well as many new complex financial instruments. Indeed, this gap in risk treatment arose largely because new scope and degree of financial innovation did not exist at the time when it was originally drafted.

[600] See Joseph J. Norton & Chridtopher D. Olive, The Ongoing Process of International Bank Regulatory and Supervisory Convergence: A New Regulatory-Market "Partnership", 16 Ann. Rev. Banking 227, 298 (1997).

Additionally, Internally active banks conducted more heavily traditional banking and intermediary functions where credit risk was the most significant factor.[601]

The 1996 Amendment[602] mainly coped with the ways banking institutions should adjust their capital based on market risk that arises from broad factors in contrast to risk of loss from specific loss from specific loans and investments. Its significance is the addition to the Basel Accord of qualitative standards for banks basing their capital requirements on the consequences of internal models, a relatively new approach to the measurement of capital proposed to the banking community in 1995. Tentatively accepted in the 1996 amendment was the use of the bank's own internal model as an evaluation of specific risk. The 1996 amendment allowed banks to choose between a standardized approach developed by the Basel Committee for measuring market risk, or to use their own internal value-at-risk (VAR). The purpose of this choice was to recognize that many international banks develop and use risk management systems that

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[601] In April 1993, the Base Committee formally addressed guidelines concerning capital adequacy requirements for market risk. See Basel Committee, The Supervisory Treatment of Market Risks (Apr. 1993).
[602] Basel Committee on Banking Supervision, Overview of the Amendment to the Capital Accord to Incorporate Market Risks (1996), available at http://www.bis.org/publ/bcbsc23,pdf (last visited Oct. 1, 2004).

are far more sophisticated and tailored to the international institutions than could ever be developed by a regulatory authority. However, recognizing the shortcoming in its policy, the Basel Committee amended its market rules so that banks can use internal risk measurement systems if they can demonstrate that the systems adequately capture risk.[603]

Here it is significant to note that the 1996 amendment adopted self-regulation concept in its market risk guidelines.[604] Also, the guidelines require close working relationships between banks and their supervisors in a public-private partnership.[605]

The 1998 Amendment is the second modification.[606] Under the 1998 Amendment, the Basel Committee resolved certain speculations contained in the 1996 Amendment. Its chief purpose in the 1998 Amendment was to confirm the bank's ability to use its own internal model to estimate both market risk and specific risk. Although it is not

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[603] Basel Committee on Banking Supervision, Explanatory Note: Modification of the Basel Capital Accord of July 1988 (Sept. 19,1997), available at http://www.bis.org/press/p970918a.htm (last visited Oct.1, 2004).

[604] See Norton & Olive, The Ongoing Process of International Bank Regulatory and Supervisory Convergence, supra note 600, at 309.

[605] This partnership, among regulators, and large and complex banking organizations (LCBOs), so called elite banks, shows at least greater reliance by public sector on private sector involvement. See Joseph J . Norton, A Perceived Trend in Modern International Financial Regulation: Increasing Reliance on A Public-Private Partnership, 37 Int'l L. 43, 43 (2003).

[606] Basel Committee on Banking Supervision, Amendment to the Capital Accord to Incorporate Market Risks (1996, updated 1998), available at http://www.bis.org/publ/bcbsc222,pdf (last visited Oct. 1, 2004).

provided in the 1998 Amendment, the bank's internally created model is deemed as the device of the future in the establishment of bank capital. The use of the model was contingent upon the bank's establishing supervisory approval of the model from both home and host countries.[607] The approval is on the basis of four principles: (1) the bank's risk management system must be conceptually sound and implemented with integrity; (2) the bank has a sufficient number of trained staff; (3) the model must have a record of reasonable accuracy; and (4) bank conducts stress tests of its model. On its face, the amendment seemed to be another example of the Basel Committee's responsiveness to industry trends. However, its attempt to keep up with market developments has fallen short of the mark. Consequently, a widespread recognition that the Basel Accord needs to be revised to match capital to risk has created Basel II.

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[607] See id. at 38.

ii. Basel II

On June 26, 2004, the Basel Committee released Basel II, a new capital adequacy framework for banks, with the endorsement of G-10 central bank governors and heads of supervision.[608] Following the publication of the Committee's first round of proposals for revising the capital adequacy framework in June 1999, an extensive consultative process was set in train in all member countries and the proposal were also circulated to supervisory authorities worldwide. The Basel Committee subsequently released additional proposals for consultation in January 2001 and April 2003, and furthermore carried on three quantitative impact studies related to its proposals. As a consequence of these efforts, many valuable improvements have been made to the original proposals.[609] While the Basel Accord focused on the bank's capital level, Basel II emphasizes the measurement and management of significant banking risks, such as credit risk, market risk, and operation

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[608] Basel Committee on Banking Supervision, Basel II: International Convergence of Capital Measurement and Capital Standards: a Revised Framework, Basel Committee Publications No. 107 (June 2004), available at http://www.bis.org/publ/bcbs103.pdf (last visited July 3, 2004). Basel II will be implemented in two phases. The so-called standardized and foundation levels of capital adequacy—which will still be set by regulators—are due to come into force at the end of 2006. The advantage system, which will see more sophisticated banks use their own systems to calculate the required amount, will follow a year later. See Elizabeth Rigby, G10 nations put Basel II on the map—Bank Capital, Financial Times, June 28, 2004, at 24.
[609] See id.

risk.[610] Basel II framework seeks to compare the maximum losses that the bank may suffer over the year ahead with the available buffer for the losses.[611] Its purpose is to provide a methodology for the bank to prepare a statement that compares risk and buffer.

Basel II framework builds on two significant trends to incorporate a new philosophy for banking supervision.[612] It combines a risk-focused approach to supervision with incentives for prudent risk-taking into coherent policy objective that seeks to promote adequate capitalization. Basel II reinforces the focus of management on control structures through incorporating in all three of its pillars clear incentives for banks to improve their management of risk.[613]

- First, in Pillar 1(Minimum Capital Requirements) regulatory capital charges are aligned more closely to the bank's own measures of risk. This creates immediate incentives for banks to improve those measures.
- Likewise, Pillar 2 (Supervisory Review) emphasizes that responsibility for

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[610] See Ryozo Himino, Basel II—towards a new common language, BIS Quarterly Review (Sept, 2004) at 41.
[611] See id.
[612] See Jaime Caruana: Making diligent preparations for Basel II, Opening Remarks at the 13th International Conference of Banking Supervisors (Sept. 22-23, 2004), available at http://www.bis.org/review/r040928h..pdf (last visited Dec. 5, 2004)., supra nopte .
[613] The Basel Committee, Basel II: International Convergence of Capital Measurement and Capital Standards: a Revised Framework (June 2004), supra note 608.

assessing capital adequacy lies with the bank's management. Supervisors willl review and respond to those internal assessments, thereby creating incentives for banks to evaluate their exposures thoroughly and to plan their capital strategies carefully.

- Finally, Pillar III (Market Discipline) seeks to make the bank's risk profile more transparent to outside investors and market participants. This should better enable the market to reward banks that takes a responsible approach to risk management and penalize those that do not. Market disciple can serve as a powerful incentive for prudent behavior in that markets are sometimes stricter than supervisors.

Basel II's combination of a process-oriented focus with incentives for banks to improve their risk management intends to provide benefits both for individual banks and for the banking system as a whole.[614] For an individual bank, Basel II attempts to encourage management to adopt approaches that are related to the risks the bank confronts and that are appropriate for its level of sophistication so that it can ensures that the bank takes prudent

[614] See id.

steps to protect itself against losses, including making appropriate use of its capital resources.

Since a consultative paper for a new capital adequacy framewok was put forward in 1999, the Basel Committee's proposals have attracted critiques from financial practitioners, academics, and politicians. One of the main concerns over Basel II is its complexity. Basel II comprised of 251 pages is filled with high technical language and arcane mathematical formulations, while the Basel Accord of 1988 comprised 30 pages. The complexity is an obstacle to enforcement and makes it easier for vested interests to find ways around new rules.[615] Its enormous complexity will impose a heavy cost burden on bankers who are required to design systems and educate staff to deal with the complex new rules.[616] Moreover, it is very difficult to implement even-handedly across numerous regulatory regimes. Accordingly, Basel II framework needs to be relatively simplified.

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[615] See Avinash Persaud, The Basel plan must get back to market basics, Financial Times, Sept. 3, 2003, at 21.
[616] Basel II Bombshell, The Banker (April 1, 2003) (quoting Comptroller of the Currency John J. Hawke).

Another concern about Basel II is that its sophisticated prescriptions place emerging countries and companies at disadvantage.[617] Banking regulation should not be too prescriptive. Good banking involves the ability to use different information in a different way, to lend safely to borrowers to whom others do not lend. In this sense, the special situation and concern of emerging countries should be taken into account. Additional mounting criticism is that Basel II penalizes small and medium sized enterprises. In this regard, American unilateralism over Basel II has upset Europeans. Because of the criticism that Basel II will give larger banks an advantage, the U.S. regulators plan to apply the new risk-based capital standards only to the largest banks, whereas Basel II is to be incorporated into EU law and applied to all banks and investment firms, not just internationally active banks.[618] As noted above, Basel II is decidedly controversial. Thus the adoption of Basel II should not be the end of the story. As we have learned from considerable financial turmoil and policy responses over the past decades, a mechanism for continued review of the capital regulation should be included in financial regulation.

[617] See Persaud, supra note 615, at 21.
[618] Basel II Bohmshell, supra note 616.

C. Lessons to be Drawn from Basel

As witnessed in the Basel Committee's creation of the bank supervisory standards, the Committee's attempts to keep pace with the improvements of risk management in banking organizations have fallen short of the mark. Since the 1996 Amendment, the Basel Committee has incorporated the concept of the public-private partnership between bank authorities and leading large and complex banking organizations (LCBOs), called as elite banks, approach into bank supervision. Notably, this partnership approach vests elite banks with greater independence and discretion to identify, measure, monitor, and manage the material risks arising from trading book and banking book activities, subject to compliance with qualitative and quantitative parameters.[619] As a result, banking supervision paradigm increasingly guides the commercial banks to develop and implement comprehensive risk management and internal control frameworks that are suitable for their

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[619] See Joseph J. Norton, Selective Bank Regulatory and Supervisory Trends Upon Entering the 21st Century, Essays in International Financial & Economic Law, No. 34 (2001) at 30.

particular institutional risk profiles—a form of qualified self-regulation—subject to prudential standards.[620]

Nonetheless, elite banks and their banking authorities have recently been caught in significant risk management and internal control failures including the OTC derivatives and counterpart credit episodes underscoring the Asian financial crises over 1997-1998, and more significantly the LTCM episode of 1998. These cases imply that the risk management and internal control standards created by the Basel Committee may not be successfully implemented or self-enforced by the elite banks. Indeed, the collective motivation and incentives for elite banks to successfully implement and enforce these standards seem to be absent or compromised by profitability concerns.[621] Accordingly, the framework for risk management and internal control systems needs to establish a careful and transparent rebalancing of power such that elite banking interests do not unduly affect or overcome the safety and soundness interests of banking authorities.[622] In this regard, it is noteworthy the Basel Committee's adoption of three pillars in Basel II despite

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[620] See id. at 31.
[621] See Norton, A Perceived Trend in Modern International Financial Regulation, supra note 605, at 57.
[622] See id.

considerable criticisms against the Basel II. In particular, the pillar 2—a higher priority on bank supervision: an increased supervisory review of a bank's internal assessment of its own capital adequacy— is a new approach relying more than before on the internal measures and management practices of banks, and giving them more incentives to invest in better information systems and controls. Likewise, the pillar 3—an increased emphasis on market discipline: additional disclosure of bank risk profiles— may be a dramatic change from many practices. Although market judgments would never be perfect, market feedback can play a larger role as banks develop and disclose better information. For their part, bank supervisors can certainly use the market's help as they deal with ever-more-complex rules and banking practices. These developments could herald a fundamental transformation of the regulation as a pure public function to a joint public/private undertaking.

The premise of these two pillars is that well-functioning markets can go a long way to induce firms to make socially optimal decisions. There is a role for government, but the best way to carry out that role is to encourage the banking market to do as much of the

work as possible. However, it seems idealistic for bank regulatory authorities to direct market incentives to attain the regulatory goals of safe and stable banking markets, which enhance maximum sustainable growth. In this sense, it can be said that market discipline is not a panacea, because financial disclosures do not always provide the market with sufficient information to fully assess a bank's risk position and overall capital adequacy. At the same time, there are limits to how much informed and timely discipline the banking market can assert, because of the inherent difficulty of measuring and understanding banking risks. Furthermore, Basel II's vagueness that gives national bank regulators a lot of discretion with regard to the validation of banks' internal systems and the disclosure necessary to use those systems for the determination of capital charges creates uncertainty among market participants and regulators alike, which most certainly does not contribute to providing financial stability. As a consequence, bank regulatory authorities will easily be able to engage in regulatory forbearance and be subject to corruption. In these circumstances, it is not easy to predict how Basel II will work well although it is premature to do so.

As noted, vigorous efforts have been made by the Basel Committee to establish international bank regulatory and supervisory standards that build on and offer the potential to globalize the standards that exist within the most advanced countries. Similarly, other international financial institutions urge developing countries to adopt global financial standards through the harmonization of regulatory frameworks. If the harmonization conflicts with domestic economic imperatives, legitimate forms of global financial governance may be called into question. In this context, international policy makers should fully consider local conditions, such as national legal, business, and political practices and institutions when they design and formulate global standards. Most importantly, developing countries active on global financial markets should be allowed to comply with international standards by different routes and through divergent institutional arrangements. Consequently, the establishment of the new Basel capital adequacy accord (Basel II) should not be the end of the story.

V. The Search for a New International Financial Order

A. The Dilemmas of International Financial Regulation

Arguably, there are probabilities for regulatory arbitrage to occur where countries adopt identical capital adequacy policies but totally different rescue policies for failed banks among countries.[623] The bank rescue policies adopted by central banks are highly divergent in ranging from strict market discipline denying recovery to shareholders of failed banks to full bailouts for bank shareholders prevalent in emerging economy markets. The bank rescue policies have feedback effects that change the future risk propensity of banks.[624] No variance of capital adequacy rules in different countries has provided internationally active banks incentives to charter in countries with lenient bank rescue policies since they are not required to reserve additional capital to offset the heightened incentives for risk created by lenient bank rescue policies. Furthermore, international banks in less-regulated countries that operate abroad through branches rather than

[623] In the United States, approximately three quarters of failed banks are resolved through assisted mergers with other banks, whereas Japan, Finland, Sweden, and Norway rely principally or exclusively on open bank assistance (government bailouts). See Acharya, Is the International Convergence of Capital Adequacy Regulation Desirable? 16 (Nov. 2, 2002), available at http://papers.ssrn.com/sol3/abstract_id=223768 (last visited Jan. 10, 2003).

[624] If a state bails out the bank's shareholders, the bailout encourages other banks' shareholders to increase risk-taking with impunity. See id. at 24-26.

separately incorporated subsidiaries have higher incentives to increase their risk-taking abroad and at home. This is because if the bank becomes insolvent, the generous rescue policies of the lenient country will apply to the entire banking group including its overseas branches. As one argues, global convergence of capital regulation is desirable only if it is accompanied by a standardization of other aspects of banking regulation, such as monetary policies and bank rescue packages as well.[625] Thus, an appropriate divergence in capital requirements may be necessary where such accompanying convergence is infeasible. "Differences in economic conditions and organizational structures across countries may also accentuate the need for such divergence."[626]

These circumstances take this study to another significant issue: if banks should be regulated by governments, is there a need for international financial regulation to manage international financial integration? In other words, has governments' ability to look to national regulation to maintain stability of banks incorporated in their jurisdictions been eroded by increasingly changing financial activity, and thereby necessitates a shift to

[625] See id. at 16.
[626] See id.

international regulation? Arguably, governments need not shift regulation away from independent national regulatory authorities, because international financial integration creates no new market failures.[627] Here international coordination of regulatory responsibility is necessary, but states can arrange this coordination through agreement rather than internationally harmonizing prudential regulation.

There is another question to be answered. If domestic regulation and international agreements can cope with banks' exposure to risk, then why does international financial regulation coexist with domestic regulation? As witnessed by the U.S. proposals for harmonized capital adequacy regulations, states created this regulation primarily as a political response to banks' fears about international competition. That is, disparities between domestic regulations brought about cost differentials that place banks at a competitive advantage or disadvantage. As a result, the banks in less-regulated states can provide banking services to customers at a lower price. Accordingly, international

[627] See Oatley, supra note 556, at 37.

regulation that requires all governments to adopt a set of common standards removes these disparities by creating a level playing field in international finance.

However, harmonizing international regulation may harm banks' safety through creating a level playing field. As regulation always creates unintended outcomes, there is a potential for harm arising from the interaction between the unintended consequences of financial regulation and the hostile nature of international decision-making.[628] This interaction leads to a less safe banking system.

Given the unintended outcomes, the Basel Accord may have made banks less secure. As noted, these problems have driven the revision of the Basel Accord. As evidenced in Basel II, the negotiations have produced, efforts to attain a better national banking regulation has not been in progress until the conclusion of a better international agreement on banking.[629] A better international banking agreement has been in no progress by distributive struggles between banks incorporated in distinct jurisdictions, between banks of

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[628] See id.
[629] See id. at 38.

different sizes, and between banks and other non-banking institutions.[630] Due to these attempts to use international regulation to create a level playing field have caused harmful delays in the introduction of necessary regulatory reforms.

As national banking regulations are quickly outmoded, regulators struggle to catch up with the market development and unexpected negative effects. In these circumstances, governments need to retain the ability to regularly adjust and revise the regulatory framework. By contrast, international negotiations are not well suited to the task.[631]

The ongoing international financial integration causes governments to continuously encounter a difficult regulatory dilemma. National financial regulation appears to create a safer financial system, but it can also cause financial institutions to shift their business to less regulated states.[632] To the contrary, international financial regulation can remove the unwanted competitive outcomes of unilateral national regulation, but it may create a weaker financial system.[633] Hence, a domestic approach to regulation creates safer

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[630] Id. at 38-39.
[631] See id. at 39.
[632] See id.
[633] Id.

financial institutions but less domestic financial business, whereas an international approach protects domestic financial business at the price of potentially weaker financial institutions.

As discussed, the better solution may lie in domestic regulation supported by an international agreement on broad principles rather than opting for either domestic or international regulation.[634] Governments can move further away from one-size-fits-all international regulations in favor of establishing broad regulatory goals that each state can then pursue through domestic regulation. To ensure that each state adopts regulations consistent with international objectives, the international community can implement a review process.[635] Such an approach would not only eliminate the competitive consequences of purely national regulation but also maintain the flexibility of national regulation.[636]

However, this perspective emphasizes exclusively the significance of governments, that is national regulators' role in regulating banking and other financial institutions.

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[634] See id.
[635] Id.
[636] Id.

Accordingly, this view does not reflect the increasing importance of role of private sectors at both national and international financial markets, which will be addressed later.

B. The Role of Private Regulation

As noted, the world's bank regulatory authorities have been struggling to catch up with the market innovation over the past decades. This situation pertains in both developed and developing countries. Moreover, government central banks have been obsolete,[637] whereas advances in information technology have increased the advantages of private interest regulation in several respects. Even though central banks currently enforce a variety of legal constraints on commercial banks, many of these restrictions have been undermined by financial innovations fueled by the information revolution. In particular, depositors too easily avoid any inefficient restrictions on domestic banks, as the price of remote access to offshore banking services is falling toward zero. In this regard, private clearinghouse

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[637] Today central banks play five major roles: monopoly issuer of currency, banker's bank, regulator of commercial banks, lender of last resort, and conductor of monetary policy. See Lawrence H. White, In What Respects Will the Information Age Make Central Banks Obsolete?, Cato Journal, Vol. 21, No.2 (Fall 2001) at 219.

association have always found it useful to improve and to enforce solvency and liquidity standards for their members, to ensure that their clearing partners would not default at the next clearing session.[638] In this way, private clearinghouses are fully able to assess and internalize settlement risks and have a great track record even if central banks recall doomsday scenarios and fear about systemic risk in private delayed-settlement systems.[639] To prevent shrinkage of domestic banking industry, regulators are required to put an end to inefficient public regulations. The traditional public regulations that will survive will be those that provide advantages both to banking organizations and their customers.

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[638] See id. at 223. The membership of clearinghouse that is a members-only club, with high standards for membership, has provided a credible seal of approval for depositors seeking a safe bank. Id. In the United States, private clearinghouses were never completely suppressed, they rather continue to process some checks, automated payments, ATM transfers, and large-volume transactions. The clearing volume on the private Clearing House Interbank Payment System (CHIPS) of the New York Clearing House Association (NYCHA) continues to rival the volume on the Federal Reserve's Fedwire system. See id. at 221-222. The CHIPS which is owned and operated by the NYCHA, an organization of the major New York City banks is a communication and net settlement system for payments by and two classes of participant banks located in New York city: settling and non-settling participants. For the detail, see Scott & Wellons, supra note 5, at 600-615. As another type of the U.S. large value transfer system, the Fedwire is a communication and settlement owned by the twelve U.S. Federal Reserve Banks. For its operation, see id. at 599-600. A crucial point to note is that clearinghouses and organized exchanges are the classic examples of the private strategic responses to concerns about the stability and integrity. See Randall S. Kroszner, The Role of Private Regulation in Maintaining Global Financial Stability, Cato Journal, Vol. 18, No. 3 (Winter 1999) at 356.

[639] See White, supra note 637, at 222 ("If commercial banks are freed from the constraint of holding account balances at the central bank, more of the clearing business may return to the private sector. This is particularly likely if central banks continue their current fixation with imposing real-time gross settlement in place of the more efficient netting and delayed-settlement systems, but not for any reason that withstands serious scrutiny.").

In fact, numerous international financial transactions take place in a realm that is close to anarchy. The offshore markets harbor safe from financial regulation and international agreements. When contractual disputes arise in international financial transactions, it is not easy to determine where they would be litigated and what laws would apply. The past several decades have witnessed the rapid expansion of global financial markets, and the remarkable growth of internationally active banking and financial institutions. The point to note is that the growth of many of the largest and most active global financial markets have actually been driven by the avoidance of traditional government regulations. Whereas frauds, mismanagement, and bankruptcies take place, market forces have been effective regulators that have created order, rule and norm out of the apparent catastrophe of the international banking and financial markets.[640] As the collapse of BCCI and the debacle of Barings have shown, regulatory structures set forth and operated by national governments and designed to supervise domestic financial activities have been outmoded if not obsolete. Even though the overall stability and integrity of these markets is due

[640] See E. Kane, How Market Forces Influence the Structure of Financial Regulation, *in* Restructuring Banking and Financial Services (R.M. Kushmeider ed., 1988).

primarily to the role of private regulators rather than public regulatory authorities, many committees and institutions have attempted to coordinate domestic regulatory policies and negotiate international standards without projecting regulatory oversight into a global economy to avoid the complexity of multiple, overlapping regulatory structures that have been an important problem in financial market regulation.

In that regard, it deserves noting one observer's application of three approaches to the allocation of regulatory authority: centralization, competition, and privatization.[641] According to these approaches, the Basel Accord is the best example of centralization of regulation of banking and financial institutions. As is always the case with centralization of regulatory standards, the critical question in the area of financial institutions regulation is whether wide-scale compliance or even compliance within the narrow range of the Basel Committee member countries or the OECD countries is a realistic aspiration. As shown in the Asian financial crisis, countries have found it difficult to coordinate domestic regulatory

[641] See Howell E. Jackson, Centralization, Competition, and Privatization in Financial Regulation, 2 Theoretical Inquiries in Law 649, 664 (2001).

structures with international standards.[642] Domestic interest groups and political consideration, which created different and typically lax regulatory structures in the past, remains resistant to reforms, despite the existence of international standards.[643] Centralization of regulatory functions is difficult to implement in the context that lacks a coordinating public authority, a characteristic that is often absent in the transnational arena and may even be only marginally effective in regional alliance such as the Europe Union.[644] On most of these dimensions, allocation of regulatory authority among member states represents an intermediate solution. It can create competitive pressures on regulatory officials if regulated firms have mobility to select among a range of legal regimes and that other conditions of competition are present. If centralization of regulatory standards cannot always deal with issues of regulation of financial institutions in international markets, models of competition or privatization could provide alternative solutions.

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[642] See Raudi Bonte et al., Supervisory Lessons to be Drawn from the Asian Crisis, Basel Committee Working Paper No.2 (June 1999), available at http://www.bis.org/publ/bcbs_wp2.htm (last visited Jan. 10, 2003).

[643] See Scott, supra note 259.

[644] See Jackson, supra note 641, at 670.

The elements of regulatory competition that already exist under the Basel Concordat of the 1970s have been redefined in the aftermath of the BCCI failure of the early 1990s.[645] To allow private firms to choose among the regulatory systems of member states raises the probability of sub-optimal outcomes in contexts where the mechanisms of competition are incomplete or where substantial agency costs and negative externalities may be present.[646]

An instructive demonstration of the privatization solution is the international swaps market.[647] The swaps market is an example of the kind of complex contractual networks in the global economy. It is primarily regulated by privately developed legal rule, most notably the standard agreements of the International Swap Dealers Association (ISDA).[648] However, even in the swaps market, where privatization is the dominant regulatory paradigm, a debate has been increasing over whether national or supranational, that is

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[645] Under the Basel Concordat, domestic regulators were assigned to supervisory responsibility over certain foreign branches of domestic banking organizations so that for some time, national financial supervisors have had to taken an interest in the offshore activities of domestic banks. See Mandanis Schooner & Michael Taylor, Convergence and Competition: The Case of Bank Regulation in Britain and the United States, 20 Mich. J. Int'l L. 595, 599-605 (1999); see also Basel Committee, supra note 465. The collapse of the BCCI called upon domestic supervisory agents to look upstream where domestic banking organizations are controlled by foreign financial conglomerates to evaluate the efficacy of the entity's consolidated supervision. See Daniel M. Leifer, Note, Putting the Super Back in the Supervision of International Banking, Post-BCCI, 60 Fordham L. Rev. S467 (1992). In this way, the world's bank regulators have increasingly been projecting their oversight internationally and offering the rudimentary structure of global supervision rather than concerning themselves exclusively with financial activities occurring within their own national boundaries.

[646] See Jackson, supra note 641, at 670.

[647] See id. at 665.

[648] See the ISDA homepage at http://www.isda.org/index.html.

centralized regulatory constraint should supplement existing safeguards.[649] In particular, the failure of Long-Term Credit Management Limited in 1999 has drawn calla for reform in this area of financial supervision. Privatization of regulatory functions provides the greatest degree of flexibility and space for experimentation.[650] More importantly, private firms often have elaborate internal procedures for controlling risks, and those procedures may be likely to provide an efficient substitute for more traditional forms of mandatory governmental oversight.[651] Accordingly, innovations in strategic organizational design and governance for financial institutions can handle international regulatory challenges more effectively than traditional public regulation.

[649] See Jackson, supra note 641, at 666.
[650] See id. at 670.
[651] In this regard, one observer argues that "[w]hile there are ample reasons to doubt whether private incentives for risk-regulation are, in fact, appropriately aligned with the public interest, one can appreciate how private firms and their representatives could perceive private regulatory solutions as a cost-effective alternative to more familiar systems of supervision." See id. Further, it is asserted that "while representatives of private entities are not unmindful of issues of systemic risk and negative externalities, they may be less attuned to the possibility that the optimal level of risk-taking from a public perspective may well be lower than the optimal level from the perspective of the individual firm. As the costs of systemic risk and negative externalities are borne in large part by parties not in contractual privity with private firms, the market is not likely to force firms to internalize these costs. In addition, moral hazard problems, collective action problems, and the incentive-suppressing effects of public regulation may deaden cost internalization on the part of some parties, like depositors, who are in contractual privity with regulated firms. Finally, industry representatives involved in policy debates are likely to be drawn from better-managed and more successful firms. They may be less cognitive of the problems of incompetent managers and the perverse incentives facing firms in financial distress than are governmental officials, who deal with bad apples on a regular basis." See id. at 671 n.58.

The private strategic responses to concerns about stability and integrity take many forms.[652] A traditional solution had been to create a members-only club, with high standards for membership, such as clearinghouses and organized exchanges. However, most recent growth in the global financial markets has been occurring outside of traditional members-only institutions. Over-the-counter derivatives trading has grown sharply during the past decades. It is noteworthy that much of the movement toward OTC markets is spurred by the desire to avoid the domestic regulation that has been imposed over time on organized exchanges.[653] National financial regulatory authorities have struggled with claiming that such financial activities fall within their jurisdictions. In these effectively unregulated OTC markets, the strategic responses to the challenges of stability and integrity have taken a variety of forms. Independent credit-rating agencies play a key role in certifying the quality of potential counterparties to a transaction.[654] Thus, private regulators have carried out the auditing, screening, and monitoring functions of the public regulators and have been quite effective even if they do not have the same legal powers to

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[652] See Kroszner, supra note 638, at 356.
[653] See id.
[654] Id.

obtain information that public regulators do. By contrast, public regulators cannot be insulated from political and interest group pressures.[655] The political pressures offer a background incentive different from that for the private regulators. Moreover, the public regulators have much greater difficulty than do the private regulators. Giving public regulators wide discretion is an invitation to political and interest group pressure. One argues that whereas the market is not a perfect regulator, the public regulatory alternative should not interfere with the creative experimentation and innovation.[656] Further, a unified international regulator seems to slow the engine that generates the innovations that have driven the growth of the global financial markets without any clear stability advantages.[657]

C. The Market as a Regulator

Over the past decades, debates over the proper allocation of regulatory authority in banking and financial sectors have increasingly been common. This trend mainly attributes to the globalization of finance. In earlier times, technical constraints have not

[655] Id. at 359.
[656] See id. at 360.
[657] Id.

enabled issuers and intermediaries to engage in substantial volumes of financial transactions across national boundaries. As a consequence, regulatory jurisdiction could be allocated on a territorial basis. However, the evolution of technologies and financial markets has eroded national boundaries, and forced regulatory authorities to choose between the imposition of overlapping, potentially inconsistent supervision on a territorial basis and the creation of new paradigms for allocating or coordinating regulatory jurisdiction. In these circumstances, there is a need for the creation of a new regulatory paradigm.[658]

This new regulatory paradigm necessitates a radical rethinking the scope of regulation and regulatory techniques. One possible option would be to use the market as the primary regulator, and insofar as traditional public regulation would continue to exist, it would seek to work with market mechanisms.[659] This view highlights that the supervisory function might be limited to monitoring compliance with a few simple principles leaving the more difficult issues to be evaluated by the marketplace, such as other financial intermediaries, or

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[658] See Michael Taylor, The Search for a New Regulatory Paradigm, 49 Mercer L. Rev. 793, 793 (1998).
[659] See id. at 802.

credit rating agencies on the basis of legislatively mandated full disclosure of a bank's risk exposures. In this regard, the obligation to disclose may be backed up by stringent punishment of directors to make sure that they bear full responsibility both for the activities of their institutions and for the information released into the public domain. However, there are still some problems with reliance on greater disclosure.[660] Most of banks active in foreign country are subsidiaries of major international banking organizations, and thus subject to the consolidated supervision of their home country supervisors. Additionally, there remain serious obstacles to the reliance on enhanced public disclosures as a way of dealing with the problem of supervising of institutions with active trading options. As noted above, the use of derivative instruments has increased the complexity and opacity of the risk profiles of financial institutions in ways that traditional accounting techniques cannot cope with. Moreover, the new financial instruments are off-balance-sheet in the context that entering into a derivatives contract does not give rise to immediate cash flows to the extent of the contract's face value, which is different from traditional loans. Since a

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[660] Id. at 803.

derivative contract concerns future rights and obligations, how to value this is of significance.

Although an exclusively disclosure-based regime might have its difficulties, it could be supplemented by enhanced reliance on the forces of self-regulation.[661] However, there are still two fundamental problems with relying on greater public disclosure or self-regulation as a substitute for supervision.[662] The first is the residual contagion risk that may result from the bank's failure, either through a loss of confidence in the banking sector as a whole or through banks' complex interplay in the payments system. As discussed above, the loss of confidence argument has been exaggerated in the integrated global economy, because there is little evidence that the bank's failure drive a widespread systemic crisis as the result of panic withdrawals by depositors.[663] The payments systems aspects of contagion risk are also being lessened by remarkable improvements to the payment and settlements system

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[661] See Group of Thirty, Global Institutions, National Supervision and Systemic Risk 12 (1997) ("the fundamental responsibility for ensuring the stability of financial institutions, and thereby limiting systemic risk, rests with the board and management of global institutions themselves."). The standing committee notion is in effect a proposal for the leading international financial institutions to adopt a system of self-regulation. See id.

[662] See Taylor, supra note 658, at 804.

[663] In fact, the evidence of recent banking crises in the East Asia is that bank collapses were entailed by a flight to quality in which depositors tend to move their funds to well-capitalized institutions authorized by jurisdictions with a high regulatory reputation. See id.

themselves. As risks within the payment systems become legal risks—the ability to take a charge over the collateral— rather than the credit risk of large intra-day exposures, the character of risks changes even if they are not abolished entirely. Although a large banking organization may theoretically fail without being the cause of widespread disruption to the whole banking system, there remain residual risks which it may be difficult to abolish.[664]

The second reason that exclusive market-driven regulation may not be the solution is that it is politically impossible if the taxpayer continues to underwrite banks' deposit liabilities in the form of deposit protection schemes and access to lender of last resort facilities in most of countries although there are some differences in deposit guarantee arrangements.[665] The movement toward relying on greater use of market forces and self-regulation can only be fulfilled provided that there remains an explicit or implicit taxpayer guarantee against the outcomes of bank failure. Since the continued existence of deposit guarantee arrangements is a legacy of the old regulatory paradigm that provided a publicly-

[664] See id. at 804.
[665] Id. at 804-805.

funded indemnity to consumers against the risk of loss, the potential risk to taxpayers was supposedly limited by a regulatory system that emphasized stability. Accordingly, deposit insurance schemes could exist precisely because an excess of regulations ensured that bank failures would be rare even if the price of this was steadily accumulating inefficiency in the financial system.[666]

The point to note is that the techniques or regulation applied under the old paradigm cannot be transplanted to the new environment of financial services. Market forces may not be the exclusive substitute for the need for regulation. As such a new regulatory paradigm needs to involve much less of a role for traditional public regulation, that is external governmental regulation than was case before. There is a growing consensus that the partnership between regulatory authorities and market actors (private interests) is essential for the good governance and prudential regulation of global financial markets.

[666] See id. at 805 ("[A] key component of the new regulatory paradigm must be to rethink the role of deposit insurance schemes now that their symbiotic relationship with restrictive regulation has vanished.").

D. Public-Private Partnership

Global financial integration has considerably challenged the policy autonomy of the state to supervise and regulate international transactions. National regulatory authorities' efforts to cooperate with their foreign counterparts in order to design and formulate effective regulatory standards have often become problematic. This is partly because of the difficulties of cooperation in an international system, and partly because of variations in domestic market structures, financial institutions and legal systems. Attempts by national and international supervisory and regulatory authorities are often proved insufficient for the effective formulation and implementation of global financial standards in emerging market economies.

While the private sector activities have increasingly dominated global financial transactions, the wider public sector policy and regulatory objectives of financial governance have become more difficult. As such, powerful private interests have increased their dominance of national economic policy making, and have played an important role in formulating financial market rules and structures, whereby state policies

tend to promote market-led adjustment policies.[667] The process of global financial integration has strengthened the position of private market actors in governance of financial system at national, regional and international levels. Given that private sector activities have increasingly dominated global financial transactions, and private interests are crucial to the governance of financial systems, private market actors need to be incorporated into the rule-making process. An important issue examines how to design private sector involvement in formulating and implementing financial standards and regulations.

The private sector must be involved in the standard-setting process in two ways: (1) the private sector's integration of the use of standards into their risk management techniques, (2) the private sector's development of best practice standards in the financial sector.[668] These goals may be accomplished either through private-public collaboration or by the private sector themselves. Given that private market actors have played an important role

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[667] Geoffrey R. D. Underhill & Xiaoke Zhang, Global Structures and Political Imperatives: In Search of Normative Underpinnings for International Financial Order, *in* International Financial Governance Under Stress: Global Structures versus National Imperatives 82 (Geoffrey R. D. Underhill et al. eds., 2003) (arguing that the process of global financial integration has altered the notions of the public interest that underpin the operation of financial order, changed regulatory parameters and objectives in public sector responsibility, and posed a problem of democratic accountability).
[668] George Vojta & Marc Uzan, The Private Sector, International Standards and the Architecture of Global Finance, *in* International Financial Governance Under Stress: Global Structures versus National Imperatives, supra note 667, at 284.

in developing financial structures, and identifying and refining international standards for acceptable practices, they can help enhance the limited expertise and capacity of regulatory authorities.[669] In this sense, the private sector should be fully incorporated into the process of standard formulation and implementation. If the task of standard setting and enforcement would be exclusively left to the public sector, market disciplines may fail to play their role in financial governance and regulation.

While a consensus that the private sector is crucial to the governance of financial system at national, regional and global levels has been reached, how to fashion the appropriate balance between the public authority and private interests is a crucial issue. That is, to what extent and under what conditions should the regulatory authority's rule-making power be ceded to private market forces? Since the recent global financial crises have revealed that the private dominance of financial sector and regulatory process would lead to the legitimacy deficit, economic instability and turbulence, the changing balance between public authority and private market power in the financial regulatory process

[669] See id. All this demonstrates the significance of private sector involvement in the formulation and implementation of global financial standards.

affects both the stability of the financial system and the nature of the democratic order.[670] In this sense, the impact of private domination of regulatory processes on financial stability, democratic accountability and legitimacy should be addressed.

A proper balance of public and private interests is essential to the legitimate functioning of a market economy. Although financial transactions in the market-based economies are mainly private, the way in which the financial system operates makes it part of the essential infrastructure in any economy, of the value to the operation of markets, to the needs of states and to the well-being of civil society that it should be placed at the center of the public domain.[671] Over time, regulatory authorities need to have more close relationship with private market actors to respond promptly to their demands, and work in communion with private interests to monitor and supervise properly financial transactions. Symbiotic relations and shared-world views developed in public-private interactions provide private market actors with the opportunity to be incorporated into regulatory processes in the

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[670] See id (noting that the private dominance of regulatory process has altered the notions of the public interest that underpin the operation of financial order, changed parameters and objectives in public responsibility, and generated a fundamental problem of democratic accountability).

[671] See Geoffrey R. D. Underhill, The Public Good versus Private Interests in the Global Financial and Monetary System, International Comparative and Corporate Law Journal, Vol. 2, No. 3 (2000) at 335-359 (discussing the notion of the public domain and corresponding interpretations of the public interest in relation to the financial order).

financial system and to affect the nature of financial governance.[672] As a result, it is getting difficult to distinguish the public interest from the claims of private market actors in relation to the financial system[673]

Although private interests need to be incorporated into the process of regulatory reforms, the private sector itself is diverse and far from being monolithic and homogeneous.[674] This diversity implies the complexity of interactions between regulators and market actors who have conflicting interests and are marked by different relationships to national regulatory authorities. This difficulty has called into question how regulators can effectively coordinate diverse private market actors to design and formulate standards that are to be applied to financial sectors. In this sense, regulatory authorities at national,

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[672] See supra note 667, at 84.
[673] See id.
[674] See supra note 668, at 298. The banking sector, particularly in emerging market economies, is usually composed of commercial, specialized and development institutions. Diverse types of banking organizations tend to have dissimilar business activities, varying degrees of international exposure and divergent preferences for the design of standards for sound managerial practices. As a result, it is difficult to coordinate different private institutions and their respective interests in standard formulation and implementation within a international context. See id. at 285.

regional and global levels should consider these constraints in their attempts at designing new market disciplines.[675]

The private domination of the financial sector and regulatory process can change the notions of public good which underpin the formulation of regulatory standards designed to ensure market stability, compromise the policy autonomy of states to maintain their legitimacy, and pose a fundamental problem of democratic accountability.[676] In this regard, the clear definition of public interests distinct from the claims of private market actors is the key to ensuring the predominance of such interests in the financial system. The problems of democratic accountability and legitimacy become more acute in the international domain as witnessed in the recent episodes of economic turmoil resulting from the undue dominance of financial regulatory processes by powerful profit-seeking private market forces. In the absence of strong public authority over private market forces, international regulatory standards may not only conflict with economic and financial imperatives in developing and emerging market countries but also pose serious problems of

[675] Id.
[676] See id. 298.

policy management.[677] In these circumstances, existing institutional arrangements in the global financial system are more likely to facilitate the interests of powerful private actors and institutions from the leading industrial countries than to address the major concerns of the developing world and further financial market stability.[678] Unless this issue is addressed, deep skepticism will run over ongoing efforts to reform the international financial architecture.

E. The Need for Regional Cooperation

Despite strong pressures for the convergence of one-size-fits-all standards throughout the global system, the current global governance agenda has given little attention to the tension between harmonizing pressures of financial globalization led by advanced financial centers and prevailing diversity of financial systems and to their economic consequences.

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[677] Maintaining strong public authority over private market power requires the strengthening of democratic institutions of accountability in the national, regional and global levels of governance. *See* Geoffrey R. D. Underhill & Xiaoke Zhang, Conclusion: Towards the Good Governance of the International Financial System, *in* International Financial Governance Under Stress: Global Structures versus National Imperatives, supra note 667, at 367.

[678] See supra note 668, at 299 (arguing that "[t]he real issue about private involvement in standard formulation is thus a normative one about who can and ought to benefit from new regulatory standards and about whose interests these standards are to serve.").

Prevailing variations in national financial practices continue to complicate policy and regulatory cooperation through international institutions. Given that the failure of national governments to collaborate effectively at the international level, prospects for the successful restructuring of the global financial regime through international cooperation based on harmonization have been attenuated. Hence, persistent national differences in financial market structures and institutions have significant implications for international cooperative efforts at global financial governance. In order to enhance global financial governance toward a new world order in the international finance, it needs to explore specific policy and regulatory options to national and international policy makers in devising patterns of regional and international cooperation.

Since international cooperation has demonstrated little aptitude for effective cooperation in the past, regional cooperation has an important alternative that could operate alongside global monetary and financial governance.[679] The process of regional economic and monetary integration experiences of European countries provide valuable lessons. In

[679] It can be argued that regional cooperation is not immune to the difficulties of institutional collaboration.

these circumstances, many countries, particularly developing countries have shown increasing interest in regional institutional cooperation to manage the global monetary and financial system. At the regional level, emerging market governments have increasingly realized that they tend to encounter similar problems with market integration and have similar interests in financial regulatory framework, and would be better able to prevent financial market instability and to insulate vulnerable economies from negative spill-over effects from crises. The effects of financial contagion and the growing pressures for global financial integration have emphasized collaborative ties among Asian governments. Due to the tough conditions of IMF rescue packages, regional central bankers and financial regulators strived to seek the chance for the establishment of regional facilities. In particular, the Asian financial crisis of 1997 proved that the region did not have a regional financial mechanism to prevent and manage such crises. Since the crisis, the plan of a regional stability fund as a regional supplement system for the IMF has been put forward.[680] In general, the proposal targets to create a fund that is exclusive to Asia, while

[680] The Asian Monetary Fund would have been capitalized to the tune of USD 100 billion from the reserves

maintaining the decision-making within Asia. This attributes to a deep suspicion toward the decision-making of the major international financial institutions dominated by the United States.[681] The U.S. was opposed to the idea, claiming that funds were likely to be loaned on lenient terms that could be damaging in the long-term.[682]

As a matter of fact, the greatest obstacles to regional cooperation in East Asia have come from outside the region itself. Even if a regional monetary fund can provide countries with contingent credits during crisis periods under much more favorable conditions than those mandated by the IMF, and make Asian governments more independent and less subject to the policy demands of international institutions, greater regionalization faces a strong opposition from the institutions dominated by the U.S. Nevertheless, various proposals ranging from modest plans on more effective coordination

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of Japan, China and Taiwan. See generally Walden Bello, Inviting Another Catastrophe, 162 Far E. Econ. Rev. 42 (Aug. 1999).

[681] See *HK bank chief argues for Asian Monetary Fund,* Fin. Times, Jan. 6, 1999. Both the U.S. Treasury and the IMF were opposed to the proposal for a regional stability fund because it would weaken the IMF. See Bello, supra note 680.

[682] See *Japan seeks Asian Monetary Fund,* Fin. Times, Dec. 16, 1998. Interestingly, the U.S. Treasury has been critical of economic cooperation in areas where it cannot exert influence and produce practical outcomes to its liking. See Yokoi-Arai, supra note 585, at 1654.

among financial regulators and joint efforts to create more extensive Asian monetary union or common currency have been set forth.[683]

Although the Asian Development Bank (ADB)[684] has the potential to support policy dialogue on regional financial regulation, its diversity of membership may attenuate the development of financial regulatory aspects within. Other institutions such as Asia-Pacific Economic Cooperation (APEC), Association of South East Asian Nations (ASEAN), Executives' Meeting of East Asian and Pacific Central Banks (EMEAP), and Soth East Asia, New Zealand, Australia Forum of Banking Supervision (SEANZA) are not appropriate because of the informality of these institutions.[685] Hence, it needs to explore the benefits of a regional financial regulatory institution, because there is a strong desire to establish the institution within East Asia.

A regional financial regulatory institution would benefit East Asia since it would be possible to take advantage of geographic proximity and cultural understanding of the

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[683] See *East Asian nations reach accords on further co-operation,* Fin. Times, Nov. 29, 1999.
[684] The ADB is the only formal institution with a large number of Member States and legal entities. In 1966, the ADB was founded to promote social and economic progress of the Asian and Pacific region. See 8 Basic Documents of Asian Regional Organization 8 (M. Haas ed., 1980).
[685] For the analysis of regional institutions in Asia, see Yokoi-Arai, supra note 585, at 1648-1654.

region.[686] As for the advantages of a regional institution, it deserves noting one observer's analysis of the institutional approach.[687] First, a regional institution could have the advantage of being a "midway" between national regulatory authorities and international bodies. Such an institutional approach could play an important role in local specifics, and could design an appropriate regulatory framework for international standards to be applied in order to produce the identified effect within the region. Second, an appropriate regional institution could help attenuate the tension of applying regulations that are politically difficult to adopt. In a regional institution, negotiators could use regional peer pressure for the change of domestic policy on the basis that the regional institution is more aware of financial regulation. Third, cooperative formulation of financial regulation is likely to prevent the race to the bottom in financial regulation and to encourage the application of new international standard. Moreover, a regional institution could also be used to

[686] See Yokoi-Arai, supra note 585 at 1659 ("National regulators do not always have the objectivity or political will to conduct adequate supervision and to penalize non-compliant parties. International bodies may not have sufficient access to local particulars necessary to conduct adequate supervision.").
[687] See id. at 1660

encourage the enforcement of international regulatory standards by more effective involvement in the process of its formulation.

However, there are many arguments against the establishment of a regional institution for the supervision of financial activities and the formulation of financial regulation.[688] One counterargument is redundancy of international institutions, and another is opposition to an international organization constraining financial regulation based on sovereignty. The redundancy of international institutions lies in their inefficiency, not necessarily in the number of organizations. Over time, many international institutions and agencies become obsolete due to their bureaucratic inefficiency, mismanagement, and corruption. This is because of the difficulty in measuring their achievements relative to their objectives. In this sense, all public institutions at national, regional and international levels need to be structured to be more accountable. In response to the argument with traditional sovereignty of states, it should be noted that sovereignty is not preserved within the national domain.

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[688] See Yokoi-Arai, supra note 585, at 1666.

As noted, a regional institution can coordinate the implementation of financial regulation in order to obtain the identified effect, and can provide safety and soundness to the financial system. Given the benefits of a regional financial regulatory institution, the establishment of such an institution in East Asia would arguably require the existence of a regional community within the region to facilitate and support its operation.[689]

East Asia has a successful model of a regional community in the EU. It is important to note that European countries could move faster toward a community, because they have shared similar culture with languages based on the same Latin roots. In contrast, lack of linguistic, ethnic, religious, political homogeneity hinders cooperation within East Asia. Compared to other regions, East Asia has no converging sense of regional interests and the accompanying drive for regional integration.[690] Due to the experience of colonialism and imperialism, East Asian countries do not enthusiastically seek strong ties with advanced states, in particular Japan. Skepticism is still running over Japan, because the Japanese has justified past aggression and colonization of neighboring countries, and distortion of history

[689] See id. at 1664.
[690] Id. at 1665.

textbooks that whitewashed atrocities committed by Japanese soldiers against neighboring countries during World War II. In order for East Asian countries to forge a future-oriented relationship of cooperation, Japan needs to apologize for the country's past militarism in Asia. Since East Asia is the region, where ethics and feelings may be considered more important than economic benefits, a feeling of togetherness, self-confidence and mutual understanding of each other are essential to regional cooperation. There is still a glimmer on regional cooperation within Asia in that Asian countries are enthusiastic of creating Asian Monetary Fund based on Asian values.[691] These moves may strengthen the kind of collaborative ties that will support more ambitious programmes of regional and monetary cooperation in the near future

Since the rule of consensus has been a norm for most East Asian community, the initial stage of this community will depend on its consensus-making more than legal orientation.

[691] Their attempts at the establishment of a regional stability fund are displayed in the participation of central bank governors and finance ministers from Japan, Korea and China in the swap agreement of ASEAN. See *Asian Currencies: Swapping Notes*, Economist, May 13, 2000. Korea agreed to swap arrangements with Japan (USD 7 billion), China (USD 2 billion), Thailand (USD 1 billion). See Ministry of Finance and Economy, Republic of Korea, at http://www.mofe.go.kr/mofe2/html/mainindex.php3 (last visited March 15, 2004). This fund would be based on the core function of inter-governmental forum, member surveillance, and technical assistance. The fund should be supported by the creation of a zone of law in the region to enhance the law-based nature of the framework. See Yokoi-Arai, supra note 585, at 1668.

To attain and sustain economic development, East Asian countries should adopt new principles to further integrate. In any event, this objective can be accomplished only if there is legitimacy and procedural fairness in its decisions, and there is support from the legal orientation of the institution.[692] Needless to say, regional cooperation involves not only regulators but also private sector actors and their interactions with regulatory authorities at national and international levels.

[692] See Yokoi-Arai, supra note 585, at 1666.

VI. Conclusion: Toward a Just World Order in the Global Finance

A. International Standards and Global Governance

The past decades have witnessed a significant evolution of the international financial system. The globalization of finance has led to a remarkable increase in the economic integration in the world economy, and greater cross-border capital flows around the globe. Moreover, the emergence of new and complex financial instruments over the preceding decades has posed formidable challenges to financial regulatory authorities. The impact of financial globalization has raised considerable concerns in the wake of economic turbulence around the world. As such, the globalization of finance has attracted increasing attention to the integrated international regulation of financial institutions.

At the same time, the question of global governance has become an agenda for rethinking about the rules and norms that underpin the world order as a result of the Asian crisis of 1997. The financial crisis has shifted the focus in global and domestic policy debates back to the notion of market failure. Liberalization, deregulation and privatization are not likely to be simply considered as sound economic theory. They are viewed to have

negative redistributive consequences that the invisible hand cannot address rather than welfare enhancing outcomes. The consequence is a need for a new paradigm for governing globalization, because the global governance agenda that emphasizes the universalization of understanding of global governance based on efficiency and effectiveness through one-size-fits-all formulas, in which democratic accountability and participation is a secondary viable even though a diverse world cannot have rigid rules and regulations uniformly. Continued national differences in financial market structures and institutions have the important implications for international cooperative efforts at global financial governance. Since international cooperation based on harmonization will continue to be difficult, the regional solution can be a more effective alternative for governing and regulating the global financial markets. As a consequence, many countries, particularly developing countries have shown increasing interest in regional cooperation through regional institutional coordination. Regional solutions may help attenuate the tension between harmonizing pressures of financial globalization led by the advanced

financial centers and persistent national variations in financial systems and regulatory frameworks.

Furthermore, the ongoing standard-setting process has a crucial shortcoming in that most developing countries have had little participation in the standard-setting process, and thereby do not have the incentives to embrace and implement international financial standards. That is, the current global governance agenda is dominated by the powerful states, alliance constructions and interest representations that feature in the structures of international institutions and groupings. If less developed countries are excluded from the standard-setting process, the process may come to little consequence. In these circumstances, calls for the expansion of the membership in nontraditional international organizations recognize that institutional constructions of key global policy fora are not adequate in the context of global collaboration on a range of policy issues. Without the global collaboration through the extended participation, the global governance agenda aiming to construct a new world order is in need of reevaluation due to the inequitable nature of the negotiating processes themselves. Further, there is a need to devise effective

and legitimate international institutions for the global era in a world infused by democratic norms.

B. Democracy, Legitimacy and Accountability in the International Financial Order

Transgovernmentalists arguably look to the evolving practice of formal and informal governmental networks as the most realistic hope for asserting democratic principles, not to the empowerment of traditional international organizations as the way forward for democracy.[693] Yet the transgovernmentalism is undoubtedly controversial. The sharpest charge against networks is their lack of accountability in that they are networks of the world's technocrats. As there is no formal recognition of the role of government networks, accountability remains a concern. In response to the critiques on the lack of accountability in the networks, some highlights the difference between the creation of the Basel Accord and other global public policy initiatives.[694] According to the observer, one significant difference to note between the Basel case and the other cases, such as

[693] See Slaughter, Government Networks: The Heart of the Liberal Democratic Order, supra note 298, at 199.
[694] See Reinicke, Global Public Policy, supra note 181, at 113.

international trade is the participation of nongovernmental actors in the various policymaking stages is limited in the Basel case to one set of interests. Thus, the absence of conflict among domestic interests in the Basel case expedited the agreement reached by central bankers from member states. This loss of accountability at the domestic level was not compensated for at the international level in that the postwar international institutional structure was built to accommodate international economic interdependence, which, from a public policy perspective, is best accommodated by facilitating intergovernmental relations, and thus did not concern its democratic deficit. This view emphasizes that a democratic deficit facilitated the conclusion of a compromise. Further, the absence of accountability and transparency is arguably welcome for the timely conclusion of an agreement, and the prevention of a global financial crisis.[695] In this way, transgovernmental networks can arguably operate more quickly and effectively than formal bodies. This efficiency-oriented perspective is problematic in that trade-off

[695] See id. at 114. Here it deserves noting a charge against the Basel Committee in light of its slow response to the Asian economic crisis in 1997. Until the fall of 1997—more than a month after the Thai financial crisis exploded—that the Basel Committee did not start moving, apparently realizing the severity of the crisis facing developing countries. See Jaret Steiberg, The American Banker , Dec. 8, 1998, at 1.

between democratic accountability and efficiency in global public policymaking may not be based on a full consideration of equity and justice.[696]

In fact, transgovernmental networks do not provide mechanisms for either delegated or participatory accountability.[697] It is often unclear which organizations have delegated powers to them because the networks are informal. Moreover, participatory accountability is minimal in that the general public is not involved and transparency is typically lacking. Although abuses of power may in some instances be controlled by the fragmentation of power and conflicts of interests between the participants, cooperation among the members of the networks can easily become collusion of outsiders. It can be said that there is some peer accountability within transgovernmental networks, because the entities involved may request information from one another and sanction other entities

[696] Nevertheless, it is argued that "the informality, flexibility, and democratization of networks mean that it is very difficult to establish precisely who is acting and when. See Slaughter, Governing the Global Economy, supra note 193, at 193-194. In response to the critiques of democratic accountability, Slaughter claims that the critics often miss several key points: legitimacy may derive from performance as well as process; government networks typically operate through persuasion rather than authoritative decision; and these networks may actually empower democratic politicians and their governments by promoting cooperation among them when the alternative could be leaving decisions to markets. See id.

[697] See Grant & Keohane, Accountability and Abuses of Power, supra note 275, at 11.

for perceived misbehavior.[698] However, there are no clear mechanisms of accountability since accountability requires a public standard of legitimacy to which political actors are held. Nonetheless, there is the potential for negotiation constraints. The power of an entity in the network may be checked only where abuses are against the interests of principles of the other entities within the networks.[699] In this regard, diversity among parties is a precondition for negotiation constraint. Otherwise, collusion is likely to follow.[700] However, serious issues of democratic accountability still remain because transgovernmental regulatory organizations operate like clubs. In short, the organizations look like closed and secretive clubs to functional outsiders, even in the same government.

By pointing to democratic deficit, globalization protesters call into question the legitimacy of international institutions and transgovernmental organizations in that they are undemocratic, but their rules have powerful effects despite the weakness of the institutions

[698] See Nye, The Paradox of American Power, supra note 97, at 108
[699] Id.
[700] Id.

and organizations.[701] As such, consistency with democratic procedures has become increasingly important in today's world. In this context, there is a need to develop the legitimacy of global governance. To that end, three key things are required: (1) greater clarity about democracy, (2) a comprehensive understanding of accountability, and (3) a willingness to experiment.[702] In short, the club model requires modification. As one argues, it is significant not to put more weight on the organizations than they can bear.[703] Rather than pursue strong institutions to strengthen deep integration at the international level, it is more appropriate to pursue "networked minimalism."[704] Putting too much weight on the organizations before they are sufficiently legitimate to bear leads to deadlock.

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[701] It deserves noting the protesters' interesting points: long lines of delegation from multiple governments and lack of transparency often weaken accountability; although the organizations may be agents of states, they often represent only parts of states. See id.

[702] See id. at 109. It is argued that "[d]emocracy is government by officials who are accountable to the majority of the people in a jurisdiction ... For democracy to work well, "the people" have to regard themselves as a political community. ... Democratic governments are judged both on the procedures they follow (inputs) and on the results they obtain (outputs)." See Robert O. Keohane & Joseph S. Nye, The Club Model of Multilateral Cooperation and Problems of Democratic Legitimacy, *in* Efficiency, Equity, and Legitimacy: The Multilateral Trading System at the Millennium 281-282 (Roger B. Porter et al. eds., 2001). Further, both inputs and outputs influence legitimacy at the international level. Thus, for international institutions to be legitimate, their practices and the result of their activities need to meet broadly democratic standards. See id.

[703] See id. at 290.

[704] Id. According to some observers, "[n]etworked minimalism is a broad principle of governance—more a matter of what not to try (hierarchy and intrusiveness in domestic policies) than what to do." See Josph S. Nye & Robert O. Keohane, Introduction, *in* Governance in a Globalizing World 37 (Joseph S. Nye et al. eds., 2000) Further, "[n]etworked minimalism seeks to preserve national democratic processes and embedded liberal compromises while allowing the benefits of economic integration." See id.

In short, government networks may reinforce the traditional undemocratic features of international law by consolidating the position of the state over the individual unless transparency and certainty over the impact of such processes are present. In this prescriptive process, the benefits of greater plurality will be lost. Hence, developing appropriate measures to judge the transparency and democratic accountability in the institutions is crucial to deal with global problems.[705]

Similarly, national governments need to achieve a balance between expertise and representativeness, and accountability to ensure democratic governance at the domestic level. While globalization has played a major role in convincing many countries to free their central banks from political control, what has been overlooked in the rush to make central banks independent is the fact that such political insulation does not come at a price. Indeed, the insulation of central banks from popular control has become one of the signifiers whereas achieving a balance between representativeness and independence is a tough task. Supporters of central-bank independence defend it in two related ways. The

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[705] Through their participation in decision-making, global civil society, in particular, epistemic communities, and markets play a role in enhancing the legitimacy of global governance. See Keohane & Nye, The Club Model of Multilateral Cooperation, supra note 702, at 291.

first is theoretical and justifies treating monetary policy differently from other kinds of policy due to its supposed special characteristics. The second is practical and justifies treating monetary policy differently because so doing supposedly creates significant economic benefits.[706] In response, some observers note that monetary policy is simply not that distinctive and need not be treated differently while they admit that monetary policy is actually complicated and confusing; politicians and public do often view with a short term perspective.[707] The second rationale for central-bank independence is also strictly practical and unconvincing.[708] As far as developing countries as opposed to industrial ones are concerned, the positive impact of independent central banks on inflation do not simply continue to exist, both because politics in developing countries is often misguided by informal rules rather than coercive laws and formal procedures, and because such countries

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[706] According to advocates of central-bank independence, monetary policy cannot be entrusted to normal policymaking process because it is complicated and requires a disciplined, long-term perspective to succeed. Further, ordinary people and politicians cannot also think far into the future or accept pain now for gain later in the context of time inconsistency problem. See Sheri Berman & Kathleen R. McNamara, Bank on Democracy: Why Central Banks Need Public Oversight, Foreign Affairs, Mar.-Apr. 1999, at 3.
[707] See id.
[708] It is argued that central-bank independence has no measurable effect on real economic performance. That is, insulating a country's central bank from popular control from politicians and publics, and giving it to technocrats seems neither to span economic growth nor to reduce unemployment. See id. at 4. The one area where a possible boon from central-bank independence has been detected may be in fighting inflation. However, some note that independent central banks have little positive long-term impact on inflation unless backed by a societal consensus on the need for stable prices. Id. at 5.

lack the range and depth of institutions required to carry out full policy implementation and coordination.

By turning over monetary policy to unelected and often unaccountable technocrats, countries concede much control over their economic fates.[709] Since surrendering such authority would be a critical decision, it is worth taking only after full national debate. Since economic benefits are questionable, fully taking control of monetary policy away from government regardless of the particular national or economic context could have dire outcomes. Moreover, one argues that even though "transparency—openness—is now recognized as a critical aspect of democratic process[, and t]here cannot be effective democratic governance without information[, y]et central banks continue to operate in secrecy."[710] In short, transparency and democratic control on balance create moderation,

[709] In this regard, it is enough to ask whether national policy should not be delegated to independent delegates. See id. at 4 ("Anyone unwilling to go so far should be prepared to let monetary policy be just as subject to democratic control as everything else.). On the opposed perspective, see Keohane & Nye, supra note 702, at 277 ("U.S. institutions that are deliberately insulated from elections—in particular, the Supreme court and the Federal Reserve Board—routinely publish their deliberations or opinions, so that not only the results, but the reasoning and disagreements involve, can be publicly known. These institutions are held accountable through criticisms by professional networks, such as legal scholars writing in law journals and economists writing scholarly articles and offering opinions in the public media. Without transparency, these means of accountability would be eviscerated.").

[710] See Berman & McNamara, supra note 706, at 7 ("If the [central] bank's decision-making processes were reasonably transparent and open to democratic oversight, the pain could perhaps be explained and justified.").

success, and most importantly legitimacy whereas they may produce mistakes and embarrassment. These are exactly the qualities that the world economy needs in the global era. Consequently, the rhetoric of democracy has an important role in the absence of systemic democracy at the national and international levels in a globalizing world.

C. The State-Market Condominium of Global Finance

While the global financial community is still in a state of transition, much more understanding of the relationship of the state to the market is required to govern and regulate properly an increasingly integrated world economy in the global era. Indeed, the relation between states and markets has varied by place and by time. Over time markets have become more extensive, more integrated, and more intricately interwoven into the fabric of life. Evolving and integrated markets pose different challenges for governance and regulation than those it was sought to master when markets were simpler, more

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In this context, Keohane and Nye assert that"[t]ransparency does not imply governance through elections, as the examples of the Supreme Court and the Federal Reserve Board show. Transparency does mean that the arguments and reasoning on trade rules, and the adjudication of those rules, are made public. Democratic societies demand this of institutions that allocate values profoundly affecting people's lives." See Keohane & Nye, supra note 702, at 277.

segmented, less audacious in their reach. The growing scale, reach, and complexity of market institutions and market players are reopening everlasting questions about the role of the public and private sectors, and redefining what it means to govern and regulate properly. In this regard, from the more state-centric perspective one argues that the state is still very much in control of the process of global financial integration, working through the cooperative regulatory and supervisory process of the Basel Committee among others.[711] By contrast, the other claims that the market was winning in the contemporary period of transnational integration, which yielded a retreat of the state in the face of market ascendancy,[712] largely self-induced, with serious dangers for the legitimacy and functioning of the global financial system. These two viewpoints recognize the continuous interaction or interdependence of states and markets in the process of governance and regulation, but they imply that states and markets are antagonists competing blueprints for social organization. As a result, it is argued that when one advances, the other gives away.

[711] See Kapstein, Governing the Global Economy, supra note 209, at 103-128.

[712] See Susan Strange, The Retreat of the State: The Diffusion of Power in the World Economy 121 (1996) (arguing that the balance between the state and the market shifted after 1970s in a way that made the state just one source of authority among several and left "a yawning hole of non-authority or non-governance").

Although the state-market dichotomy approach viewing states and markets as separate (if interacting) entities is often a useful abstraction, it is critical to note that states and markets are part of the same integrated ensemble of governance and regulation, a state-market condominium, and should be thought of as such.[713] The regulatory and policy-making institutions of the state are one constituent of the market, one set of institutions, through which the overall process of governance and regulation operates.[714] At the same time, the state is and should be involved in the market, because the market cannot function as a system without political and regulatory processes that national regulatory authorities represent.[715] Likewise financial regulation and supervision has always involved private sectors. Recent financial regulatory and supervisory trend is toward more market-oriented in a global context, and a corresponding adjustment of national practices. Furthermore, the state has progressively delegated a number of tasks either to private bodies or international organizations. In this sense, there is not so much a retreat of the state in the face of market

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[713] See Geoffrey R.D. Underhill, States, Markets and Governance for Emerging Market Economies: Private Interests, the Public Good and the Legitimacy of the Development Process, International Affairs, Vol. 79, No.4 (2003) at 765.

[714] See id.

[715] Id. at 779. Democratic accountability is required to build the state-market condominium where functioning democracy is absent or poorly embedded because the condominium is not immune from rent-seeking, powerful and predatory private interests. See id. at 777.

forces as transformation of the state in symbiosis with transformation of markets.[716] The form and functions of the state will rather continue to evolve, as they did in the past. As such, the private sector plays a crucial role in regulating global financial markets, even as it seems to operate in private ways.

However, the significant to note is that the market will become discredited as an instrument of policy and regulation when the private market processes reveal only greed and privilege for the very few, and the extent to which private agent cannot fulfill their responsibility to society as shown in the Enron debacle.[717] As a matter of fact, the private sector can play a crucial role in the financial system at national, regional and international levels as long as there is an appropriate balance between public authority and private interests in the domain of global financial governance and regulation. To that end, there is a need to maintain strong public authority over private market power in the financial system

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[716] See id. at775

[717] Id. at 779.

because of threats posed to democratic accountability by the undue private dominance of public purpose become more severe in the international domain.[718]

As noted, the global era is a time of unprecedented opportunities and unique challenges to market participants, and regulatory authorities alike in that the increasing complexity of globalization brings with it in a global system of governance and regulation. Needless to say, both the public and private sectors are required to play a key role in dealing with challenges posed by technological advancements and the rapid innovations, and pursuing the objective of a modern, flexible yet stable economic system. Although the perspectives of the public and private sectors may differ from time to time, the objective of both parties is the same—to maintain a strong and vibrant economic system. It is evident that each satisfying one's responsibilities and reinforcing the other through the sustained cooperation will be able to properly govern a rapidly evolving, ever-more integrated world economy in the global era.

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[718] Democratic accountability is required to build the state-market condominium where functioning democracy is absent or poorly embedded.

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