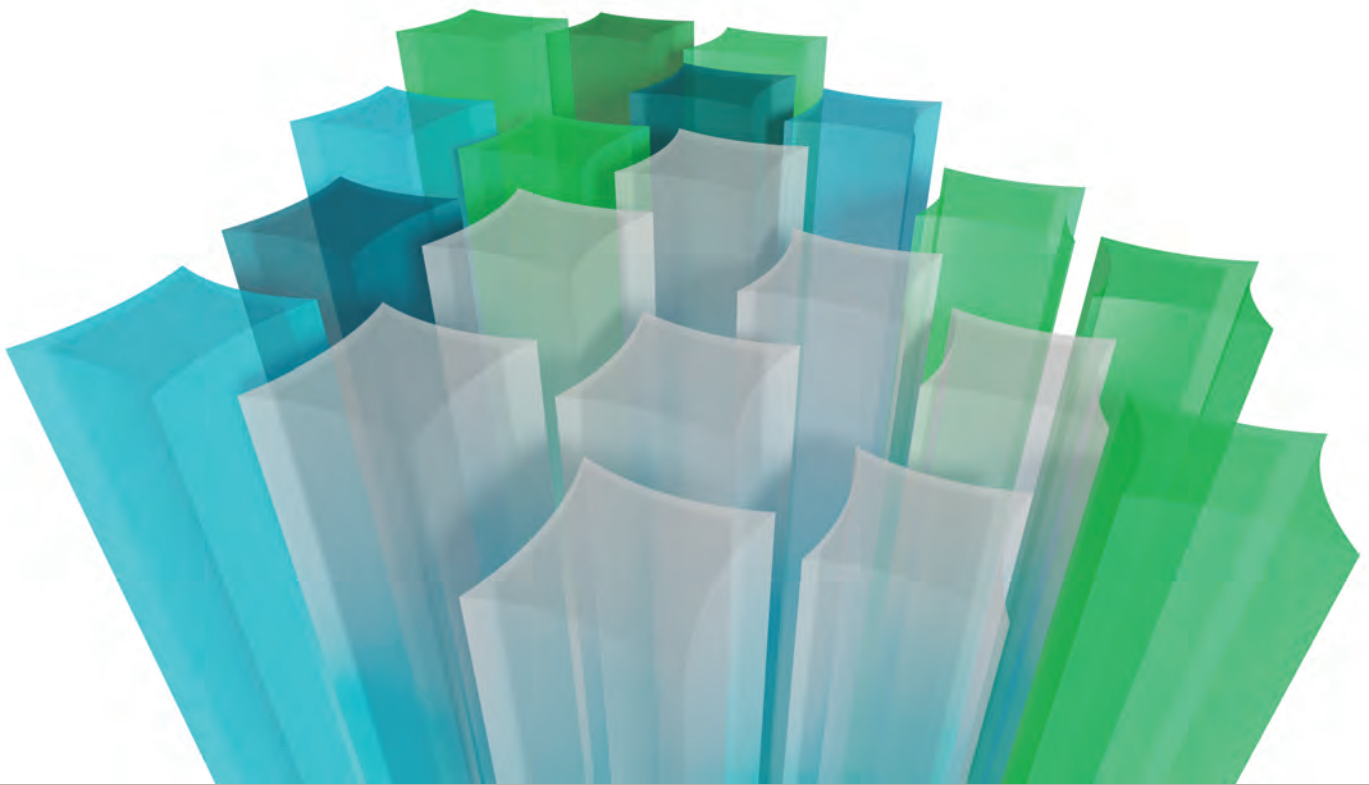


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The Financial Stability Board and International Standards



Eric Helleiner



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Addressing International Governance Challenges

Table of Contents

Summary	2
About the Author	3
Introduction	3
Membership and Legitimacy	2
Widening Membership and New Challenges	5
Enduring Legitimacy Problems vis-à-vis Non-members	7
Mechanisms for Promoting Compliance	8
Strengthening Compliance in Four Ways	9
New Challenges and Priorities	11
The Importance of Macroprudential Regulation	12
A Stronger Capacity to Address Macroprudential Issues	13
The Challenges of Macroprudential Regulation	15
Addressing Private Capture	16
Conclusion	17
Appendix: Comparing the Financial Stability Forum and the Financial Stability Board	20
Works Cited	22
Acronyms and Abbreviations	25
About CIGI	26

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Summary

Established in April 2009 by the Group of 20 (G20) leaders, the Financial Stability Board (FSB) has been described by US Treasury Secretary Tim Geithner in very ambitious terms as a new “fourth pillar” of the architecture of global economic governance alongside the International Monetary Fund (IMF), World Bank and World Trade Organization (WTO). Its basic structure and mandate build directly on those of its predecessor, the Financial Stability Forum (FSF), an institution that did not live up to the hopes of many of its founders. Will the FSB meet the same fate in its efforts to strengthen international prudential standards?

Three features of the FSB will help it overcome some of the FSF’s weaknesses: its larger membership addresses some of the FSF’s legitimacy problems; it has been assigned more effective mechanisms to encourage compliance with international standards; and the FSB has been given a stronger capacity to tackle macroprudential issues. Each of these features also raises new challenges and priorities to be addressed:

- With the FSB’s larger membership, the following should be encouraged: more focus on principles-based international standards rather than detailed rule-based ones; the strengthening of the voice of new developing country members within the institution; and further efforts to address its lack of accountability to non-members.
- Each of the FSB’s four new mechanisms to strengthen compliance with international standards could be improved: the mandatory regular Financial Sector Assessment Programs (FSAPs) and publication of the detailed IMF/WB assessments related to the ROCSs for members; the new membership obligations to implement international standards; the new peer-review process for FSB members; and the new FSB-led process to tackle non-cooperating jurisdictions.
- The FSB’s capacity to tackle macroprudential issues could be strengthened by: clarifying the standard setting bodies’ (SSBs) accountability to the FSB; continuing to prioritize the creation of international standards for counter-cyclical regulation and the treatment of systematically important institutions, markets and instruments; and devoting more attention to the task of minimizing the risk of private sector capture of financial regulatory policy making.

If these challenges and priorities are met successfully, the FSB will strengthen the institutional foundation of international regulatory cooperation. Rather than becoming a powerful international body, however, its role would remain primarily focused on facilitating transgovernmental networks, with ultimate responsibility for financial regulation and supervision still resting firmly at the national level (or perhaps at the regional level in the case of Europe).

About the Author

Eric Helleiner is CIGI Chair in International Political Economy at the Balsillie School of International Affairs and Professor of Political Science of the University of Waterloo. He received his PhD from the London School of Economics and is author of *States and the Reemergence of Global Finance* (1994), *The Making of National Money* (2003), and *Towards North American Monetary Union?* (2006). He is author of many articles and chapters on issues relating to international money and finance, and is co-editor of a number of collections, including most recently *The Financial Stability Board: An Effective Fourth Pillar of Global Economic Governance?* (CIGI 2010), *Global Finance in Crisis: The Politics of International Regulatory Change* (Routledge, 2010), *The Future of the Dollar* (Cornell, 2009), *The Geopolitics of Sovereign Wealth Funds* (special section of *Geopolitics*, 2009), and *At Home Abroad? The Dollar's Destiny as a World Currency* (special issue of *Review of International Political Economy*, 2008). He has been a Canada Research Chair, and has won the Trudeau Foundation Fellows Prize, the Donner Book Prize, and the Marvin Gelber Essay Prize in International Relations. He was also recently a member of the Warwick Commission on International Financial Reform (2009) and is presently co-editor of the book series *Cornell Studies in Money*.

Introduction

Established in April 2009 by the G20 leaders, the Financial Stability Board (FSB) has been described by US Treasury Secretary Tim Geithner in very ambitious terms as a new “fourth pillar” of the architecture of global economic governance alongside the International Monetary Fund (IMF), World Bank (WB) and World Trade Organization (WTO) (US Treasury, 2009).¹ But the FSB is a very different kind of pillar than these other institutions. It lacks any formal power and has only a tiny staff, and its creation has not been ratified by any national legislature. The FSB’s membership also includes an odd mix of central bankers, finance ministry officials and supervisory and regulatory authorities from a relatively narrow group of countries alongside officials from international financial institutions and standard-setting bodies. The FSB is designed to act more as a loose network of these various national and international officials than a substantial

1 For their helpful comments, I am grateful to Rolf Alter, Tom Bernes, Amar Bhattacharya, Jack Boorman, Colin Bradford, Ralph Bryant, Peter Gakunu, Morris Goldstein, Jim Haley, Sungmin Kim, Rajiv Kumar, Jacques Mistral, Avinash Persaud, Tony Porter, Cyrus Rustomjee, Pierre Siklos, John Sloan, Paola Subacchi and Jong-Goo Yi. None of these individuals is, of course, responsible for the content of this paper.

inter-governmental institution along the lines of the IMF, World Bank or WTO.

The FSB may look like an unusual institution, but its basic structure and mandate build directly on that of its predecessor, the Financial Stability Forum (FSF). Created in the wake of the last major global financial crisis in 1997-1998, the FSF also began its life with high hopes. But the organization came to play a more marginal role in global financial governance than many of its founders had hoped. As Howard Davies and David Green (2008: 116) put it, “the FSF has not met some of the ambitious aims foreseen for it when it was established in early 1999.” Will the FSB meet the same fate? This paper addresses this question with a special focus on the FSB’s mandate to strengthen international prudential standards.²

I argue that three features of the FSB will help it overcome some of the FSF’s weaknesses: its larger membership should help it address some of the legitimacy problems that the FSF faced; it has been assigned stronger mechanisms for encouraging compliance with international standards; and it has been given a stronger capacity to tackle macroprudential concerns. At the same time, each of these changes raises new challenges and priorities, and I advance suggestions to address them (which are summarized in the conclusion for readers wanting to go directly to the punch line). If these challenges and priorities are met successfully, the FSB will strengthen the institutional foundation of international regulatory cooperation. Rather than becoming a powerful international body, however, its role would remain primarily focused on facilitating transgovernmental networks, with ultimate responsibility for financial regulation and supervision still resting firmly at the national level (or perhaps at the regional level in the case of Europe).

Membership and Legitimacy

Although the construction of international prudential regulatory standards dates back to the 1988 Basel Accord on bank capital standards, the process really accelerated after the 1997-1998 global financial crisis when the Group of Seven (G7) policy makers launched an ambitious effort to develop and promote international financial standards in a wider range of sectors. The principal rationale for the construction of this “international standards regime” was that the 1997-1998 crisis had emanated primarily

2 The FSB’s mandate also includes tasks such as conducting (jointly with the IMF) early warning exercises, setting guidelines for and supporting the establishment of international supervisory colleges for private institutions and supporting contingency planning for cross-border crisis management.

from developing countries whose domestic financial regulation and supervision needed to be improved (Walter, 2008). International prudential standards were created or endorsed (in the case of pre-existing standards) for banking supervision, securities, insurance, payments systems, corporate governance, accounting and auditing.³ These standards were developed in a number of standard-setting bodies (SSBs), including the Basel Committee on Banking Supervision (BCBS), the International Organization of Securities Commissions (IOSCO), the International Association of Insurance Supervisors (IAIS), the Committee on Payment and Settlement Systems (CPSS), and two private bodies, the International Accounting Standards Board (IASB) and the International Federation of Accountants (IFAC).

The FSF was created by G7 finance officials in February 1999 to coordinate the emerging international standards regime by bringing together in one place for the first time representatives of most of the key SSBs (BCBS, IAIS, IOSCO, IASB and the CPSS), the relevant international institutions and bodies (the IMF, WB, Bank for International Settlements (BIS), Organisation for Economic Co-operation and Development (OECD), and the Committee on the Global Financial System), and the central bank, finance ministry, and regulatory and supervisory authority from each G7 country (along with the European Central Bank (ECB)⁴). The FSF was assigned a very small secretariat (seven staff and a secretary-general) in Basel and a chairman, Andrew Crockett, then general manager of the BIS.⁵ As one of its first tasks, the FSF compiled a compendium of existing international prudential standards, from which it identified 12 as priorities to be promoted worldwide.

The FSF's ability to encourage the adoption of these standards was undermined from the start by a basic legitimacy problem. The very countries whose practices this initiative was designed to improve were excluded from the FSF's membership (which was restricted initially to G7 countries). The legitimacy problem was compounded by the fact that the representation of developing countries was also very limited within many of the SSBs. Before 2009, the BCBS membership consisted entirely of developed countries (the G7 countries plus Belgium, Luxemburg, the Netherlands, Spain, Sweden and Switzerland). The

CPSS's membership was restricted to the G7 countries, Belgium, the Netherlands, Singapore, Hong Kong, Sweden and Switzerland. Even within the more universal IOSCO, the key regulatory initiatives came from its Technical Committee that had members from only the G7 countries, Australia, Hong Kong, Mexico, the Netherlands, Spain and Switzerland. The private IASB was also dominated by representatives from developed countries.

The fact that the international standards regime was divided so starkly into "rule-makers" and "rule-takers" undermined the commitment of the latter to its goals. Not surprising, many developing country officials were wary of embracing standards whose content they had had little say in creating. The standards usually drew on the practices of developed countries, and more specifically on what Andrew Walter (2008) calls a model of "regulatory neoliberalism" based on an (idealized) Anglo-American experience. The specific content of many of these standards was often seen as inappropriate to domestic needs and contexts in developing countries, and skewed to benefit developed countries. Even when the standards were deemed desirable, their implementation often involved large costs for developing countries, both economic and political. More generally, some developing country policy makers questioned the fact that the creation of international standards regime had been driven by an assumption that domestic policy failures in developing countries had been the prime cause of the late 1990s' crisis. This assumption, they believed, overlooked the role that international private financial flows had played in generating and exacerbating the crisis.

The legitimacy problems created by the narrow membership of the FSF and SSBs were in fact widely predicted at the time of the FSF's creation. The first official proposal for a body like the FSF had come from a working group of the G22, an informal grouping of developed and developing countries that the US had organized in early 1998 to respond to the global financial crisis. Its October 1998 report called for the creation of an institution (the Financial Sector Policy Forum) whose mandate and structure was very similar to the eventual FSF except that it would have involved the "full inclusion of systemically important emerging markets." The rationale for wider membership was clear:

Standards should be developed in a collaborative manner to ensure that both the developed and emerging world have a voice in the standard-setting processes. The inclusion of a wider range of countries helps to ensure that the standards developed are more widely adopted in a timely fashion. (G22, 1998: x,v)

3 The G7 also encouraged compliance with IMF standards relating to macroeconomic policy and data transparency, a World Bank standard on insolvency and creditor rights and the FATF's recommendations relating to anti-money laundering and terrorist finance.

4 Davies and Green (2008: 114) note that the ECB "turned up uninvited at the first meeting and has never been shown the door."

5 Crockett was succeeded by Roger Ferguson of the US Federal Reserve, and then Mario Draghi, governor of the Bank of Italy.

One of the strongest supporters of the FSF's creation, the Canadian finance minister at the time, Paul Martin (1999b), echoed this argument in the summer of 1999:

it is not reasonable to expect sovereign governments to follow rules and practices that are 'forced' on them by a process in which they did not participate. Therefore, whatever form the renewed global financial architecture ultimately takes, all countries must 'buy into it' and take ownership. Only then will the framework have legitimacy.

Despite these arguments, G7 finance officials established the FSF as a G7-only institution, a strategy that had been recommended in a February 1999 report they had commissioned from Hans Tietmeyer that laid out the rationale for the new institution. Tietmeyer's (1999: 6) report cautiously suggested that membership could be extended over time to include "a small number" of additional countries, and the G7 countries took up this suggestion later that year, inviting Australia, Hong Kong, the Netherlands and Singapore to join (and then Switzerland in 2007). But Tietmeyer and others resisted further expansion (Martin, 2008: 204). Drezner (2007: 147) argues that the preference for a narrowly constituted FSF reflected the desire "to ensure control over the establishment and enforcement of common financial standards." Wider membership would likely have made agreement on common standards more difficult. Indeed, when the G22 working group (G22, 1998:6) cited above endorsed the development of international standards, it had cautioned that "a 'one size fits all' approach would be unwise given countries' different stages of development."

The G7's refusal to expand the FSF's membership remained a source of frustration to many developing country policy makers in subsequent years. To be sure, the creation of the G20 finance ministers' and central bank governors' meeting in September 1999 — with Martin as the initial chair — was designed to help address this legitimacy issue and some speculated that it might coordinate the FSF's activities. But this latter idea was not endorsed at the first meeting and the body played a low-profile role in this issue area before the current crisis (Drezner, 2007: 141, 146; Martinez-Diaz, 2007). The FSF involved some developing country representatives within its working groups and held regional meetings involving non-member countries in Africa, Latin America, Asia-Pacific, and Central and Eastern Europe. Other bodies, such as the BCBS, also engaged in various consultations and outreach activities with non-member countries and regional groupings, including through its Core Principles Liaison Group (Porter and Wood, 2002: 245-248; Porter, 2009). Indeed, its 1997 Core Principles for Effective

Banking Supervision had been developed by a group that included non-member developing countries.⁶ Although these various activities were important, they did not overcome the weak or non-existent formal representation of developing countries within the FSF and SSBs.

Widening Membership and New Challenges

It was not until the creation of the G20 leaders' forum and their first summit in November 2008 that this legitimacy issue finally began to be addressed more squarely. At that summit, the G20 leaders endorsed the FSF's leadership role in coordinating international regulatory reform in light of the new financial crisis, but this endorsement came with a key condition: "the Financial Stability Forum must expand urgently to a broader membership of emerging economies." When the creation of the FSB was announced at the second G20 leaders' summit in April 2009, its membership included all the initial members of the FSF, the rest of the G20 countries as well as Spain and the European Commission.⁷ The FSB was also made formally accountable to the G20 leaders (whereas the FSF had been accountable to G7 finance officials). Even before the FSB's creation in April 2009, the G20 leaders had already assumed the role of setting the agenda on international regulatory reform through the formation of working groups, each of which was co-chaired by a developed country and a developing country.

At their first summit, the G20 leaders had also stated that "other major standard setting bodies should promptly review their membership." Many key SSBs quickly expanded to include emerging market countries as members. IOSCO's Technical Committee invited Brazil, China and India to join before the April 2009 G20 Leaders' Summit, while the BCBS expanded in an awkward two-step process (first in March 2009 and then June 2009) to include all G20 countries that were not yet members, plus Hong Kong and Singapore. The CPSS also welcomed in July 2009 the following new members:

6 The non-members included: Chile, China, the Czech Republic, Hong Kong, Mexico, Russia and Thailand. The BCBS (1997: 2) reports that nine other countries were also "closely associated with the work": Argentina, Brazil, Hungary, India, Indonesia, Korea, Malaysia, Poland and Singapore.

7 The G7 countries along with the Brazil, Russia, India and China (BRICs) were assigned three representatives each in the new body, while Australia, Mexico, the Netherlands, Spain, South Korea and Switzerland were given two, and everyone else was left with one (Argentina, Hong Kong, Indonesia, Singapore, Saudi Arabia, South Africa and Turkey). To make plenary discussions manageable with the enlarged membership, delegations with more than one seat have one member seated at the back (but who retains the rights of the table and can be rotated with the others according to topic).

Australia, Brazil, China, India, Mexico, Russia, Saudi Arabia, South Africa and South Korea. In addition, the IASB guaranteed geographical diversity on its board for the first time in a manner that guaranteed developing country representation.⁸

These various reforms mark a major change in the governance of international financial standards: many developing countries now have a seat at the rule-makers' table. This change should help to boost the legitimacy of the international standards regime in the ways that the G22 working group predicted in the late 1990s. Interestingly, two of the key leaders of the effort to create the FSB — FSF chairman Mario Draghi and US Treasury Secretary Tim Geithner — were members of that earlier working group.⁹ At the same time, these reforms raise some challenges for the FSB that need to be addressed.

First, wider membership may make decision making within the FSB more difficult. The FSB's key decision making body — its plenary involving all the members — operates on a consensus principle. The task of reaching consensus on international standards in a body whose country membership has doubled to 24 from 12 is obviously more difficult, particularly when many of the new developing country members may bring quite distinct perspectives on regulatory standards to the table. The difficulties of reaching consensus in this larger and more heterogeneous group may be compounded by the loss of prestige of pre-crisis Anglo-American regulatory models which had provided a kind of focal point for international harmonization before 2007 (Helleiner, Pagliari and Zimmermann, 2010).

One possible way forward is the approach endorsed by the G22 working group in 1998: policy makers could reconsider the benefits of a one-size-fits-all model for international standards that has been promoted over the past decade. International standards could more explicitly recognize the distinctive needs of special classes of countries, such as developing countries, in

the way that international trade rules sometimes have.¹⁰ A more effective strategy, however, might be simply to place more emphasis on core principles in international standard standing rather than detailed harmonized rules. This approach would leave considerable discretion for national authorities to interpret standards according to local conditions and preferences.

Some analysts argue that a more principles-based approach is not just politically realistic but also desirable in its own right.¹¹ Dani Rodrik (2009) notes that detailed rules-based global standards may “end up converging on the wrong set of regulations” and they overlook the fact that “desirable forms of financial regulation differ across countries depending on their preferences and levels of development.” Former Bank of Canada Governor Gordon Thiessen (2010: 9) makes a similar point:

Countries and their financial systems are different, and one size does not fit all. Having all major countries subject to the same precise regulation seems to me to be moving in the direction of making risks even more highly correlated internationally in the future.

Thiesen also highlights one further benefit of principles-based vis-à-vis rules-based regulatory cooperation: “once rules are set out, the implication is that anything that is not covered by the rules is acceptable. A huge amount of activity is then devoted to finding ways around the rules.” Another supporter of principles-based international standards, Daniel Tarullo (2008: 284), notes one further drawback of detailed international rules at the end of his detailed study of Basel II:

the history of Basel II bolsters the common criticisms of such initiatives as too likely to be maladapted to conditions in each country and too difficult to modify in response to changing external circumstances. The Basel II experience also suggests that the effort required to complete and sustain a complex harmonization arrangement may come with high opportunity costs, as other more productive modes of international cooperation remain comparatively undeveloped.”¹²

8 It expanded the membership of the board from 14 to 16 and then required that four members were from Asia/Oceania, four from Europe, four from North America, one from Africa, one from South America, and two others. The IASB's trustees who oversee its operations are also selected with guaranteed regional representation. The IASB also now has a new Monitoring Board, on which a representative of IOSCO's Emerging Markets Committee sits (along with a representative from IOSCO's Technical Committee, the US Securities and Exchange Commission (SEC), Japan's Financial Services Agency and the European Commission).

9 Draghi was in fact its co-chair, representing Italy (he worked in the Ministry of Finance at the time). Geithner was working in the US Treasury.

10 Drezner (2007: 137) notes that only one of the 12 standards promoted by the FSF provided “any differentiation for the country's stage of economic development.” This is an IMF data dissemination standard, rather than any of the financial prudential standards.

11 This is not to say that there are not some areas where detailed rule-based international standards are important — see the Challenges of Macprudential Regulation section 4.2 of this paper.

12 Other recent advocates of principles-based international standards include Bryant (2003; 2008), Eichengreen (2009), Sheng (2009) and the Warwick Commission (2009).

Efforts to centre international regulatory cooperation more around broad principles than detailed rules are likely to enhance the commitment of the new members of the FSB to the institution by promising more policy space. This commitment could also be bolstered by ensuring that their new formal participation in international rule-making translates into real influence. Stephany Griffith-Jones (2009) suggests that the FSB's various committees might consider the model of the G20 working groups involving co-chairs from developed and developing countries (this was also the model of the G22 working groups in the late 1990s). Another approach might be to rotate the chair roles between developed and developing countries. To cultivate effective influence in the FSB and SSBs, Griffith-Jones suggests that developing country governments might also benefit from greater technical and research support, perhaps via a developing country body such as the Group of 24 (G24). The FSB could also create a standing committee or working group focused on issues of particular relevance to developing countries (in a similar fashion as IOSCO's Emerging Markets Committee).

Enduring Legitimacy Problems vis-à-vis Non-Members

In addition to addressing the challenges posed by larger membership, the FSB must also confront the fact that its membership is still very narrowly constituted in comparison to the other three pillars of global economic governance. Because the FSB has high ambitions to promote worldwide compliance with the standards that it endorses (see next section), its legitimacy vis-à-vis non-members may become quite politicized quickly. Mechanisms need to be developed to provide a voice within the FSB for these countries.

The FSB's initial Charter includes provisions for non-member countries to be included, on an ad hoc basis, in its working groups, standing committees and plenary meetings. In addition, it notes that the FSB will consult with non-members "in the development of the FSB's medium- and long-term strategic plans, principles, standards and guidance" including through "regional outreach activities to broaden the circle of countries engaged in the work to promote international financial stability." If the FSB remains narrowly constituted, it will be important to move beyond these provisions to formalize the FSB's willingness to consult with non-member countries. The FSB could, for example, commit to request comments from non-members on any issue discussed by the plenary, or promise formal consultation

at regular intervals. Cooperation with non-members involving information sharing, research collaboration and capacity building could also be developed.

A more ambitious mechanism for providing voice for non-members would be to make the FSB accountable not to the G20 leaders' forum but to a more universal body such as the IMF. The de Larosière report on financial supervision in the European Union in February 2009 recommended this course, suggesting that the FSF report to the IMF's International Monetary and Financial Committee (IMFC) (particularly if that committee were transformed into a formal decision-making Council at the ministerial/governor level allowed for under the Articles of Agreement) (High Level Group, 2009: 61). According to an undated "fact sheet" about the FSF on the BIS website, the FSF had already been briefing not just the G7 finance officials and central bank governors but also the IMFC.¹³ At their April 2009 Summit, the G20 leaders reinforced this practice by calling on the FSB to report to both themselves and the IMFC and on issues relating to "build up of macroeconomic and financial risks and actions needed to address them."

The final and perhaps most obvious way to address the FSB's accountability problem would be to expand its membership further. When Paul Martin suggested an FSB-like body in April 1998 (he called it an "international supervisory surveillance secretariat"), he proposed that membership be open to all IMF and World Bank members and that its secretariat report to those same institutions (Department of Finance, 1998). The FSB's Charter allows for the plenary to expand the membership, as long as countries accept certain commitments.¹⁴ If the membership were to expand considerably to address the legitimacy issue, it need not become an unwieldy body. A strong executive body could involve regional representation or IMF-style constituency systems. The IAIS, for example, represents regulators and supervisors from over 140 countries. To handle the practical problem involved in decision making with such a large group, it has established an Executive Committee with representatives from different regions. Similarly, IOSCO's Technical Committee reports to the full membership of the organization, which includes representatives from more than 100 countries and has an Executive Committee that draws heavily on a principle of regional representation (Helleiner and Porter, 2009).

13 <http://www.bis.org/about/factsfsf.htm>. Accessed May 7, 2010.

14 "Member jurisdictions commit to: (a) pursue the maintenance of financial stability; (b) maintain the openness and transparency of the financial sector; (c) implement international financial standards; and (d) undergo periodic peer reviews, using among other evidence IMF/World Bank public Financial Sector Assessment Program reports."

The FSB has already moved in the direction of consolidating decision making within an executive body. Because its membership was growing to 64 participants, the FSB was established with a more complex system of internal governance. In addition to being given a slightly bigger secretariat and full-time Secretary General, the FSB was created with a permanent steering committee that provides operational guidance between the semi-annual meetings of the full plenary and which has considerable power to create working groups, to commission work from the standing committees and to perform joint strategic reviews of the policy development work of the international SSBs. The composition of the steering committee must provide “balanced representation in terms of geographic regions and institutional functions.” The FSB has also created three standing committees (for Assessment of Vulnerabilities, Supervisory and Regulatory Cooperation, and Standards Implementation) and these have been assigned some important functions in the decision making of the FSB, as noted below. If the FSB’s membership was expanded further, further reforms of this kind would be needed (and the question of the FSB’s accountability to the G20 leaders’ forum would likely need to be reconsidered).

Mechanisms for Promoting Compliance

In addition to its wider membership, the FSB has also been assigned more effective mechanisms for encouraging compliance with international standards. At the time of the FSF’s creation, the primary mechanism endorsed was assessment and monitoring by the IMF and World Bank. A few months later the IMF and World Bank established the Financial Sector Assessment Program (FSAP) to conduct reviews of national financial sectors and the IMF began to prepare Reports on the Observance of Standards and Codes (ROSCs) which summarized countries’ compliance levels with the 12 core international standards and made recommendations. The rationale for delegating these tasks to the IFIs had been their near-universal membership, the IMF’s established surveillance mechanism (which had already begun to examine financial sector issues) and the World Bank’s expertise in this area (for example, G22, 1998).

G7 countries initially hoped to include compliance with international standards into IMF and World Bank loan conditionality. But concerns among developing country officials about the international standards project led them to block this initiative. Developing countries also insisted that the FSAPs and ROSCs be voluntary and that governments be allowed to block publication of the

results either in part or in full (for example, Drezner, 2007: 139-140). It was not just developing country resistance that weakened compliance mechanisms. Although the US initially agreed to participate in the FSAP, this position was reversed when the Bush administration came to power (Truman, 2008: 22, footnote 41). The US had still not undergone a FSAP by the time of the outbreak of the current global financial crisis. Neither had some other G20 countries such as China, Indonesia and Argentina.

The effectiveness of the compliance mechanism was also diluted by the weakness of market discipline. G7 governments had hoped that the results of the FSAPs and ROSCs would encourage investors to reward compliance and discipline those countries not complying. But evidence is mixed about whether markets rewarded those states that were compliant with standards vis-à-vis those that did not (or those that did not publish the results). Even in cases where policy makers worried about market reactions, Walter (2008) highlights how “mock” compliance was common, particularly with respect to corporate governance, accounting and bank supervision standards where private sector compliance costs were high and where third party monitoring of compliance was difficult. In these situations, domestic resistance to reform often generated regulatory forbearance at the government level, administrative resistance and/or private sector non-compliance.

The only area where the FSF embraced a tougher approach to compliance beyond IMF and World Bank assessment was with respect to offshore financial centres (OFCs). In March 2000, the FSF endorsed a working group report that recommended the consideration of “positive and negative incentives” or a “carrots and sticks” approach that could be applied against those deemed non-complying vis-à-vis a small number of core international standards relating to cross-border cooperation and information sharing, and essential supervisory powers and practices.¹⁵ The report noted that these incentives could be applied either individually or collectively by FSF member countries, but it favoured the latter to maximize effectiveness and minimize competitive disadvantages that might accrue to countries applying sanctions on their own.

Two months later, drawing on a survey of onshore and offshore officials, the FSF divided 42 OFCs into three categories, according to the quality of their cooperation, regulation and supervision, and encouraged a focus on the less cooperative and less regulated two groups. In addition to this “name-and-shame” approach, the

¹⁵ Quotes from FSF (2000: 29). The working group included representatives from some non-member countries such as Singapore and Thailand.

FSF outlined specific measures that could be taken subsequently against non-complying jurisdictions (FSF, 2000: 31-32):

- Membership in international groupings (for example, IOSCO, IAIS, committees of bank supervisors etc.) could be revoked;
- Financial assistance, including access to IMF and multilateral development bank financing, could be made conditional on progress towards implementation of relevant international standards;
- Market access could be restricted for financial institutions from non-complying jurisdictions;
- Increased “know-your-customer” obligations or other reporting requirements could be applied for financial institutions doing business with individuals or legal entities established or registered in non-cooperative jurisdictions;
- Home country supervisors could tighten their scrutiny of institutions operating in non-cooperative jurisdictions, impose higher capital requirements or even refuse to allow operations to be maintained in those jurisdictions; and
- Financial transactions with counterparties in non-cooperative jurisdictions could be restricted or even prohibited.

After this flurry of activity, however, the FSF pulled back. The IMF subsequently assumed the role of assessing adherence and the FSF took more of a backseat role of applauding reforms that OFCs launched (Sharman, 2006: 35). The threatened counter-measures were never invoked and in 2005 the FSF declared that its 2000 list “had served its purpose and is no longer operative” (FSF, 2005: 1). Although the FSF retained the option of direct action against problematic OFCs at this point, it simply welcomed the IMF’s commitment to do more assessments in those jurisdictions where weaknesses remained as well as IOSCO’s initiative to develop Multilateral Memorandum of Understanding (MMoU) for cooperation and information sharing among securities regulators.

Strengthening Compliance in Four Ways

With the creation of the FSB, policy makers have shown a determination to improve the compliance process in four distinct ways. To begin with, FSB members have agreed to undergo an assessment under the FSAP every five years,

and to publicize the detailed IMF/WB assessments used as a basis for the ROSCs.¹⁶ Second, membership within the FSB comes with an obligation to “implement international financial standards.” Although the FSB Charter does not mention which standards must be implemented, the press release announcing the FSB’s creation specified that this obligation included the 12 core international standards that had been promoted since the late 1990s (FSF, 2009: 1). Since the FSB’s creation, it has become clear that this obligation also applies to standards that the FSB itself creates such as “FSB Principles for Sound Compensation Practices,” which were endorsed by G20 leaders at the time of the FSB’s creation. This commitment to implement international standards could be interpreted as a slight hardening of the “soft law” quality of the pre-FSB regime; membership within the FSF had not been associated with any obligations (the body did not even have a Charter).

Third, FSB members have committed to undergo peer reviews. At the time of the FSF’s creation, the benefits of peer review had been recognized. The G22 working group report of October 1998 made the case well in recommending voluntary peer review as an important complement to the IFIs’ surveillance and monitoring role: “in the right circumstances, it may also be more effective than existing surveillance mechanisms because of such features as collegial relationships, familiarity with regional conditions, and participants treating one another as fellow practitioners” (G22, 1998: 48).¹⁷ But the idea had not found its way into the FSF’s mandate, perhaps falling victim to the more top-down conception of advice flowing from the narrowly constituted FSF to developing countries rather than the more two-way flow that is embodied in the peer review model.¹⁸

With the creation of the FSB, advocates of peer review finally found their moment. The FSB Charter commits all members to “undergo periodic peer reviews, using among other evidence IMF/World Bank Public Financial

16 These commitments are not in the Charter. They are contained in the January 2010 “FSB Framework for Strengthening Adherence to International Standards.” As noted below, the Charter says only that members agree to “undergo periodic peer reviews, using among other evidence IMF/World Bank public Financial Sector Assessment Program reports.”

17 Paul Martin had proposed a process of non-mandatory peer review every two to three years among domestic supervisors to be conducted by officials from a cross-section of countries (including emerging markets) (Department of Finance, 1998). The G7 finance ministers and central bank governors (1998) too initially had called for a “process of peer review” alongside IMF surveillance when giving Hans Tietmeyer a mandate in October 1998 to prepare the report that led to the FSF’s creation (quoted in Tietmeyer 1999:1). Tietmeyer’s report made no mention of peer review.

18 The FSAPs had some elements of “peer review” in that they involved some outside experts from central banks and supervisory agencies (as well as SSBs) in the process (Gola and Spadafora, 2009: 37).

Sector Assessment Program reports.” These peer reviews will include not just country reviews but also thematic ones which “focus on the implementation across the FSB membership of policies or standards agreed within the FSB, with particular attention to consistency in cross-country implementation and the effectiveness of the policy or standard in achieving the intended results” (FSB, 2009c: 9). The first peer review, between December 2009 and March 2010, was a thematic one focusing on the implementation of the “FSB Principles for Sound Compensation Practices.” By the end of the year, the FSB plans to have completed two more thematic reviews (including one on risk disclosures by market participants) and three country reviews (of Italy, Mexico and Spain, each of which has recently completed an FSAP).

Peer reviews will be based on reports drafted by small teams of experts from FSB countries and international bodies which are supported by the FSB secretariat. The substantive peer review process will then take place in the FSB’s Standing Committee on Standards Implementation (SCSI).¹⁹ The FSB’s plenary will be asked to approve the review and, if it is does, the report will be publicized. The FSB will then also monitor the implementation of agreed actions and will apply “peer pressure” if implementation lags. The new peer review process thus puts the FSB — its secretariat, its committees, its plenary’s decision-making capacity — much more at the centre of the compliance process than the FSF ever was. It is designed to encourage adherence to international standards by fostering greater dialogue among peers. As the FSB itself puts it, “the added value of FSB peer reviews will come in significant part from the cross-sector, cross-functional, system-wide perspective brought by its members.”

Fourth and finally, the FSB has signalled its intention to take a more active role in encouraging compliance among all countries and jurisdictions not complying with international prudential standards. It was asked by the G20 leaders (2009a) at their April 2009 summit “to develop a toolbox of measures to promote adherence to prudential standards and cooperation” with non-cooperative jurisdictions (NCJs). In early September 2009, G20 finance ministers and central bank governors (2009a) reiterated this commitment to “deliver an effective programme of peer review, capacity building and countermeasures to tackle NCJs that fail to meet regulatory standards” and they called on the FSB “to report on criteria and compliance against regulatory standards by November 2009.” A few weeks later at their third summit in Pittsburgh, the G20 leaders (2009b: 10)

also called on the FSB to report on progress by November and also “to initiate a peer review process by February 2010” vis-à-vis NCJs.

In November 2009, the FSB (2009c: 10) reported that it had chosen to focus initially only on “jurisdictions that pose a risk to financial stability because of their systemic importance and weak adherence to the relevant standards.” The FSB noted in January 2010 that it would begin by concentrating solely on compliance with the international cooperation and information exchange principles embodied in three key standards: the BCBS Core Principles for Effective Banking Supervision; the IAIS Insurance Core Principles; and the IOSCO Objectives and Principles of Securities Regulation. This approach was very similar to that advocated by the FSF’s working group vis-à-vis OFCs in 2000. Another similarity was that the FSB stated that targeted countries were to be made aware that non-compliance with these standards could be met with “a balance of positive and negative measures” which would “include the option of publishing by the end of 2010 the names of non-cooperative jurisdictions in the event that other measures to promote adherence to international cooperation and information exchange standards are not achieving sufficient progress” (FSB, 2010b: 4). The specific negative measures then outlined in March were also almost identical to those outlined in 2000. By February, the FSB had identified priority jurisdictions for further evaluation and was inviting them to participate in a confidential dialogue.

While the similarities with the OFC initiative of 2000 are remarkable, one important difference is that the FSB appears determined to retain more control of the process rather than allowing the IMF to take the lead, as happened after 2000. To be sure, compliance with the key standards will be evaluated by using information from ROSCs prepared by the IMF and World Bank (and, in the cases of the IOSCO standards, the signing of an IOSCO MMoU). But in developing policy towards specific jurisdictions, the FSB will take the lead. Its SCSI will create expert teams to prepare reports with timetables of recommended actions. The teams will be supported by the FSB Secretariat and will consist of five members, including one FSB representative from a central bank, regulatory agency and finance ministry, and one expert nominated by the BCBS, IAIS or IOSCO.²⁰ The jurisdiction being discussed will be permitted to comment on the team’s preliminary report and discuss it with the SCSI. The FSB plenary will then be asked to approve the report

19 The SCSI is presently chaired by Canadian Tiff Macklem and includes representatives from Australia, Brazil, China, France, Germany, Hong Kong, India, Italy, Japan, Russia and Saudi Arabia.

20 The fact that non-members are not included in the review teams makes the G20 leaders’ use of the term “peer review” at the Pittsburgh summit not terribly appropriate in situations where non-members are being reviewed.

and measures to promote adherence, including whether to identify the jurisdiction as non-cooperating.

The other key difference from the OFC initiative of 2000 is that the FSB is willing to target all countries and jurisdictions that are non-cooperative. Although the FSB has chosen to focus on only a select group of NCJs initially, its members have clarified that the institution has these wider ambitions. As the FSB noted in March 2010:

the ultimate goal is to promote adherence by all countries and jurisdictions to regulatory and supervisory standards concerning international cooperation and information exchange. Following completion of the first round of evaluations, the Expert Group will engage in a further round of dialogue with a different group of jurisdictions, subject to approval by the plenary after review by the SCSI. (FSB, 2010c: 10)

New Challenges and Priorities

If the FSB has strengthened the mechanisms to encourage compliance with international standards in these four ways, each raises challenges that will need to be addressed. First, with the FSAP and ROSCs having been assigned a more prominent place in the international standards regime, the IMF and World Bank now need to coordinate these programs more closely with the FSB's objectives. As Davies and Green (2008: 224, 246) put it in discussing the FSF (just before the FSB's creation),

the IMF and the World Bank should take the work of the Forum more seriously, and should be prepared increasingly to organize their own assessment programs and technical assistance work in the light of priorities debated and agreed at the FSF.

For example, they suggest that “the Fund could put forward a work programme [for FSAPs] for discussion at the Forum, to ensure that there is input from regulators who deal directly with problem countries” (Davies and Green, 2008).

Second, it is unclear how the new formal membership commitment to implement international standards will really “bite.” Given the consensus rule of the plenary, it is hard to see how a country could have its membership revoked for non-compliance unless that country itself supported the decision. More generally, because the FSB's creation has not been ratified by any national legislature, Article 16 of its Charter acknowledges that the Charter “is

not intended to create any legal rights or obligations.”²¹ It is not entirely clear, then, how this new membership obligation shifts the FSB away from its soft law approach. The processes for dealing with a non-complying member, and the consequences of non-compliance, need to be clarified, particularly if the membership is to grow even further in the coming years.

Tony Porter (2010) has put forward some interesting proposals in this regard. Instead of relying on the threat of expulsion, he suggests that “all states' membership rights should automatically lapse over a cycle of five years and require renewal.” He also highlights how gradations in membership rights could be created: “for instance, only members engaged in good faith efforts to comply should be allowed to serve on the Steering Committee, peer review teams, Standing Committees or working groups.” Porter also notes that other standard setting bodies could restrict certain roles in their organizations to those countries that were participating in good faith with the FSB peer review process.

The new peer review process itself could also be strengthened. Analysts have highlighted how peer review processes, such as those pioneered by the OECD since the 1960s, are more effective than the top-down surveillance processes of the Fund because the former involve more exchange and dialogue (Woods and Lombardi, 2008; Momani, 2006). But the FSB peer review may be weakened by the very small size of the FSB's secretariat. In the OECD's peer review process, OECD staff play an important role in drafting initial and final reports, supporting reviewers and maintaining high technical standards (Pagani, 2002; Porter and Webb, 2008).

Greater consideration should also be given to the composition of the countries involved in the peer review process, both at the level of the expert teams (whose composition is not yet specified) and within the SCSI. The G22 working group report of October 1998 made the important suggestion that “peer review may be most effective if exercised among groups made up primarily of countries with similar levels of financial market development and regulation” (G22, 1998: 45; see also IEO, 2005: 102).

Another issue requiring more attention concerns the decision to have the peer reviews adopted by the FSB by consensus and made public. Might the reviewers be more inclined to engage in what Keynes called

21 It is interesting that the only ratification mentioned in the FSB's Charter concerns the membership of international organizations: “The acceptance of membership by the international financial institutions in the FSB is subject to the approval of their respective governing bodies.”

“ruthless truth telling” if the reviews could be adopted without the acceptance of the reviewed country (quoted in Moggridge, 1995: 324)? At the same time, a clear tension is involved here: if the peer review process is to be effective, members must trust it enough that they are comfortable admitting weaknesses and sharing sensitive information. The same complexity emerges with the commitment to make peer reviews public. As the G22 report noted, there is a balance to be struck “between enhanced frankness among colleagues and the added discipline and credibility that are afforded by making key results available to the public” (G22, 1998: 45). Equally important, countries may be reluctant to participate fully and openly in the peer review process if its results are associated with a system of penalties (for example, restrictions in membership rights or the penalties applied against NCJs). For this reason, Porter (2010) suggests that compliance mechanisms should be linked less to the direct results and information revealed in specific reviews than to the willingness to engage in good faith with peer review processes over time.

Finally, the FSB’s tough approach towards the problem of NCJs presents an important challenge beyond the questions of legitimacy raised in the previous section. The decision to assign the FSB plenary the role of approving action against NCJs may weaken the initiative. If the plenary agrees on sanctions, they will certainly be effective since the FSB members collectively have the kind of “market power” that could generate formal compliance around the world; for example, a threat to deny market access to the FSB members’ financial markets would be a very effective tool. But one has to question how tight the solidarity of the rather heterogeneous FSB membership would remain in a context where its resort to coercive measures had become highly politicized among non-members. The experience of the politics involved in the G20’s efforts to draw up a list of NCJs to target vis-à-vis tax issues also raises questions about the FSB members’ ability to reach consensus in targeting relevant NCJs in the regulatory sector. In addition, the consensus rule of the plenary ensures that any consideration of sanctions against a NCJ that was a FSB member could be blocked by that jurisdiction.

An alternative approach, building more on the WTO model, has been suggested by Barry Eichengreen. Instead of relying on the FSB plenary to be the ultimate judge of compliance, Eichengreen (2009: 19) suggests this task could be assigned to “independent panels of experts” similar to the WTO’s dispute settlement panels.²² If a panel judged that minimum standards were not being

met, FSB members — either collectively or individually — would be permitted to block access to their markets to firms chartered in that NCJ. Eichengreen argues that an advantage of this proposal would be that private institutions seeking to operate abroad would have a clear incentive to lobby for tighter reforms at home. Another advantage might be that this approach could bring pressure to apply on NCJs that are not just outside the FSB but also inside. This would, in other words, provide some teeth to enforce the new commitment of FSB members to implement international standards. At the same time, however, this proposal raises many difficult questions about the criteria by which panels might be selected and the relationship among these panels and the FSB’s expert teams, the SCSI and the peer review process.

The Importance of Macroprudential Regulation

A final area where the FSB looks set to improve upon the FSF’s experience has to do with efforts to address macroprudential concerns about systemic risks. When the FSF was first created, the Tietmeyer (1999: 3) report noted that “concerted procedures are needed for a better understanding of the sources of systemic risk and to formulate effective financial, regulatory and supervisory policies to mitigate them.” Tietmeyer criticized the fact that “the various regulatory groupings deal predominantly with micro-prudential issues pertaining to the stability of the individual institutions within their purview” (1999: 3). In his view, it was necessary “to consider micro-prudential policies in a wider setting” (1999: 3-4) and to overcome “the separate treatment of micro-prudential and macro-prudential issues” (1999: 2). In light of subsequent experience, it is worth noting some of wider issues that he deemed significant (Tietmeyer, 1999: 3-4):

- “the ways in which such [microprudential] policies could be blunted or sharpened by market practices and disciplines, or have unintended aggregation effects”;
- “systematically overseeing the processes by which markets and market participants are adequately informed”;
- “systemic threats can also arise from unsupervised financial service providers, notably major highly leveraged institutions”;
- “spill-over effects could arise from difficulties at non-bank financial institutions and large insurance companies”; and

²² Eichengreen advances this proposal in the context of his proposal to create a new “World Financial Organization” rather than vis-à-vis the FSB.

- “disabling shocks to the global financial system can arise from a variety of factors and circumstances, including macroeconomic weaknesses, the collapse of major individual institutions, and weaknesses in the infrastructure that underpins and connects financial systems.”

A key rationale for establishing the FSF was that it might be easier to address these wider macroprudential issues if all the key national authorities, SSBs and international financial institutions were brought together within one body for the first time. Tietmeyer (1999: 5) and other FSF proponents had high hopes that it could emerge in a leadership role “to assess issues and vulnerabilities affecting the global financial system and to identify and oversee the actions needed to address them.” In its first year of existence, the Forum looked set to meet these expectations. At its first meeting, the FSF created three working groups to study issues that had been identified as potential vulnerabilities for the global financial system: offshore financial centres, short-term capital flows and highly leveraged institutions.

After this, however, the FSF’s leadership role faded. Its subsequent publications consisted more of status reports on relevant initiatives and “vulnerabilities” assessments for members. In the words of Howard Davies and David Green (2008: 223, 118), the FSF came to act primarily “as a clearing house for initiatives and ideas emerging elsewhere” and it was not able to “carve out a distinctive position, integrating the various perspectives of the diverse membership, as was originally hoped.”²³ The FSF also failed to encourage the incorporation of macroprudential concerns into international regulatory initiatives.²⁴ As Andrew Sheng (2009: 352) puts it, the pre-crisis regulatory focus had “the mindset of doctors rather than public health experts – as long as the health of individuals was fine, public health would be all right, forgetting that viral attacks could wipe out whole populations.”

23 Alongside these judgements of the FSF’s record, Davies and Green (2008: 116-118) also noted some of its accomplishments: 1) its compilations and compendia were “undoubtedly useful”; 2) its vulnerabilities exercise was “useful in focusing minds”; 3) it helped establish “habits of cooperation between finance ministries, central banks, and regulators which may have enhanced their capacities to respond collectively in the event of a serious crisis”; 4) its existence gave “added impetus to the work of the individual sector-based regulatory groupings’ such as IOSCO and IAIS; 5) it “helped to educate Ministries of Finance on financial stability issues”; and 6) it “provided the impetus for the push” to use the World Bank and IMF to pressure countries to implement international standards.

24 The one partial exception was the FSAPs, which included a focus on “macroprudential analysis” (IEO, 2006: 24). See also Gola and Spadafora (2009: 40-42: 53, footnote 64).

Davies and Green (2008: 116) assign blame for the FSF’s failure to take on more of a leadership role to US policy makers who “consistently argued that that the Forum should not take initiatives of its own.” In addition to the broader scepticism of the Bush administration towards multilateral institutions, the US stance may have been linked to the free market orientation of top US officials during this period. Supporters of macroprudential regulation worried about the inherent tendency of financial markets to experience instability and generate systemic risks, particularly pro-cyclical booms and busts. But influential US officials were more inclined to trust the capacity of markets to self-regulate. As international financial markets grew rapidly in size and sophistication after the Asian crisis, support for light-touch and self-regulatory practices was increasingly echoed in other Western countries as well. This trend was reinforced by lobbying from private financial interests at the national as well as international levels.

A Stronger Capacity to Address Macroprudential Issues

The FSB’s mandate to address “vulnerabilities” in the global financial system is remarkably similar to that laid out by the Tietmeyer report. But its capacity to lead in this area has been strengthened in three ways. First, it has been empowered to conduct “joint strategic reviews of the policy development work of the international standard setting bodies” and “promote and help coordinate the alignment of the activities of the SSBs.” The standard-setting bodies are also now required to report to the FSB on their work in order to provide “a broader accountability framework” for their activities, although the FSB Charter notes that “this process should not undermine the independence of the standard setting process.” Second, unlike the FSF, the FSB has been empowered by its members to fill cracks in the existing regulatory environment by creating its own standards. The first of these — compensation standards — has been explicitly developed to address macroprudential concerns.

The third and most important change is that the body to which the FSB is accountable — the G20 leaders’ forum — has endorsed macroprudential regulatory philosophy much more strongly than the G7 finance officials ever did. This began at their first summit in November 2008 when the leaders asked the IMF, the FSF and other regulators and bodies to

develop recommendations to mitigate pro-cyclicality, including the review of how valuation and leverage, bank capital, executive compensation, and provisioning practices may exacerbate cyclical trends. (G20 Leaders, 2008)

The commitment became even stronger by the time of the second G20 summit in April 2009 in London which agreed “to extend regulation and oversight to all systemically important financial institutions, instruments and markets” (G20 Leaders, 2009a). The case for macroprudential regulation was well laid out by the G20’s Working Group 1 (2009: 2) at that time: “while each financial crisis is different, the crises over history generally share some key common elements including excessive risk taking, rapid credit growth and rising leverage. This points to the need for regulators, supervisors, and central bankers to supplement strong microprudential regulation with a macroprudential overlay to more effectively monitor and address the build-up of risks arising from excess liquidity, leverage, risk-taking and systemic concentrations that have the potential to cause financial instability.”

At the London Summit, G20 leaders endorsed the implementation of some detailed proposals for mitigating pro-cyclicality in international financial regulation; these proposals had been developed by working groups the FSF established after the first G20 Leaders’ Summit (in collaboration with the BCBS, IOSCO and CGFS). The leaders gave particular support to proposals to improve accounting standards, introduce a leverage ratio for banks²⁵ and require banks to build up buffers in good times that could be drawn down in times of stress (either via dynamic loan loss provisioning or via adjustments to the “quality and level” of bank capital). In London, the G20 leaders also called on the FSF to work with the BIS and SSBs to “develop macro-prudential tools” and they asked the IMF and the FSF to “produce guidelines for national authorities to assess whether a financial institution, market, or an instrument is systemically important” (G20 Leaders, 2009a).

They also agreed that “large and complex financial institutions require particularly careful oversight given their systemic importance” (G20 Leaders, 2009a). They then followed up this statement at their September 2009 summit by assigning the FSF the specific task of proposing measures to address systemically important institutions by October 2010, “including more intensive

supervision and specific additional capital, liquidity, and other prudential requirements.” As they put it then, “our prudential standards for systemically important institutions should be commensurate with the costs of their failure” (G20 Leaders, 2009b: 9).

G20 leaders have also backed efforts to better prepare for failures of systemically important institutions in ways that address moral hazard issues and minimize future cost to taxpayers and the wider economy. They have supported a requirement for these institutions to prepare “living wills” which detail how firms would be wound down in the event of trouble, and have called for strengthened legal frameworks and international cooperation to handle these situations. At their November 2009 meeting, the G20 finance ministers and central bankers (2009b) called for “for the rapid development of internationally consistent, firm-specific recovery and resolution plans and tools by end-2010.” At their summit two months earlier, the G20 leaders (2009b: 10) also asked the IMF

“to prepare a report for our next meeting with regard to the range of options countries have adopted or are considering as to how the financial sector could make a fair and substantial contribution toward paying for any burdens associated with government interventions to repair the banking system.”

These mandates from the G20 have prompted very extensive work within the FSF as well as the IMF, BIS and SSBs concerning the implementation of macroprudential regulation. The importance of this work cannot be overstated. After the global financial crisis of 1997-1998, concerns were expressed about the need to address systemic risks, but policy makers failed to hardwire macroprudential concerns into the detailed content of the international regulatory regime. As a result, once the memories of the crisis faded and the urgency of reform dissipated, regulators lacked the tools and incentives to address the build-up of systemic risks, despite various warnings from bodies such as the BIS. As Charles Goodhart (2008: 3) has put it, “the problem [leading up to the post-2007 crisis] was not lack of foresight about the dangers of the massive credit expansion and housing price bubble, but a lack of instruments to counter it, and/or a lack of willingness to use those that they did have to hand.” The flurry of activity by the FSF and other bodies highlights a much greater consensus today within policy-making circles than a decade ago about the need to incorporate macroprudential concerns into international regulatory standards.

25 The actual wording was more ambiguous: “a simple, transparent, non-risk based measure which is internationally comparable, properly takes into account off-balance sheet exposures, and can help contain the build-up of leverage in the banking system” (G20 Leaders, 2009a: 2). A leverage ratio was backed more explicitly by the G20 at the next summit in September 2009.

The Challenges of Macroprudential Regulation

But the FSB faces some important challenges in this area. At the governance level, questions remain about its capacity to provide leadership vis-à-vis the SSBs. Although the FSB's role in coordinating the activities of the SSBs has been made more explicit, the FSB's Charter also makes clear that the independence of the latter cannot be challenged. The resistance of bodies such as the IASB to some elements of the macroprudential reform agenda has clearly revealed the limits of the FSB's influence. If the FSB is to play a lead role in the macroprudential area, the ambiguous nature of the lines of accountability between the FSB and the SSBs may need to be clarified.

At the level of content, the implementation of macroprudential regulatory policies raises many thorny policy issues, of which a few of the more prominent can be mentioned briefly. The first concerns the efforts to introduce counter-cyclical buffers for banks. There is a strong political economy case for national authorities to rely fairly heavily on rules in this area in order to overcome domestic resistance to tightening during booms (for example, Sheng, 2009: 368, 393; Warwick Commission, 2009; Brunnermeier et al., 2009). But if a rule-based approach is endorsed, international coordination beyond the level of general principles will be difficult because credit cycles differ across countries. As the BIS (2009: 132) puts it, counter-cyclical capital buffers "must be adjusted separately for each geographical portfolio held by an institution operating across national boundaries." The BCBS (2009: 71) recommends that international banks be required to "calculate their buffer as a weighted average of the buffers which are being applied in jurisdictions to which they have [credit] exposures." Others have argued that counter-cyclical buffers might be implemented more effectively simply on a host country basis with requirements that foreign bank branches be converted into separately capitalized subsidiaries (for example, Warwick Commission, 2009; Brunnermeier et al., 2009).²⁶

These implementation issues are complicated and they may raise competitive concerns when rules are tightening in one country vis-à-vis others. There are reports that these difficulties — combined with opposition from accountants — are prompting some regulators to have second thoughts about the international reform agenda in

26 The Warwick Commission (2009) also argues that this approach could enable developing countries to better tackle distinctive macroprudential risks associated with pro-cyclical capital flows and currency mismatches. The Commission also notes that some smaller and poorer countries might need international assistance to boost their capacity to implement effective host country regulation. The capacity of all host countries would be strengthened through cooperative research, early-warning systems for global risks and extensive information sharing (relating to market developments, activities of large firms, regulatory initiatives abroad, and so forth). See also Griffith-Jones and Ocampo (2010).

this area (Jackson, 2010). Regulators may end up focusing international coordination that addresses counter-cyclical vis-à-vis banks around tools where consensus may be more easily reached such as the development of an internationally harmonized leverage ratio for banks (the G20 leaders' have set the goal of this being developed for the end of 2010).

The regulation of systemically important institutions is also raising particularly difficult and controversial questions. G20 leaders and the FSB have focused on this issue not just because of frustrations with the massive bailouts of 2008 but also because of forward-looking concerns. Emerging from the post-2007 crisis are many even larger and more interconnected financial institutions than before the crisis. These institutions are also more keenly aware than ever that they are backed by implicit state support because of their systemically significant status. The result is a massive "moral hazard" problem which may encourage these institutions to resume excessively risky activities.²⁷ But there are complications involved in developing clear policy in this area.

The first is how to identify these institutions. A November 2009 report from the FSB, IMF and BIS (2009: 4-5) highlighted that only very general international principles could be developed in this area because "a high degree of judgment and flexibility to reflect national and conjunctural circumstances will inevitably be involved in the assessments" and because "developing (and communicating) assessment criteria that are too specific may raise moral hazard by creating incentives for firms to game the system, and weaken its usefulness in mitigating systemic risk." It recommended that countries agree simply on the principle of the need to assess the systemic importance of financial institutions (as well as markets and instruments) on an ongoing basis. That principle could then be backed up by more specific guidelines for good practices concerning issues such as broad common definitions of systemic importance, the assignment of roles and responsibilities for agencies involved in assessments, the types of information and methods used, the frequency of assessments, periodic review of assessment framework, and international information sharing and joint assessments.

Even if systemically important institutions can be identified, the question remains of how to regulate them. Debates on this topic have been fierce. Some favour simply breaking them up to ensure that no financial

27 Quote from the G20 finance ministers and central bank governors (2009b) who welcomed "the FSB's work to reduce the moral hazard posed by systemically important institutions" in their November 2009 communiqué.

institution is too big or too interconnected to fail. Others prefer restricting large banks from high-risk, casino-like activities and forcing them to focus on core commercial banking activities. As noted above, the G20 has so far focused primarily on a third approach of subjecting these institutions to tighter supervision and regulation, requiring them to prepare living wills, strengthening cooperation surrounding cross-border resolution and considering ways to force them to pay for future bailouts.

Given the raging debates on these issues within many countries, it is proving difficult to arrive at an international consensus in this area. This raises the question once again of how tightly policy in these areas needs to be coordinated internationally. On some issues, it may be politically possible and desirable to push ahead with specific and detailed international initiatives. For example, journalists reported in November 2009 that the FSB had already drawn up a private list of 30 systemically important institutions (24 banks and six insurance companies from Europe, North America and Japan) which will be asked to develop living wills or “recovery and resolution plans” (Jenkins and Davies, 2009). International harmonized rules on leverage ratios and strengthening capital standards also seem likely.²⁸

In other areas, however, principles-based international standards are more politically realistic.²⁹ There will also be some issues on which international consensus of any kind may not be possible to reach, such as creating international burden-sharing arrangements to fund future bailouts (Pauly, 2009). If countries cannot agree on the latter, support is likely to grow for host country regulation with the branches of foreign banks transformed into subsidiaries backed by local capital in order to avoid the “Iceland problem” (for example, Pomerleano, 2009). Fear of this kind of forced “ring-fencing” of their international business is in fact what may have prompted a number of leading international banks to endorse international taxation initiatives recently (Jenkins and Braithwaite, 2010). Even without mandatory ring-fencing, international bankers may be forced to think of their operations in a more territorially segmented way due to the new requirements to develop living wills.

28 The regulation of the infrastructure of systematically important global markets (for example, settlement, clearing, reporting requirements) is another area where detailed rules-based international cooperation may be desirable (for instance, Warwick Commission, 2009).

29 For example, the FSB released some high-level principles on Cross Border Cooperation on Crisis Management in April 2009. These were followed up by BCBS (2010) standards in March 2010 for cross-border bank resolution.

Addressing Private Capture

While the FSB and others are hard at work attempting to resolve these various items on the macroprudential agenda, a larger political issue has not received the attention it deserves in policy-making circles. To implement effective macroprudential regulation, the question of the possible “capture” of the regulatory process by private actors needs to be addressed more squarely. Macroprudential regulation requires regulators to take a strong stance against market trends, such as cyclical booms or growing concentration and risk taking within the financial system. If regulators’ relationships with private market actors are too cosy, this role cannot be performed well.

Sheng (2008: 391) worries that there has been a “deafening silence” in official circles about the need to address the question of private capture and he urges more attention to the issue. As he points out, the contrast with the discussions after the Asian crisis is particularly striking. Then, many Western policy makers were quick to blame the crisis on “crony capitalism” and to prescribe governance reforms as a solution. Indeed, the international standards regime itself was designed in part to address this governance issue. Now that the crisis has struck the markets of countries at the core of global financial system, the issue has not had the same official profile.

This is particularly odd given the widespread discussions in the media and scholarly circles about the role that private sector capture of the regulatory process, in the leading markets and at the international level, may have played in contributing to the post-2007 crisis (for example, Johnson, 2009; Underhill and Zhang, 2008; Baker, 2010). Top regulators themselves also seem implicitly to acknowledge the risks of private capture when they urge that post-crisis regulatory reforms be implemented quickly before the resistance of private actors grows too strong (for example, Draghi, 2009: 9).

Reforms already discussed might help to address the capture issue. I have already mentioned how more rules-based counter-cyclical regulation at the national level may play a useful role. Some of the macroprudential rules to restrict the size of banks may also reduce the political clout of those institutions. Regulatory initiatives that reduce complexity and opacity — such as simple leverage rules, or forcing credit derivatives onto exchanges — should also help to constrain the ability of market participants to dominate regulatory debates through their expertise. Greater reliance on host country regulation of banks might also lessen the “mercantilist” pressures on regulators to defend the international competitive position of their countries’ banks in international regulatory negotiations.

The peer review process may also help to counteract private lobbying by bolstering the independence of national authorities.

But the FSB could also address the issue of private capture more directly. It could, for example, develop standards for regulators that minimize the problem of “revolving doors” by outlining mandatory public disclosure of all past and present industry ties of individuals on those bodies, and/or rules specifying a minimum number of years before regulators can shift to private-sector lobbying and vice versa (Helleiner and Porter, 2009). The FSB could also develop procedures to address the role of private sector influence within its own deliberations. The latter may be particularly important since the FSB Charter (2009a) states that, when developing its medium and long-term goals, the FSB “will consult widely amongst its Members and with other stakeholders including private sector and non-member authorities.” By restricting its choice of societal actors to the “private sector,” the FSB has left itself open immediately to the charge that it may provide privileged access to private financial interests. This impression may be reinforced in another part of the Charter that states: “In the context of specific sessions of the Plenary, the Chair can also invite, after consultation with Members, representatives of the private sector” (FSB, 2009a: Article 8). The first FSB (2010c: 1) peer review process of compensation practices also welcomed “feedback from financial institutions and other stakeholders on practical experiences in implementing the FSB Principles and Standards.”

If private sector actors are being invited to contribute to the FSB’s activities in these ways, active efforts should be made to counter balance their influence by encouraging participation from other societal groups as well (Mattli and Woods, 2009). Already, civil society groups are complaining about their lack of access to influence FSB discussions (for example, Transparency International, 2009). The other pillars of global economic governance have developed consultation processes with wider societal groups that could be emulated.

A counterbalancing role could also be played by officials from outside financial policy-making circles. Analysts have described how capture can be a function not just of lobbying but of broader belief systems that can emerge among tightly networked regulators working closely with the private sector. For example, the head of Britain’s Financial Services Authority, Lord Turner, has described how there was a kind of “regulatory capture through the intellectual zeitgeist” during the years leading up to the crisis (Prospect Magazine, 2009). To minimize the risk of narrow groupthink emerging among FSB circles, transnational groupings of legislators and non-financial

officials could be invited to provide input into the FSB’s deliberations. They could also be encouraged to monitor its work, as could an arms-length body similar to that of the IMF’s Independent Evaluation Office (for example, Kapstein, 2008: 149; Helleiner and Porter, 2009). Peer review processes could also invite input from wider official circles.

Conclusion

There is no question that many features of the FSB address weaknesses in the FSF’s role within international regulatory policy making (for an overall comparison of the FSF and FSB, see Appendix, page 20). Its wider membership (and that of the SSBs) has created a more legitimate institution compared to the more narrowly constituted FSF. The FSB has also been given stronger mechanisms for encouraging compliance with international standards, including: mandatory regular FSAPs and publication of the detailed IMF/WB assessments related to the ROCSs for members; membership obligations to implement international standards; a new peer review process for FSB members; and a new FSB-led process to tackle non-cooperating jurisdictions. The FSB also has acquired a much stronger capacity to address macroprudential concerns because of its new mandates vis-à-vis the SSBs, its ability to create its own standards, and strong G20 support for the project of developing macroprudential regulatory tools.

These changes also create new challenges and priorities for the FSB, for which some responses have been suggested in this paper. These can be briefly summarized:

Challenges and Priorities Related to Enlarged Membership

- The FSB’s larger and more heterogeneous membership may make consensus more difficult to reach. This strengthens an already-existing case for focusing more on principles-based international standards than detailed one-size-fits-all rules-based international standards.
- To bolster their commitment to the FSB, new developing country members must feel that their voice counts within the institution. Their influence could be strengthened through the use of co-chairs, or rotating chairs, from developed and developing countries within FSB working groups and standing committees as well as through the provision of research and technical support and/or the creation of a standing committee or working group focused on issues of particular relevance to developing countries.

- The FSB must address its lack of accountability to the large number of non-member countries. A limited mechanism would involve a FSB commitment to request comments from non-members on any issue discussed by the plenary, or to consult at regular intervals. Cooperation with non-members involving information sharing, research collaboration and capacity building could also be developed. A more ambitious response would be to make the FSB accountable to the IMF's IMFC instead of the G20 leaders' forum. Alternatively, the FSB's membership could be expanded further and a strong executive committee could be introduced with regional representation or IMF-style constituency systems.

Challenges and Priorities Related to Compliance Mechanisms

- Now that FSAPs and ROSCs have been assigned a more prominent role in the compliance process, the IMF and World Bank need to coordinate these programs more closely with the FSB's objectives.
- The FSB's Charter states that members must implement international standards, but the processes for dealing with a non-complying member, and the consequences of non-compliance, need to be clarified. Possible approaches might include a regular membership renewal process and/or gradations in membership rights.
- The new peer review process would be strengthened if the FSB's secretariat were larger. Reviews among countries with similar levels of financial market development and regulation should also be encouraged. The costs and benefits of the decision to have reviews adopted by consensus and made public also may deserve more attention. Compliance mechanisms involving penalties should also be linked less to the direct results and information revealed in specific peer reviews than to the willingness to engage in good faith with peer review processes over time.
- The new FSB-led initiative to encourage compliance among non-cooperating jurisdictions may be weakened by the choice of relying on the FSB plenary as the ultimate judge of non-compliance. An alternative approach could rely on the judgement of an expert panel (similar to WTO dispute settlement panels) whose rulings could legitimate collective or individual sanctions by FSB members, although this proposal raises many difficult questions.

Challenges and Priorities Related to Macroprudential Regulation

- If the FSB is to assume a lead role in macroprudential regulation, the precise lines of accountability between the SSBs and the FSB may need to be clarified.
- Priority should continue to be given to finalizing common international standards for counter-cyclical regulation as well as the treatment of systematically important institutions, markets and products. In some areas — such as the development of living wills — detailed international cooperation may be possible and desirable. In many areas, however, principles-based standards will be more likely and appropriate. Countries will also need to consider greater use of host country regulation if international agreement on international burden-sharing rules for future bailouts proves too difficult.
- Much more attention needs to be devoted to the task of minimizing the risk of private sector capture of financial regulatory policy making. The FSB could develop international standards for regulators which address issues such as the “revolving door” phenomenon. To balance financial industry influence, the FSB should also foster consultation with societal groups beyond the financial industry, as well as with national legislators and non-financial officials. The monitoring of the FSB's activities by these groups as well as by an arms-length body similar to that of the IMF's Independent Evaluation Office should also be considered.

If serious efforts are made to address these various challenges and priorities, the FSB will stand a better chance of evolving into the role of a more substantial fourth pillar of global economic governance. Under that scenario, it would still not become the kind of powerful global regulator that some have hoped for. The strategic place of finance in domestic political economies makes any serious delegation of power to a global regulator politically very unlikely in the near to medium-term future (this task has proven difficult even in Europe). Like the FSF, the FSB's role will remain focused primarily on facilitating and strengthening transgovernmental networks, with ultimate responsibility for financial regulation and supervision still firmly located at the national level (or perhaps regional in the case of Europe).

Even if it was politically possible for the FSB to eventually evolve into the role of a powerful global regulator, the desirability of that outcome is questioned by many. The drawbacks of the kind of one-size-fits-all international standards that a global regulator would likely create have already been noted. Tarullo (2008: 252) also argues that a global regulator would result in “the loss of regulatory

flexibility to respond to local conditions (including macroeconomic conditions), the suppression of possibly healthy regulatory experimentations or competition, and the removal of regulatory authority further away from the points of democratic accountability.”³⁰ More generally, Rodrik (2009) makes the following case against a global regulator:

the world economy will be far more stable and prosperous with a thin veneer of international co-operation superimposed on strong national regulations than with attempts to construct a bold global regulatory and supervisory framework. The risk we run is that pursuing an ambitious goal will detract us from something that is more desirable and more easily attained.

Strengthening this “thin veneer of international cooperation” may be the key task that the FSB performs in the coming years.³¹

One alternative future scenario for the FSB, however, needs to be considered. Many initiatives that the FSB has undertaken since its creation in April 2009 have been strikingly similar to those of the FSF during its first year of life. Like the FSB, the FSF started off its existence with high hopes and a flurry of activity. But within a few years, complacency set in and the FSF fell into relative obscurity. If the challenges and priorities outlined in this paper are not addressed, the FSB could easily meet the same fate.

30 See also Paul Martin’s (1999a) comment in the late 1990s that a global regulator “would be too large and too far removed from the institutions it would oversee to be effective.”

31 Rodrik (2009) describes the “thin veneer of international cooperation” as one in which countries agree to “an international financial charter with limited aims, focused on financial transparency, consultation among national regulators, and limits on jurisdictions (such as offshore centres) that export financial instability.” The FSB’s role is not far off that description. See also Warwick Commission (2009) and Helleiner (2010).

Appendix: Comparing the Financial Stability Forum and the Financial Stability Board

	Financial Stability Forum (Details from 1999 Tietmeyer report unless otherwise noted)	Financial Stability Board (Details from Charter and subsequent statements)
Mandate	<ul style="list-style-type: none"> • “assess issues and vulnerabilities affecting the global financial system and identify and oversee the actions needed to address them, including encouraging, where necessary, the development or strengthening of international best practices and standards and defining priorities for addressing and implementing them.” (G7 statement) • “ensure that national and international authorities and relevant international supervisory bodies and expert groupings can more effectively foster and coordinate their respective responsibilities to promote international financial stability, improve the functioning of the markets and reduce systemic risk” (G7 statement) 	<ul style="list-style-type: none"> • Assess vulnerabilities affecting the global financial system and identify and review on a timely and ongoing basis the regulatory, supervisory and related actions needed to address them, and their outcomes. • Promote coordination and information exchange among authorities responsible for financial stability. • Monitor and advise on market developments and their implications for regulatory policy. • Advise on and monitor best practice in meeting regulatory standards. • Undertake joint strategic reviews of the policy development work of the international standard setting bodies to ensure their work is timely coordinated, focused on priorities and addressing gaps. • Set guidelines for and support the establishment of supervisory colleges. • Support contingency planning for cross-border crisis management, particularly with respect to systemically important firms. • Collaborate with the IMF to conduct Early Warning Exercises. • The FSB will promote and help coordinate the alignment of the activities of the SSBs to address any overlaps or gaps and clarify demarcations in light of changes in national and regional regulatory structures relating to prudential and systemic risk, market integrity and investor and consumer protection, infrastructure, as well as accounting and auditing.
Country Membership (numbers of representatives)	<ul style="list-style-type: none"> • G7 (3) • Added in 1999: Australia (1), Singapore (1), Hong Kong (1), Netherlands (1) • Added in 2007: Switzerland (1) 	G7 (3), Brazil (3), Russia (3), India (3), China (3), Australia (2), Mexico (2), Netherlands (2), Spain (2), South Korea (2), Switzerland (2), Argentina (1), Hong Kong (1), Indonesia (1), Singapore (1), Saudi Arabia (1), South Africa (1), Turkey (1)
Other Members (number of representatives)	IMF(2), World Bank (2), BIS (1), OECD (1), BCBS (2), IOSCO (2), IAIS (2), GCFS (1), CPSS (1), ECB (1)	Same plus European Commission
Level of Representation	“Representation should be at a high level (that is, Deputy Ministers and Deputy Governors, Deputy Heads of the IFIs, Chairs and appointed members of international groupings).” (Tietmeyer, 1999)	“Representation at the Plenary shall be at the level of central bank governor or immediate deputy; head or immediate deputy of the main supervisory/regulatory agency; and deputy finance minister or deputy head of finance ministry. Plenary representatives also include the chairs of the main SSBs and committees of central bank experts, and high-level representatives of the IMF, the World Bank, the Bank for International Settlements (BIS) and the Organisation for Economic Co-operation and Development”

	Financial Stability Forum (Details from 1999 Tietmeyer report unless otherwise noted)	Financial Stability Board (Details from Charter and subsequent statements)
Internal governance	<p>Chairperson</p> <p>Secretary-General</p> <p>Secretariat (in Basel)</p> <p>Plenary (consensus rule)</p> <p>Ad hoc working groups</p>	<p>Chairperson</p> <p>Secretary-General</p> <p>Secretariat (in Basel)</p> <p>Plenary (consensus rule)</p> <p>Ad hoc working Groups</p> <p>Steering Committee</p> <p>Standing Committees</p>
Accountability	Reports to the G7 finance ministers and central bank governors	Reports to the G20 leaders
Relationship to SSBs	Not specified	<ul style="list-style-type: none"> • “the standard setting bodies will report to the FSB on their work without prejudice to their existing reporting arrangements or their independence. This process should not undermine the independence of the standard setting process but strengthen support for strong standard setting by providing a broader accountability framework” • FSB will “undertake joint strategic reviews of the policy development work of the international standard setting bodies to ensure their work is timely, coordinated, focused on priorities and addressing gaps” • FSB will “promote and help coordinate the alignment of the activities of the SSBs to address any overlaps or gaps and clarify demarcations in light of changes in national and regional regulatory structures relating to prudential and systemic risk, market integrity and investor and consumer protection, infrastructure, as well as accounting and auditing”
International Standard-setting	<ul style="list-style-type: none"> • delegated to SSBs 	<ul style="list-style-type: none"> • delegated to SSBs • FSB
Compliance Mechanisms	<ul style="list-style-type: none"> • voluntary IMF/WB surveillance • market pressure • Name and shame, and possible sanctions vis-à-vis OFCs 	<ul style="list-style-type: none"> • IMF/WB surveillance (for members, mandatory FSAPs every five years, and publication of assessments used as a basis for the ROSCs) • market pressure • name and shame, and possible sanctions against all non-cooperating jurisdictions • membership requirement to implement international standards • mandatory peer reviews for members

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Acronyms and Abbreviations

BCBS	Basel Committee on Banking Supervision
BIS	Bank for International Settlements
CGFS	Committee on the Global Financial System
CPSS	Committee on Payment and Settlement Systems
ECB	European Central Bank
FATF	Financial Action Task Force
FSAP	Financial Sector Assessment Program
FSB	Financial Stability Board
FSF	Financial Stability Forum
G7	Group of 7
G20	Group of 20
IAIS	International Association of Insurance Supervisors
IASB	International Accounting Standards Board
IFAC	International Federation of Accountants
IMF	International Monetary Fund
IMFC	International Monetary and Financial Committee
IOSCO	International Organization of Securities Commissions
MMoU	Multilateral Memorandum of Understanding
NCJ	non-cooperative jurisdiction
OECD	Organisation for Economic Co-operation and Development
OFC	offshore financial centre
ROCS	Reports on the Observance of Standards and Codes
SCSI	Standing Committee on Standards Implementation
SSB	standard setting body
WTO	World Trade Organization

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Publications Team

Senior Director for Publications: Max Brem

Publications Coordinator: Jessica Hanson

Media Designer: Steve Cross

Publications Assistant: Matthew Bunch



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Governance Innovation
Centre pour l'innovation dans
la gouvernance internationale

57 Erb Street West
Waterloo, Ontario N2L 6C2, Canada
tel +1 519 885 2444 fax +1 519 885 5450
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