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The Soft Touch of International Financial Regulation: Status, Flaws and Future

Niall O'Shaughnessy*

Table of Contents

A. Introduction 61
B. The Basel Accords 62
I. Development and Internal Flaws 62
II. Oversights and Omissions 65
III. A Flawed Theoretical Foundation 68
C. Explaining the Dominance of Soft Law 72
D. The Future of Financial Regulation 75
I. The Revolutionary View: A New Global Authority 76
II. The Reformist View: Improving Soft Law 80
III. Theoretical and Regulatory Innovations 82
E. Conclusion 85

* Niall O'Shaughnessy is an LL.M. candidate at Katholieke Universiteit Leuven. The author would like to thank the anonymous reviewers for their invaluable comments, and the editorial board for all their help. Any remaining mistakes are the author's own.

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Abstract

The 2008 global financial crisis focused attention on the relationship between the behaviour of international financial institutions and the rules they follow. Many banks in the US and Europe failed, in part, due to their inability to absorb the fallout of the US mortgage market collapse. If international financial institutions could not protect themselves from the cycles of the market, how come regulators were unable to do so either? The most relevant instrument of international financial regulation for understanding the 2008 crisis is the Basel Accords, the rules that specify how much capital a bank should always hold in reserve. However, these rules are 'soft law' and so, non-binding.

It is a myth of course that soft law is the only way to regulate international finance, as many scholars argue. Despite numerous rounds of reform, the Basel Accords have always been inadequate. The purpose of this paper is to account for the flaws of the Basel Accords and the role that soft law plays in creating those flaws. This paper also analyses the competing theories behind the rise of soft law within financial regulation and the 'political economy' explanation is endorsed. The final section of the paper discusses the future of financial regulation and soft law, as well as highlighting innovations from outside the hard/soft law dichotomy and outside the Global North. This paper concludes by stating that the theory behind soft law does not play out in practice within finance and that it remains in place because it suits the interests of large institutions and powerful states. At the same time, a return to Bretton Woods or a new *World Financial Organization* is problematic and, as such, we must look beyond the hard/soft law debate and embrace the work of the Global South and East.

A. Introduction

Just as the world's leading economies were abandoning the fixed exchange rate system, and financial globalization was taking shape, then United States (US) Treasury Secretary Henry Fowler said in 1972 "[…] the free world has backed inadvertently into a developing international capital market rather than affected a rational and conscious entry".[1] Rather than correct this path, international efforts to regulate finance have been defined by the characteristics of the system, accepting those characteristics rather than changing them.[2] The rationale goes as follows: traditional instruments of international law, such as treaties and global authorities with corrective powers, are unsuited to the size, volatility and complexity of international finance. As such, regulation must be malleable and informal enough to respond to the unique and ever-changing demands of finance, hence the prevalence of so-called soft law.[3] The 2008 global financial crisis (GFC) called this logic into question as individuals, banks and States throughout the world felt the impact of the collapse of the sub-prime mortgage market in the US.

The primary instruments of international financial regulation (IFR) are the Basel Accords. The Basel Accords are non-binding agreements that are intended to guide domestic regulators and international financial institutions about appropriate levels of reserve capital. Having sufficient levels of reserve capital protects banks against acute liquidity shortages. The development of the Accords has been defined by crises and criticism but because the organisation responsible, the Basel Committee, cannot create binding rules, the Accords are mostly shielded from domestic politics. In a sense, international finance regulates itself – banks have historically complied with IFR on their own terms, industry representatives were involved in drafting the Accords and there is a *revolving door* of personnel between public and private institutions. Questioning this arrangement is difficult as the perceived complexity of finance lends itself to technocratic regulation. I agree with those who argue that this is intentional,

1 United States House of Representatives, Committee on Foreign Affairs, 'The International Implications of the New Economic Policy: Hearings, Ninety-second Congress', First Session(1971), 16.

2 P-H. Verdier, 'The Political Economy of International Financial Regulation', 88 *Indiana Law Journal* (2013) 4, 1405, 1416.

3 See, for example, C. Brummer, 'Why Soft Law Dominates International Finance – And Not Trade', 13 *Journal of International Economic Law* (2010) 3, 623; C. Brummer, *Soft Law and the Global Financial System: Rule Making in the 21st Century*, 2nd ed. (2015), ch. 3 [Brummer, Soft Law and the Global Financial System].

that such a system suits powerful States, institutions and companies. As such, I hope to highlight the fallacy of soft law in finance by identifying the many theoretical and legal gaps.

Accordingly, the primary purpose of this paper is to account for the flaws of the Basel Accords and the role that soft law plays in creating those flaws. The first section will trace the development of the Accords, accounting for the substantive flaws before moving onto omissions and, lastly, to the flawed theory behind them. Because the theoretical arguments for soft law's place within finance have been the primary source for IFR's problems, the second section will examine the different accounts that try to explain soft law's dominance. Much in the same way the first section divides the problems of the Accords into internal and external categories, the third and final section will appraise the different proposals for the future of IFR within and outside the soft law framework. I believe the suggestions of both sets of authors lack rigour, this final section therefore also includes reforms that look beyond the hard/soft law debate, as well as recent innovations from the Global South and East.

B. The Basel Accords

The 2008 financial crisis highlighted the vulnerable position banks put themselves in, due in large part to insufficient capital reserves. These weaknesses were immediately exposed by an unexpected event like the collapse of the subprime markets in the US.[4] The problems that accrued from the accompanying *credit crunch* were not contained within the US. In particular, banks operating in the EU experienced liquidity emergencies as a result of loan shortages. These events justify the rationale behind regulating capital requirements on an international basis, the purpose of the Basel Accords. The following section traces the development of the Accords, before presenting the flaws from an internal perspective (issues with the substance and omissions of the Basel Accords) and an external perspective (issues that stem from its soft law nature).

I. Development and Internal Flaws

The last global crisis was not an isolated event; the first crisis that spurred the international community into action was the collapse of the Herstatt Bank

[4] Of course, many commentators predicted the impending crisis. For a general discussion on what preceded the '08 crisis, see A. Tooze, *Crashed: How a Decade of Financial Crises Changed the World* (2018).

in 1974, which led to the first Basel Accord being introduced in 1988.[5] This also marked the beginning of a trend in IFR with crises being a catalyst for changes from Basel I to II to III, as is set out below. The collapse of a medium-sized German bank revealed serious shortcomings in the capitalisation of banks in the US, Europe and Japan. As such, US regulators mounted pressure on the international community to match their domestic capital requirements but also to ensure their own banks remained globally competitive.[6] Specifically, banks operating on an international level would be required to hold a minimum capital requirement of 8%. The 1988 Accord has since been adopted by over 100 countries.[7] The first Accord came under heavy criticism as it featured an explicit bias against developing countries – credit to non-OECD banks was assigned an 80% higher risk weight if it took over one year to mature.[8] This measure was a contributing factor to the Asian financial crisis of the late 1990s as it encouraged short-term lending practices.[9] As such, Basel I failed on its own terms as a stabilising influence in global finance.

The Accord was revised in 2004 to address these issues and brought in two additional pillars to go along with capital requirements: supervisory review and market discipline.[10] However, Basel II granted the banks themselves discretion in deciding how much capital should be reserved, according to their own internal policies.[11] As some authors point out, Basel II was "[…] based primarily only on what the big banks are able, or perhaps more accurately, willing, to do to their capital structures […]".[12] The ability of banks to sidestep capital requirements, and become excessively leveraged, is crucial to understanding the 2007 crisis;[13]

5 R. Bollen, 'The international financial system and future global regulation', 23 *Journal of International Banking Law and Regulation* (2008) 9, 458, 462.

6 *Ibid.*, 462.

7 S. Griffith-Jones & S. Spratt, 'Will the proposed new Basel Capital Accord have a net negative effect on developing countries?', *Institute of Development Studies* (2001), 1.

8 *Ibid.*, 1.

9 S. Griffith-Jones & J. Cailloux, 'Encouraging the Long Term; Institutional Investors and Emerging Markets', *Institute of Development Studies* (1998), 33.

10 L. J. Rodríguez, 'International Banking Regulation - Where's the Market Discipline in Basel II?', 455 *Policy Analysis* (2002), 1.

11 Basel Committee on Banking Supervision, 'The New Basel Accord' (2001), available at https://www.bis.org/publ/bcbsca02.pdf (last visited 20 April 2021), 32-35.

12 J. Linarelli, M. E. Salomon & M. Sornarajah, *The Misery of International Law: Confrontations with Injustice in the Global Economy* (2018), 193 [Linarelli, Salomon & Sornarajah, The Misery of International Law].

13 A. Admati & M. Hellwig, The Bankers' *New Clothes: What's Wrong with Banking and What to Do about It* (2014), 4 [Admati & Hellwig, The Bankers' New Clothes]. The

for instance, at the beginning of the crisis, major financial institutions like Swiss bank UBS held equity to the equivalent of 2 to 3 percent of its total assets.[14]

Once again, a global crisis in 2008 refocused attention on the role of regulators in international finance. The Basel Committee even indirectly recognised its own shortcomings in the Basel III framework publication: "[T]he global banking system entered the crisis with an insufficient level of high quality capital. The crisis also revealed the inconsistency in the definition of capital across jurisdictions".[15] Accordingly, Basel III reemphasised the need for increased capital ratios – 8% of risk-weighted assets at all times – with a more nuanced and extensive definition of regulatory capital.[16] Basel III also attempted to address the systematically crucial, *too big to fail* banks through proposed capital surcharges, as well as *conservation* and *countercyclical* buffers.[17] In short, Basel III encouraged banks to stockpile capital in times of economic growth and stability.

Unfortunately, the central flaw of Basel II – the means and discretion banks used in assigning risks to assets – was not undone in Basel III.[18] As outlined above, the ratio of capital held as a percentage of risk-weighted assets increased. However, as banks were still able to calculate risk-weighted assets as they wish, the ratio was completely malleable. Secondly, the capital buffers proposed were worthy of little enthusiasm as the realities of their implementation were down to what national authorities decided was suitable.[19] Further, Basel III was still structured to allow banks to hold capital reserves of 3% of total assets.[20] In other words, the changes proposed in response to the 2007 crisis would likely have had no bearing on the contagion had they been in place beforehand.

Basel III was originally intended to come into force at the start of 2013 but was delayed due to simultaneous changes in the regulatory architecture of both the US and Europe.[21] Basel III's full implementation was also hindered

authors rely on quotes explaining the crisis from CEOs of banks like Bank of America, JPMorgan and Morgan Stanley.

14 *Ibid*., 96.

15 Basel Committee on Banking Supervision, Basel III: *A global regulatory framework for more resilient banks and banking systems* (2010), 12.

16 *Ibid*., 12.

17 *Ibid*., 7 and 54-57.

18 Verdier, 'The Political Economy of International Financial Regulation', *supra* note 2, 1464.

19 *Ibid*., 1465.

20 Admati & Hellwig, 'The Bankers' New Clothes', *supra* note 13, 96.

21 P. Yeoh, 'Global banking reforms: mission accomplished?', 33 *Journal of International Banking Law and Regulation* (2018) 9, 305, 310.

by a new set of reforms published by the Committee in December 2017. The intention of the December 2017 reforms was surprisingly far-reaching and could more appropriately be classified as Basel IV.[22] Semantics aside, the most striking addition to the final version of Basel III is the reversal of internally-calculated risk weighted assets.[23] In its place, the Committee drafted a standardised approach, with risk weights assigned based on an asset's alphabetical rating if the exposed organisation involved is a bank (there is a unique *look-up table* for exposures to corporate, real-estate, equity and debt etc.).[24] So for instance, where a financial institution is a creditor to another bank with an AAA to AA rating, it is now obliged to assign that asset a risk weight of 20%.[25] The Basel Committee acknowledged the degree to which the internal model regime undermined its ability to regulate. Committee Chairman, Stefan Ingves, felt the Basel Committee had lost the trust of bank stakeholders and the general public,[26] rather than outwardly admit failure on behalf of the regulator.

II. Oversights and Omissions

The following points – regulatory arbitrage, undetectable transactions and the pitfalls of focusing on capital requirements and bank size – are still framed as substantive flaws but there is a common thread throughout. The actors that are best placed to identify these shortcomings and assess how great a threat they pose to financial stability are the banks themselves. Whilst some may argue that this is a prime reason for embracing the self-regulation that comes with a soft law regime, the fact that such flaws exist demonstrate that financial institutions cannot regulate themselves.

With the benefit of hindsight, allowing banks discretion to decide their own capital requirements using internal policy seems like an inevitable path to exploitation. However, Beltratti and Paladino don't see this as regulatory oversight and go as far as calling the Basel II reforms *sound* and that they "[…]

22 ABA Banking Journal, 'Basel Committee Releases 'Basel IV' Capital Framework' (2017), available at https://bankingjournal.aba.com/2017/12/basel-committee-releases-basel-iv-capital-framework/ (last visited 20 April 2021).

23 Basel Committee on Banking Supervision, *High-level summary of Basel III reforms* (2017), 2.

24 *Ibid.*, 3.

25 *Ibid.*, 3.

26 S. Ingves, 'Basel III: Are we done now?', Keynote Speech at the Institute for Law and Finance conference, Frankfurt (2018), available at https://www.bis.org/speeches/sp180129.pdf (last visited 20 April 2021), 2.

promised to better tune the financial structure of each bank to its (and its own home country—) individual characteristics […]".[27] Instead, they enquire whether it was the banks themselves that engaged in regulatory arbitrage – locating and exploiting gaps in the law – and undermined the international system as a whole.[28] Beltratti and Paladino found that for banks *not* under the Basel II umbrella, they had to pay more for equity capital (what an investor expects to receive for investing their money) as the proportion between the risk-weighted assets the bank held, and its total assets, increased.[29] This is a logical relationship: if a bank engages in risky loan practices that may result in a series of defaults, the investor deserves a higher return; similarly, this dissuades investors who are not in a position to embark on such high-risk investments. However, Beltratti and Paladino found that for banks operating in Basel II jurisdictions, they were able to employ their own internal measurements for risk-weighted assets and display this as a lower share of their total assets, thereby lowering the cost of equity capital.[30] This may deceive a potential investor, but as the last crisis has shown, when banks voluntarily weaken their own contingency plans, the impacts are not contained to the financial system itself. Further, the fact that banks did voluntarily weaken themselves directly undermines the effectiveness of self-regulation.

Despite the progress of the Basel Accords, some commentators still stress that the system is not yet sufficiently countercyclical. In an IMF Working Paper, Singh and Alam argue that international finance as a whole is failing to appreciate the role played by transactions that do not traditionally appear on bank balance sheets.[31] Specifically, it is pledged collateral transactions that undermine how accurately systematic risk can be judged. Pledged collateral transactions are different from other banking activity in that they are funded using assets that have been pledged to them from a non-bank institution, like a hedge fund. As this asset is not yet in the possession of the bank – it has only been agreed that it shall come into its possession should loan repayments cease – it is not counted as an asset or a liability for the purposes of a bank's balance

27 A. Beltratti & G. Paladino, 'Basel II and regulatory arbitrage. Evidence from financial crises', 36 *Journal of Empirical Finance* (2016), 180, 180 [Beltratti & Paladino, Basel II and regulatory arbitrage].

28 *Ibid.*, 181.

29 *Ibid.*, 181.

30 *Ibid.*, 195.

31 M. Singh & Z. Alam, 'Leverage—A Broader View', IMF Working Paper WP/18/62 (2018), available at https://www.imf.org/en/Publications/WP/Issues/2018/03/19/Leverage-A-Broader-View-45720 (last visited 20 April 2021), 4.

sheet. The central thesis of Singh and Alan's paper is not to suggest that the global financial infrastructure is necessarily made fragile by these transactions, but that we cannot fully grasp the stability of international finance without accounting for all forms of leverage being used by financial institutions. What the authors find curious is that, for US banks, credit to the wider economy has not changed much since 2008 despite lower levels of leveraging (money borrowed to fund investments) and only minor increases in bank capital.[32] This is explained through gathering available data on Globally Systematically Important Banks in the US and EU on the volume of pledged collateral and off-balance sheet funding. Volumes have not declined in pledged collateral since the shock of the Lehman Brothers collapse and, in fact, off-balance sheet funding has increased on the whole.[33] Taking the specific example of Barclays, it reported over £1 trillion in total assets in 2016 and exhibited £466 billion in pledged collateral. However, only £34 billion of that pledged collateral made it onto the balance sheet.[34] According to Singh and Alam, most pledged collateral transactions take place across borders,[35] which demonstrates the financial system is still highly vulnerable to the contagion witnessed when the sub-prime mortgage collapsed in 2007.

The vulnerability of a bank or financial institution need not necessarily be a fatal wound in international financial systems. Identifying what organisations are Systematically Important Financial Institutions (SIFIs) or Global Systematically Important Banks (G-SIBs) requires more than ranking banks in order of size, or amount of assets held.[36] For example, look at how exposed a relatively minor institution like Northern Rock was to the sub-prime mortgage crisis, eventually leading to its nationalization.[37] Accordingly, Varotto and Zhao argue that fighting systemic risk through minimum levels of reserve capital is a narrow-minded approach.[38] Once again, if self-regulation were working in reality, Northern Rock would have recognised the risks of immense interconnectivity and corrected itself.

Others have argued that, even if we accept that size is the most relevant factor for determining systemic risk, limiting size in banking would have a

32 *Ibid.*, 12.
33 *Ibid.*, 16.
34 *Ibid.*, Table 2, 18.
35 *Ibid.*, 13.
36 S. Varotto & L. Zhao, 'Systemic risk and bank size', 82 *Journal of International Money and Finance* (2018), 45, 46.
37 *Ibid.*, 49.
38 *Ibid.*, 46.

detrimental effect on consumers through reducing economies of scale within banking.[39] For example, prices in bank services may increase due to competitive disadvantages that arise if bank size is regulated in one jurisdiction only. Regulators remaining open to restricting bank size can be reconciled with Varotto and Zhao's warnings about a preoccupation with size: if a sizeable bank is also highly interconnected, then limiting growth is a viable option. Barth and Wilhborg further argue there is a danger in relying on capital requirements to act as a disincentive for further size and complexity in banking, which can be thought of as a tax that tries to discourage such behaviours.[40] Their point is that burdensome capital requirements may succeed to a point but that once a bank reaches a 'trigger point' of size/complexity, there is no further disincentive to stop there. Barth and Whilborg also argue that large capital requirements would actually mobilise banks to evade regulation.[41] This is a difficult claim to stand behind because, yes the Basel Accords had trouble with regulatory arbitrage and encouraging compliance in general, but these issues are traceable to the soft law nature of the regulation, they are not a result of setting capital requirements. Under Barth and Whilborg's logic, any soft law regulation encourages the very behaviour it attempts to change.

III. A Flawed Theoretical Foundation

International financial bodies like the Basel Committee can be classified as *Transnational Regulatory Networks* (TRN), relying on principles or guides to be adopted at the national level; in Segura-Serrano's words, a decentralised enforcement mechanism.[42] TRNs are synonymous with soft law and advocates for TRNs rely on similar rationales of providing flexibility for actors that are fearful of binding agreements, as well as offering a forum that is insulated from domestic politics.[43] TRNs are not inherently flawed as a standalone concept but there are reasons to suggest that they cannot fulfil their promise within

[39] J. Barth & C. Wihlborg, 'Too Big to Fail and Too Big to Save: Dilemmas for Banking Reform', 235 *National Institute Economic Review* (2016), R27, R33.

[40] *Ibid*., R36.

[41] *Ibid*., R36.

[42] A. Segura-Serrano, 'International Economic Law at a Crossroads: Global Governance and Normative Coherence', 27 *Leiden Journal of International Law* (2014) 3, 677, 689 [Segura-Serrano, International Economic Law at a Crossroads].

[43] P-H. Verdier, 'Transnational Regulatory Networks and Their Limits', 34 *Yale Journal of International Law* (2009) 1, 113, 162.

finance. For one, as Verdier points out,[44] the Basel II negotiations show that regulators within TRNs cannot truly balance domestic pressures and global interests – that process was consistently held up by intervention from Germany, the US and industry lobby groups and the eventual compromises rendered the Accord wholly inadequate.[45] On top of that, one alleged advantage of TRNs is that the regulators involved cannot and should not concern themselves with the distributive consequences of agreed measures. In securing wide agreement for Basel I, the Basel Committee was forced to sacrifice a guarantee of financial stability to allow for a flexible approach to defining capital. This then allowed banks to heavily invest in risky assets that eventually became the source of the last financial crisis.[46] TRNs offer powerful States a veil of technocracy where democracy and distribution are ignored, whilst still providing a regulatory forum to exert influence.[47] By way of example, the Basel I process was overseen by the US and the United Kingdom who managed to secure broader levels of capitalisation globally without harming the competitiveness of their domestic banks.[48]

The Financial Stability Board's (FSB) annual report on the implementation of the so-called *G20 Reforms*, which include Basel III frameworks, provides an insight into compliance levels amongst its 28 member States.[49] Certain aspects of Basel III, such as changes to risk-based capital requirements and Liquidity Coverage Ratio, began being phased in during 2013 and 2015 respectively.[50] Relatively speaking, levels of compliance are high with all but 6 of the 28 jurisdictions adopting the risk-based capital changes and effectively all of the 28 implementing rule changes around liquidity.[51] Notably however, the 6 non-compliant States are the FSB's EU members and the United Kingdom. The EU's implementation of the initial Basel III reforms, the Capital Requirements Directive (CRD) IV,[52] was watered down to such an extent as to be classified as

44 *Ibid.*, 162.
45 *Ibid.*, 141.
46 *Ibid.*, 163.
47 *Ibid.*
48 *Ibid.*, 117.
49 Financial Stability Board, 'Implementation and Effects of the G20 Financial Regulatory Reforms: 2020 Annual Report'(2020), available at https://www.fsb.org/wp-content/uploads/P131120-1.pdf (last visited 20 April 2021).
50 *Ibid.*, 3.
51 *Ibid.*, 3.
52 Council Directive 2013/36/EU, OJ L 176/338, 27 June 2013.

materially non-compliant.[53] Put more succinctly, the EU's divergence means that 31% of the market has not implemented the Basel III framework for risk-based capital.[54] Further, only 10 States were found to comply with Basel III exposure framework and 11 complied with final rules for the Net Stable Funding Ratio.[55] The Basel III finalisation process also highlighted the systematic shortcomings in the drafting process; the countries at the table fought not for what they believed was most appropriate internationally, but what their banks had asked them to bargain for. France and Germany, home to many of the institutions responsible for ensuring the crash in the US derivatives market in 2007 became a European problem, lobbied for decreases in the amount of capital reserves required.[56] As with previous iterations of Basel Committee standards, compliance is an enormous obstacle. In 2018, the Committee noted over 1,200 deviations from capital reforms encouraged under Basel III.[57]

On its face, a soft law approach is not without its advantages. For one, a hard-law alternative would require intense negotiation that must be consistent with rules around treaty formation.[58] Similarly, soft law navigates the *globalization paradox*,[59] in other words the tension between responding to challenges that exist across borders and the delicate subject of sacrificing national sovereignty. Unfortunately, the weight given to these advantages is generous. If the negotiations around the finalisation of guidelines already demand large amounts of resources, surely they would be better channelled towards treaty negotiations. Also, the benefits gained from navigating the *globalization paradox* have historically been too minimal compared to the lack of protection provided by guidelines such as the Basel Accords.[60] Further, the processes used by TRNs to draft new guidelines do not make room for the views of developing countries despite the expectation of compliance, giving rise to accusations of political

[53] L. Quaglia, 'The politics of state compliance with international "soft law" in finance', 32 *Governance* (2019), 45, 57.

[54] Financial Stability Board, *supra* note 49, 7.

[55] *Ibid*., 6.

[56] Verdier, The Political Economy of International Financial Regulation, supra note 2, 1465, cites D. Borak, 'Bair Details Inside Story of Regulatory Clash Over Basel III', American Banker (2012), available at https://www.americanbanker.com/news/bair-details-inside-story-of-regulatory-clash-over-basel-iii (last visited 20 April 2021).

[57] Ingves, *supra* note 26.

[58] K. Alexander, 'Global Financial Standard Setting, the G10 Committees, and International Economic Law', 34 *Brooklyn Journal of International Law* (2009) 3, 861, 879.

[59] Segura-Serrano, 'International Economic Law at a Crossroads', *supra* note 42, 689.

[60] Linarelli, Salomon & Sornarajah, *supra* note 12, 208.

illegitimacy.[61] The characteristics of TRNs do not lend themselves to solving regulatory issues; the regulators involved have been tasked with representing domestic interests, not to inspire international cooperation.[62] There is also the ease with which States can ignore, or walk away from, commitments made to TRNs.[63] Finally, soft law develops not out of a long-term vision of what prudential regulation could and should look like, its development is *path-dependent* and *ad-hoc*, merely representing a series of isolated compromises.[64] According to Verdier, this is not a coincidence, as such an informal institution, lacking in cohesion, suits those looking to exert influence.[65]

The proliferation of TRNs in the 1990s – with the strengthening of the Basel Committee, International Organization of Securities Commissions and the International Association of Insurance Supervisors – is indicative of the *fragmentation* of international law. Fragmentation in this context means the continual creation of regulatory bodies with "[…] overlapping jurisdictions and ambiguous boundaries".[66] Benvenisti and Downs have described this phenomenon as a tool "[…] to undermine the normative integrity of international law".[67] Powerful States maintain their position in the arena of international law using the decentralised nature of international regulation. According to Bevenisti and Downs, this is accomplished in two ways: hide the fact that developing countries are involved in a *repeating game*, i.e. make smaller States believe this particular negotiation is their only chance to protect their interests, and take away opportunities for developing countries to resolve their differences.[68] The prior may be accomplished through halting the establishment of a permanent law-creating and enforcing body (like a potential World Financial Organization [WFO]). The latter can be achieved through ensuring there are multiple, similar forums available for exploitation (such as the three TRNs mentioned above).

61 K. Alexander, R. Dhumale & J. Eatwell, *Global Governance of Financial Systems: The International Regulation of Systemic Risk* (2005), 153.

62 Verdier, 'Transnational Regulatory Networks and Their Limits', *supra* note 43, 121.

63 UN, 'Report of the Commission of Experts of the President of the United Nations General Assembly on Reforms of the International Monetary and Financial System' (2009), available at https://www.un.org/en/ga/econcrisissummit/docs/FinalReport_CoE.pdf, 107 (last visited 20 April 2021).

64 Segura-Serrano, 'International Economic Law at a Crossroads', *supra* note 42, 684.

65 Verdier, 'The Political Economy of International Financial Regulation', *supra* note 2, 1408.

66 E. Benvenisti and G. W. Downs, 'The Empire's New Clothes: Political Economy and the Fragmentation of International Law', 60 *Stanford Law Review* (2007) 2, 595, 596.

67 *Ibid.*, 597.

68 *Ibid.*, 608.

The analysis of Quaglia around State compliance and the Basel Accords sheds some light on the process an international agreement goes through to become implemented domestically, and where the transplant often falls down.[69] Quaglia's starting point is the compliance records of the US and EU with Basel II and Basel III; the US complied with Basel III but not Basel II and the EU vice-versa, compliance with II but not III.[70] In both instances of non-compliance, when it came to implement the Accords domestically, this was the only stage at which domestic interest groups could hope to exert influence (international institutions are primarily active at the inter-governmental drafting stage). In the US, whilst the implementation of Basel II was being discussed, domestic banks won over politicians by highlighting the comparative disadvantage that Basel II would bring in comparison with international institutions, whose capital requirements would actually be reduced.[71] European banks pressured domestic and regional parliamentarians by arguing that Basel III neglected characteristics of finance that were unique to Europe, namely European banks' links with the *real economy*.[72] Quaglia points out that democratically elected politicians only play a significant role at the implementation stage. The initial drafters are domestic regulators, whose technical aptitude places them there ahead of parliamentarians, and lobbyists from international banks. Even at the implementation stage, the influence of finance remains, albeit in a different form. As Quaglia concludes, that difference deserves attention as it highlights a democratic deficit at the global level of financial regulation, where politicians and domestic interest groups are largely excluded.[73]

C. Explaining the Dominance of Soft Law

There are three dominant theories that attempt to explain the current position of soft law within international finance: the historical path dependence approach, the contractarian approach and the political economy approach. Historical path dependence has its roots in the international relations theory of historical institutionalism, which argues that the foundational structures of institutions set the boundaries for future development.[74] In the context of IFR,

[69] Quaglia, *supra* note 53.
[70] *Ibid.*, 47.
[71] *Ibid.*, 52.
[72] *Ibid.*, 56.
[73] *Ibid.*, 58.
[74] O. Fioretos, 'Historical Institutionalism in International Relations', 65 *International Organization* (2011) 2, 376, 371.

much of the current system can be traced back to the Bretton Woods conference in 1944 that established the rules around fixed exchange rates but not a specific governing authority.[75] When those measures were abandoned in the 1970s, and finance took advantage of unrestricted capital flows, domestic regulators had to contend with a new era of globalization in the absence of a central international authority. Hence, we have the informal coordinating actions that have led to measures like the Basel Accords.[76] Lastra argues that this process is found elsewhere in international law and makes the point that there are ties between the historical development of *lex mercatoria* (commercial law)and *lex financier* (financial law).[77] In the case of the former, much current commercial law owes its foundations to the *lex mercatoria* of the middle ages – a series of uncodified customs around trade and maritime practices. Lastra provides three reasons why international financial law has progressed so precariously. First of all, the legal mandate to pursue a hard law regime has been absent. Secondly, regulatory changes have always been a reaction to something, not as part of a long-term plan. Finally, the relationship of mutual dependence that national governments have with their financial institutions has made them reluctant to relinquish any regulatory power to a global authority.

Another group of theorists have put forward a more sympathetic narrative framework to explain soft law's popularity: the contractarian approach. Abbott and Snidal argue that if international agreements are viewed as contracts, the decisions and attitudes of State actors are more easily understood.[78] In other words, the *contracting costs* associated with soft law are significantly more attractive than those associated with hard law.[79] The most politically contentious aspect of international cooperation is sovereignty; certain characteristics of soft law alleviate these concerns, such as escape clauses, substantive imprecision or discretion in delegating authority.[80] Similarly, the absence of being bound gives States the chance to evaluate the impacts of an agreement and may eventually lessen perceived costs if the agreement then becomes binding. The authors

75 M. Waibel, 'Financial Crises and International Law', *University of Cambridge Faculty of Law Legal Studies Research Paper Series* (2019) 18, para. 34.

76 Verdier, 'The Political Economy of International Financial Regulation', *supra* note 2, 1427.

77 R. Lastra, 'Do We Need a World Financial Organisation?', 17 *Journal of International Economic Law* (2014) 4, 787, 795-797.

78 K. Abbott & D. Snidal, 'Hard and Soft Law in International Governance', 54 *International Organization* (2000) 3, 421.

79 *Ibid.*, 434.

80 *Ibid.*, 435.

offer a predictor for determining the likelihood of future agreements being soft law or hard law; on one end of the scale, if sovereignty costs and the level of uncertainty are both low, a hard law agreement is most likely. If only one variable is high, options around delegation and the precision of the agreements are explored. In the event that both variables are high, soft law becomes an inevitability.[81] Unfortunately, the puzzle is not that simple – the contractarian approach requires a version of States' interests that excludes the influence of non-political actors such as domestic finance and lobby groups. The contractarian theory also falls down on its own terms as it assumes that where the likelihood of opportunism is high, the less attractive the soft law option is.[82] However, the prevalence of regulatory arbitrage throughout the history of the Basel Accords defies this logic.[83] If the contractarians were correct, such a record of exploitation would have encouraged a shift towards a hard law regime.

The third approach to explaining the prevalence of soft law is the political economy approach, advocated by the likes of Verdier.[84] Verdier has three central issues with contractarian theory; first of all, soft law regimes have had a varied record of success – yes the regulation of bank capital reserves is multifaceted and thorough, however, moves to secure cooperation in areas like insurance have failed.[85] The contractarian approach cannot explain this failure despite its potential. The contractarians also point to "[…] the sheer multiplication of […] bodies, reports and standards" as evidence of a system working well but this is not a measure of how well States implement or abide by measures.[86] Finally, it misinterprets the role that markets play in enforcing soft law.[87] Take the 1997 Asian financial crisis for example, with governments caught between foreign pressure to adopt international standards, and domestic pressure to resist, a *mock compliance* approach was adopted.[88] In other words, Asian governments complied with IFR on paper but not in practice, thereby undermining the validity of the market correction argument. Accounting for the prevalence of

81 *Ibid.*, 444.

82 Verdier, 'The Political Economy of International Financial Regulation', *supra* note 2, 1423.

83 Beltratti & Paladino, 'Basel II and regulatory arbitrage', *supra* note 27, 195.

84 Verdier, 'The Political Economy of International Financial Regulation', *supra* note 2, 1405.

85 *Ibid.*, 1424-1425.

86 *Ibid.*, 1425.

87 *Ibid.*, 1424-1425.

88 A. Walter, *Governing Finance: East Asia's Adoption of International Standards* (2011), 42-43.

soft law within financial regulation first requires accounting for the parties involved and why their interests might align with characteristics of soft law. Because of the perceived complexities of finance, regulating at the domestic level is often delegated to technocrats. When such agencies enter the realm of international cooperation, they prioritise domestic mandates and are reluctant to make strict commitments and agree to further oversight. Further, domestic regulators are more likely to accept an agreement that does not require domestic legislative changes, preferring to implement under their own mandate.[89] Such an arrangement also suits the financial industry, which maintains an open line of communication with domestic regulators, either through routine supervision or the ease with which employees move in between the public and private sector.[90] Despite the technocratic nature of soft law regimes, they are not immune from the dynamics of international relations, particularly the interests of the so-called *great powers* like the US or the EU.[91] The absence of a World Trade Organization (WTO)-like independent institution suits more powerful States, who can take advantage of a disorganised regime to pursue policy objectives and choose a particular forum to suit their needs. Linarelli, Salomon and Sornarajah further evidence Verdier's version of events by highlighting how notions like rent-seeking and regulatory capture essentially reverse the expected power dynamic between regulator and the targets of regulation.[92] Baker points to the link between the Institute of International Finance – a collective representation of the world's biggest banks – and Basel II as proof of regulatory capture. The Institute actually drafted the first version of the agreement and, through repeat consultations, effectively wrote Basel II.[93]

D. The Future of Financial Regulation

Recent reception from domestic and regional regulators to Basel IV provides an insight into how new capital requirements will work going forward. In the EU, Directive 2019/878 (commonly referred to as CRD V)[94] – the EU's

[89] Verdier, 'The Political Economy of International Financial Regulation', *supra* note 2, 1431.

[90] *Ibid.*, 1433.

[91] *Ibid.*, 1434.

[92] Linarelli, Salomon & Sornarajah, *The Misery of International Law*, *supra* note 12, 208.

[93] A. Baker, 'Restraining Regulatory Capture? Anglo-America, Crisis Politics and Trajectories of Change in Global Financial Governance', 86 *International Affairs* (2010) 3, 647, 650.

[94] Council Directive 2019/878, OJ 2019 L 150/253.

implementation of Basel IV – permits banks to achieve capital requirements with debt, not just equity. The first EU bank to avail of these measures was Italy's UniCredit, who disclosed that its equity demands have been reduced by 0.8 percentage points, in contrast to the 1.1 percent increase stipulated for European banks under Basel IV.[95] Similarly, Valdis Dombrovskis from the European Commission has recently warned Britain against starting a regulatory *race to the bottom* if London's financial firms are to access the Single Market post-Brexit.[96] Such a remark is, first of all, quite ironic given the EU's generous interpretation of Basel IV. Secondly, the fact that the economic stability of the European continent going forward is dependent on threats, or the good will of politicians, highlights a blinding flaw in global financial regulation: compliance is voluntary. This puts the *soft law* approach under a microscope and requires an examination of its suitability in relation to securing compliance. For the purposes of this discussion, arguments about the future development of IFR are divided into the revolutionary and reformist views. Exploring the revolutionary view contains an account of the tension between globalization and international regulation. This section concludes with an account of recent theoretical and regulatory innovations into IFR, which will hopefully set the tone for future research.

I. The Revolutionary View: A New Global Authority

Rodrik has written extensively about the relationship between domestic politics and the trend towards globalization.[97] As he sees it, there is an insurmountable tension when it comes to advancing the following three objectives: increased globalization, strengthening the nation State and encouraging further democratic engagement.[98] Achieving all three is impossible, Rodrik argues, we can pursue only two. Rodrik asks us to picture a world economy that is wholly globalised – trade restrictions and barriers to capital flow are a thing of the past – the only role for a nation State in such circumstances is to ensure this

95 P. Jenkins, 'Worrying signs that a great global deregulation has begun', Financial Times (2019), available at https://www.ft.com/content/fc15abec-182e-11ea-8d73-6303645ac406 (last visited 20 April 2021).

96 J. Brunsden, S. Fleming & P. Stafford, 'EU chief issues Brexit warning over City of London access', Financial Times (2019) available at https://www.ft.com/content/59569142-12c9-11ea-a7e6-62bf4f9e548a (last visited 20 April 2021).

97 D. Rodrik, *The Globalization Paradox; Democracy and the Future of the World Economy* (2012).

98 *Ibid.*, 200.

borderless market is maintained.[99] Similarly, any interference with this *status quo* from domestic politics, for example by way of labour protection policies, could not be tolerated unless the globalization project is abandoned.[100] If sacrificing democracy is too unpalatable, and reversing globalization too unrealistic, then a move towards what Rodrik calls the "[...] 'global governance' option [...]" solves the dilemma.[101] However, Rodrik goes on to rightly point out that present-day examples of shifts away from national sovereignty have been marred with resistance and controversy. Even within the EU, whose membership has a huge amount in common, both culturally and historically, full integration has been painstakingly slow and contentious. Rodrik further strengthens his point by highlighting the gap in average incomes within the EU and then internationally; in 2008, Ireland was the EU's richest country, 3.3 times more so than Bulgaria, but this ratio is closer 190 for the World's richest and poorest countries.[102] Translating the EU federalisation project to a global context thus appears impossible. Rodrik's recommendation in light of this, a shift away from globalization to an international order vaguely resembling the Bretton Woods system, would require a huge amount international cooperation – look at the dire circumstances of the post-World War II economy that laid the ground for the 1944 Bretton Woods Conference. Because of this, it is difficult to see how Rodrik's solution solves his own trilemma; yes, it does somewhat resemble a compromise between sovereignty and globalization but it is not obvious where the political will for a 21st Century Bretton Woods will come from, despite its potential. The proponents of the original Bretton Woods, the US and UK, do not enjoy the power they once did, nor do they share the enthusiasm for cooperation that they once did. Further, the GFC shattered the power dynamics of international finance and, as is set out below, it is the Global South and East that are the source of regulatory innovation in the 21st Century.

Lastra accepts that the *trilemma* between globalization, democracy and sovereignty is insurmountable but argues that sovereignty is the correct sacrifice, not globalization.[103] Lastra goes on to make the point that, whilst there may be regulatory functions in finance best left to domestic regulators,

[99] *Ibid.*, 201.
[100] *Ibid.*, 202.
[101] *Ibid.*, 202.
[102] *Ibid.*, 217.
[103] R. Lastra, 'The Globalization Paradox: Review of Dani Rodrik, The Globalization Paradox: Democracy and the Future of the World Economy', 11 *International Journal of Constitutional Law* (2013) 3, 809, 812.

enforcement is something that must be done at the international level.[104] In order to secure financial stability internationally, Lastra argues, markets require regulation, supervision and crisis management.[105] Lastra sets out the case for a WFO, akin to the WTO which initially would be tasked with cross-border dispute resolution and effectively addressing financial institutions that become insolvent.[106] The dispute resolution function would instil a degree of consistency in areas of finance that the international community has already agreed deserve attention. Lastra justifies prioritising insolvency by pointing to the collapse of the Lehman Brothers in 2008, a US-based investment bank with significant ties to international financial institutions.[107] Neither that scenario, nor a *bail out* arrangement is desirable, hence the need for a settled mechanism for resolving cross-border insolvency.

One important consideration that Lastra overlooks is that a potential WFO is a wholly different proposition to an organisation like the WTO. As Baxter sets out,[108] membership of the WTO comes with a very clear reward – uninhibited access to new markets. The reward within a WFO would presumably be financial stability but, firstly, this is not a guarantee and, secondly, would come at a great cost in terms of sovereignty. Additionally, punishing States that break WFO rules through exclusion would likely create new offshore financial centres.[109] Another difference between trade and finance is that the regulation of trade occurs for specific identifiable transactions and measures, whereas financial regulation involves supervising the daily activities of a variety of institutions, each with different structures and range of activities.[110] There is also the problem that we may not be able to wait for the negotiation process to conclude.[111] Given the extra political costs associated with a WFO, and plight of the Doha Round of WTO negotiations – a series of talks that went on for 14 years with no overarching agreement reached[112] – it is unlikely that global finance will carry

104 Lastra, 'Do We Need a World Financial Organisation?', *supra* note 77, 793.

105 *Ibid.*, 793.

106 *Ibid.*, 798.

107 See generally, L. McDonald & P. Robinson, *A Colossal Failure of Common Sense: The Inside Story of the Collapse of Lehman Brothers* (2010).

108 L. G. Baxter, 'Exploring the WFO Option for Global Banking Regulation', in L. Boulle (ed.), *Globalisation and Governance* (2011), 113, 117.

109 *Ibid.*, 117.

110 *Ibid.*, 116.

111 *Ibid.*, 117.

112 R. Azevedo, 'The Doha round finally dies a merciful death', Financial Times (2015), available at https://www.ft.com/content/9cb1ab9e-a7e2-11e5-955c-1e1d6de94879 (last visited 20 April 2021).

on crisis free whilst a WFO agreement is finalised. On that point, if finance were to remain stable for such a long period of time, it would undermine the need for a WFO and sap whatever political will was there initially. There is also the fear that the mandate of a WFO will overlap and compete with the WTO, and raises the concerns associated with fragmentation.[113] For Baxter, the debate should really focus on addressing the true cause of the GFC: bloated and highly complex SIFIs that are solely capable of bringing down the system.[114] Reform then should focus on domestic solutions as these institutions depend on public backing.[115] However, Baxter ignores the source of calls for a supranational regulator; domestic politics is ill-equipped to address large financial institutions because (a) tying SIFIs to a single jurisdiction is difficult and (b) SIFIs can wield a lot of power in domestic politics. As much as it irresponsible to wait for a WFO agreement before addressing issues in international finance, asking domestic politicians to step up is just as short-sighted.

The historical circumstances that led to the establishment of the WTO further delegitimises the WFO argument.[116] Prior to the WTO, international trade law governed State conduct through the General Agreement on Tariffs and Trade[117] and remedies were found under customary international law.[118] It was not the case that the formation of the WTO brought with it unprecedented levels of international cooperation. The regulatory architecture of pre-WTO international trade, defined by recognised sources of international law, is not analogous to international finance's current soft law regime. There is also a stark difference between how States interact when it comes to perceived or actual breaches of trade law versus finance.[119] If one State decides to impose import tariffs on another State's exports, the latter may be permitted to impose retaliatory measures.[120] It is difficult to see how this translates to finance – if one State's lax

113 Benvenisti & Downs, *supra* note 66, 595.

114 Baxter, *supra* note 108, 119.

115 *Ibid.*, 120.

116 M. Turk, 'Reframing International Financial Regulation after the Global Financial Crisis: Regional States and Interdependence, Not Regulatory Networks and Soft Law' 36 *Michigan Journal of International Law* (2014) 59, 60 [Turk, Reframing International Financial Regulation after the Global Financial Crisis].

117 *General Agreement on Tariffs and Trade*, 30 October 1947, 55 UNTS 188.

118 *ILC Draft Articles on Responsibility of States for Internationally Wrongful Acts, Yearbook of the International Law Commission* (2001), Vol. II(2), ch.IV.E.1, Art. 49-53.

119 Turk, 'Reframing International Financial Regulation after the Global Financial Crisis', *supra* note 116, 112.

120 *Marrakesh Agreement establishing the World Trade Organization*, Annex 2, 15 April 1994, Art. 22, 1869 UNTS 401.

supervision leads to economic instability for another, is the latter entitled to relax regulatory oversight for its own banks? Turk, in making this point, does argue that, for the moment, regulatory reform should focus on SIFIs rather than trying to influence States' response to crises.[121] Specifically, harmonising processes for bank resolutions, i.e. the manner in which a failed, internationally active bank's assets are to be liquidated. Turk's reasons for focusing on this measure are set out poorly: States would be able to "[…] streamline the complexity of regulatory compliance […] and reduce […] transaction costs […]".[122] Nevertheless, his suggestion has real merit as it identifies a major gap in the post-GFC regulatory response. As the analysis of Varotto and Zhao has demonstrated, remedying capital adequacy problems is only one aspect of tackling *too big to fail*.[123] Agreeing on a common resolution procedure for future banking crises would further that cause.

II. The Reformist View: Improving Soft Law

Dismissing the WFO solution on the basis that the sovereignty costs are too high also fails to account for the political economy and path dependence narratives.[124] As Verdier puts it, IFR "[…] may exist in an uneasy state of tension between pressures for reform and political and historical constraints on its evolution".[125] Even within these constraints, the current regulatory architecture can make short-term improvements. For one, the compliance capabilities of TRNs like the Basel Committee can be bolstered by allowing regulators from one country to inspect the large financial institutions of another.[126] However, Verdier has himself said that TRNs are not the apolitical, technocratic bodies that they promise to be,[127] and so, it is hard to imagine how this particular reform could avoid exploitation. Another idea involves recalibrating the balance between highly technical regulation and accessibility.[128] As many non-regulators are involved in securing compliance, assessing whether a State or institution

121 Turk, 'Reframing International Financial Regulation after the Global Financial Crisis', *supra* note 116, 115.

122 *Ibid.*, 115.

123 Varotto & Zhao, 'Systemic risk and bank size', *supra* note 36, 14.

124 Verdier, 'The Political Economy of International Financial Regulation', *supra* note 2, 1471.

125 *Ibid.*, 1471.

126 *Ibid.*, 1471.

127 Verdier, 'Transnational Regulatory Networks and Their Limits', *supra* note 43, 163.

128 Verdier, 'The Political Economy of International Financial Regulation', *supra* note 2, 1472.

is acting in accordance with regulation should be as simple as possible. In the context of the latest measures put forward by the Basel Committee, the likelihood of compliance may be increased by simplifying the large number of assets that have a specific risk-weight. The latest iteration of the Basel Accords is a vast improvement on Basel II but it illustrates the tension between technical prowess and accessibility. Such measures would however involve asking regulators to give up one of their trump cards as the more technical the regulation is, the more their perceived expertise is needed. Verdier's final recommendation is the strongest by far, rather than waiting for the onset of the next crisis to provide the political will to introduce binding regulations, set out a template in advance to reduce painstaking negotiation. Unfortunately, Verdier does not answer questions such as how will present-day regulators know enough about the next crisis to have an adequate solution in place? If that were the case, would those measures not already feature in the regulation? Nevertheless, the core of Verdier's idea is sound and is a realistic workaround to one of the main obstacles to formalising IFR. Leaving pre-treaty negotiations to TRNs during periods of economic stability is an area of governance research that deserves future attention.

Another strong opponent of the WFO option is Chris Brummer whose 2015 book *Soft Law and the Global Financial System* is, in the round, a defence of TRNs for finance's unique regulatory problems.[129] His proposals for reform, unsurprisingly, apply within the boundaries of the current architecture. If the possibility of a WFO is "small to non-existent",[130] Brummer's proposals are so practical and unambitious that it is hard to see potential for any significant improvements. He calls for regulators to be more persuasive in seeking compliance for reluctant international actors and for countries to abandon the *do what I say, not what I do* hypocrisy.[131] Not only are these recommendations quite obvious but Brummer fails to explain where exactly in the IFR system these issues are most prevalent. To his credit, Brummer does echo a sentiment expressed by Verdier and stresses the need to be proactive and not wait for the next crisis to incentivise further cooperation.[132] Because soft law depends on market forces to secure compliance, a "critical mass" of adoption is needed to highlight the risk of ignoring a measure.[133] The earlier this process takes place, the earlier stability may be achieved – and ideally at a pre-crisis stage. Brummer

[129] Brummer, *Soft Law and the Global Financial System*, *supra* note 3.
[130] *Ibid.*, 329.
[131] *Ibid.*, 336, 340.
[132] *Ibid.*, 334.
[133] *Ibid.*, 334.

also makes the point that IFR still has a legitimacy problem owing to the hegemony of the Anglo-American model pre-GFC but argues that this can only be rectified slowly as regulators and financial institutions start to take regulatory risk seriously.[134] It is worrying that Brummer fails to see the circularity here – does IFR need legitimacy to secure compliance or does it require compliance in order to reclaim legitimacy?

III. Theoretical and Regulatory Innovations

Whilst the debate on IFR's problems typically revolves around its soft law nature, Brummer goes a step further and questions the usefulness of the hard law/soft law dichotomy.[135] The lines that theoretically divide hard and soft law are much less distinct upon closer inspection. For instance, the threat of reputational damage exists in both regimes, but the presumption is that a breach of a hard international law instrument is far more harmful. As far as Brummer can see, the hard law of some United Nations Resolutions concerning human rights abuses or environmental protection are often disregarded. By contrast, for regulators in a soft law regime to remain credible as reforms progress, it is essential they be seen to be trustworthy. Brummer goes on to stress that, when analysing an international legal instrument, its *true nature* is not found in its formal status *but the range and activity of supplemental measures supporting the legal mandate*.[136] Brummer's point is undermined by the absence of concrete examples but it is valuable in encouraging us to look beyond the hard/soft law debate for other solutions.

Most commentators ignore the role that banking and finance plays in upholding the social contract and whether future regulation has space for this. Linerelli, Salomon and Sornarajah's account of how finance has neglected this role is a crucial addition to the regulation debate.[137] One important social function that financial institutions undertake is money creation through the sale of credit.[138] That comes with significant discretion over how to allocate this money, a decision typically dependent on creditworthiness and/or a high chance of repayment. These distributive considerations are also contingent on economic

[134] *Ibid.*, 342.
[135] *Ibid.*, 179.
[136] *Ibid.*, 180.
[137] Linarelli, Salomon & Sornarajah, *The Misery of International Law*, *supra* note 12, 206.
[138] The role of central banks in this process is diminishing; Linarelli, Salomon & Sornarajah cite Adair Turner, *Between Debt and the Devil: Money, Credit, and Fixing Global Finance*, (2016), 58.

growth with banks less willing to lend during a downturn. On top of that, the impacts on the price of assets makes debt even more burdensome for the ordinary individual. With domestic governments relying on finance to carry out what was once viewed as a central function of the State,[139] the possibility of States paying any of the sovereignty costs associated with deeper regulatory cooperation are lowered. This all amounts to a "[…] moral failure" on the part of IFR,[140] but Linarelli, Salomon and Sornarajah do not offer any detailed plans for the future. Regulating how governments interact with their domestic banks when it comes to the provision of credit could never be seriously considered at the international level.

Other commentators have focused on the future of theorising the place TRNs have within IFR.[141] There is a parallel to be drawn between how the GFC ruptured the *orthodox* consensus within economics[142] and the network theory that underpinned the soft law rationale.[143] As the *efficiency* payoff of a totally free market became a tougher sell,[144] so too did the theory that soft law is the most efficient way to regulate international finance to the detriment of distribution and legitimacy considerations.[145] Alternative schools of thought have emerged as a result; advocates for a Global Administrative Law (GAL) argue that attempts to democratise soft law would be futile.[146] As such, principles of administrative law should be incorporated into global governance structures to fill the gaps and introduce elements of liberal democracy such as accountability, transparency and proportionality.[147] As de Stefano correctly points out though, this same argument is used in a domestic setting to justify the democratic deficit within

139 B.A. Simmons, 'The Legalization of International Monetary Affairs', 54 *International Organization* (2000), 3, 573, 573.

140 Linarelli, Salomon & Sornarajah, *The Misery of International Law*, *supra* note 12, 225.

141 C. de Stefano, 'Reforming the Governance of International Financial Law in the Era of Post-Globalization', 20 *Journal of International Economic Law* (2017) 3, 509.

142 V. A. Beker, 'From the Economic Crisis to the Crisis of Economics', in B. Moro & V.A. Beker (eds), *Modern Financial Crises, Financial and Monetary Policy Studies*, vol. 42 (2016), 183.

143 De Stefano, *supra* note 141, 527.

144 See generally, H-J. Chang, *23 Things They Don't Tell You about Capitalism*, (2011).

145 De Stefano, *supra* note 141, 527.

146 D. Etsy, 'Good Governance at the Supranational Scale: Globalizing Administrative Law', 115 *Yale Law Journal* (2006) 7, 1490, 1503.

147 M. Barr & G. Miller, 'Global Administrative Law: The View from Basel', 17 *European Journal of International Law* (2006) 1, 15, 18.

an independent administrative agency.[148] However, such bodies are answerable to the legislature and the same cannot be said for TRNs in the area of IFR.[149] By contrast, the *democratic-striving* approach asserts that in any instance where authority is exercised, democratic legitimacy must be a priority.[150] It gets around the GAL argument that democratisation is utopian by embracing an *inchoate* form of democracy that works to "prevent processes from becoming arbitrarily closed or captured" and focuses on political equality.[151] Again, de Stefano is unconvinced that the democratic-striving approach addresses the root causes of IFR's legitimacy problems as identifying what communities or political actors are to be engaged is left unanswered.[152] Whilst this may be the case, de Stefano is too quick to dismiss the normative potential of the democratic-striving approach as its one of the few reforms that is aimed at systemic flaws but still operates within the boundaries of soft law.

One striking aspect of the GFC was how *non-global* its origins were. Yes, the consequences of the crisis were felt around the world but it was the financial systems of the US and Europe that were the source of the problems. Within the context of this reputational crisis for international finance and its central players, governments of the Global South and East had an opportunity reform their financial systems on their own terms.[153] As Grabel points out, there have been two trends in regional cooperation in the Global South and East – reserve pooling arrangements and development finance institutions.[154] The most relevant for issues of international governance are reserve pooling arrangements, which in some instances had been in place before the crisis. However, after 2008, existing institutions such as the Latin American Reserve Fund and the Chang Mai Initiative expanded significantly to extend liquidity support to their

148 De Stefano cites L. Schultz Bressman & R. B. Thompson, 'The Future of Agency Independence', 63 *Vanderbilt Law Review* (2010) 3, 599, 612.

149 De Stefano, *supra* note 141, 529.

150 G. de Búrca, 'Developing Democracy Beyond the State', 46 *Columbia Journal of Transnational Law* (2008) 2, 101, 129.

151 *Ibid*., 131-133.

152 De Stefano, *supra* note 141, 530.

153 I. Grabel, 'Post-Crisis Experiments in Development Finance Architectures: A Hirschmanian Perspective On 'Productive Incoherence', 73 *Review of Social Economy* (2015) 4, 388, 389 [Grabel, Post-Crisis Experiments in Development Finance Architectures].

154 I. Grabel, 'Financial Crises and the Emergence of New Financial Architectures: Towards a Post-Neoliberal World', in D. Barrowclough & R. Gottschalk (eds), *Solidarity and the South, New Directions in Long-Term Development Finance* (2017), 24, 26.

regions.[155] Similarly, two new reserve pooling arrangements were established – the Eurasian Fund for Stabilization and Development and the Contingent Reserve Arrangement.[156] These measures are not monumental shifts in the global architecture but they do suggest there are cracks in the hegemony.[157] As such, the Global South and East may be the source of future innovations in regulating financial institutions. A further point of note is the sweeping reforms taken by Ecuador in the early stages of the GFC. For instance, the government of President Correa established a liquidity fund that was funded by taxes paid by banks, as well as requiring that 45% of bank liquid assets be held domestically.[158] The partial effect of these measures was that when the crisis took hold, and oil prices plummeted (Ecuador's main export), its economy only initially shrank by 1.3% of GDP and had returned to pre-recession levels within 2 years.[159] Of course, implementing such reforms on a global scale is a non-starter, however they are further proof that the Global South and East are the primary source of ambition in the future of financial regulation.

E. Conclusion

At the time of writing, the global financial system is coming face-to-face with its latest challenge as the Covid-19 pandemic takes an unprecedented toll on the health of economies throughout the world.[160] In response, the Basel Committee has deferred until 2023 the implementation date of the December 2017 version of Basel III.[161] It is too early to judge the impact this measure may

155 *Ibid.*, 26.

156 *Ibid.*, 27.

157 Grabel, 'Post-Crisis Experiments in Development Finance Architectures', *supra* note 153, 407.

158 M. Weisbrot, J. Johnston & S. Lefebvre, Centre for Economic and Policy Research, 'Ecuador's New Deal: Reforming and Regulating the Financial Sector' (2013), available at https://cepr.net/documents/publications/ecuador-2013-02.pdf (last visited 20 April 2021), 3.

159 *Ibid.*, 16.

160 R. Partington & J. Kollewe, 'Dow suffers biggest-ever points loss as FTSE 100 hits eight-year low', The Guardian (2020), available at https://www.theguardian.com/business/2020/mar/16/markets-hit-by-further-losses-despite-us-interest-rate-cut-willie-walsh-ba-coronavirus (last visited 20 April 2021).

161 Basel Committee on Banking Supervision, 'Governors and Heads of Supervision announce deferral of Basel III implementation to increase operational capacity of banks and supervisors to respond to Covid-19' (2020), available at https://www.bis.org/press/p200327.htm (last visited 20 April 2021).

have, but it does exemplify the speed with which soft law can respond. Global finance was blindsided in 2007 by the complexity of the financial products associated with the US mortgage market, and underestimated the impact of the Greek sovereign debt crisis on the Eurozone. Whilst the Basel Committee has promised to remedy its previous mistakes, financial regulators will likely still have to contend with further unfamiliar challenges. Some argue that the private corporate sector debt – specifically the giants of technology – is another weak point in the system.[162] Others stress the need for regulators to start thinking about the impact the climate crisis will have on global finance with insured losses due to weather amounting to $55 billion a year (and rising).[163] The FSB regards nine insurance firms as G-SIBs.

This paper has argued that the Basel Accords are not fit for purpose. Their development has been rife with difficulties. Basel I was undone by bias against developing countries and Basel II and III recklessly allowed banks to determine their own capital requirements. The notion that finance requires a degree of flexibility and self-regulation is undermined by internal flaws that remain ignored. Banks easily sidestep rules, keep transactions off balance sheets, and regulators may be overly focused on bank size. In addition, the theory that supposedly supports soft law in finance does not play out in practice. TRNs like the Basel Committee shield finance from politics and are fora for technocrats and lobby groups.

The current state of IFR is a direct product of the questionable intentions of domestic regulators and industry insiders, who have been successful in keeping IFR away from political pressures. Some proponents of soft law may like to argue that it is simply a better approach from a cost-benefit analysis. However, the system is tailored to the interests of those involved.

Despite the undeniable failures of the Basel Accords, the advocates of a centralised financial authority resembling the WTO are unconvincing. A return to Bretton Woods is not feasible due to recent monumental shifts in global economic and political influence. We also cannot draw a direct comparison between the nature of international trade law and the nature of financial regulation – the WTO has, in some ways, very apparent membership advantages. At the

162 R. Foroohar, 'How big tech is dragging us towards the next financial crash', The Guardian (2019), available at https://www.theguardian.com/business/2019/nov/08/how-big-tech-is-dragging-us-towards-the-next-financial-crash (last visited 20 April 2021).

163 A. Tooze, 'Why Central Banks Need to Step Up on Global Warming', Foreign Policy (2019), available at https://foreignpolicy.com/2019/07/20/why-central-banks-need-to-step-up-on-global-warming/ (last visited 20 April 2021).

same time, it is difficult to endorse the efforts of those seeking reform within the current soft law system. Soft law reforms would merely be an extension of the current architecture, the basis of which is severely lacking. As such, it is my view that the future of financial regulation lies beyond the confines of the hard/soft law debate and the hegemony of Global North-led governance. Democratic legitimacy and distributional impact must become priorities within IFR. Innovations in the Global South and East, as well as the damage done to those regions in the Accords, have shown that the involvement of those States is non-optional going forward.

The politics and problems around the procurement of Covid-19 vaccines has exposed the perils of interpreting truly international concerns as solely domestic issues. We are only just beginning to see the scale of the gaps between the winners and losers. Furthermore, as damaged economies cherish the Dollar swap lines the US Federal Reserve has put in place to preserve liquidity, a new era of cooperation becomes not just optional but almost inevitable. Even for heavy hitters like the US and the EU, taking advantage of the weaknesses of soft law in such an interconnected system is short-sighted. The mask is starting to slip on soft law within IFR and a series of impending crises may just rip it off for good.