An Analysis of Basel III as a Prophylactic

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By

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ABSTRACT

The aim of this research is twofold. The first is to gauge the efficacy of Basel III which is the Basel Committee on Banking Supervision's response to the global financial crisis that broke out in the summer of 2007, while the second is the examination of the role of law in crisis. The Basel Committee on Banking Supervision is the international agency tasked with standard setting for internationally active banks and within this remit is the charge to position these banks to withstand crisis and possibly forestall the outbreak or spread of crisis. One the other hand, the concept of law serves as an original, self-creating justification for regulating human conduct. Law has a number of unique features that may benefit international banking regulation. As the global community becomes ever smaller and systemic risk continues to plague the already heavily interconnected global financial system, these investigations are important to ensure the growth and development benefits of a stable global financial and economic system are enhanced.

To meet this aim, this research investigates the doctrine behind the way law is used to check crisis. Since the primary reason for the accord in the global financial crisis and crisis represents crash in a financial system, hence inefficiency, the research pairs law with economics to determine whether efficiency is to be had in the present state. The data relied upon is secondary data from the extensive literature that exists on each of the subject matters. In the end,

the research findings are that Basel III is an improvement on Base II but may be plagued by implementation issues like its predecessors and that the is a likelihood of another financial crises and the BCBS is doomed to be reactionary rather that preventive. Also, lacking the coercive quality of law, international financial regulation is in a porous state and may benefit from conceptual and structural changes.

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DEDICATION

This one is for you… You know who you are.

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First and most importantly, I acknowledge the almighty God, the giver and sustainer of life. And following closely would be the wonderful family God, in His wisdom, blessed me with. I cannot but mention my father, two mothers, and twenty brothers and sisters; HRM Richardford Orukarebai Koroye, Cecilia Eneni Koroye, Pere-ere Rose Koroye, Oyintonye, Ekembraka, Oyinkepreye, Yamieseifa, Akpozua, Bubraye, Kemeebidikumo, Nimine, Ebikumororo, Ebibulokemi, Tariela, Seitonkumo, Miebougha, Tamarakuro, Beinmote, Eyinimiere, Ebiakpo, Angodi, Oyinmiebi, and Daniel. Their love, faith in me, and material assistance went a long way.

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AUTHOR'S DECLARATION

I declare that all the material contained in this thesis is my own work.

INTRODUCTION

In the summer of 2007, a global financial crisis broke out. This crisis has shaken the very foundation of the global financial architecture and revealed, more than ever before, the extent of the economic and financial interconnectedness and interdependence of the world. As with catastrophes such as this, researchers, governments, international financial institutions and agencies, and commentators immediately set out to understand the phenomenon and its causes. While the curiosity of academia was naturally more centred on an investigation of the phenomenon for intellectual purposes, governments and other agencies were more interested in determining pathways and adjustments to tackle the instant outbreak and possibly prevent a similar or other crisis in the future. All of this curiosity and actual work has resulted in an ever-growing literature on the crisis as well as a tide of amendments to existing regulations and the introduction of new regulation. Among the regulatory responses is Basel III by the Banking Committee for Banking Supervision (the committee or BCBS). Basel III seeks to reposition internationally active banks to better withstand crises such as the 2007 one and possibly repel future crises. This research gauges Basel III as a response to the global financial crisis and ultimately examines the role of law in the management of financial crisis.

The global financial crisis has been blamed on activities predicated on years of defective macroeconomic policies *i.e.* the failure of unbounded capitalism[1] and institutional failures *i.e.* failure of regulators and regulation[2]. These factors, as well as others, were the fuel upon which the spark the subprime mortgage practices in the United States and the hugely profitable market for investment vehicles created therefrom, burnt violently. The ensuing panic upon a succession of defaults created a liquidity squeeze felt mostly in financial intermediaries such as banks and from the banks the crunch was transmitted to the real economy.[3] At the centre of the crisis were banks, particularly internationally active banks.[4] Kim captures international banks interestingly by limiting a bank's basic dimensions to having a parenting organisation, possession of the appropriate facilities and products, and the existence of a customer base for their products and services. And if one or more of these dimensions transcend national boundaries, the services rendered may be deemed international banking services and the entity itself, an international bank.[5] International banks typically carry on business in more than one country and have become an important part of both the international financial system as well as national economies where they operate. Apart from the important benefits these entities offer as banking

[1] See Adam Szyszka and Yochanan Shachmurove, 'The financial crisis: What is there to learn?' (2011) 22 GFJ 238

[2] See Ricardo Cabral, 'A perspective on the symptoms and causes of the financial crisis' (2013) 37 JBF 103

[3] See Eric Helleiner, 'Understanding the 2007–2008 Global Financial Crisis: Lessons for Scholars of International Political Economy' (2011) 14 ARPS 67

[4] See Schnabl, P, 'Financial Globalization and the Transmission of Bank Liquidity Shocks: Evidence from an Emerging Market' (2012) 67(3) JF 897

[5] See Taeho Kim, *International Money and Banking* (Routledge 1993)

institutions; the nature of their structure and practices makes them a peculiar and frequent conduit for the transfer of contagion to or from the real economy or between economies. This systemic risk posed by their cross-border nature serves as the most important factor in the regulation of international banks.[6]

To put Basel III as a regulatory response to crisis in perspective, one must appreciate not only financial crises, but also the concept of regulation and the factors affecting international regulation. A financial crisis is a sudden crash in a financial system that impairs its functionality. These crashes usually unravel by way of an unexpected drop in asset value, together with a hasty, panicked withdrawal of funds from financial institutions.[7] Financial crises have occurred in one form or another since mercantile society took form. The reasons for, types of, palliative steps, and preventive measures of financial crises have fascinated political scientists, economists, and other writers since the earliest instances of financial crises.[8] The resultant literature is considerable and steep in microeconomic theory and policies as the bases of the health of any economy. The perennial debate about the exact origin and nature of financial crises benefits either side of the debate with regard to whether crises are inbuilt or freakish temporary blips in an otherwise stable system depending on the peculiar

[6] See Hasman, Augusto, 'A Critical Review of Contagion Risk in Banking' (2013) 27(5) JES 978; M. K. Lewis and K T Davis, *Domestic and International Banking* (MIT Press 1987)
[7] See Charles P. Kindleberger, *Manias, Panics, and Crashes: A History of Financial Crises* (Wiley 2005)
[8] See Carmen M Reinhart and Kenneth S. Rogof, *This Time Is Different: Eight Centuries of Financial Folly* (Princeton University Press 2009)

manifestation of each instance of crisis.[9] It is noteworthy however that the peculiarities of the recent global crises bear out the theories of an inherent propensity to a correction after a period of greed, wanton financial exuberance, and deregulation leading to the proverbial Minsky moment.[10]

Regulation, on the other hand, is problematic to define[11] but for our purposes, it shall entail the direct lawful influence of the activities of subjects and the resultant instruments of this process. This process encompasses the direction of the actions of subjects who may not be subjects of the regulator but are under an obligation to comply. This obligation is not necessarily owed to the regulator, but to the system that allows for the exercise of the power to regulate.[12] The will behind any regulatory effort goes a long way in determining what regulation really is and its purpose in society. Hence, to fully appreciate regulatory effort, one must determine whether it is a restriction or the encouragement of certain behaviour that is intended and to what purpose.[13] Regulation entails the existence of an indirect relationship in which the regulator is not required to enjoy a direct

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[9] See Nouriel Roubini and Stephen Mihm, *Crisis Economics: A Crash Course in the Future of Finance* (Penguin Books 2010); Hyman P. Minsky, *Stabilizing an Unstable Economy* (McGraw-Hill 2008)

[10] See L. Randall Wray 'Minsky's Money Manager Capitalism and the Global Financial Crisis' (2011) 40(2) IJPE 5; Nouriel Roubini and Stephen Mihm, *Crisis Economics: A Crash Course in the Future of Finance* (Penguin Books 2010)

[11] Bronwen Morgan and Karen Yeung, *An Introduction to Law and Regulation Text and Materials* (CUP 2007)

[12] See Kenneth J Meier, *Regulation: Politics, Bureaucracy, and Economics* (St. Martin's Press 1985)

[13] See Barry M. Mitnick The Political Economy of Regulation: Creating, Designing, and Removing Regulatory Forms (CUP 1980)

benefit from the endeavour sought to be regulated.[14] Regulation is not always the activity or process of creating these directions or restrictions as it also describes the instruments (body of specific rules) created therefrom. In Llewellyn's words, regulation in the financial sphere, is 'a body of specific rules or agreed behaviour… [that] limits the activities and business operations of financial institutions.'[15]

One instance of the financial institutions contemplated in Llewellyn's definition of financial regulation is an international bank. Now even though regulation of banks is notoriously strict as a result of the important role a bank plays with regard to the economic soundness and financial safety of an economy and indeed the world,[16] and international banking services evolved and developed at a relatively fast pace, efforts at establishing uniform international standards only found fulfilment in recent decades in the founding and work of the BCBS which was formed with the mandate of supervising the activities of internationally active banks.[17] This work of the committee has removed the regulation of cross border banking from the purview of domestic regulation.[18] Basel III which is the

[14] *ibid*
[15] D. T Llewellyn, 'The Regulation and Supervision of Financial Institution' (1986) TIB 9
[16] See L Jacobo Rodriguez, 'Banking stability and the Basel capital standards' (2003-2004) 23 CJ 115
[17] See Charles Goodhart, *The Basel Committee on Banking Supervision A History of the Early Years, 1974–1997* (CUP 2011) ;Patricia A. McCoy, 'Musings on the seeming inevitability of global convergence in banking law' (2000-2001) 7 CILJ 433; Emmanuel N. Roussakis, 'Global Banking: Origins and Evolution' (1997) 37(4) ACFSP 45
[18] See Rolf H. Weber & Douglas W Arner, 'Toward a new design for International Financial Regulation' (2007) 29(2) UPJIL 39; Patricia A. McCoy, 'Musings on the seeming inevitability of global convergence in banking law' (2000-2001) 7 CILJ 433

third in the series of accords the committee has released is the “international banking” regulatory reaction to the global financial crisis and has the mandate to bolster the banking sector with regard to its ability to absorb shocks arising from financial and economic stress. The accord also seeks to improve risk management and governance practices, enhance transparency, and ultimately prevent another crisis of a similar scale.[19]

Every modern society has institutions and guidelines that restrict, control, and facilitate said restriction and control of the conduct of affairs in that society for the common good of the society. These institutions and guidelines constitute the concept known as law. For purposes of this research, law is the sum of the self-sufficient intangible authority that allows for processes and institutions for the maintenance of order in any society. Hence all the structures and agents deployed to maintain order and balance in any space comprising individuals or entities pursuing divergent and often conflicting ends are encompassed in the concept law.[20] Law’s contribution in modern society is covered by its functions which include provision of amenities, defence of person and property, and - of particular importance to this thesis – the safeguard and facilitation of the

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[19] See Bank for International Settlements Basel Committee on Banking Supervision, Basel III: A global regulatory framework for more resilient banks and banking systems (December 2010 [rev June 2011]) < http://www.bis.org/publ/bcbs189.pdf> accessed 6 July 2017

[20] See generally Richard Swedberg, ‘The Case for an Economic Sociology of Law’ (2003) 32(1) TS 1; H L A Hart, *Of laws in General Jeremy Bentham 1748-1832* (Herbert Lionel Adolphus Continuum International Publishing Group 1970); Denis Galligan, *Law in Modern Society* (Oxford University Press 2007)

commercial cum financial activities in any society.[21] One of the ways law does it is *via* regulation.

As noted above, one of the functions of law is the facilitation and safeguarding of commercial activities. This is where economic and financial regulation come into play. Economic regulation describes the actions the state or sovereign takes to ensure the struggle for control of resources within the state is fair and balances evenly with the atmosphere within which individuals may promote their financial self-interests and the state may prosper.[22] Whether economic regulation or its subset, financial regulation, aims at the promotion of the public interest or serves as an instrument in the hands of interested parties to further their selfish aims, regulation remains is apparently an important instrument in society and its deployment to correct abnormalities is almost universally used and roundly appreciated.[23] An important aspect of economic regulation is the complexity and sophistication of the entities it covers.[24] These complex entities exist, function, and conform to rules exercised by an authority which itself is exercised or legitimised by an intangible popular agreement. Thus, regulation in this instance is a product of state action that seeks to ensure risky behaviour is curtailed for

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[21] See generally Joseph Raz, *The authority of law: Essays on law and morality* (Oxford Scholarship Online: March 2012); Jose P. Bengzon, 'Law as a Function of the Social Order' (1968) 43 PLJ 699; Ehrenberg, Kenneth M., *The Functions of Law* (Oxford University Press 2016)

[22] T. Barton, 'Prospects for a general theory of economic regulation' (1989) 46 (1) WLLR 41

[23] See Posner, Richard A., 'Theories of Economic Regulation' (1974) 5(2) BJEMS 335; Arthur Cecil Pigou, *The Economics of Welfare* (4th edn, Macmillan 1932)

[24] Ioannis Glinavos, *Redefining the Market-State Relationship: Responses to the Financial Crisis and the Future of Regulation* (Routledge Research 2014)

the benefit of the system in which it operates. If regulation is the product in this conceptualisation, then the instrument used to deliver this product is law. Law is the basis of regulation. Law is the means of legitimacy on which regulation emanates as well as the machinery that ensures compliance.[25]

Deep inquiry into the politics, ideology, and normative commitments that inform the regulation of international finance is beyond this research.[26] Furthermore, the rules governing the regulatory powers, responsibility, and reach of the BCBS, as well as, whatever body of rules (whether written or unwritten) governing the enforceability of the standards and the debates surrounding the legitimacy, mode, and transparency of decision-making processes of the BCBS[27] are only glossed over where the need arises. Finally, it is noted that Basel III is not strictly speaking a regulatory instrument as standard setting activities of agencies under the parent body of the BCBS, the BIS, do not carry the force of law and are not considered treaties under international law. They are not binding but tend to enjoy considerable global compliance informed by many countries' need to benefit from the recognition adhering to best standards bestows.[28] However, the

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[25] See Morgan, B and Yeung, K, *An Introduction to Law and Regulation: Text and Materials* (Cambridge University Press 2007); Ioannis Glinavos, *Redefining the Market-State Relationship: Responses to the Financial Crisis and the Future of Regulation* (Routledge 2014)
[26] See generally Robert Gilpin, *Global Political Economy: Understanding the International Economic* Order (Princeton University Press 2001)
[27] For a general discussion on these, see Sanaa Ahmed, 'The Politics of Financial Regulation' (2015)11 SLR 61
[28] See Harlan Grant Cohen, 'Finding International Law: Rethinking the Doctrine of Sources' (2007) 93 ILR 65; Basle Committee on Banking Regulations and Supervisory Practices, Revised Basle Concordat on Principles for the Supervision of Banks' Foreign Establishments (May 1983) <https://www.bis.org/publ/bcbsc312.pdf> accessed 12 September 2017 where it is stated that 'The report deals exclusively with the responsibilities of banking supervisory

accords remain the closest thing to regulation in the international banking sphere.[29]

An important aspect of international or global financial regulation[30] is the diffusion of responsibility that arises from the arduousness of holding a particular regulator or body responsible for its implementation and enforcement. They are examples of 'transnational non-state regulatory regimes'. The regulation envisaged in this model is typically carried out by nongovernmental organisations, civil society groups, non-state regulatory authorities *etc*.[31] In this context, regulation refers to any means directed at guiding individuals, institutions, and activities to align with formal or informal rules.[32] Notwithstanding, since financial stability is recognised as a global public good affording benefit to virtually every country irrespective of its contribution, or lack thereof, to its attainment, it is still important to examine the incentive for the BCBS to ensure that international banking standards, at their core, are effective and flexible enough to enable as many countries as possible to conform to a set

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authorities for monitoring the prudential conduct and soundness of the business of banks' foreign establishments. It does not address itself to lender-of-last-resort aspects of the role of central banks.'

[29] See Melissa Boey, 'Regulating Bankerspace: Challenging the Legitimacy of the Basel Accords as Soft Law' (2014) 87 SCLRP 74

[30] See John Braithwaite and Peter Drahos, Global Business Regulation (Cambridge: Cambridge University Press, 2000) where the globalisation of financial regulation is defined as 'the spread of some set of regulatory norms'

[31] See Natasha Tusikov, 'Transnational non-state regulatory regimes' in Peter Drahos (ed), *Regulatory theory: foundations and applications* (ANU Press 2017)

[32] See Picciotto, S, 'Introduction: Reconceptualising regulation in the era of globalisation', (2002) 29(1) JLS 1

of common standards.[33] Also, since there is substantial evidence that the number of worldwide banking crises, their severity, and cost to society, including government bailouts, have increased significantly since 1970[34], there is the likelihood of another financial crisis involving international banks in the future. And if there is, the BCBS will either tweak the existing accord or introduce a brand new one. But before then, the strength of the latest response must be gauged. A clear understanding of the nuances of financial crises and the appropriate considerations in the formulation and deployment of appropriate regulation will go a long way to aid this endeavour.

Methodology

This research is carried out principally in law. For this reason, whatever methodological approach utilized must be compatible with legal research. Legal research methodologies range from doctrinal to, socio-legal, critical, and comparative research. This list however is ever expanding and now includes approaches such as Marxist theory, feminism, Queer theory, post-colonial theory, constitutionalism, liberalism, and the "law and …" genres i.e. law and economics,

[33] Hellvig Robert Claudiu, 'The regulation necessity of the international financial and banking system' (2015) 32 PEF 968

[34] C. W. Calomiris and S. H. Haber, *Fragile by Design: The Political Origins of Banking Crises and Scarce Credit* (Princeton University Press 2014)

law and psychology, etc.[35] This research is carried out using a hybrid of the doctrinal and the law and economics methodologies.

Of importance to any legal study is to determine that the underlying doctrine is clearly articulated. The next step is to establish that the doctrine is followed. These steps enable the researcher to determine whether defects or uncertainties are a result of faulty doctrine or defective compliance with an otherwise sound doctrine[36] and this is the essence of doctrinal research. Doctrine in law is 'a synthesis of rules, principles, norms, interpretive guidelines and values. It explains, makes coherent or justifies a segment of the law as part of a larger system of law'.[37] Thus, doctrine is the basis of any legal pursuit; the underlying thought that forms its foundations and governs procedure.

Doctrinal research proceeds from the determination and examination of doctrine and was the dominant method of research scholarship in the 19th and 20th centuries.[38] Legal doctrinal research however, possesses as a feature, an unrelenting formalism that has been criticised as lacking in social conditions and insights and this has led to a rebellion of sorts. This rebellion against doctrinal research has led to the introduction and proliferation of "socio-legal" research

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[35] See See Nicholas Mercuro and Steven G. Medema, *Economics and the Law from Posner to Post Modernism and Beyond* (Princeton University Press 2006)
[36] See Dawn Watkins and Mandy Burton, *Research Methods in Law* (Routledge 2013)
[37] T. Mann, *Australian Law Dictionary* (OUP 2010)
[38] *ibid*

methodologies that seek to ensure emphasis lies on awareness of social and economic factors that affect laws and decision-making.[39]

One of the results of this marriage between law and the social sciences, and of importance to this research, is law and economics. Mercuro and Medema define law and economics 'as the application of economic theories – primarily microeconomics and the basic concepts of welfare economics – to examine the formation, structure, processes and economic impact of law and legal institutions.'[40] The principal focus of economics is the efficient allocation of scarce resources. Thus for proponents of this approach, an economic approach to legal analysis will bring the advantage of the search of efficiency in the application of law. Some have argued that all analysis of the law should have efficiency as a standard and that since policy debates always agonise about the direction in which law should go, an evaluation of the efficiency of each position not only yields better results but also allows for clarity in the consideration. The focus of how economic analysis of the law should proceed is not clear-cut as various schools battle for predominance within this approach. These include the

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[39] See Edgar Bodenheimer, *Jurisprudence: The Philosophy and Method of the Law* (Harvard University Press 1974); Nicholas Mercuro and Steven G. Medema, *Economics and the Law from Posner to Post Modernism and Beyond* (Princeton University Press 2006); Martha Minow, 'Law Turning Outward' (1987) 73 T 79

[40] Nicholas Mercuro and Steven G. Medema, *Economics and the Law from Posner to Post Modernism and Beyond* (Princeton University Press 2006)

Chicago school approach, public choice theory, institutional law and economics, and the new institutional economics.[41]

The doctrinal approach proceeds by identifying the existing doctrine, analysing it to determine its validity, and proceeds to determine where defects in its implementation lie. Doctrinal research, in spite of criticism of its rigidity, is an unavoidable starting point for this research. The research delves into law as a means of social control and it is important to determine first what doctrines inform the deployment of financial law, especially during or in response to crisis..

The literature on the subject matters of this research cover international banking and its regulation, regulation, financial crises, the global financial crisis of 2007, Basel III, and commentary on Basel III as a regulatory response to the crisis and these emanate from various disciplines such as Economics, Law, and Banking and Finance. The interdisciplinary nature of the research necessitates the utilization of a methodology that not only accommodates transdisciplinarity[42] but also remains connected to the primary focus of law. The choice of law and economics is informed by the unique quality of economics in the fold of social sciences, which is that its emphasis is more on approach rather than content.[43] This interaction of law and economics has the unique benefit of promoting an

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[41] *ibid*
[42] Used here to highlight how the research focus traverses different disciplines
[43] See Becker, Gary S., *The Economic Approach to Human Behavior* (The University of Chicago Press 1976)

improved understanding which may then be used to enhance the quality of legal systems.[44]

For this research, after arriving at the underlying doctrines using the doctrinal methodology, an economic analysis is applied to determine whether the BCBS's reforms represent the rational choice in the circumstance. The research procedure is the examination of existing literature on each of the subject-matters as secondary data and reaching conclusions therefrom.

Contents

The content structure of this research is as follows. The first chapter introduces law, regulation, and crises as some of the subject-matters on which this study is carried out. The chapter defines and discusses each of the concepts. Each of these concepts is crucial and has attracted a considerable amount of debate and discussion such that the literature is large and daunting. However, the chapter discusses the role of law in society, the nature of regulation, and the relationship between law and regulation. And the dimensions for a full understanding of crises and law factors into them are explored. Chapter 2 moves the discussion onto international banking. The chapter examines how international banking grew to become the integral part of modern society. The chapter traces the

[44] See Dirk Heremans, Katrien Bosquet, 'The Future of Law and Finance after the Financial Crisis: New Perspectives on Regulation and Corporate Governance for Banks' (2011) UILR 1551

historical development and examines the systemic importance of international banks and as globalization ensures financial and economic activities become more trans-national and these entities attain more significance to the global financial system, the chapter also analyses the attempts and the present state of their regulation. The evolution of international banking has brought with it both benefits and challenges and these are covered in this chapter. Chapter 3 continues the discussion on international banks but narrows the discussion to the BCBS and its accords. The chapter covers the incidents necessitating the creation of the BCBS and the developments that informed the accords it has released so far. Further in this chapter, the build-up to the global financial crisis which broke out in 2007 is considered and the trajectory that resulted in Basel III is drawn. Finally in this chapter, the exact reforms in Basel III are highlighted. Chapter 4 analyses the global financial crisis to elicit the lessons therefrom. In this chapter it is demonstrated that Basel III's shortcomings and the fact that crises are unpredictable will almost certainly ensure another crisis strikes. Further, the discussion covers the inability of law to aid the regulation of crisis. The thesis ends with a conclusion chapter where it is suggested that the present Basel regime may benefit from structural and contextual changes.

CHAPTER 1: LAW, REGULATION, AND CRISES

1.1 Introduction

Law, regulation, and financial crises are some of the subject-matters on which this study is carried out. Each of these concepts is either constantly relevant in the modern society or of such impact in everyday life by virtue of its nature or occurrence that collectively, they have attracted a considerable amount of debate and discussion resulting in the existence of a daunting and constantly growing literature. Regardless, a consideration of the discussions and realities of each conjures up a fascinating new dimension of the relationship amongst them and how each interacts with the others. To make meaningful contributions to what is already known about crises and the various attempts at preventing and, as is frequently the case, ameliorating an outbreak of crisis while hoping to prevent a future outbreak, one must appreciate the still ongoing discussions of the meaning, causes, progression, and economic underpinnings of crisis. Attempts to 'check' crisis typically comprise advancing policies or guidelines to fix lapses or control areas, sectors, acts, or actors deemed to be causal or contributory to the outbreak of crisis. This advancement of policies or guidelines is regulation. Hence the determination of the efficacy of a particular regulatory attempt to check crisis necessitates an understanding of what exactly regulation is in a financial context, and the considerations which drive its deployment. Furthermore, it is the existence of a structure that supports financial and economic activities that creates the possibility of the misfortunes that are commonly referred to as financial crises. This structure must, as of necessity, be created and maintained by an entity or moulded on a concept. For the purposes of this research, that structure is society and the entity or concept that births and maintains it is law. This chapter serves to introduce the understanding of law, regulation, and crisis that will shape the rest of this research. The introductory discussion herein is to create a theoretical underpinning for the basis of the introduction of Basel III in response to the financial crisis.

This chapter discusses the role of law in society, the nature of regulation, and the relationship between law and regulation. The chapter also examines the nature, causes, types, and theories of financial crises.

1.2 Law

The basis of the continued existence of modern society is the existence of order.[45] Each society is comprised of individuals and entities with personal interests, goals, desires, and urges they might attempt to fulfil, achieve, or pursue. The control of these interests, impulses, desires, and urges which embody the collective known as society presupposes processes and an authority that directs the way. These processes and authority that guarantee order are

[45] See Richard Swedberg, 'The Case for an Economic Sociology of Law' (Feb., 2003) 32(1) Theory and Society 1; Swedberg suggests that order in this context connotes the balance among self-*albeit*-conflicting interests and the guiding rules in society

collectively what is known as law. Hence, jurist and legal commentator, Jeremy Bentham famously describes law as the supreme instrument of achieving society's goals.[46] The search for this so called order is the classical justification for the existence of law and informs Weber's well known definition; 'An order will be called ... law if it is externally guaranteed by the probability that physical or psychological coercion will be applied by a staff of people in order to bring about compliance or avenge violation.'[47] Law is in existence wherever there are institutions ensuring (enforcing) normative stipulations formulated to guarantee order in society.[48] Law has become necessary, even essential in the survival of any society. The necessity of law encompasses the basic social tasks of protecting each individual from the excesses of all others, as well as, the orderly facilitation of such basic social engagements as agreements, property rights and dealings, as well as family relations.[49]

Another approach to the basic understanding and appreciation of law is to view the concept as a conflict management tool. An iteration of this view of the utility of law may be found in a quote by Fuller; 'Law is the enterprise of subjecting human conduct to the governance of rules.'[50] Humans have evolved to live in a society and carry out tasks that are aimed at satisfying needs. These tasks involve

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[46] See H L A Hart, *Of laws in General Jeremy Bentham 1748-1832* (Herbert Lionel Adolphus Continuum International Publishing Group 1970)
[47] Max Weber, *Economy and Society: An Outline of Interpretive Sociology* (first published 1922, University of California Press 1978) 34
[48] See Richard Swedberg, 'The Case for an Economic Sociology of Law' (Feb., 2003) 32(1) TS 1
[49] See Denis Galligan, *Law in Modern Society* (Oxford University Press 2007)
[50] Lon L Fuller, *The Morality of Law* (New Haven revised ed. 1969) 106

unavoidable interaction and these interactions, borne out of almost purely selfish impulses, guarantee conflict. This fact reveals what the exact business of Law is; the settlement of disputes as they arise, the institution of processes and institutions to encourage development and peaceful co-existence, and the avoidance of foreseeable disputes. For Kelsen, the tasks involved include prevention of disputes from arising and setting out procedures for settling disputes bound to arise in the future.[51] Law's task in society is principally that of holding the fabric of society together and ensuring the smooth running of its affairs. Thus, law exists in any society or organisation that has developed a distinct legal order. A legal order develops enforceable norms with the sole aim of regulating human behaviour.[52]

The functions of law are specific as well as common to any society with any form of legal order. Identifying the functions of law is *sine qua non* in any enquiry into the nature and adequacy of existing laws. Identifying these functions aids the explanation of the interaction of other disciplines with Law and the determination of the principles that should guide the formulation of new laws.[53] Raz identifies four heads of functions of law. First, Law aims to prevent undesirable behaviour and promote desirable ones. As law seeks to tackle disputes in society, it stands to reason that the first step must be to discourage

[51] See K N Llewellyn, *The Bramble Bush* (first 1930, New York 1960)
[52] See H Kelsen, *The Pure Theory of Law: Legality and Legitimacy* (Oxford Scholarship Online January 2009)
[53] See Joseph Raz, *The authority of law: Essays on law and morality* (Oxford Scholarship Online March 2012)

certain actions. The province of criminal law and the law of torts serve to punish – with a bid to deter in some circumstances and to exert society's 'pound of flesh' in others– such acts as murder, robbery, kidnapping, sexual offences, trespass *etc.*, as well as placing a liability for the breach of a duty of care while dealing with certain vulnerable persons or engaging in potentially dangerous activities. On the other hand, providing for specific powers and mandating the bearer to exercise them in specific events looks to take advantage of favourable circumstances for society's benefit or ensuring the opportunity to right wrongs is not missed. Secondly, law facilitates private engagement amongst individuals. This function is the basis for the existence of a large part of private law. Certain elements of criminal law and the law of torts also fulfil this function. Under this head, law provides for such instruments and devices for the smooth actualization of society's needs as marriage, trade unions, banks, companies, contracts *etc.* Thirdly, law facilitates the settlement of both disputes whose confines and resolution are expressly provided for and those not forbidden by any law (the behaviour may not even be obnoxious or undesirable in itself) but whose occurrence occasions loss or detriment to society. And finally, law is instrumental in ensuring efficient provision of services, as well as the distribution and redistribution of goods. Law provides this function by offering armed forces for protection against external aggression, establishment of some type of tax regime, providing arrangements for clearing sewage, construction and maintenance of roads, provision of health services, developing education, regulating contracts and commercial activities, subsidizing the provision of essential services *etc.*[54]

1.3 Regulation

Regulation has been defined so often and with such variety that it has become difficulty to ascertain a generally accepted or applicable definition for the term.[55] The existing definitions tend to cater to either the discipline under which a definition is sought or the purpose for which the definition is sought.[56] This has led to the existence of a plethora of specialised definitions alongside a few attempts at a multidisciplinary approach. A foremost attempt at a multidisciplinary approach is the definition of regulation as 'any attempt by the government to control the behaviour of citizens, corporations, or sub governments.'[57] Emphasis is on the act of a sovereign with regard to subjects just as much as its own agents. This definition of Meier's presupposes the existence of an established social order or hierarchy and the need to maintain it by a controlling act. In contrast, Mitnick divorces the regulator from the sphere of the

[54] See generally Joseph Raz, *The authority of law: Essays on law and morality* (Oxford Scholarship Online 2012); Jose P Bengzon, 'Law as a Function of the Social Order' (1968) 43 Philippine Law Journal 699; Ehrenberg, Kenneth M, *The Functions of Law* (Oxford University Press 2016)

[55] See Bronwen Morgan & Karen Yeung, *An Introduction to Law and Regulation Text and Materials* (CUP 2007)

[56] See A I Ogus and C G Veljanovski, *Readings in the Economics of law and Regulation* (Claredon Press 1984); Brown Morgan and Karen Yeung, *An Introduction to Law and Regulation Text and Materials* (CUP 2007)

[57] Kenneth J Meier, *Regulation: Politics, Bureaucracy, and Economics* (St. Martin's Press 1985) 7

regulation and instead places emphasis on the limitation of the choices available to the subjects of regulation.[58] This suggests that regulation entails the existence of an indirect relationship in which the regulator is not required to enjoy a direct benefit from the endeavour sought to be regulated. For others, regulation is more an instrument than a process. In this instance, focus shifts from the actors onto the instrument.[59] The process that produces this instrument is largely ignored and focus is on the resultant rules. These rules operate as behavioural limitations that are imposed or simply agreed upon and which ensure the smooth operation of a society, industry, or sector.[60] Simply put, regulation is the particular instrument that conveys the will, decision, or agreed limitations consisting the entirety of the process of regulation.

Hancher and Moran highlight the presupposition that the existence of the need to regulate, and indeed regulations, points at a social order sought to be defined or protected.[61] The argument is that there must already be in existence some manner of 'society' which requires stipulations for its order or continued existence. There is also the presupposition that this society has an established hierarchy of power or influence. This means there should be in place an establishment that exercises some influence or has some authority over subjects and which also has as a task; the will, intention, and power of preserving the system of social

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[58] Barry M Mitnick, *The Political Economy of Regulation: Creating, Designing, and Removing Regulatory Forms* (CUP 1980) 5
[59] See D T Llewellyn, 'The Regulation and Supervision of Financial Institution' (1986) IB 9
[60] *ibid*
[61] Hancher, L and Moran, M, *Capitalism Culture, and Economic Regulation* (OUP 1989)

organisation.[62] A regulator, in exercise of the power or responsibility to ensure or protect the collective good, acts for the good of the collective by either establishing guidelines that ensure balance or fairness or setting up fora and institutions that ensure compliance or retribution in the event of default.

The easy conclusion that may be drawn from the preceding paragraph is that regulation is the direct lawful influence of the activities of subjects in a collective by whatever name so called for the benefit of that collective.[63] The use of the term subjects in this context does not indicate subordination in terms of hierarchy. Rather, the subjection intended refers to the implicit agreement to be bound by the resulting rules. Hence, regulation may emanate from a constituted authority just as well as an external body to the subjects of the regulation or may even be self-imposed.[64] The existence of regulation relies principally on influence. For regulation to exist there is the presupposition of a body or entity that wields influence that may ensure compliance. It is the influence that is exerted on a sector, industry, or society by an exerting authority either external or internal to the subjects that ensures the enforceability of the regulation. Hence, a professional association may empower members, who ordinarily do not enjoy privileges beyond their membership, to make rules for governing the association.

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[62] *ibid*

[63] See Kenneth J Meier, *Regulation: Politics, Bureaucracy, and Economics* (St. Martin's Press 1985)

[64] See D T Llewellyn, ‘The Regulation and Supervision of Financial Institution’ (1986) IB 9

Regulation encompasses both the process leading to, and the resulting instrument of this lawful influence.[65]

Another important factor in the discussion of regulation is the analysis of motives that drive regulation. The reasons for regulation include the need for fairness in dealings, the establishment of practical limits, attempts at achieving efficiency of resources, time and manpower, and to enshrine as much equality as possible in a society or organisation.[66] The motives for regulation are implicit in the definition of regulation and depend heavily on the area of human endeavour sought to be regulated. In the instance of financial regulation seeking to preventing crisis or checking the spread of crisis, the obvious motives would be to establish practical limits for market participants and ensure efficiency is maintained. Another motive that drives regulation is the attempt to balance the inevitable clash of interests among members of any sector, industry, or section of society.[67]

1.4 Law and Regulation

The terms Law and regulation are frequently used interchangeably, whether in the description of the resultant instrument or the principal processes that result in the instrument (the second usage refers to the personification of the term ‘law’ in

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[65] *ibid*
[66] See Denis Galligan, *Law in Modern Society* (Oxford University Press 2007)
[67] *ibid*

academic treatises). Whether the concepts are interchangeable and the significance of any distinction between them is the subject of some debate. The debate exists and thrives mostly because of the varied definitions given of each of these concepts as well as the varied perspectives from which each has been considered.[68] Regardless of the lack of consensus, it is important to identify the differences between them. The importance of determining if a clear-cut distinction exists between these concepts lies in the importance of identifying the functions of each as distinct of the other as forms of social control. Also, a determination of the differences of the concepts will ensure the adequate consideration is put in the deployment of each. For instance, in the determination of how regulatory attempts at preventing or curbing financial crisis should be developed, it is important to determine if the solution sought lies in the area of regulation *i.e.* the establishment of the proper regulating authority, practices, and instruments, or in law *i.e.* the understanding of the basic order upon which society's needs need to be conform to.

Conceptually, regulation is the orderly direction of complex and sophisticated organisations responsible for the tasks that form the social structure of society.[69] The complexity of these organizations and the impact of their actions necessitate regulation. Law on the other hand provides for the existence, functioning, and

[68] See Julia Black, *International finance regulation: the quest for financial stability* (Wiley 2014)

[69] See Morgan, B and Yeung, K, *An Introduction to Law and Regulation: Text and Materials* (Cambridge University Press 2007)

conformity to rules exercised by an authority which itself is exercised or legitimised by an intangible popular agreement. Thus, regulation is a product of state action that seeks to ensure risky behaviour is curtailed for the benefit of the system in which it operates. If regulation is the product in this conceptualisation, then the instrument used to deliver this product is law. Law is the basis of regulation. Law is the means of legitimacy on which regulation emanates as well as the machinery that ensures compliance.[70]

It has been argued, and correctly, that regulation is principally a method of carrying out the functions of law.[71] The role of law as a form of economic and social control in any society may be fulfilled through means other than regulation *e.g.* legal rules. The reach of law goes beyond the utilization of instruments such as regulation and legal rules as law also stands as an arbiter in instances where legal rules, as opposed to regulation that may be voluntary, clash with the collective expectations of the society. Furthermore, law includes the means of enforcement of both legal rules and regulation and is the totality of the machinery that creates a relationship that enables regulation and its enforcement. This is a particularly important distinction because it ensures that the facilitative

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[70] See Morgan, B and Yeung, K, *An Introduction to Law and Regulation: Text and Materials* (Cambridge University Press 2007); Ioannis Glinavos, *Redefining the Market-State Relationship: Responses to the Financial Crisis and the Future of Regulation* (Routledge Research 2014)

[71] See Bronwen Morgan and Karen Yeung, *An Introduction to Law and Regulation: Texts and Materials* (CUP 2007)

quality of law is so directed that it serves the best interests of regulatory efforts.[72] Thus, if the legal basis of any regulatory effort is sound, there are reasonable chances that the resultant regulation will effectively serve its purpose.

1.5 Economic and Financial Regulation Gone Global

While almost every facet of life may be the subject of regulation, of importance to the considerations of this research is regulation in the financial sphere. In an ideal world, markets function perfectly *i.e.* attain and remain in a state of Pareto optimality. This means demand and supply balance each other out and market competition is perfect. However, markets tend to diverge from perfect competition by a concept generally referred to as market failure.[73] Market failures are a justification for government action *i.e.* regulation. Weimer and Vining identify four traditional instances of market failure; inefficient distribution of public goods, the existence of natural monopolies, distortions brought about by externalities, and market information asymmetries.[74] First, injustice or incompetence in the distribution of public goods may clash with socially accepted beliefs of equality and this alters market outcome. Public goods

[72] See generally Ioannis Glinavos, *Redefining the Market-State Relationship Responses to the Financial Crisis and the future of regulation* (Routledge 2014); Bronwen Morgan and Karen Yeung, *An Introduction to Law and Regulation: Texts and Materials* (CUP 2007); Ogus, A, *Regulation: Legal Form and Economic Theory* (Hart Publishing 2004)
[73] See The Oxford Handbook of Law and Politics Edited by Gregory A Caldeira, R Daniel Kelemen, and Keith E Whittington (Online Publication Date: Sep 2009)
[74] See David L. Weimer and Aidan R. Vining, *Policy Analysis: Concepts and Practice,* (2nd ed, Prentice Hall 1992)

are such goods as are nonexclusive in their ownership or consumption and have the exclusive characteristic of being the preserve of the government to provide. Examples include healthcare, education, defence *etc.* Under this head, we also class the redistribution of income earned from taxation as taxes are the primary source of providing these goods. Second, a natural monopoly develops where low fixed cost of production of a product and a low aggregate demand give a specific firm the ability to restrict output relative to price such that its profit maximisation compromises economic efficiency. In other words, one firm can manufacture the product in question at lower cost than any competitor and so is able to determine the output and control price. Third, externalities - which are costs or benefits brought upon goods or services that affect the inadvertent consumer – may cause market distortions. Externalities may either be negative or positive and they tend to affect consumers differently and as such their costs or effects are notoriously difficult to access or control. And finally, information asymmetry exists where a party to a transaction, usually the buyer, possesses significantly less information about the product than the producer or seller or a situation where information even where available, is of such technical nature that the buyer or consumer is incapable of taking maximum advantage of its existence. The result is that the market suffers a social surplus loss.[75]

Market failures tend to muddy the economic waters of economies and attempts by governments or the authorities to tackle instances of market failure are

[75] *ibid*

usually *via* economic regulation. According to Barton, discourses on economic regulation characteristically approach the subject from three perspectives. The first is regulation as actions the state takes. Some writers (prominent among who are Hans Kelsen and James W. Harris) lay significance on the state as the initiator and implementer of regulation. The state's legitimacy is evidenced in the capacity to promulgate and enforce regulation.[76] There is little agreement among scholars of this persuasion as to the motivation behind the choice of regulation or the criteria to determine efficiency as these depend on the explanatory model adopted towards the concept of statehood. If the state is considered a system of laws and associated norms[77], then all other considerations such as morality, ethics, and sentiment should be kept separate from the law which itself must emanate from, and cater to purely essential needs of the masses. Regulation, which must emanate from the legislature after rigorous debate, is therefore subsumed into the static body of existing laws to perpetuate the state and its existence. The principal consideration is the masses. On another hand, if the state is considered a non-social directing intelligence, then the state is the embodiment of right; the foundation of the expression of humanity. The state acts (makes regulation) as the ultimate consummation of the right the individuals and for its own survival.[78] In the voluntary contractual association view of

[76] See generally Han Kelsen, *General Theory of Law and State* (Harvard University Press 1945); J W Harris, *Law and Legal Science: An Inquiry into the Concepts Legal Rule and Legal System* (Oxford University Press 1979)
[77] See Hans Kelsen, *Pure Theory of Law* (University of California Press 1967)
[78] See Georg Wilhelm Fredrich Hegel, *Philosophy of Right* (Oxford University Press 1973)

Hobbes and Locke[79], the state emerges and produces a government as a protective hedge for the benefit of the state. The voluntary association is entered into for the preservation of the state. All regulation is made to ensure the collective survives. These are a few of the notions of statehood that determine the criteria for the efficacy of regulation.

Barton’s second perspective approaches economic regulation as a struggle for control within a state. This is an offshoot of the above and demonstrates a reaction of specific groups to the authority the statists defend. Hence, the subjects of the regulation either are influenced by or rely on factors outside of the direct control or legitimacy enjoyed by the regulatory group and its agencies to fight the resulting regulation. This struggle to exert or influence regulation ensures a richer and more complex context for these group theorists. The final is regulation as actions by individuals in promotion of their self-interests. The principal concern of studies in this category is the motivation for the creation of regulation and the possibility of perverse, self-beneficial compliance. The focus here is not simply on the subjects as policymakers may embark on politicised regulation, accept unsatisfactory implementation, or be subject to capture.[80]

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[79] See Thomas Hobbes, *Levathian* (London 1651); John Locke, *Second Treatise of Government* (1689)

[80] See generally T Barton, ‘Prospects for a general theory of economic regulation’ (1989) 46 (1) Washington and Lee Law Review 41

Posner delineates economic regulation theorization into two schools; public interest and capture theories.[81] The public interest theory subsumes Barton's first approach and the earliest proponent of the public interest theory, the welfare economist Pigou, views regulation as a means of promoting the interest of society.[82] This approach argues that regulation is a solution to imperfections in markets, which are otherwise known as market failures. The line of thinking is that if regulation fixes market failures, then this promotes the welfare of the community and is in the public's interest.[83] The second arm of Posner's division covers the second and third approaches of Barton's. On the other hand, Stigler holds that '...as a rule, regulation is acquired by the industry and is designed and operated primarily for its benefit.'[84] Stigler argues that administrative failures ensure that groups with special interests in the subject of the regulation compromise the regulatory process and the resulting regulation.

The basis of economic regulation is the orderly direction of dominating, complex, and sophisticated organisations responsible for a large range of social tasks and often endowed with incredibly diverse interests.[85] The crucial roles these organizations play and the impact of their existence and actions are so significant that their subjection to control is inevitable. These organisations exist, function, and conform to rules exercised by an authority which itself is exercised or

[81] See Posner, Richard A, 'Theories of Economic Regulation' (1974) 5(2) BJEMS 335
[82] See Arthur Cecil Pigou, *The Economics of Welfare* (4th edn, Macmillan 1932)
[83] A Ogus, *Regulation: Legal Form and Economic Theory* (Hart Publishing 2004)
[84] See George Stigler 'The theory of economic regulation' (1971) 2(1) B. J. E. M. S. 3
[85] Ioannis Glinavos, *Redefining the Market-State Relationship: Responses to the Financial Crisis and the Future of Regulation* (Routledge Research 2014)

legitimised by an intangible but popular agreement. Thus, economic regulation is a product of state action that seeks to ensure risky behaviour is curtailed and the system for which regulation was enacted survives.[86]

Economic regulation presupposes the regulation of whole economies, while financial regulation brings it down to the regulation of the sector of an economy that may be described at the heart of it all. In general, the theories of regulation that apply to economic regulation, apply just as much to financial regulation and whichever doctrines relied upon for an economic regulatory regime, will invariably determine the financial regulatory regime. Having established that some sort of regulation or control is required to establish and maintain order in any society[87], one must determine what the inverse must be in the financial sector, especially in light of the importance and fundamentality of the financial sector of any economy. It must be pointed out that in this context, the inverse situation contemplated is the imposition of regulatory restrictions from an external entity to the subject of regulation. This is because virtually every sector of an economy is capable of sustaining itself by self-imposed rules and practices (whether written or otherwise). In reality, no society is without regulation.[88] The question that requires answer is whether and what the financial sector benefits

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[86] See Morgan, B. and Yeung, K, *An Introduction to Law and Regulation: Text and Materials* (Cambridge University Press 2007); Ioannis Glinavos, *Redefining the Market-State Relationship: Responses to the Financial Crisis and the Future of Regulation* (Routledge Research 2014)

[87] See Morgan, B and Yeung, K, An Introduction to Law and Regulation: Text and Materials (Cambridge University Press 2007)

[88] Dowd, K., *Competition and Finance: A Reinterpretation of Financial and Monetary Economics* (Macmillan 1996)

from regulation. In other words, why is it necessary to have institutional financial regulation in place? There is argument that the financial space, especially banking, may benefit from self-regulation. The creatively worded argument is reproduced in its entirety;

> *The argument for financial laissez-faire (or free banking) is essentially very simple: if free trade is generally desirable, then what is wrong with free trade in the financial services sector? If nothing is wrong with it, the whole panoply of government intervention into the financial sector - the central bank, government-sponsored deposit insurance and government regulation of the financial system - should presumably all be abolished.*[89]

Indeed, free markets benefit from strong internal infrastructure and self-regulation to keep costs down and achieve efficiency.[90] Inflicting the seeming menace of regulation upon an otherwise unhindered financial market has the added disadvantage of weakening both the innate incentive of market participants to exercise caution and control in their activities and clients' or customers' inclination to be diligent in their dealings with the owners. The existence of regulation creates a measure of complacency as market participants, depending on the sense of security a regulated environment may provide, may fall into laziness or indulge their greed and the result may be that financially

[89] See Dowd, K 'The Case for Financial Laissez-Faire' (1996) 106 (436) EJ 679
[90] See Coase, R H, *The Firm. The Market and The Law* (University of Chicago Press 1988)

destructive habits are formed.[91] Nevertheless, the regulation of financial services reoccurs and remains important and this is because the various financial crises over the last few decades have created in the public, and researchers in the area as well, an apprehension evidenced in the outcry for ‘better control’ after each episode of financial crises. Also, there is the much parroted need to ensure that monopolies do not develop.[92] The former reason has led to the introduction of an avalanche of regulations targeted at whichever financial activity or intermediary is blamed for the instant case. The public pressure push for regulatory response to crises aside, the usual formal justification for regulatory intervention in financial activities of the public sector are that; the exercise of monopolistic control of any area of finance actually violates basic conditions for Pareto optimality and may potentially lead to inefficiency in the market, the balance of relationship between market participants (owners and clients) tilts unfairly in favour of the sophisticated owners as against the less informed clients who deserve protection from the potential exploitation this asymmetry may afford, and the social costs of crises to an economic system are such that systemic stability is a priority and must be maintained or restored.[93]

For purposes of analysing the efficacy of an international instance of financial regulation *i.e.* Basel III, this research must highlight and analyse the unique

[91] See Charles Goodhart, Philipp Hartmann, David Llewellyn, Liliana Rojas-Suarez, Steven Weisbrod, *Financial Regulation Why, how and where now?* (Routledge 1998)
[92] See generally James M. Buchanan, Gordon Tullock, ‘The Dead Hand of Monopoly’ (1968) 1 ALER85
[93] See generally Charles Goodhart, Philipp Hartmann, David Llewellyn, Liliana Rojas-Suarez, Steven Weisbrod, *Financial Regulation Why, how and where now?* (Routledge 1998)

considerations that drive international financial regulation. International financial regulation describes the normative, interventional rule-making and standard-setting activities by an international organisation seeking to influence macroeconomic and microeconomic activities of a state.[94] The typical aims of these regulatory activities include minimizing the likelihood of the international transfer of risks in economic activities and the promotion of growth through financial development.[95] It also falls within the ambit of international financial regulation to attempt to minimize such inherent risks in business as insolvency risk, market risk, and systemic risk. The underlying reason for the check on these risks is to insulate, as much as possible, the associated social costs of contagion transfer through the failure of a financial intermediary.[96]

The financial crisis of 2007 has prompted the priotization of international prudential financial regulation as a top item on the list of global public policy concerns. Now more than ever, scholars, as well as policy makers, grapple with 'the political dynamics associated with this aspect of global economic policymaking.'[97] The history of any attempt at international financial regulation dates back to about 1944 when the leadership of the allied powers, *i.e.* United States and the United Kingdom, agreed on a design for the redevelopment and

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[94] See Rolf H Weber; Douglas W Arner, 'Toward a New Design for International Financial Regulation' (2007) 29 UPJIL 391

[95] See John William Anderson, Jr, 'Regulatory and Supervisory Independence: Is There a Case for Independent Monetary Authorities in Brazil?' (2004) 10 LBRA 253

[96] See Jan H Dalhuisen, *Dalhuisen on International Commercial , Financial and Trade Law* (Hart 2000)

[97] Eric Helleiner and Stefano Pagliari 'The End of an Era in International Financial Regulation? A Postcrisis Research Agenda'(2011) 65 International Organization 169

rebuilding of the various economies of the world that were destroyed by actual or seeming warfare in the preceding three decades. This design became the Bretton Woods international economic system which became the primal instance of international cooperation and institutional trade liberalization. The Bretton Woods system contemplated the creation of both the International Bank for Reconstruction and Development (IBRD), as well as the International Monetary Fund (IMF), and proposed fixed exchange rates in a bid to achieve economic stability which was considered a foundation for political stability.[98]

Around the same period – the end of World War II - international finance picked up in the form of the Bretton Woods fuelled Euromarkets. However, there was no parallel international attempt to regulate the emerging global financial system. The regulation was left to domestic law.[99] Attention was drawn in the 1970s to the importance of the emerging global financial system and the need for its regulation when considerable cross-border risks were revealed by the interdependence between domestic financial intermediaries and systems evidenced by the collapse of Germany's *Bankhaus Herstatt* and other financial institutions in that decade. As a direct result of these financial calamities and their far-reaching global-markets-upsetting aftermath, concrete attempts were made at regulation, or in the very least, introduction of common standards or a central database or information hub. This meant the creation or establishment of

[98] See Joseph J Jr. O'Connell, 'Bretton Woods' (1945) 5 LGR 60
[99] See Rolf H. Weber, Douglas W Arner, 'Toward a New Design for International Financial Regulation' (2007) 29 UPJIL 391

the BCBS, the Committee on the Global Financial System (created in 1971), the Committee on Payments and Market Infrastructures (initially set up in 1980 as a Group of Experts on Payment Systems and having gone through a series of changes of name and broadening of functions and scope) by the Bank of International Settlements. Almost exclusively, international financial regulation has developed alongside internationally significant financial devastation. The new and increasing wave of crises that would grow to have international effects developed on the back of the internationalization of finance and its services. These crises include global stock market collapses,[100] and financial crises in East Asia, Europe, Russia, Argentina, and Mexico. International cooperation towards common standards or practices to prevent repetitions of these events spawned the creation of an ever-growing number of international financial organisations which enjoy varying authority to develop, implement, or monitor implementation of standards and policies.[101]

1.6 Financial Crises

The only certain aspect of financial crises is that their occurrence has been regular in the history of civilization. The number of theories, explanations, and

[100] Notably the so-called black Monday crash of Monday, October 19, 1987 which spread globally from Honk Kong

[101] See Rolf H Weber, Douglas W Arner, 'Toward a New Design for International Financial Regulation' (2007) 29 UJIL 391; BIS <https://www.bis.org/cpmi/about.htm?m=3%7C16%7C29> accessed 22 January 2018;

hypotheses that exist about the origin, cause, and progression of financial crises attest to the difficulty in expounding a categorical, all-encompassing theory of financial crises. Despite this seeming uncertainty, the explanation following each episode or instance of crisis falls under any of a series of heads and these are institutional weaknesses in a system, unfortunate macroeconomic developments, poor risk management and abuse of leverage, failure of management, behavioural factors, and an ill-managed shift to liquidity.[102] This list is neither exhaustive nor are the heads mutually exclusive in the explanation of any instance of crisis. Further to the uncertainty of the nature of financial crisis, is that the above-mentioned heads do not always cover or address the actual origination of the crisis even where it is easy to identify the supervening factor that provided the climate for the particular instance. Furthermore, the mode of transmission or spread of crises from a sector of an economy to another or others is just as unsettled as when the manifestation of crises shifts from an identifiable manner to another.[103] In spite of this uncertainty, an examination of the types or manifestation, as well as the better-known theories of financial crises has practical advantages. First, financial crises, in one form or another tend to occur and reoccur. An understanding of the dynamics of each instance helps to identify catalysts and this in turn aids measures aimed at prevention. Also, in the event

[102] See Lars Oxelheim, Clas Wihlborg, Finn Østrup, 'The Origins and Resolution of Financial Crises' in Robert W Kolb (ed.) *Financial Contagion: The Viral Threat to the Wealth of Nations* (John Wiley & Sons 2011); Østrup, Finn, Lars Oxelheim, and Clas Wihlborg 'Origins and Resolution of Financial Crises; Lessons from the Current and Northern European Crises' (2009) Asian Economic Papers 8

[103] See Franklin Allen and Douglas Gale, *Understanding financial crises* (Oxford University Press 2007)

that another financial crisis occurs, an understanding of the subject of financial crises will aid combative or containment steps as well as lighten the responsibility to justify policy or regulatory adjustments.

A financial crisis is essentially a sudden crash or halt in a financial system. The suddenness of the disruption is such that it impairs the functionality of the system. A financial crisis usually takes the form of a significant fall in asset value coupled with a sharp depletion of funds in the system and often, a bank run ensues.[104] A uniform definition of financial crises is of limited utility because each incident has its own causes or catalysts and possesses case-dependent attributes in the way it unravels. Perhaps the most that may be gotten from the definition above is the primary feature of a financial crisis which is the disruption to the system.

Financial crises take various forms. A common classification however is made based on the method of defining the episode in question. This classification divides the manifestation of financial crises into two distinct types; those crises that can be defined by quantitative data and terminology and those other that may only be described *via* qualitative and judgmental analysis. While the former classification covers currency and sudden stop crises, the latter are mainly debt

[104] See Charles P Kindleberger, *Manias, Panics, and Crashes: A History of Financial Crises* (Wiley 2005)

and banking crises.[105] Currency crises occur when the currency of a country suffers a sharp depreciation. This specific type of crisis may be caused by speculation or such other factors as political or economic uncertainty. Furthermore, the depreciation may be as voluntary *i.e.* because of regulatory action (e.g. increase in interest rates or imposition of foreign exchange restrictions). In cases such as this, the depreciation is essentially a purposeful devaluation that spirals out of hand. On the other hand, a sudden stop crisis occurs either when the aggregate capital flows to a country drops suddenly or when the country registers a significant fall in international capital inflow. [106] A debt crisis entails a sovereign authority being unable or refusing to meet its debt obligations. This default may be on either a domestic or a foreign debt. In the domestic instance, the country fails or refuse to honour its fiscal obligations.[107] A banking crisis on the other hand, manifests in actual or potential bank runs arising out of a loss of confidence in the banking system precipitated by an actual or anticipated financial calamity. The significance of this mode of financial crises is apparent in the crucial role banks play in any economy and exacerbated by the fact that the cause or catalyst of the crisis need not emanate

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[105] See Reinhart, C M and Rogoff, K. S., *The Aftermath of Financial Crises* (NBER Working Paper Series 14656, 2009)
[106] See Claessens, S and Kose, M A, Financial Crises: Explanations, Types, and Implications (International Monetary Fund WP/13/28, 2013)
[107] *ibid*

from the banking sector, a particular bank, or even be banking related for bank runs to occur.[108]

As noted above, financial crises are difficult phenomena to theorise on. This fact has not stopped economists and other writers from attempting to either propound theories for soundness of economies or at the very least attempt to theorise based on the occurrence of financial crises. Scholarship on these subjects goes as far back as the earliest records of significant economic calamity.[109] Theories of financial crises fall into schools of thought that argue either a self-regulating market or inherent instability model. Both sides of this divide provide fascinating analyses that tend towards the inherent theory or monetarism.[110]

The stability school of thought comprises a collection of writers and economists who hold that markets are inherently stable *i.e.* capable of rational self-governance and the occurrence of crises is an abnormality that disappears naturally. This principle is traceable to the 'invisible hand' mentioned by Scottish thinker Adam Smith in his book, Wealth of Nations that was published in 1776.[111] Smith argues that acting on their own self-serving instincts and desires; economic actors (nations) balance one another out and naturally bring

[108] See I L Van Jaarsveld, 'Domestic and International Banking Regulation and Supervision - Defying the Challenges' (2002) 119 SALJ 71
[109] See Òscar Jordà, Moritz Schularick, and Alan M Taylor, 'Financial Crises, Credit Booms, and External Imbalances: 140 Years of Lessons' (June 2011) 59 (2) IMFER 340
[110] See Nouriel Roubini and Stephen Mihm, *Crisis Economics: A Crash Course in the Future of Finance* (Penguin Books 2010); Hyman P. Minsky, *Stabilizing an Unstable Economy* (McGraw-Hill 2008); F A Hayek, *The Fatal Conceit: The Errors of Socialism* (University of Chicago Press 1991)
[111] Nouriel Roubini and Stephen Mihm, *Crisis Economics: A Crash Course in the Future of Finance* (Penguin Books 2010)

the equilibrium to the markets that no external force or factor may. The principles therein caught on and became the basis for much economic theory and policies for a considerable length of time.[112] Many notable economists and writers of the period built on Smith's position and either expounded his views or used them as a plinth for theirs. Prominent among them is Ricardo who is widely considered the father of comparative advantage. Drawing inspiration from Smith, he advocated a system in which countries would focus on goods or products in which they had comparative advantage to avoid clashes or shortages that may destabilise the economy and advocated free trade to ensure the effective distribution of goods thus produced.[113] Marshall on his part was very instrumental in expanding the works of both Smith and Ricardo. In extending their thoughts, he placed emphasis - and was the first to emphasize – on the phenomena of demand and supply in the study of economic choices and participation.[114] Numerous other writers built on these basic premises and expounded offshoot theories of this school of economic thought up to the culmination of its most important expression – the efficient market hypothesis.[115]

Fama, who is widely considered the father of the efficient market hypothesis, divides market efficiency into forms and argues that since in the highest form

[112] See Adam Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations* (1776) Book I, Part II, Section I 261
[113] See Ricardo, David, *On the Principles of Political Economy and Taxation* (Library of Economics and Liberty 1821)
[114] See Alfred Marshall, *Principles of Economics* (first published 1890, Macmillan 1920)
[115] See George Cooper, *The Origin of Financial Crises: Central Banks, Credit Bubbles and the Efficient Market Fallacy* (Harriman House 2010)

(strong efficiency) the sum of the inputs reflected in prices would defy even a market participant with insider information, markets are unsearchable. A second arm of his thinking is the vexed and much debated view that one cannot discountenance the notion of an efficient market without discountenancing the existence of an equilibrium price. Hence, to hold that there is an optimal price for any asset is to hold that markets are capable of rational self-governance.[116] The thrust of the hypothesis is that asset prices reflect the equal collective knowledge of market participants and as such do not require external influence and also that as a result of the wisdom reflected in asset prices, markets are naturally at an equilibrium and able to self-correct anomalies.[117] Accordingly, it is impossible to conceive of a situation where an internal force or occurrence destabilises the market and even in the off chance of such an occurrence, no external interference would be required to restore equilibrium since the market is self-correcting. Proponents believe that, crises are nothing but 'freak events: highly improbable, extremely unusual, largely unpredictable and fleeting in their consequences.'[118] Critics however argue that certain repetitive market patterns in the returns of a security are inexplicable. The reasoning is that the fact that there is a traceable pattern, which repeats itself, means market participants may align themselves with this pattern and profit and this is a negation of the conclusions of the

[116] Eugene F. Fama, 'Efficient Capital Markets: A Review of Theory and Empirical Work' (May 1970) 25(2) TJF 383
[117] See George Cooper, *The Origin of Financial Crises: Central Banks, Credit Bubbles and the Efficient Market Fallacy* (Harriman House 2010)
[118] Nouriel Roubini and Stephen Mihm, *Crisis Economics: A Crash Course in the Future of Finance* (Penguin Books 2010)

hypothesis.[119] Some of these patterns or anomalies (as they are referred to) include the 'size effect' *i.e.* stocks of small-capitalization companies consistently outperform their larger counterparts over the course of a year[120], such calendar effects as holiday and weekend gaps[121], and the reliability of price-earnings ratios in forecasting expected returns.[122]

Other critics rely on behavioural tendencies to challenge Fama's findings. The premise of the efficient market hypothesis that all market participants are rational is itself irrational. The research proves that investment decisions of investors - both retail and institutional - tend to depend heavily by their characteristic idiosyncrasies.[123] Instances include the tendency to accept a smaller profit earlier rather than hold out for a significantly larger profit later in future[124], regret avoidance[125], the tendency to overreact to new information introduced into the market[126], loss aversion[127], herding[128], and overconfidence[129]. Keen argues that

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[119] See Andrew W. Lo, 'Efficient Markets Hypothesis' in L. Blume and S. Durlauf (eds) *The New Palgrave: A Dictionary of Economics* (2nd edition, Palgrave McMillan 2007)
[120] See generally Rozeff, M. and Kinney, W. Jr., 'Capital market seasonality: the case of stock returns' (1976) 3 JFE 379
[121] See generally Lakonishok, J. and Smidt, S., 'Are seasonal anomalies real? A ninety-year perspective' (1988) 1 RFS 403
[122] See generally Basu, S., 'The investment performance of common stocks in relation to their price–earnings ratios: a test of the efficient market hypothesis' (1977) 32 JF 663
[123] Ekanshi Gupta, Preeti bedi, and Poonam lakra, 'Efficient Market Hypothesis V/S Behavioural Finance' (April 2014) 16(4) JBM 56
[124] See Laibson, D, 'Golden eggs and hyperbolic discounting' (1997) 62 QJE 443
[125] See Bell, D, 'Risk premiums for decision regret' (1982) 29 MS 1156
[126] See DeBondt, W and Thaler, R, 'Does the stock market overreact?' (1985) 40 JF793
[127] See Kahneman, D. and Tversky, A, 'Prospect theory: an analysis of decision under risk' (1979) 47 E 263
[128] See Huberman, G. and Regev, T., 'Contagious speculation and a cure for cancer: a nonevent that made stock prices soar' (2001) 56 JF 387
[129] See Fischoff, B. and Slovic, P., 'A little learning...: confidence in multicue judgment tasks' in R. Nickerson Hillsdale (ed.) *Attention and Performance VIII* (Erlbaum 1980)

the proponents of an efficient market fail to recognise processes that have a lag in their occurrence but instead believe that every action of market actors occurs in equilibrium. For such a model to work, the inherent processes of the market must be stable and this is virtually impossible. The conclusion is that there are flaws inherent in that model that would eventually lead to crisis.[130]

Friedrich August von Hayek vigorously challenged the premises and tenets of socialism; claiming the underlying theory was illogical and incorrect. Arguing further, he goes on to state that civilization is a product of such independent and creative effort as the acquisition and accumulation of personal property, trade, and expansion and this led to the so called extended order. The view here is the socialist tenet that only purposeful design may sustain human economic endeavour is defective and equilibrium may only be found in non-interference. He stresses that since the need for continuity in the non-purposeful order is based on non-interference, interference would only serve to cause disruptions. He stresses that price signals were the only reliable means of communicating specialized, tacit knowledge from each decision maker to another or others.[131] Crisis, therefore, is the result of disruptions in the economy caused by interference. There seems to be instances where state interference is inevitable. The most prominent instance is the provision of public goods. Even Hayek tacitly acknowledged this inevitability of state input in acknowledging that 'in no

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[130] Steve Keen, *Debunking Economics: Naked Emperor dethroned?* (Zed books 2011)
[131] F A Hayek, *The Fatal Conceit: The Errors of Socialism* (University of Chicago Press 1991)

system that could be rationally defended would the state just do nothing'. These instances where state input is inevitable include provision of social security and infrastructural safety net, performance of task free markets were incapable of, ensuring equity by regulating legal production, preservation of competition, regulation of the environment (negative externalities), and preventing fraud.[132]

The instability school of thought, on the other hand, subscribes to a model that argues an inherent propensity of an economy to disruptions of varying magnitude *i.e.* correct itself by way of crisis. One of the earliest describers of crises as "busts" that follow "booms" was John Stuart Mill. Mill, who was a subscriber of the free market paradigm, attempted in his book, Principles of Political Economy, to explain the financial upheavals commonplace in his time. According to him, bubbles develop by unforeseen incidents that lead to wanton speculation. The speculation blossoms on unreasonable expectations of gains and the frenzied enthusiasm of numerous imitators. He goes on to hypothesize, in frightening accuracy, that 'a great extension of credit takes place [and] not only do all whom contagion reaches employ their credit much more fully than usual; but they seem to be making unusual gains and because it generally reckless and adventurous feeling prevails, which disposes people to give as well as the credit more likely than at any other times, and give it to persons not entitled to it.' This bubble busts when a handful of firms underperform and unreasonable pessimism grips

[132] F A Hayek, *The road to Serfdom* (Routledge Press 1944)

speculators. Prices fall and the effects spill over into the real economy leading to 'a condition of more or less impoverishment.'[133]

The boom - bust cycle held sway in economics cycles but no significant addition was made to its tenets until Marxism arose with the publication of The Communist Manifesto. Marxists view crises as inherent in capitalism and a flaw that would spell its eventual demise. Marx had propounded the theories that society is embroiled in a seeming class struggle between the "haves" (Bourgeois) and the "have nots" (Proletarians). He argues that society has always favoured the minority haves, who being the owners of the means of production oppressed the disadvantaged majority. Mechanisation as a cost-cutting device has resulted in overproduction and underemployment and crises are a demonstration of rebellion of the people.[134] The centre of Marxist thinking is that capitalism goes beyond an economic system to attain an all-consuming political thought pattern whose reach affects every aspect of the life of the people. As such, not only does crisis manifest the ills of capitalism, it also represents a form of struggle; a struggle of the masses not so much against the bourgeois class as against a philosophy. Marx's views have attained considerable longevity with so-called Marxists springing up from their seeming passivity each time a crisis occurs – as has been the case with the academic scene post 2007.[135]

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[133] John Stuart Mill, *Principles of political economy* (first published 1848, OUP 1994)
[134] Karl Marx, *The Communist Manifesto* (first published 1848, Pluto Press 2008)
[135] See Beverungen, A, Dunne, S, and Hoedemaekers, C, 'The University of Finance' (2010) 9(4) TPO 261

Schumpeter, while agreeing with Marx's prediction that capitalism would eventually collapse and be replaced by socialism, differed in the exact manner the collapse would come about. Classical Economics functions like waves; the crest of which were prosperous times and the trough, times of financial distress. Believing that capitalism would naturally weaken and eventually implode, Schumpeter used the now immensely popular term, creative destruction, to describe the natural propensity of capitalism to implode due to its inherent disadvantages. A noteworthy element in this argument is the intellectual activistic prophesy that this implosion would be brought about by intellectuals who would then go ahead to defend the interests of the masses. Another noteworthy element is the seeming natural selective tendency of the so-called 'creative destruction' where only some entities will survive the uncomfortable fallout of collapse of capitalism.[136] Criticisms of this position include the fact that crises tend to be caused by factors divorced from activism by the intelligentsia. Schumpeter's views are not very popular and are all but forgotten in discussions on financial crises.[137]

The 1929 stock market crash in the United States and the worldwide depression that ensued created fodder for economists to theorize on crises. Fisher drew inspiration from this to develop a theory of economic crisis he christened debt

[136] Joseph Schumpeter, *Capitalism, Socialism, and Democracy* (first published 1943, George Allen and Unwin 1976)
[137] See Christopher Freeman, 'Schumpter's Business Cycles and Techno-Economic Paradigms' in Wolfgang Drechsler, rainer Kattel, and Erik S. Reinert (eds.) *Techno-Economic Paradigms: Essays in Honour of Carlota Perez* (Anthem Press 2009)

deflation. The theory argues that over-indebtedness and deflation are the causes of any crisis. He argues that the bursting of credit bubbles was the cause of that crisis and led to crucial negative effects in the real economy. According to him, the real issues were 'over-indebtedness to start with and deflation following soon after; that where any of the other factors do become conspicuous, they are often merely effects of symptoms of these two.' The combination of an unchecked growth of debt and the deflation that over-indebtedness brings are the negative effects. He lists these as a drop in output, which would cause unemployment, a drop in profits and asset prices, hoarding of cash as businesses go bankrupt, a loss of investor and consumer confidence, interest rates drop, a contraction of money supply as a result of payments of bank loans, and distress selling.[138] Fisher's views have suffered criticism for the limited scope of his reference in formulating his theory. Fisher relied on only three, albeit devastating, crises to arrive at his conclusions. Furthermore, not all global crises occurred after a deflation as Fisher claimed. His strict view that an accelerated growth of debt coupled with deflation though correct for the crisis still devastating the world when he formulated his theory does is now of rather little significance for its shortcomings.[139]

[138]Irving Fisher, 'The Debt Deflation Theory of Great Depressions' (1933) 1 E 337, 343
[139] See Robert J. Shiller, 'Irving Fisher, Debt Deflation and Crisis' (Cowles Foundation Discussion Paper No. 1817, August 2011) < https://www.law.ox.ac.uk/sites/files/oxlaw/oscola_2006.pdf > accessed 18 September 2017

Perhaps the most important theoretical movement on crises that resulted from the crash of 1929 is Keynesianism. Keynesianism arose from the fallout of the1929 crash and gained a lot of traction in the two decades following the publication of The General Theory of Employment, Interest and Money. For Keynes, aggregate demand is more important than the price of labour in the determination of the level of employment. Thus, if demand falls, investors would be less enthusiastic about investing leading to the closure of businesses. As wages freeze up or disappear, consumers would spend as little as possible and attempt to save more resulting in a "paradox of thrift". His position is that competitive markets will not deliver full employment. He claims underemployment is bound to ensue if governmental action is not taken. His central argument is that the "uncertainty" inherent in an unplanned economy would not make for an equilibrium state. Instead, the potential for untrammelled speculation was a real threat.[140] Keynes' views held considerable sway and were influential in government policy up until the 1970s.[141] Keynesian economics enjoyed resurgence in the wake of the 2007 global financial crisis especially with regard to monetary policy and fiscal stimulus.

Minsky wondered if considering proponents of the inherent stability school argue that the markets are self-correcting, there was the possibility of another

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[140] John Maynard Keynes, *The General Theory of Employment, Interest and Money* (first published 1946, Mariner books 1965)

[141] See Nouriel Roubini and Stephen Mihm, *Crisis Economics: A Crash Course in the Future of Finance* (Penguin Books 2010)

crisis of the scale of the crash of 1929. His conclusion was that there was the need for an economic theory that factored crises into itself as a possibility *i.e.* an inherently unstable system.[142] Minsky's financial instability hypothesis has provided the framework upon which other proponents of an inherently unstable system have lain their argument. Notable among them is Kindleberger. By analysing numerous historical instances of crises against the Minsky Model, we are provided with the five stages of a financial crisis *i.e.* displacement, monetary expansion, overtrading, revulsion, and discredit. In the displacement stage, an optimistic economic atmosphere encourages investors to speculate more as there is the apparent assurance of profit. In the second stage, the optimism infects banking and other financial institutions who lend more and more resulting in an expansion of credit. The overtrading stage is where the availability of easy credit, coupled with the general euphoria of the favourable economic atmosphere, fuels speculators to borrow and invest more. The revulsion and discredit stages linked. Price reaches an optimum and a reversal begins. Fear and uneasiness creep in and cause an over cautiousness that spells illiquidity. Firms begin to fail as panic assumes a firm grip on market participants and it all declines into a full crisis.[143]

The advent of the financial crisis in 2007 prompted vociferous criticism of the self-stabilizing school of thought.[144] It is argued here that there is no better

[142] See Hyman P. Minsky, *Stabilizing an Unstable Economy* (McGraw -Hill 2008)
[143] Charles P. Kindleberger, *Manias, Panics, and Crashes: A History of Financial Crises* (Wiley 2005) 4
[144] Nouriel Roubini and Stephen Mihm, *Crisis Economics: A Crash Course in the Future of Finance* (Penguin Books 2010)

expression of instability is an inescapable flaw of capitalism than Hyman Minsky's financial instability hypothesis especially in the wake of the global financial crisis. A lifelong admirer of Keynes, Minsky based most of his views on the macroeconomics of Keynes[145]. As Minsky's theory posits, the availability of cheap credit and the high optimism tend to shift investors risk appetite from the secure edge of the investment options spectrum to the polar opposite where the unusually high yield investment vehicles exist. In the instant case, it was the optimism fuelled by innovative financial engineering birthing instantly popular but complex securitization of various assets especially subprime mortgages. In doing this, these investors relied heavily on short term debt financing and depended on credit default swaps as risk diversification measures. In addition, credit rating agencies where appropriating inaccurate and sometimes dubious analyses to the dependability of these assets. The result turned out to be the crash in the market that grew into a global crisis. [146] The crisis, to a large extend, demonstrates that crises tend to reflect the bust of the boom bust circle.

1.7 Conclusion

The principal basis for the existence of law is the establishment and maintenance of order in any collective. Regulation, especially of the economic genre, is

[145] See Hyman P. Minsky, *John Maynard Keynes* (first published 1975, McGraw-Hill, 2008)
[146] See A Minsky Meltdown: Lessons for Central Bankers (FRBSF Economic Letter Number 2009-15, May 2009)

primarily deployed in institutional aid of efficiency in light of the existence of market failures.[147] With or without regulatory effort, times of financial or economic chaos characterised by drops in asset value, shortage of liquidity, and panicked withdrawals of funds from financial institutions occur. These crises are generally thought to occur as a result either as an in-built tendency in economies to crash as a corrective measure after a period of excesses or representing nothing more than the effect of interference in an otherwise self-regulating economy.[148] Studies on historical instances of similar crises to the recent global financial crisis conclude that most financial crisis develop on the backs of bubbles built on wanton speculation fuelled by porous regulation and tend to exhibit inbuilt tendencies.[149]

To appreciate the role of law in financial crises, one must first appreciate the role of law in financial development and stability. There have been advances in financial development over the last two decades and the reason lies in changes in finance which have been encouraged, to a large extent, by internationalization and integration, as well as advances in information technology. Law, legal

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[147] See Richard Swedberg, 'The Case for an Economic Sociology of Law' (2003) 32 (1) TS 1; David L. Weimer and Aidan R. Vining, *Policy Analysis: Concepts and Practice*, (2nd edn, Prentice Hall 1992)

[148] See Nouriel Roubini and Stephen Mihm, *Crisis Economics: A Crash Course in the Future of Finance* (Penguin Books 2010); Charles P Kindleberger, *Manias, Panics, and Crashes: A History of Financial Crises* (Wiley 2005); Hyman P. Minsky, *Stabilizing an Unstable Economy* (McGraw-Hill, 2008); F A Hayek, *The Fatal Conceit: The Errors of Socialism* (University of Chicago Press 1991)

[149] See J Barkley Rosser, Jr, Marina V Rosser, Mauro Gallegati 'A Minsky-Kindleberger Perspective on the Financial Crisis' (Jun 2012) 46(2) Journal of Economic Issues; Abingdon 449

systems, legal institutions and regulatory systems lie at the heart of these advances. The financial development the world has known is not without its shortfalls with crises being the most drastic and important. It has become much easier for weaknesses or disruptions in a particular financial system or economy to impact other financial systems or economies around the world in light of the interlinkage of processes and systems both domestically and globally. So while legal structures aid financial development, they also facilitate the likelihood of the transmission of contagion in financial markets and economies.[150] A principal mode of transmission of contagion from one economy to another or others is a bank. More so a bank that operates across bothers.

[150] See Douglas W Arner, *Financial stability, Economic Growth, and the Law* (CUP 2007)

CHAPTER 2: INTERNATIONAL BANKING AND ITS REGULATION

2.1 Introduction

International Banking has become an integral part of modern society. Remarkable innovation in financial services, the globalization of banking services, and outstanding technological advancements have brought with them benefits and challenges both for international banking and the global financial system. The present state of international banking is a remarkable leap from its origins. The systemic importance of banking in itself and the risk of transfer of contagion through banking services make the regulation of international banking an important factor in the quest for global financial stability. The build up to Basel III must trace the origins of international banking, its systemic importance in the global financial system, the events that have driven its growth, the stimuli for regulatory efforts, regulation attempts, and the hindrances that have been encountered.

This chapter develops the history of international banking from the inception of banking from around 1000 BC to the systemically important phenomenon it has become. Further, the chapter examines the efforts towards its regulatory and the challenges in the way.

2.2 Banking at International Scale

The modern bank is an institution that carries out the functions of banking.[151] These functions include acceptance of funds – in the form of deposits - and other valuables for safekeeping, extension of credit, transmission of funds, the creation of money in specific circumstances, the creation of a conduit between savers and investors, and the facilitation of the transfer of information in the financial sector.[152] The discovery of the necessity of these functions lies in trade.[153] Trade itself arose out of the necessity of accessing goods or services required but not available or within the competence of the party who needs them. Thus, basic needs grew into the wise decisions to store for future consumption and the storage of wealth. These needs naturally involved trade with counterparts who may be a considerable distance away and from this characteristic arose issues of security and convenience.[154] Soon the demand for these services conducive to trade created a natural supply and involvement and specialization in their provision arose. According to Christophers, this led not only to ingenuity in the services provided *e.g.* the development of money and credit, but also an avenue of wealth creation and further developments in banking services.[155]

[151] See Deborah K. Dilley *Essentials of Banking* (2nd edn, Wiley 2008)
[152] *ibid*
[153] See Shahzavar Karimzadi, *Money and its origins* (Routledge 2013)
[154] *ibid*
[155] Brett Christophers, *Banking Across Boundaries: Placing Finance in Capitalism* (Wiley & Sons 2013)

The development of international banking moved from the development of rudimentary banking activities and commercial practices of the Greeks and Phoenicians around 1000 BC all the way to rise and fall of the Roman Empire, the emergence of the Byzantine Empire, and to the subsequent Arab conquests.[156] At about the twelfth century, the Roman Catholic Church had begun to lose the sway it enjoyed in both everyday life and banking activities (through the activities of the religious order of the Knights of the Holy Temple of Jerusalem [Knights Templar])[157] and this renaissance saw the emergence, dominance, and fall of Italian, German, Dutch, and British banking families (also called houses) respectively. Each of the dominating houses would establish branches (usually by placing a family member to stir its affairs) in the leading financial centres in Europe and utilizing communication networks to coordinate the affairs of the family.[158]

The growth of modern international banks began and took shape around the two World Wars.[159] The havoc wreaked by the First World War created a need for funds for reconstruction and these funds were eagerly provided by a consortium of American banks – led by J. P. Morgan and Company - who, together with

[156] Roy C. Smith and Ingo Walter, *Global Banking* (3rd edn, University Press Scholarship 2003)
[157] See Adam N S G Baldwin, *Heroes and villains of finance: the 50 most colourful characters in the history of finance* (Wiley 2015)
[158] Emmanuel N Roussakis, 'Global Banking: Origins and Evolution' (1997) 37 (4) RAE 45
[159]See J Bradford De Long, 'Did J. P. Morgan's Men Add Value? An Economist's Perspective on Financial Capitalism' in Peter Temin (ed.), *Inside the Business Enterprise: Historical Perspectives on the Use of Information* (University of Chicago Press 1991); Roy C Smith and Ingo Walter, *Global Banking* (3rd edn, University Press Scholarship 2003)

other investors, saw new opportunities to speculate on securities on the loans made out. The activities of these American banks and investors were far reaching in their influence of cross border banking and were so significant that they contributed to the crash of 1929 and the ensuing great depression.[160] The destructive aftermath of the Second World War saw another bout of frenzied financial globalization and the growth of the internationalization of banking services.[161]

The nationalities of the leading international banks have shifted over time but their basic structure and services have remained the same; the establishment of counterparts, branches, or wholly owned subsidiaries in other countries, and an innovative and ever expanding range of services ranging from the traditional to more specialised banking and investment services.[162]Most of the services offered by modern international banking converge on granting international - mostly syndicated - loans, management of foreign risks, and engaging in foreign exchange market activities.[163] International banks carry out these functions by offering of credit and repurchasing agreements; the issuing of standby letters of

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[160] See *ibid*

[161] See Jordi Canals, *Universal Banking: International Comparisons and Theoretical Perspectives* (OUP 1997)

[162] See See Emmanuel N Roussakis 'Global Banking: Origins and Evolution' (1997) 37(4) RAESP 45

[163] See Charles W Hultman, *The Environment of International Banking* (Prentice Hall 1990)

credit; the granting of acceptances; and engaging in transactions such as currency futures, interest rate options, and currency swaps among others.[164]

The entities that operate as international banks presently have emerged and thrived as a result of technological advancements and the liberalization financial markets have enjoyed in the last few decades.[165] Improvements in information and communications technology have caused a significant reduction of costs in associated with the generation, transmission, and utilization of financial information and this has allowed for ease in real-time synchronisation and control of affairs overseas. On the other hand, the rise of institutional investors and the demand for capital by such parties as the member Republics of the former Soviet Union (post its dissolution in 1991) and developing countries set on building efficient economies has seen the development of international financial markets. This has come with the prudence of liberalisation and further growth of international banking.[166] These catalysts pair up with demand for financial services by both multinationals and emerging economies to ensure that international banks play an important role in economic progress in the future. International banks are also important in the global economy for the roles they play which are complimentary to those of international financial markets.[167]

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[164] Izelde van Jaarsveld, 'The International Banking Business' (2000) 8 JBL 102
[165] See Emmanuel N Roussakis 'Global Banking: Origins and Evolution' (1997) 37(4) RAESP 45
[166] *ibid*
[167] See Financial System CGFS Papers No 41 'Long-term issues in international banking' (July 2010) available at <http://www.bis.org/publ/cgfs41.pdf> accessed 12 October 2017

2.3 Systemic Importance of International Banking

The importance of international banking lies just as much in its role as a corollary to international trade and financial development or redevelopment, as in the risks its failure poses.[168]

Banks, whether national, regional, or international, have the unique quality of being intertwined in their dealings; banks routinely lend to and borrow from one another, maintain deposit balances with one another, and rely on a common payment clearing system. This creates an intricate and somewhat delicate financial dependency in which the failure of one unit may likely and quickly spill over to the next or others and threaten the system.[169] This makes the banking system more susceptible to systemic risk and more so is the case of international banks or banking and by, extension, the case of the global financial system. Systemic risk is not the only risk inherent in international banking; others are 'safety and solvency risks, through imprudent lending or trading activity, and … risks to depositors, through the lack of adequate bank insurance.'[170] However, in considering the systemic importance of international banking and its role in financial crisis, crucial consideration should be had to the unique position international banks occupy in relation to the financial health of the world and no

[168] See Thomas F. III McInerney, 'Towards the Next Phase in International Banking Regulation' (1994) 7 DBLJ 143
[169] See George G Kaufman, 'Bank Failures, Systemic Risk, and Bank Regulation' (1996) 16 CJ 17
[170] Thomas F McInerney III, 'Towards the Next Phase in International Banking Regulation' (1994), 7 DBLJ 143

factor exemplifies this importance as much as the systemic risk inherent in its activities.

Systemic risk, simply put, is the likelihood that a defect in a component will negatively affect the whole as a result of the interdependence of the components that form the whole. Put differently and in a financial context, it is 'the probability that cumulative losses will occur from an event that ignites a series of successive losses along a chain of institutions or markets comprising a system.'[171] In the financial sphere, Kupiec and Nickerson have defined it as 'the potential for a modest economic shock to induce substantial volatility in asset prices, significant reductions in corporate liquidity, potential bankruptcies and efficiency losses.'[172] This 'possibility of a series of correlated defaults among financial institutions … that occurs over a short period of time, often caused by a single major event'[173] typically affects banks. The usual mode of transmission is the default by bank in the discharge of its obligation to another bank and this negatively affects the ability of the second bank to meet its own obligations and the default creates a chain reaction which may eventually veer out of the banking sector.

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[171] Kaufman, G. "Comment on Systemic Risk." In G.G. Kaufman (ed.) *Research in Financial Services* (Greenwich: JAI Press 1995) 47-52

[172] Paul Kupiec and David Nickerson, 'Assessing Systemic Risk Exposure from Banks and GSEs Under Alternative Approaches to Capital Regulation' (2004) 48 JREFEC 123

[173] Nicholas Chan, Mila Getmansky, Shane M. Haas, Andrew W. Lo, 'Systemic Risk and Hedge Funds' (NBER Working Paper No. 11200, March 2005)

There is slight disagreement as to the exact meaning of systemic risk. This disagreement stems from the focus of individual writers in defining the term. The disagreement concerning what exactly systemic risk is, evolves around the regulation of banks and their fragility.[174] Alan Greenspan sums up the confusion by observing that even though it is not in contention that systemic risk portends some sort of disruption in a financial system, different observers may come to completely different interpretations of the exact cause and effect loop of the concept. Hence, the same outcome that may be described as market failure may as well be viewed as a natural, wholesome, *albeit* harsh market outcome.[175]

To appreciate the connection between systemic risk and the internationalisation of banking services, one must understand the nuances of international expansion of banking services. International expansion of the banking services of a particular bank will affect its risk profile and stability as a result of risk diversification and efficiency gains.[176] As a bank's operations and services transcend its geographical limitations, the specific institution often engages in diversification of the riskiness of its overall portfolio and enjoys a reduction of riskiness in the process. Research exists that suggests that this benefit tends to cause the bank to engage in more risky practices as it enjoys the possibility of

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[174] See George G. Kaufman, 'Bank Failures, Systemic Risk, and Bank Regulation' (1996) 16 CJ 17

[175] George G. Kaufman, 'Bank Failures, Systemic Risk, and Bank Regulation' (1996) 16 CJ 17 (quoting Alan Greenspan's conference remarks on 'Risk Measurement and Systemic Risk' (Board of Governors of the Federal Reserve System, 1995)

[176] See Berger, A, R Demsetz, P Strahan 'The consolidation of the financial services industry: causes, consequences, and implications for the future' (1999) 23 JBF 135

reaping higher returns as compared to its exposure.[177] Thus, the diversification advantage of international expansion also comes with risk of recklessness in banking practices. This does not necessarily mean internationalisation of banking is a bad idea as the enhanced risk sharing therefrom may ensure that the global financial system enjoys financial stability. Claessens has demonstrated that this enhanced risk sharing reduces the likelihood of 'a financial crisis and lead[s] to less procyclical lending behaviour.'[178] De Nicoló *et al* argue that the risks involved in internationalization of banking services may not be significant so far as risks are properly accessed by the parent institution.[179]

An important operations positive from the cross-border nature of international banking is the advantage branches of international banks tend to enjoy by way of credit supply support from the parent foreign bank in a financial crisis. The same channel serves the double-edged function of also being the conduit for contagion into the host economy in times of crisis.[180] To better understand the exact contribution to the worsening or alleviation of financial crisis in a financial system depends largely on the ability of foreign banks to assess and manage

[177] Demsetz, R., P. Strahan, 'Diversification, size and risk at bank holding companies, (1997) 29(3) JMCB 300; Girardone, C., E. Gardener, P. Molyneux (2004) 'Analysing the determinants of bank efficiency: the case of Italian banks' 36(3) AE 215; Hughes, J., L. Mester 'A quality and risk-adjusted cost function for banks: evidence on the 'too-big-to-fail' doctrine'(1993) 4 JPA 293

[178] Claessens, S., 'Competitive implications of cross-border banking' (World Bank Policy Research Papers no 3854, 2006)

[179] De Nicoló, G., P. Bartholomew, J. Zaman, M. Zephirin 'Bank consolidation, internationalization, and conglomeration: trends and implications for systemic risk' (IMF Working Papers, no WP 03/158, 2003)

[180] See De Haas, R., I van Lelyveld, 'Internal capital markets and lending by multinational bank subsidiaries' (2010) 19(1) J FI 1

cross-border risks. As the efficiency of cross-border risks management is such an important factor in the exposure of any economy that hosts an internationally active banking organisation, any failure in the banking in the sector's role as a source of capital to such an economy would deprive the economy of capital and cause its cost to increase and thus a classical demonstration of an instance of systemic failure. The scarcity and increase in cost of capital 'the most serious direct consequences of a systemic failure.'[181]

The primary task of protecting any economy from the consequences of mismanaged systemic risk lies in local or domestic regulators. The primary objective of regulators in host countries of international banks is the safety of their own economy. However, factors such as the level of technological advancement, rate of innovation in financial services, and the imprudence of an inordinately restrictive economy, tend to create a situation where regulation of international banking activities seem beyond the reach of country level regulation. Even though domestic regulators in economies beset by the inadequacies listed above (or any restrictive regulatory system) will focus primarily on measures that ensure insulation from the effects of systemic risk, their best efforts will hardly confer immunity from systemic risk as all it takes for systemic risk to become real is for a single institution to fail – in this instance,

[181] Steven L. Schwarcz, 'Systemic Risk' (2008) 97 GLJ 193

a single bank.[182] This creates need for some level of international cooperation and coordination of international banking activities.

2.4 Regulation of International Banking

The importance of banking in any economy accounts for it being the subject of greater and more restrictive control than any other sector of the economy.[183] The failure of a bank is often believed to be more important than the failure of any other kind of financial business because it is thought to cause more drastic adverse disruptions in the economy.[184] According to Jaarsveld, the failure of a bank may 'seriously disrupt the monetary system of a country. Not only does the financial loss of depositors negatively affect domestic capital availability, but questions are raised internationally about the effectiveness and soundness of such a country's fiscal controls.'[185] According to Rodriguez, a bank is such a financial institution whose soundness and survival is the backbone of the soundness of an economy and as such regulatory efforts must cover economic soundness, safety, and regard for the protection of consumers.[186]

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[182] See Hal S Scott, 'Supervision of International Banking Post-BCCI' (1992) 8 GSULR 487
[183] See I L Van Jaarsveld, 'Domestic and International Banking Regulation and Supervision - Defying the Challenges' (2002) 119 SALJ 71
[184] George G. Kaufman, 'Bank Failures, Systemic Risk, and Bank Regulation' (1996) 16 CJ 17
[185] I L Van Jaarsveld, 'Domestic and International Banking Regulation and Supervision - Defying the Challenges' (2002) 119 SALJ 71
[186] See L Jacobo Rodriguez, 'Banking stability and the Basel capital standards' (2003-2004) 23 CJ 115

Banks are strategically important also because of the functions they perform in any economy. For instance, it is banks that carry out the function of financial intermediation *i.e.* the acceptance of deposits which is then given out as loans. However, since a bank's liability to depositors is payable on demand while the loans which it gives are not, failure or mismatch in the volume of repayment of loans and request for deposit may easily trigger a liquidity crisis in the economy. Hence banks provide the further service of liquidity insurance and since this intermediation service puts them in a position to gather important information on the health of an economy (by gauging the rates of saving and borrowing), banks are in prime position to conduct ongoing monitoring and production of this information.[187] International banks are essentially banks and the importance of the national bank is multiplied in an international bank. Hence, if the role and importance of domestic banking to an economy are projected to international banking and the global economy, it becomes apparent that the state of health of the global financial system may easily be gauged from the analytics of international banking.

Earlier in this chapter, it was demonstrated how international banking emerged and developed alongside international trade and development. Interestingly however, and in spite of the important role international banks came to play in

[187] L. Jacobo Rodriguez, 'Banking stability and the Basel capital standards' (2003-2004) 23 CJ 115; João A C Santos, 'Bank capital regulation in contemporary banking theory: A review of the literature' (2001) 10(2) FMII 41

the global financial system, attempts at regulation and harmonisation of their operations only left the sphere of domestic law late in the twentieth century.[188]

An implication of the internationalisation of banking, and indeed any other industry, is that the elements that affect (and should affect) its regulation are difficult to adequately enumerate. This is because there is an almost endless and complicated comparison, contradistinction, and juxtaposition of the will and policies at the domestic and international levels.[189] The reconciliation of the consideration at these levels involves harmonizing the likelihood of divergent objectives and amount of importance attached to specific aspects of each objective.[190] In spite of this tense and difficult balance, the need for this reconciliation is ever present as globalisation continues and mutual accommodation is necessary. This difficult balance somewhat explains the delay in the initiation of international attempts to regulate internationally active banks.

Banking regulation, for what it is today (both domestic and international), was the exclusive preserve of domestic law until well into the mid-80s. The task of balancing regulatory objectives, priorities, and interests among international banks, the local economy and regulators, and the international community lay in laps of central banks.[191] It took the collapse of West Germany's *Bankhaus*

[188] See Rolf H. Weber & Douglas W. Arner, 'Toward a new design for International Financial Regulation' (2007) 29(2) UPJIL 391
[189] See Brian P Volkman, The Global Convergence of Bank Regulation and Standards for Compliance, (1998)115 BLJ 550
[190] See Taeho Kim, *International Money and Banking* (Routledge 1993)
[191] Andreas Busch, *Banking Regulation and Globalization* (OUP 2008)

Herstatt in 1974 for efforts to harmonise international banking to kick off.[192] Prior to the *Herstatt* collapse, central banks held sway.

In the absence of formal arrangements for international banking institutions, their regulation was subject to the usual prudential regulation and banking supervision of central banks. According to Polizatto, 'prudential regulation is the codification of public policy toward banks, banking supervision is the government's means of ensuring compliance.'[193] The specific tasks that central banks fulfil for this functions may be grouped into three; investor protection, micro-prudential supervision, and macro-prudential scrutiny. Under the investment protection head, central banks focus on the formulation and introduction of rules regarding the conduct of banking business and the management and disclosure of information. Individual banks are subjected to on and off-site surveillance and control to ensure the protection of depositors' funds under the micro-prudential head. And finally, macro-prudential scrutiny involves ongoing monitoring of banks' exposure to systemic risk as well as the vigilance for threats arising from market developments and infrastructures.[194] These are basic central bank functions alongside those of lender-of-last-resort and reserve holding which justify its existence.[195] Most of the roles central banks played prior to the

[192] See Patricia A. McCoy, 'Musings on the seeming inevitability of global convergence in banking law' (2000-2001) 7 CILJ 433
[193] Vincent Polizatto, 'Prudential Regulation and Banking Supervision' in Dimitri Vittas (eds), *Financial Regulation Changing the Rules of the Game* (The World Bank 1992)
[194] See Europe Central Bank ' The Role of Central Banks in Prudential Supervision' < https://www.ecb.europa.eu/pub/pdf/other/prudentialsupcbrole_en.pdf > accessed 23 May 2017
[195] See Goodhart, C., *The evolution of central banks* (MIT University Press 1988)

introduction of international standards are still intact and are still played by them till this day.

The earliest attempt to coordinate international banking regulation was made by the BIS and was in response to the *Herstatt* calamity of 1974. The BIS, composing central banks of G-10 countries and central banks of about 28 other countries and the central banks of Australia, Canada, Japan, South Africa and 22 other countries created the BCBS.[196] The activities of the BIS and its agencies are not binding under international but command persuasive authority for the patronage they enjoy.[197] In 1974 the BCBS was formed and given a mandate to supervise international banking and in 1975 the committee issued the Basel Concordat.[198] The concordat first recommendation was to subject all foreign banks to supervision and encouraged said supervision to be the joint responsibility of authorities both in the host and home countries.**[199]** Other rules made thereunder applied to issues of solvency, foreign exchange exposures, and liquidity levels. They were to apply to activities of banks operating in a country

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[196] See Charles J. Siegman, ‘The Bank for International Settlements and the Federal Reserve’ (1994) 80 FRB 900; James V. Hackney, Kim L. Shafer, ‘The Regulation of International Banking: An Assessment of International Institutions’ (1986) 11 NCJILCR 474 (Curiously no developing country is a member)

[197] Basle Committee on Banking Regulations and Supervisory Practices, Revised Basle Concordat on Principles for the Supervision of Banks' Foreign Establishments, 22 I.L.M. 900 (1983) (stating "The revised Concordat... emphasizes that it is concerned only with supervisory responsibilities and not with those of lenders of last resort.")

[198] *ibid*

[199] See Basel Committee on Banking Supervision, ‘Principles for the supervision of banks' foreign establishments (Concordat)’ (May 1983)<https://www.bis.org/publ/bcbsc312.htm> accessed 10 December 2017; Daniel M. Laifer, ‘Putting the Super Bank in the Supervision of International' Banking-Post CCI’ (1992) 60 FLR 467

other than the mother company whether these activities are channelled through branches, joint companies, or subsidiaries. The supervision envisaged still allowed central banks sway over the activities of international banks but allowed for some supplementary international coordination with regulators (Central banks) in the home country.[200]

In 1983, the 1975 concordat was replaced. The new concordat set out guidelines to improve the efficacy of the supervisory relationship between parent and host authorities. This concordat did not address lender of last resort roles of central banks but instead sought to establish responsibilities central banks in monitoring prudential conduct and soundness aspects of foreign based or owned banks.

> *The principles set out in the report are not necessarily embodied in the laws of the countries represented on the Committee. Rather they are recommended guidelines of best practices in this area, which all members have undertaken to work towards implementing, according to the means available to them.*[201]

Interestingly, what may be termed formal coordination is also traceable to the collapse collapse of *Bankhaus Herstatt* in 1974. Even though the collapse of

[200] See Klaus Peter Follak, 'International Harmonisation of Banking Supervision and Regulation' (1997)3 ITBLA 205

[201] Basel Committee on Banking Supervision, 'Principles for the supervision of banks' foreign establishments (Concordat)' (May 1983)<https://www.bis.org/publ/bcbsc312.htm> accessed 10 December 2017

Bankhaus Herstatt is the best known and probably most frequently mentioned[202] catalyst for regulatory efforts in that period, steam had already picked up from a number of prior and contemporary bank failures in that decade including those of Franklin National Bank and the Israeli British Bank (IBB). The *Herstatt* failure evolved around questionable foreign exchange dealings by the bank and poor regulatory supervision by the West German authorities. This resulted in huge losses on the part of counterpart banks in other countries, hiccups on the international payment system, and even the unintended consequence of causing the collapse of the Israeli British Bank (IBB) and brought into focus the risks of unregulated cross-border banking. [203] These consequences raised serious questions, as Mourlon-Druol put it, 'as to who would regulate and supervise what and where'. [204]

The answer proffered by bank governors of G10 countries - under the auspices of the BIS – was to create the body that later became known as the Basel Committee on Banking Supervision. The committee's primary objective was to promote information exchange and ultimate harmonisation of regulations through 'model standards'.[205] And thus the BCBS became the standard bearer as far as standards for international banks are concerned. However, a variety of

[202] Even the Basel Committee on Banking Supervision mentions it as the primary catalyst See <http://www.bis.org/bcbs/history.htm> accessed 23rd September 2017
[203] Margaret Reid, *The Secondary Banking Crisis, 1973–75: Its Causes and Course* (Hindsight Books 2003)
[204] Mourlon-Druol, Emmanuel, 'Trust is good, control is better: The 1974 Herstatt Bank Crisis and its Implications for International Regulatory Reform' (2015) 57(2) BH 311
[205] See Patricia A. McCoy, 'Musings on the seeming inevitability of global convergence in banking law' (2000-2001) 7 CILJ 433

other (mostly financial) intuitions, either directly or indirectly, influences the direction of international banking functions and practices. These include the International Monetary Fund (IMF), the Institute for International Finance, the BIS, and the World Bank.[206]

The succeeding chapter focuses on the BCBS and the accords it has released.

2.5 Challenges of International Banking Regulation

International banking, amongst other things, facilitates the movement of vast amounts of a variety of currencies at breath-taking speed across borders with remarkable ease. Rather unfortunately, the regulatory framework in place (principally the accords of the BCBS) is believed to lag while dealing with the challenges the ease and volume of these transactions have brought about as well as bring uniformity in the regulation of the sector.[207] The feats of ease and efficiency international banking enables are not unconnected with the developments in the sector over the last few years. The growth of international banking, in light of technological strides and advancements in information and communication technology, has thrown up new and heretofore unknown challenges for regulators. The best exemplification is the rate at which

[206] See James V Hackney, Kim Leslie Shafer, 'The Regulation of International Banking: An Assessment of International Institutions' (1986) 11 NCJILCR 475

[207] Thomas F McInerney III 'Towards the Next Phase in International Banking Regulation'(1994) 7 DBLJ 143

technology driven financial innovation outpaces regulation to curb the excesses therefrom. As challenges of are tackled (whenever the opportunity arises) by regulators, the further challenge of harmonising regulatory efforts between the more industrialised nations of the west with those of the less developed world festers.[208]

Perhaps the most prominent of the host of challenges not connected with technological advancement is that international banking 'is particularly burdened with issues related to the flow of information between financial institutions and prudential authorities, as well as among financial institutions themselves.' These issues tend to increase vulnerability of the global financial system. According to Turner, an example is of 'supervisors in central and Eastern Europe [complaining] that foreign banks, which are of systemic importance to the region, often release insufficient information about their operations.'[209] This secretiveness, whether to bolster their positions or to gain an advantage over competitors or regulators, makes for poor data collection on the state of the sector and in consequence, inadequate regulation.[210]

Another challenge is the seeming, *albeit* informal, protectionism practiced by host countries of international banks. Host countries, rather selfishly but not imprudently, attempt to enjoy the advantages of international banking while

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[208] *ibid*
[209] Turner, P, 'The banking system in emerging economies: how much progress has been made?' (BIS Papers no 28 1, August 2006)
[210] *ibid*

seeking to avoid contagion. The result is that there is constant selective implementation of standards which leads to a lack of harmony in international efforts. This sole parasitic goal of indulgent self-preservation, informed by the need to maintain soundness and safety of the local economy, determines the basis of domestic regulatory policy and efforts.[211] Furthermore, there is a notable reluctance of the banks and bankers to embrace attempts at international regulation.[212] Upon the release of Basel III, its biggest antagonists, the banks it seeks to regulate, through the Institute of International Finance (IIF) painted fearful pictures of doom and gloom concerning the economic cost of the accord.[213] Credit Suisse, fighting against Basel III complained that the proposed Net Stable Funding Ratio alone would require European banks to raise over a trillion euros in the long term as would naturally be pressured to curtail reliance on short-term funding.[214] This argument exemplifies the reluctance of banks to accede to regulatory efforts especially as while the argument that additional capital would have to be raised held true for a few banks, most others were awash with capital and could easily meet said requirements.[215]

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[211] See Hal S Scott, 'Supervision of International Banking Post-BCCI' (1992) 8 GSULR 487
[212] See Thomas F. III McInerney, 'Towards the Next Phase in International Banking Regulation' (1994) 7 DBLJ 143
[213] 'The banks battle back. A behind-the-scenes brawl over new capital and liquidity rules' (May 27 2010) *The Economist* < http://www.webcitation.org/5q2g8umPx> Accessed 26 December 2017
[214] *ibid*
[215] Paul J Davies, 'Basel III compliant bonds face tough sell' (August 12, 2013 9:35 am) *Financial Times* < http://www.ft.com/cms/s/0/052070d4-f4e9-11e2-b4f8-00144feabdc0.html#axzz2bwki4yZX> accessed 10 December 2017

2.6 Conclusion

As deregulation, advances in information technology, and globalisation of financial services reduce the world into an ever smaller financial space, international banking, which is at the forefront in global finance, is in an ever increasing position to have considerable impact.[216] The impact includes cross - border contagion origination and transmission by banks, scandals in the sector involving mismanagement, shocks from macroeconomic policies, a growing and fierce competition among international banks *etc*. These have created a gentle but nagging need for the sector to be protected. [217] Gentle because most domestic regulators are focused on their local economies, and nagging because the realities point to a system of that is so interdependent that contagion is easily transferred. Also, additional risks are now easily created in both the international banking sector and indeed the international financial system even though they emanated from a local bank.[218]

Previously, the regulation of international banking did not have a readily identifiable, all-encompassing objective and so the earliest efforts of the BCBS depended heavily on the prevailing economic circumstances and were geared towards promotion of safer practices, aiding regulators to advance healthy

[216] See Mathias Dewatripont, Jean Tirole, The Prudential Regulation of Banks (first published 1993, MIT Press 1994)
[217] I. L. Van Jaarsveld, 'Domestic and International Banking Regulation and Supervision - Defying the Challenges' (2002)119 SALJ 71
[218] See South African Reserve Bank Banking Supervision Department Annual Report (1998)

investments in the sector, or regaining public confidence in the sector.[219] Presently however, growth in the intellectual sphere of banking regulator has evolved enough to highlight such essential factors of banking regulation as investor and stakeholder protection, structural and prudential regulation.[220]

It is against this backdrop of the systemic importance of international banking and the challenges of international banking regulation that the BCBS's founding, remit, and accords (collectively 'the Basel Regime') ought to be measured.

[219] See Helen A Garten, *Why Bank Regulation Failed - Designing a Bank Regulatory Strategy for the 1990s* (Praeger 1991)
[220] See Brian Anderton (ed), *Current Issues in Financial Services* (Macmillan Business 1995)

CHAPTER 3: THE BCBS REGIME AS REGULATORY RESPONSE

3.1 Introduction

The previous chapter traces the path international banking has taken from its earliest form all the way to the systematically important phenomenon that has garnered enough attention to warrant the setting up of a specific agency for its regulation. Just as import as tracing the developments and efforts concerning regulating international banking, is the need to analyse the history of the BCBS and the accords it has released thus far.

This chapter builds on the discussions in the preceding chapter to chronicle the history and notable aspects of the BCBS's regime of international banking standard-setting. In this chapter, the origins of the committee, as well as, the basis of each of the accords it has released is discussed. Also, the build up to the introduction of Basel III is developed and the reforms therein are introduced.

3.2 The Basel Committee on Banking Supervision: International Banking Watchdog

The Basel regime of international banking standards came into existence as a result of the establishment of the BIS. The BIS, which is the parent organisation of the BCBS, traces its establishment to the Young Plan of 1930.[221] The bank's principal remit was to foster closer ties and co-operation amongst central banks of member countries, facilitation of loans to member states, and to act as manager and trustee with regard to international transactions connected with the reparations ordered against the German government in respect of the First World War. While the BIS is a company limited by shares duly incorporated under Swiss Law with its member states as shareholders, it is also an international organisation whose activities are beyond Swiss law. In time however, the reparation mandate of the BIS ended and the focus of the bank shifted to co-operation among central banks. In 1974, the Governors of the Central banks of the G10 (and Switzerland) established the body now known as the Basel Committee on Banking Supervision.[222]

As noted elsewhere in this work, the BCBS arose out of the collapse of internationally significant banks. 2 of these are *Bankhaus Herstatt* and Franklin National Bank.[223] *Bankhaus Herstatt* was forced to liquidate by German regulators when attempts to rescue the bank failed. The bank, partly due to fraud in its bookkeeping practices, had been due (but failed) to settle foreign interbank

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[221] Bank for International Settlements, 'The establishment of the BIS' <http://www.bis.org/about/history.htm> accessed 10 October 2017

[222] See Peihani, Maziar, 'The Basel Committee on Banking Supervision: a post-crisis assessment of governance and accountability' (2014) CFPJ 1; Matthias Herdegen, *Principles of international economic law* (Oxford University Press 2013)

[223] See Duncan E Alford, 'Core Principles for Effective Banking Supervision: An Enforceable International Financial Standard?' (2005) 28 BCICLR 237

exchange responsibilities to U. S. banks.[224] This caused a strain in U.S. payment systems and even led to the coinage of the so-called ‘Herstatt risk’ which describes the risk of failure to meet interbank payment obligations.[225] On the other hand, Franklin National Bank had gotten into excessive risky positions on currency and in so doing exposed itself to untenable currency rate risks and in spite of hefty deposits, found itself unable to meet dividend payments. Institutional depositors rushed to recover funds upon finding out of the liquidity problems as a result of the huge trading losses sustained. [226]

The fallout was the formation and adoption of the Basel concordat in 1975 with the implicit aim of imposing a measure of effectiveness in the supervision of the activities of international banks. To this end, the activities and roles of both the home regulators of international active banks and those of the host countries of branches or subsidiaries were delineated and clarification of information sharing on issues such as foreign exchange operations, liquidity, and solvency was demanded. In spite of these developments, within the members of G10, the need for uniformity in capital standards only became obvious after the occurrence of the sovereign debt crisis of 1982.[227]

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[224] W. Ronald Gard, ‘George Bailey in the Twenty-First Century: Are We Moving to the Postmodern Era in International Financial Regulation with Basel II?’ (2006) 8 TJBL 161

[225] *ibid*

[226] Duncan E. Alford, ‘Core Principles for Effective Banking Supervision: An Enforceable International Financial Standard?’ (2005) 28 BCICLR 237

[227] See Pierre-Hugues Verdier, ‘Transnational Regulatory Networks and Their Limits’ (2009) 34 YJI 113

By 1982 (beginning from 1975), Mexico, Brazil, and Argentina were in default of vast development loans obtained in the 1960s and 1970s from international debtors including commercial banks. Amongst the international creditor banks were a number of major U.S. banks. The U.S.A. fearing ‘an era of severe financial difficulties’ for both the U.S. banking sector and the economy in the event of forfeiture, began clamouring for stricter regulatory capital standards.[228] The only snag in the U.S. agitation was the imprudence of imposing unilateral standards as this would ‘jeopardize the competitiveness of U.S. banks in international markets’. The solution became to co-opt the British authorities (British banks had taken big hits as they were heavily invested in the sovereign debts of the aforementioned Latin American countries) into this plan in the hope of cajoling other countries such as Germany and Japan, which had considerably less exposure to the risks in the event of forfeiture as their banks were not as heavily invested and whose banks were also enjoying the competitive advantages of having lower capital standard.[229] The U.S.A. and the U.K. entered into a bilateral agreement to fix minimum capital standards and pushed for further negotiations with other countries like Germany and Japan. These so called negotiations were backed by not too subtle threats ‘threat that they would restrict access to their markets . . . from countries that did not implement the new capital adequacy standards’ and that new minimum standards would be applied to any

[228] *ibid*
[229] *ibid*

bank which intended to operate in the U.S. market. These negotiations led to the formulation and adoption of the first Basel Accord.[230]

3.2.1 Basel I

Formally the International Convergence of Capital Measurement and Capital Standards (simply referred to as Basel I), this document was released in 1988. According to Goodhart, the exact provisions of this accord tended to cater mostly to capital standards as it was released in response to issues of capital flows resulting from the Arab oil crisis and the international debt crisis arising out of the collapse of *Bankhaus Herstat*.[231] The Accord provided for minimum capital standards for internationally active banks and focused almost entirely on credit risk, which was perceived to be the main risk borne by banks. The four- part framework included various sections and covered the definition of capital, the structure of risk weights, definition of the target standard ratio, and transitional implementation arrangements.[232] A bank's capital, according to that accord, was divided into two tiers; the much safer tier 1 also known as 'core capital' and the significantly more inferior tier 2 capital also known as 'supplementary

[230] *ibid*
[231] Charles Goodhart, *The Basel Committee on Banking Supervision A History of the Early Years, 1974–1997* (CUP 2011)
[232] See generally Bank for International Settlements, Basel Committee on Banking Supervision 'International convergence of capital measurement and capital standards' <http://www.bis.org/publ/bcbs04a.htm> Accessed 4 June 2017

capital'.[233] The accord created risk rates (0%, 10%, 20%, 50%, and 100%) and assigned these to assets of a bank with the understanding that the lower the risk rating attained, the more creditworthy the underlying asset was.[234] After being risk-weighted, these assets determined the amount of capital the bank was required to hold. Basel I recommended that the total amount of the capital held by a bank, when divide by the total credit risk, must be equal to or greater than 8% and of this figure, 4% would have to be tier 1 capital.[235]

Although the Accord may have been designed and directly aimed at only internationally active banks in G-10 nations, it was soon adopted by a 'much wider range of banks, regional as well as international, and in non G1O as well as G1O countries, though the BCBS put no pressure on non G1O countries to do so.'[236] Goodhart describes several reasons that might have been the cause for this: that Basel addressed an obvious problem, it provided a "short, simple, and straightforward" solution to the problem, and peer pressure (among regulators, credit ratings agencies, and banks themselves) wound up being stronger than originally anticipated. [237]

From the start, critics lampooned this accord. First, and perhaps the most important criticism of the BCBS and the accord, were the issues of 'little or no

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233 *ibid*
234 *ibid*
235 *ibid*
236 Charles Goodhart, *The Basel Committee on Banking Supervision A History of the Early Years, 1974–1997* (CUP 2011)
237 *ibid*

transparency' in its creation and lack of external input in the creation process as well as the seeming draconian bindingness of the resultant accord.[238] Another perception was that the accord was simply a reaction to a string of sovereign debt defaults and in this regard was an attempt at harmonizing prices across internationally competitive banks in a bid to create a level playing field. Ahmed and Khalidi while acknowledging the apparent discriminatory assignment of a higher risk weight on non-OECD banks than their OECD counterparts[239] and the adverse impact said measure would have on developing countries, point out that the accord was meant to be dynamic.[240] Van Roy, relying on data from 6 G-10 countries, concludes that Basel I was of limited effect in effecting increase in bank capital and reducing credit risk outside of the United States of America. Furthermore, he attributed the comparative success in the United States to market discipline.[241]

3.2.2 Basel II

In 2004, the BCBS released the International Convergence of Capital Measurement and Capital Standards: a Revised Framework, (also known as

[238] See Michael S. Barr & Geoffrey P. Miller, 'Global Administrative Law: The View From Basel' (2006) 17(1) EJIL 15
[239] See generally Bank for International Settlements, Base Committee on Banking Supervision 'International convergence of capital measurement and capital standards' <http://www.bis.org/publ/bcbs04a.htm> Accessed 4 June 2017 paras 35, 36, and 37
[240] Riaz Ahmed and Dr. Manzoor A. Khalidi, 'From Basel I to Basel II' (2007) 3(3) MF 199
[241] Patrick Van Roy, 'Capital Requirements and Bank Behavior in the Early 1990s: Cross-Country Evidence' (2008) IJCB 29

Basel II). The BCBS, had prior to this, released 3 consultative papers in 1999, 2001, and 2003 setting out a proposed 3 pillar structure; the determination and maintenance of minimum capital requirements; an enhanced supervisory review process; and the maintenance and enforcement of higher market discipline.[242] The release of the accord was preceded by several necessitating factors. These include the Asian financial crisis of 1998, the regulatory arbitrage and general inefficiencies of the earlier accord, and the development of innovative risk management systems in international banks.[243] The consensus was that Basel I had missed the mark in terms of creating a level playing field and this failure was partly as a result of the differences in the country conditions and applicable accounting standards.[244] It was generally agreed that Basel I had become outdated and that in order for the accords to meet their aim of being effective risk-management measures, they must evolve with the times.[245]

The basis for the introduction of Basel II was the need to improve capital adequacy requirements as well as introduce a more holistic approach to prudential supervision of international banking. And to do this, the accord

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[242]See Bank for international Settlements, 'BIS chronology' <http://www.bis.org/about/chronology/1980-1989.htm> accessed 4 June 2016

[243] See W. Ronald Gard, 'George Bailey in the Twenty-First Century: Are We Moving to the Postmodern Era in International Financial Regulation with Basel II?' (2006) 8 TJBL 161; Pierre-Hugues Verdier, (2009) 'Transnational Regulatory Networks and Their Limits' 34 YJI 113

[244] See Pierre-Hugues Verdier, 'Transnational Regulatory Networks and Their Limits' (2009) 34 YJIL 113

[245] See W. Ronald Gard, 'George Bailey in the Twenty-First Century: Are We Moving to the Postmodern Era in International Financial Regulation with Basel II?' (2006) 8 TTJBL 161

introduced a three pillar system.[246] The first pillar covered minimum capital requirements; while the second outlines the principles upon which regulator supervise international banks; and the third pillar focuses on market discipline by stricter disclosures and internal control mechanisms.[247]

The most notable reforms include provision for a unitary capital requirement for each asset class, generation of a range of values for regulatory capital depending on the credit worthiness of the borrower, the ability of a bank to self-access the riskiness of assets it holds, and he introduction of new operational and transparency requirements on banks.[248]

Basel II had a delayed implementation but managed to attain adoption by virtually 'every country with an internationally active bank'[249] with the official figures as high as 100 internationally active banks.[250] The implementation being so tardy created a few talking points for critics. The perception was that the largest international banks stood to gain an undue advantage over smaller international banks, especially those based in developing nations since the latter may not possess the infrastructure to implement the risk assessment the accord

[246] *ibid*
[247] See Basel Committee on Banking Supervision, 'International Convergence of Capital Measurement and Capital Standards' (June 2006)<http://www.bis.org/publ/bcbsl28.pdf> accessed 12 March 2017
[248] *ibid*
[249] Blair Keefe and Andrew Pfleiderer, 'Basel III: What It Means for the Global Banking System' (2012) 27 BFLR 407
[250] See Howard Davies, *Global Financial Regulation: The Essential Guide* (Polity 2008)

demanded and the ability to bear the cost of the compliance.[251] Another concern with the tardy adoption of the reforms of the accord was that countries were intentionally holding back implementation because of a fear that premature implementation in countries with limited ability might lead to diversion of resources rom more pressing priorities and this would tend to weaken rather than strengthen the banking system.[252]

Slow implementation saw several countries still implementing aspects of Basel II into their domestic regulatory framework as late as 2008.[253] This patchy and lengthy implementation, which ran well into the onset of the global financial crisis, leaves holes in the debate of whether the accord helped to ameliorate the crisis[254] or indeed worsened it.[255]

3.3 Build up to Basel III: A New Crisis

The undisputed reason for Basel III is the global financial crisis that broke out in the summer of 2007. The catalyst of the crisis was mortgage practices in the real

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[251] See Eric Y. Wu, Basel H: A Revised Framework, (2005) 24 ARBFL 150
[252] See Trustees of Boston University, 'Developments in Banking and Financial Law: Basel II' (2006) 25 ARBFL 50
[253] See Centre for European Policy Studies, 'Basel II Implementation in the midst of Turbulence'
(23 June 2008) < https://www.ceps.eu/publications/basel-ii-implementation-midst-turbulence> accessed 4 September 2017
[254] See Sandra Rutova, Tim Volkheimer, 'Revisiting the Basel Accords: Lessons Learned from the Credit Crisis' (2011) 19 UMBLR 83
[255] See John F. Rosato, 'Down the Road to Perdition: How the Flaws of Basel II Led to the Collapse of Bear Stearns and Lehman Brothers' (2011) 17(2) CILJ 475

estate sector in the United States. For a number of years prior to the crisis, a housing bubble had developed as a result of the lure to grant mortgages to high risk home buyers because of the higher interest this practice attracted. Unsurprisingly, these borrowers defaulted on their loans and as the number of defaulters grew, Mortgage Backed Securities (MBSs) and Credit Default Obligations (CDOs) tied to these so called sub-prime mortgages began to fall into default. In a domino-effect style progression, hedge funds, and other investors (both national and foreign) with interests in investments in these mortgage-tied products followed. Soon thereafter, the liquidity squeeze and panic hit the retail space resulting in bank runs. The defining moment and the true onset of crisis was the collapse or near collapse (only because the Government stepped in) of such financial giants as Northern Rock, Bear Sterns, Fannie Mae and Freddie Mac (Fannie and Freddie), Lehman brothers, and American International Group (AIG).[256]

There is a litany of causes or at least contributing factors to this crisis and these fall under a few themes such as human frailty *i.e.* natural predatory instincts of humans, the instincts for mastery, delusions of investors, greed, herd behaviour,

[256] See Eric Helleiner, 'Understanding the 2007–2008 Global Financial Crisis: Lessons for Scholars of International Political Economy' (2011) 14 ARPS 67; Adam Szyszka, 'The genesis of the 2008 global financial crisis and challenges to the neoclassical paradigm of finance' (2011) 22 GFJ 211; Wang, F. ; Zhang, Ting, 'Financial Crisis and Credit Crunch in the Housing Market'(2014) 49 (2) JREFE 256

adaptive expectations;[257] institutional failures *i.e.* failure of regulators and regulation;[258] and defective macroeconomic policies *i.e.* the crisis was an expression of the failure of unbounded capitalism.[259]

An official position, as per the permanent subcommittee on investigations of the United States Senate, in its report on the crisis, is that there are four major causative factors of the crisis. These are high risk lending, regulatory failure, inflated credit rating, and investment bank abuses.[260]Allen and Carletti attribute the outbreak of the crisis to recent history of laxity in monetary policy of the United States Federal Reserve combined with an international trade imbalance. They posit that the availability of cheap credit and the dependence on excessive leverage by banks played a significant role the in the creation of credit bubble.[261] To Shahrokhi, the intricate matrix of the market structures, institution, and regulators of the US financial system contributed immensely to the crisis. The neoliberal variation of capitalism practiced in the US and such exogenous events as the incursive wars into Afghanistan and Iraq directly precipitated failure in the

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[257] See Allan Greenspan, 'The Crisis' (Brookings Papers on Economic Activity 201, Spring 2010); Nouriel Roubini and Stephen Mihm, *Crisis Economics: A Crash Course in the Future of Finance* (Penguin Books 2010)

[258] See Ricardo Cabral, 'A perspective on the symptoms and causes of the financial crisis' (2013) 37 JBF 103

[259] See Adam Szyszka, Yochanan Shachmurove, 'The financial crisis: What is there to learn?' (2011) 22 GFJ 238

[260] United States Senate Permanent subcommittee on Investigations 'Wall Street and the Financial Crisis: Anatomy of a Financial Collapse' (April 2011) < http://www.hsgac.senate.gov//imo/media/doc/Financial_Crisis/FinancialCrisisReport.pdf?attempt=2> accessed 13 June 2017

[261] Allen, F and Carletti, E, 'An Overview of the Crisis: Causes, Consequences, and Solutions' (2010) IRF 1

markets *i.e*. Commodities, sub-prime housing, equities, and credit.[262] There is also a case for the crisis being blamed on the non-access of the shadow banking system to the liquidity of the central bank as the lender-of-last resort.[263]

Banks and their regulation also played a part. Cabral holds that banks had been posting astronomical profits in the years prior to the crisis. Profits which came about through 'balance sheet expansion and growing default, liquidity, and term risk mismatches between assets and liabilities.' These banks continued to capitalise on the soft and porous regulatory framework to increase their leverage and in the process set the stage for a systemic crisis.[264]

For Brunnermeier *et al,* crisis was a not simply as result of an insufficient reach of regulation.[265] This is because at the heart of the crisis was highly regulated institutions. The problem was in the calibre of existing regulation. Since crises associated with banking occur fairly frequently, regulatory reaction should not be overly focused on the characteristics of a particular crisis. Hence, the existing regulations at the time the crisis occurred failed because they focus more on the

[262] Manuchehr Shahrokhi, 'The Global Financial Crises of 2007–2010 and the future of capitalism' (2011) 22 GFJ193

[263] Pozsar, Z., Adrian, T., Ashcraft, A., Boesky, H., *Shadow Banking* (Federal Reserve Bank of New York Staff Reports, No. 458, 2010)

[264] Ricardo Cabral, 'A perspective on the symptoms and causes of the financial crisis' (2013) 37 JBF 103

[265] See Markus Brunnermeier, Andrew Crocket, Charles Goodhart, Avinash D. Persaud, Hyun Shin, *The Fundamental Principles of Financial Regulation* (Princeton University and CEPR Geneva Reports on the World Economy)

particular causes of past crises rather than 'fundamental market failures that have either been ignored or improperly dealt with in our regulation so far.'[266]

Another view was that the crisis se reflected macroeconomic issues and imbalances in the global economic structure and these issues and imbalances originated in the US economy. It is argued here that the influence of the high import demand of the U. S. economy on that country's trade imbalance and the fostering of this need by the Chinese Government long-term policy of maintaining the undervalued exchange rate of the RMB. The United States hunger for imports necessitated budgetary deficits, which was fed by significant sales of treasury bills. Asian investors still reeling from the lessons of the Asian crisis of 1997 eagerly purchased these rather low yielding bills on the strength of the credibility of the U.S. Treasury Department. Additionally, the American authorities maintained low interest rates as a result of the losses suffered by Americans in the wake of the busting of the dotcom bubble and also as a device to maintain confidence in the wake of the terrorist attacks on the United States on the 11th of September of 2001 (9/11). The combination of these factors saw a consumer demand boom and an inordinate expenditure on a housing boom. These resulted in an ever-deepening debt pit dug with the aid of the availability of cheap credit.[267] Roubini and Mihm subscribe to a similar, *albeit*, more caustic notion. For them, the crisis was the manifestation of a mixture of fairy tale

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[266] *ibid*

[267] See Adam Szyszka,' The genesis of the 2008 global financial crisis and challenges to the neoclassical paradigm of finance' (2011) 22 GFJ 211

academic theories (free markets); unbridled greed evidenced in warped compensation structures, reckless and endless financial innovation, as well as the acts of corrupt ratings agencies over the past half century. They conclude that the crisis was ‘less a function of sub-prime mortgages than of a sub-prime financial system.’[268]

The principal mode of transmission of the crisis was the banking system.[269] Banks were the primary conduit of the crisis as the transmission of the financial crunch to other sectors of the economy was mainly *via* the illiquidity the banks suffered in the wake of the crisis.[270] Since it was essentially a banking crisis, the BCBS stepped up to act.

The BCBS’s response was Basel III. Remarkably, before Basel III, the BCBS announced ‘a comprehensive strategy to address the lessons of the banking crisis’ at the tail end of 2008 and soon after announced the still-born ‘enhancements to the Basel II Capital framework [popularly known as Basel 2.5].’[271] However, very soon thereafter, the committee embarked on the consultations that culminated in Basel III: A global regulatory framework for more resilient banks and banking systems and Basel III: International framework for liquidity risk

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[268] Nouriel Roubini and Stephen Mihm, *Crisis Economics: A Crash Course in the Future of Finance* (Penguin Books 2010)
[269] See Eric Helleiner, ‘Understanding the 2007–2008 Global Financial Crisis: Lessons for Scholars of International Political Economy’ (2011) 14 ARPS 67
[270] Gorton, G and Metrick, A, ‘Securitized banking and the run on repo’ (2012) 104 JFE 425
[271] Bank for international Settlements, ‘BIS chronology’ <http://www.bis.org/about/chronology/1980-1989.htm> accessed 4 October 2017

measurement, standards and monitoring – and Basel 2.5 was effectively abandoned.

3.4 Basel III

At the end of 2009, the BCBS released 'Strengthening the resilience of the banking sector' which proposed 'to strengthen global capital and liquidity regulations with the goal of promoting a more resilient banking sector.'[272] This was a consultative document. Following consultations held upon the responses to this document, Basel III was released in 2010.[273] This document has been revised with both Basel III: A global regulatory framework for more resilient banks and banking systems in June 2011 to reflect the CVA (Credit Valuation Adjustment) modification and Basel III: The Liquidity Coverage Ratio and liquidity risk monitoring tools released in January of 2013 which reflects the revision of the Liquidity Coverage Ratio (LCR) respectively.[274]

Basel III builds on the three-pillar structure of Basel II. The priority, according to the BCBS, remains strengthening 'the quality, consistency, and transparency of

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[272] Bank for International Settlements Basel Committee on Banking Supervision, 'Consultative Document: Strengthening the resilience of the banking sector' < http://www.bis.org/publ/bcbs164.pdf> accessed 20 October 2017

[273] Debbie Scanlon, 'G20 Endorses Basel III Capital Standards' (16 November 2010)< http://www.financialreforminsights.com/2010/11/16/g20-endorses-basel-iii-capital-standards/> accessed 29 October 2017

[274] Bank for International Settlements Basel Committee on Banking Supervision, 'Basel III' < http://www.bis.org/publ/bcbs189.htm> accessed 28 October 2017

the regulatory capital base.'[275] The Basel III version of the three pillar structure incudes quality and quantity of capital, risk management and supervision, and market discipline. In addition, Basel III introduces global liquidity standards with their supervision and monitoring tools.[276]

Basel III restricts Instruments which qualify as Tier 1 or Tier 2 capital substantially, completely does away with the Basel II position of having a distinction between an upper and a lower band of Tier 2 capital, eliminates tier 3 capital altogether.[277] Under Basel III, a banks is mandated to hold a higher level of stable capital up to a minimum of 8.0% of RWAs at every given time.[278] Tier 1 capital which is the primary capital is considered as the going concern capital and consists of Common Equity Tier 1 (CET 1) and Additional Tier 1. CET 1 Capital is expected to account for at least 4.5% of the RWAs of a bank and additional tier 1 should account for the remaining 1.5%.[279] CET 1 capital comprises issued shares of the bank which meet specified criteria, retained earnings, share premium, an assortment of incomes and disclosed reserves, interests held by minorities in the common stock of consolidated subsidiaries,

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[275] Bank for International Settlements Basel Committee On Banking Supervision, 'Basel III: A global regulatory framework for more resilient banks and banking systems' (revised 2011) < http://www.bis.org/publ/bcbs189.pdf> accessed 1 October 2017
[276] See Peter King, Heath Tarbert, 'Basel III: An Overview' (2011) 30(5) BFSPR 1
[277] Bank for International Settlements Basel Committee On Banking Supervision, 'Basel III: A global regulatory framework for more resilient banks and banking systems' (revised 2011) < http://www.bis.org/publ/bcbs189.pdf> accessed 1 October 2017
[278] *ibid*
[279] *ibid*

and regulatory adjustments.[280] Basel III lists criteria for shares to be classified as common equity and these include that the shares shall not rank higher than any other claim in the event of the liquidation of a bank, have a perpetual principal, be irredeemable and unbound to a cancellation or buy-back, be unencumbered by any device that makes the payment of dividend discretionary, have their payment classified as equity under the relevant accounting standards etc.[281]

Additional Tier 1 capital, on the other hand, is the sum of instruments issued by a bank that meet certain criteria for inclusion in Additional Tier 1 capital, stock surplus from the issue of Additional Tier 1 instruments, 'instruments issued by consolidated subsidiaries of the bank and held by third parties that meet the criteria for inclusion in Additional Tier 1 capital', and certain regulatory adjustments. Furthermore, the first and third components must not have been included in Common Equity Tier 1.[282] There are of 14 criteria for inclusion as additional Tier 1 capital and these include the instrument not having a maturity date or an incentive to redeem, not possessing features that hinder recapitalisation, having already been issued and paid in, not been sensitive or subject to credit vagaries, not been callable by issuer before the expiration of 5

[280] Bank for International Settlements Basel Committee On Banking Supervision, 'Basel III: A global regulatory framework for more resilient banks and banking systems' (revised 2011) < http://www.bis.org/publ/bcbs189.pdf> accessed 1 October2017

[281] *ibid*

[282] *ibid*

years, must be subordinated to the usual stakeholders and debtors of the bank, attract purely discretionary dividends etc.[283]

Tier 2 capital exists primarily to absorb loss on a ‘gone-concern basis’.[284] This capital band comprises the sum of bank issued instruments not included in the definition of Tier 1 capital, stock surplus, instruments held by third parties upon issuance by consolidated subsidiaries of the bank and which do not qualify as Tier 1 capital, loan losses as specified elsewhere in the accord, and ‘regulatory adjustments applied in the calculation of Tier 2 capital’. The above mentioned instruments and considerations must meet minimum requirements to be classified for inclusion in Tier 2 capital. The criteria spelt out in the accord for inclusion as Tier 2 Capital are somewhat similar to those for inclusion as Additional Tier 1 Capital.[285]

The reforms in Basel III include provision for adjustments to be made in the calculation of regulatory capital.[286] For instance, intangibles (such as goodwill), deferred tax assets, cumulative gains and losses attributable to unforeseeable changes in own credit risk, investments in own shares, and profit from transactions related to securitisation are all excluded from the calculation.[287]

[283] *ibid*
[284] *ibid*
[285] *ibid*
[286] *ibid*
[287] *ibid*

The BCBS introduces additional capital buffers to serve as defences against losses in the event of crisis. The buffers introduced are the Capital Conservation Buffer (CCB) and a Countercyclical Buffer (CB). The Committee's aim is to ensure that pools of capital are built during periods of stability so as to act as buffers in the event of losses as a result of crises.[288] Hence, for the CCB, banks are should hold an additional 2.5% of their total Capital in the form of CET1 in addition to the 4.5% minimum – bringing the CET1 requirement to 7% of RWAs. Banks are allowed to go below the 7% threshold during periods of stress but must be rebuilt *via* reductions from discretionary distributions such as 'decreases in dividend payments, share buy-backs, and staff bonus payments'.[289]The accord encourages domestic regulators to ensure the reductions are made until the buffer is re-established.[290] The CB, on its part is to serve an additional pool of capital sourced from excesses in periods of very high credit growth.[291] This buffer was introduced in response to the boom-boost cycle sequence credit availability tends to follow. In times of strong credit growth, the temptation of an abundance of credit creates a loan frenzy fuel by increase in prices that readily create asset bubbles. When these bubbles burst, prices drop, borrowers default on their repayment obligations, and as a result banks cut back on lending. The introduction of the CB is to ensure that there is a pool from which banks can draw to check the depletion of funds available for lending. Hence the twin

[288] *ibid*
[289] *ibid*
[290] *ibid*
[291] *ibid*

functions of this buffer is to act as check in periods of excessive credit availability and a means of bolstering credit availability in times of crisis.[292]

Basel III places the task of determining the rate of credit growth and availability on national regulators. The measures to be used for this determination may be such objective measure as the GDP and if the regulators are of the opinion 'that credit has grown to be excessive’, the regulator may impose a CB of between 0% and 2.5% to be implemented within a 12 month period if banks fail to comply, the rational regulator may enforce compliance with restrictions on discretionary distributions. This discretionary buffer may be lifted if the regulator determines that the irregular build up has been checked.[293]

Basel III introduces a leverage ratio (LR) to discourage excessive leveraging in the banking sector. The accord defines it as non-risk based and calibrated to be a ‘credible supplementary measure to the risk based capital requirements.’ The LR ensures that the banking system does not resort to deleveraging processes capable of destabilising the financial system. The LR is a non-risk based backstop tool which is calculated by putting Tier 1 capital against total exposure without factoring in RWAs. The aim is to arrive at an LR of at least 3%.[294]

[292] See Peter King, Heath Tarbert, ‘Basel III: An Overview’ (2011) 30(5) BFSPR 1
[293] Bank for International Settlements Basel Committee On Banking Supervision, ‘Basel III: A global regulatory framework for more resilient banks and banking systems’ (revised 2011) < http://www.bis.org/publ/bcbs189.pdf> accessed 28 October 2017
[294] *ibid*

Basel III provides for the capitalization and management of Counterparty Credit Risk (CCR). The accord stipulates an additional capital charge in anticipation of such losses as may be associated with depreciation in the creditworthiness of counterparties and increased risk weights on exposures to large financial institutions.[295] The Accord also provides for rather complex and wordy requirements concerning wrong way risk, Credit Valuation Adjustments (CVA), Expected Positive Exposure (EPE), and Central Counter Parties (CCP).[296]

Under Basel II, banks could rely on ratings by External Credit Assessment Institutions (ECAIs) in the assessment of risk weight. The result was banks relied entirely on the ratings of these institutions and completely desisted from carrying out internal risk-weight assessments.[297] Under Basel III however, banks are encouraged to carry out internal assessments of rated instruments and for an institution to function as an ECAI, its practices must be in compliance with the International Organization of Securities Commissions (IOSCO) Code of Conduct Fundamentals for Credit Rating Agencies.[298]

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295 See Bank for International Settlements Basel Committee On Banking Supervision, 'Basel III: A global regulatory framework for more resilient banks and banking systems' (revised 2011) < http://www.bis.org/publ/bcbs189.pdf> accessed 1 August 2017; Accenture, 'Basel III handbook' < http://www.accenture.com/SiteCollectionDocuments/PDF/Accenture-Basel-III-Handbook.pdf> accessed 28 October 2017
296 See Bank for International Settlements Basel Committee on Banking Supervision, 'Basel III: A global regulatory framework for more resilient banks and banking systems' (revised 2011) < http://www.bis.org/publ/bcbs189.pdf> accessed 28 October 2017
297 See Peter King, Heath Tarbert, 'Basel III: An Overview' (2011) 30(5) BFSPR 1
298 See Bank for International Settlements Basel Committee on Banking Supervision, 'Basel III: The Liquidity Coverage Ratio and liquidity risk monitoring tools' (January 2013) < http://www.bis.org/publ/bcbs238.pdf> accessed 28 October 2017

The fresh addition to the Basel regime (apart from the LCR) in the Basel III reforms is the provision of liquidity standards. By way of response to the crushing liquidity squeeze experienced during the crisis, the BCBS through Basel III introduced uniform bank liquidity standards by way of the Liquidity Coverage Ratio (LCR) and the Net Stable Funding Ratio (NSFR).[299] The purpose of the LCR is to ensure that internationally active banks maintain adequately High Quality Liquid Assets (HQLA) which would be enough to withstand to both systemic and institution-specific shocks over a 30 day stress period. The anticipation is that in the event of such shocks as a sudden credit rating downgrade, significant loss of deposits, a sudden rise in secured funding haircuts, or calls on off-balance sheet exposures, there should be 'adequate stock of unencumbered HQLA that can be converted into cash easily and immediately in private markets to meet its liquidity needs'.[300] Hence, in the short term, there will be the assurance of quick resilience in the face of sudden illiquidity shock. The LCR is a mitigating package introduced to strengthen a bank's ability to absorb shock and insulate the real economy from contagion from the banking sector. The BCBS further introduced a list of monitoring tools to ensure strength and to promote global consistency in the supervision of liquidity risk and liquidity risk exposure of banks. [301]In spite of the intentions of the BCBS in this regard, the sharp contrast in the treatment of retail and wholesale funding points

[299] *ibid*
[300] *ibid*
[301] *ibid*

at an unhealthy situation where competition grows for the types of funding that seem to enjoy leniency under the ration.[302]

Since the LCR covers only a period of 30 days, Basel III provides for protection against longer term liquidity risk in the form of the NSFR. The NSFR establishes a minimum liquidity ratio determined from an assessment of a bank's assets and activities. The NSFR is intended to promote medium to long term funding over a one-year period of extended stress.[303]

3.5 Conclusion

Upon its release and announcement, the most recent Basel accord has attracted mixed reactions. The debate still rages as to whether the accord is a step in the right direction and as to whether its lofty aims shall be achieved. Opinion on whether the accord will achieve its lofty aims is divided almost equally between optimistic patience and downright pessimism. Interestingly, this has been the response to the Basel regime as each of the previous accords have attracted a similar response. However, the outcry in this particular instance centred on possible negative outcomes from the stringency of its capital adequacy reforms, a possibility of a negative cost-benefit ratio of implementing the reforms,

[302] See Andrew Hartlage, 'The Basel III liquidity coverage ratio and financial stability' (2012) 111(3) MLR 453

[303] Bank for International Settlements Basel Committee on Banking Supervision, 'Basel III: The Liquidity Coverage Ratio and liquidity risk monitoring tools' (January 2013) <http://www.bis.org/publ/bcbs238.pdf> accessed 28 October 2017

shortcomings in the supervision of significantly sized institutions, and poor reach of the reforms in the area of systemic risk.[304] Furthermore, it is thought that the accord fails to address the shortcomings of Basel II adequately and domestic regulations may be better suited to address the issues the accord seeks to fix.[305] The optimistic camp of commentators believes that the costs anticipated are overestimated and that justification for whatever costs the accord may attract will be worth its crisis preventive measures.[306]

Even deeper and more significant is the debate regarding how well the attempt by the BCBS serves the effective regulation of international banks. An extension of this debate is how regulation is deployed in the prevention and amelioration of financial crises. The considerations of the next chapter capture reflections on these issues.

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[304] See Camdemir Baltali, Joeseph Tanega, 'Basel III: Dehybridasation of Capital' (2011) 8(1) JLB 1; Stefan Schwerter, 'Basel III's ability to mitigate systemic risk' (2011) 4 JFRC 337; Ranjit Lall, 'From failure to failure: The politics of international banking regulation' (2012) 19(4) RIPE 609

[305] Imad Moosa, Kelly Burns, 'Basel III as a Regulatory Response to the Global Financial' (2012) 10(1) IJABER 31

[306] See Bill Allen, Ka kei Chan, Alisair Milne, 'Basel III: Is the cure worse than the disease?' (2012) 25 IRFA 159

CHAPTER 4: ANALYSIS OF THE ACCORD AND THE LAW

4.1 Introduction

The earlier chapters have either discussed or highlighted each of law, regulation, financial crises, international banking and its regulation, the global financial crisis which broke out in 2007, the emergence of the BCBS, and Basel III. This progression, as well as the subject-matters covered so far, is necessary to fully appreciate the emergence of the accord, the phenomenon it seeks to regulate, the considerations that should determine its provisions, and whether its aims are being met. To determine the efficacy of Basel III is to match its reform to the acts and omissions the causes of the global financial crisis reveal, while to gauge its ability to prevent a future crisis will entail attempting to match lessons distilled from the entire build-up and outbreak of the crisis with the reform of Basel III.

An important concomitant of financial prudential regulation is supervision. Supervision ensures the stipulated rules are followed as well as serves as a data collation exercise since records of its activities provide a valuable store of information. As Basel III has the unique feature of merely stipulating supervisory guides and leaving the bulk of its supervision to local authorities, the important issue of implementation of the accord is germane to its success or otherwise. Since the accord is to be implementation with whatever adaptations the local authority deems fit and this implementation will invariably affect the exact rules adopted and the supervisory standards to apply, the determination of the efficacy of the accord must involve a look at how this affects the reach and therefore, applicability of the accord. Furthermore, international financial regulation being a subset of international law, throws up an investigation of the role law plays in the globalized regulation of finance.

This chapter investigates the crisis to highlight the lessons therefrom and pitches them against the reforms of the accord. Further, the role of law is gauged by examining the coercive quality of law that Basel III lacks.

4.2 The Crisis, the Lessons, and the Accord

To put the crisis in context, one must first appreciate the events surrounding the crash. In the summer of 2007, events that had built up over time came to a head and shook the very foundations of the financial and economic systems of the world. Beginning as early as 2006 with the gradual drop in the value of property in certain states in the U.S., the whirlwind would soon blow over right through the financial world and hit the real economy without mercy. The apparent catalyst, as well as final straw, in the build-up of events that eventually led to the credit crunch lies in the international and intra-national banking interests in fragile investments in securities tied to risky sub-prime mortgage in the U.S. Factor in the availability of cheap credit in the build up to the crash and leading international banks having adopted a high risk/ high reward model relying heavily on fast paced financial innovation and increased leveraging, the picture painted is that of a recipe for disaster. The crisis, like most others, is a complex mosaic of causes, incidents, and consequences. In the years leading up the crisis, Americans, who had become accustomed to cheap and easy credit stemming from policies previous decades indulged the age-long American attraction to homeownership by acquiring homes on mortgage irrespective of their creditworthiness.[307] These tendencies, encouraged by the predatory lending practices of banks and other lending institutions as well as an overabundance of credit caused the development of a credit bubble. A bubble built mostly on the back of the financial sector (particularly international banks) in the form of Mortgage-Backed Securities (MBSs) - one of the newer forms of securitization. The culpable species in this instance were privately issued MBSs that were pliable enough to be bundled up (subprime mortgages had been included from 1997) into chunks for sale and trading. These securities and the Collaterized Debt Obligations (CDOs) that could be created from them became a sort of staple investment for banks, hedge funds, and other investors.[308]

[307] See Klock, Mark, 'The virtue of home ownership and the vice of poorly secured lending: the Great Financial Crisis of 2008 as an unintended consequence of warm-hearted and bone-headed ideas' (2013) 45(1) ASLJ 135; Timothy J Sinclair, 'Let's Get It Right This Time! Why Regulation Will Not Solve or Prevent Global Financial Crises' (2009) 3 (4) IPS 450; Andrew Hindmoor and Allan McConnell, 'Why Didn't They See it Coming? Warning Signs, Acceptable Risks and the Global Financial Crisis' (2013) 61 PS 543

[308] See Eric Helleiner, 'Understanding the 2007–2008 Global Financial Crisis: Lessons for Scholars of International Political Economy' (2011) 14 ARPS 67; Nouriel Roubini and Stephen Mihm, *Crisis Economics: A Crash Course in the Future of Finance* (Penguin Books 2010)

The actual unfolding of the crisis took the form of the reaction of the markets to defaults of subprime borrowers - perhaps not so much their reaction as the effect of these defaults. The first casualties were the hedge funds whose exposures were so huge that the entities folded and next the panic arose and spread to the retail sector with British bank, Northern Rock experiencing an otherwise uncharacteristic bank run. In quick succession three events occurred that confirmed the outbreak of a crisis; the U.S. government stepped in to rescue the North American financial giants Bear Sterns and Fannie Mae and Freddie Mac, the investment banks, Lehman brothers collapsed, the U.S. government had to rescue and nationalize American International Group (AIG). At this point, the panic had already spread beyond North America and saw international banks scaling back on international loans. The squeeze was immediately felt by countries that depended heavily on these loans and the contagion spread globally mostly through effects on commodity prices and the collapse of exports.[309]

This discussion above is a simplistic recounting of the unfolding of the crisis. However, what is not as easy to achieve is to pinpoint the exact cause or causes of the crisis. Since the outbreak of the crisis, a hefty and growing literature both from official government reports and academic post-crisis commentary has emerged explaining the events leading to and postulating on the cause or causes

[309] See Adam Szyszka,'The genesis of the 2008 global financial crisis and challenges to the neoclassical paradigm of finance' (2011) 22 GFJ 211; Wang, F. ; Zhang, Ting, 'Financial Crisis and Credit Crunch in the Housing Market'(2014) 49 (2) JREFE 256; Eric Helleiner, 'Understanding the 2007–2008 Global Financial Crisis: Lessons for Scholars of International Political Economy' (2011) 14 ARPS 67

of the crisis.[310] This literature was lacking before the outbreak by way of warning of the events to come. There are a few claims of prediction of the events that manifested from the summer of 2007 but those may at best be discounted as warnings of a possibility of disruption (or to use the more technical term, correction) of a particular sector.[311] A possible reason no one saw the crisis coming is that no virtually one could have envisaged the outcome of the factors and series of events that preceded the crisis. This is not to say crises are immune to prediction, but rather that this particular crisis occurred on the back of such diverse, deep rooted, and long running factors that it is unlikely that academics, policy makers, or regulators would have tied them together to arrive at the likelihood of a crisis of that magnitude.[312] However, while the argument concerning prediction remains debatable, consensus is building in a few areas of the causes with varying attribution of importance. It is noteworthy that a unanimous and comprehensive understanding of the crisis is still rudimentary at best. And as regulatory responses are usually modelled on causal connections with past economic events and future anticipation, any hasty introduction of

[310] See Eric Helleiner, 'Understanding the 2007–2008 Global Financial Crisis: Lessons for Scholars of International Political Economy' (2011) 14 ARPS 67

[311] An authoritative work on the subject is Bezemer, D. J. Who predicted the crisis and what can we learn from them? 2011 *FIRST GREAT RECESSION OF THE 21ST CENTURY: COMPETING EXPLANATIONS*. Dejuan, O., Febrero, E. & Marcuzzo, M. C. (eds). CHELTENHAM: Edward Elgar Publishing, p. 13-32 20. In this chapter, Bezemer claims to have collated 12 academics, investors, stock market commentators, consulants etc. who predicted the crisis between 2000 and 2016. However, most of the writers merely warned of a pending correction in light of evidence in technical indicator readings

[312] See Ben S. Bernanke 'Reflections on a Year of Crisis' speech of August 21, 2009 Speech At the Federal Reserve Bank of Kansas City's Annual Economic Symposium, Jackson Hole, Wyoming Available at <https://www.federalreserve.gov/newsevents/speech/bernanke20090821a.htm> accessed 20 November 2017

sweeping reforms before ascertaining that said reforms are targeted at correct causal elements tends to be a neglect of an important foundational step.[313]

An inclusive list of virtually every conceivable head of cause of the crisis includes imprudent mortgage lending, housing bubble, global imbalances, securitization, lack of transparency and accountability in mortgage finance, rating agencies, mark-to-market accounting, shadow banking system, non-bank runs, off-balance sheet finance, government-mandated sub-prime lending, failure of risk management systems, financial innovation, complexity, human frailty, bad computer models, excessive leverage, relaxed regulation of leverage, Credit Default Swaps (CDS), over-the-counter derivatives, fragmented regulation, no systemic risk regulator, short-term incentives, tail risk, and the black swan: the impact of the highly improbable.[314] An examination of the causes of the crisis is done in the third chapter of this thesis and need not be repeated here. The lessons to be learnt therefrom however are not as obvious as the causes but may be gleaned from them.

Perhaps the most prominent lesson from the crisis debacle is that as a result of liberalization, globalization and technological advancements, the world is now a lot more interwoven in its affairs and the transfer of contagion in the financial sector has become a real and an ever growing risk. A case in point is the liberal

[313] See Joel P Trachtman, 'The International Law of Financial Crisis' (2010) 104 ASILP 295
[314] See Mark Jickling, (2010)'Causes of the financial crisis, congressional research services' 7–5700 R40173 available at <http://www.au.af.mil/au/awc/awcgate/crs/r40173.pdf> accessed 23 December 2017

approach the U.S. Federal Reserve adopted with regard to its monetary policies and the far reaching consequences the resultant boom in real estate purchases in the U.S. had in the run up to the global crisis.[315]An important lesson is the importance of the regulation of banks and their activities. Despite the age old precept concerning the need for the strict regulation of banks[316], the crisis served to reiterate this point in light of the practices rife in banks in the build up to the crisis.[317] Prior to the crisis, banks, especially internationally active ones, had developed models which took advantage of the relaxation of regulatory restrictions in the sector. These relaxed regulations were mostly either for taking advantage of competitive advantages or in enhancement of seemingly booming economic results suggested in the astronomical profits posted by financial institutions. Hence, the stage for a systemic crisis was set on the back of banks' misuse of liquidity, cheap credit, leverage, off balance sheet lending, and term risk mismatches.[318] Another lesson of the crisis is in the area of the macroeconomic thought that informs an existing financial system. The commentary and discussion prompted by the outbreak of the crisis focused more on describing what had happened with the hope of arriving at an explanation for

[315] See Allen, F & Carletti, E, 'An Overview of the Crisis: Causes, Consequences, and Solutions' (2010) IRF 1

[316] See I. L. Van Jaarsveld, 'Domestic and International Banking Regulation and Supervision - Defying the Challenges' (2002) 119 SALJ 71

[317] See Eric Helleiner, 'Understanding the 2007–2008 Global Financial Crisis: Lessons for Scholars of International Political Economy' (2011) 14 ARPS 67

[318] See Manuchehr Shahrokhi, 'The Global Financial Crises of 2007–2010 and the future of capitalism' (2011) 22 GFJ 193; Ricardo Cabral, 'A perspective on the symptoms and causes of the financial crisis' (2013) 37 JBF 103; Gorton, G, Metrick, A 'Securitized banking and the run on repo' (2012) 104 JFE 425

it and looking to devise measures to ensure there is no reoccurrence than examining the evolution and nuances of macroeconomic thought that preceded the crisis.[319] The crisis manifested heavy dependence on a free market paradigm that gave undue discretion to market participants manage their activities. This free market paradigm fed irresponsibility and greed evidenced by unjustifiable managerial compensation structures, as well as, endless and poorly regulated financial innovation to create a financial system that Roubini and Mihm describe as more sub-prime than the mortgages that precipitated the crisis.[320]

In the wisdom of the BCBS, the best strategy - by way of regulatory response - was to strengthen capital buffers and contain leverage in the banking system.[321] The BCBS claims the reforms introduced will operate 'as part of a considered process that balances the objective of maintaining a vibrant, competitive banking sector in good times against the need to enhance the sector's resilience in future periods of financial and economic stress'.[322] With its somewhat understandably rudimentary understanding of the exact causes of the crisis, the thrust of the BCBS's response is aimed at striking a balance between maintaining vibrancy in the banking sector and putting in place, preventive devices and measures in

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[319] See Adam Szyszka, Yochanan Shachmurove, 'The financial crisis: What is there to learn?' (2011) 22 GFJl 238

[320] Nouriel Roubini and Stephen Mihm, *Crisis Economics: A Crash Course in the Future of Finance* (Penguin Books 2010)

[321] Bank for international Settlements, 'BIS chronology' <http://www.bis.org/about/chronology/1980-1989.htm> accessed 4 October 2017

[322] See Bank for international Settlements 'Comprehensive strategy to address the lessons of the banking crisis announced by the Basel Committee' <https://www.bis.org/press/p081120.htm> accessed 12 December 2017

anticipation of future occurrences. The examination of the reforms of Basel III shall cover each of its three pillars namely capital adequacy, risk management, and market discipline. Also a look is had at the newly introduced liquidity standards.

The steps taken under the accord regarding capital are already controversial. The accord characteristically (same as under Basel II) increases, significantly, the amount and quality of internationally active banks' regulatory capital. While on some quarters there are calls for the levels set to be reviewed upwards, others hold that it is too high as it is and should be reduced.[323] There is arguments that increasing minimum capital requirements for banks will attract social costs. Banks and other stakeholders do not hold this view. The discussions of the concerns surrounding policies should focus fully on the costs and benefits of each position for the economy *i.e.* whether the economy, as opposed to a specific group, benefits or suffers.[324] As a rule of thumb, capital requirements should reduce procyclical effects during a down turn.[325]

Under Basel II, banks could rely on ratings by External Credit Assessment Institutions (ECAIs) in the assessment of risk weight. The result was banks relied entirely on the ratings of these institutions and completely desisted from carrying

[323] See Joel P Trachtman, 'The International Law of Financial Crisis' (2010) 104 ASILP 295
[324] See Anat R Admati, Peter M DeMarzo, Martin F Hellwig, and Paul Pfleiderer, 'Fallacies and Irrelevant Facts in the Discussion on Capital' in Charles Goodhart, Daniela Gabor, Jakob Vestergaard, Ismail Ertürk, *Central Banking at a Crossroads: Europe and Beyond* (Anthem Press 2014); Healthy Banking System Is the Goal, Not Profitable Banks," *Financial Times*, November 9, 2010
[325] See Joel P Trachtman, 'The International Law of Financial Crisis' (2010) 104 ASIL 295

out internal risk-weight assessments which led to the horrifying results witnessed.[326] Under Basel III however, banks are encouraged to carry out internal assessments of rated instruments and for an institution to function as an ECAI, its practices must be in compliance with the International Organization of Securities Commissions (IOSCO) Code of Conduct Fundamentals for Credit Rating Agencies.[327] This is a welcome development which sadly may be plagued by implementation issues.

The next pillar covers market discipline. In banking, market discipline describes the countervailing actions private sector participants take as a result of rising costs attributable to banks' risky behaviour.[328] The BCBS had suggested types of public disclosures to be released regularly by banks. These include details of capital held as buffer by banks against losses and the exposures that may result in said losses.[329] Market discipline may be used by regulatory authorities either directly or indirectly. Direct market discipline involves the collation of germane information on market participants. It is a substitution of prudential supervision of bank management. On the other hand, indirect market discipline compliments prudential supervision by encouraging stakeholders to ensure proper bank

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[326] See Peter King, Heath Tarbert, 'Basel III: An Overview' (2011) 30(5) BFSPR 1

[327] See Bank for International Settlements Basel Committee on Banking Supervision, 'Basel III: The Liquidity Coverage Ratio and liquidity risk monitoring tools' (January 2013) < http://www.bis.org/publ/bcbs238.pdf> accessed 28 October 2017

[328] See Berger, A N, Market discipline in banking. In: Proceedings of a conference on bank structure and Competition' (1991) Federal Reserve Bank of Chicago 419

[329] See Basel Committee on Banking Supervision 'Consultative paper issued by the Basel Committee on Banking Supervision' (June 1999) < https://www.bis.org/publ/bcbs50.pdf > accessed 22 November 2017

management by monitoring from their position.[330] Indirect market discipline depends on material market information and tends to impose more transparency in the activity of the market participant. It also improves the efficiency of supervision.[331]

There is evidence that market discipline is beneficial with regard to risks. Both equity and credit risks tend to reduce with market discipline.[332] However, there is also evidence that market discipline weakens after a banking crisis. Market discipline weakens more where bank regulation favours it before the crisis and more in countries with strong institutions.[333] The disclosures envisaged under the market discipline pillar of Basel III have not been proven to meet any of the ends expected either with regard to content or timeliness of disclosures.[334]

The newest revelation in the accord in the new liquidity standards introduced. Liquidity is the lifeblood banks. So fundamental is liquidity that it may be concluded it is the basis of the existence of banks. Banks perform the function of maturity transformation by accepting short term demand deposits and providing loans to households and businesses on a longer term basis. The risk in this vital

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[330] See Vahit Ferhan Benli, 'Basel's Forgotten Pillar: The Myth of Market Discipline on the Forefront of Basel III' (2016) 11(3) e-Finanse 70

[331] See Rochet, J.Ch 'Market Discipline in Banking, Where do we Stand?' in Borio, C, Hunter, W C, Kaufman, G, Tsatsaronis, K (eds) *Market Discipline across Countries and Industries* (MIT Press 2004)

[332] Khoa TA Hoang, Robert Faff, Mamiza Haq, 'Market discipline and bank risk taking' (2014) 39(3) AJM 327

[333] See Elena Cubillas, Ana Rosa Fonseca, Francisco González, ' Banking crises and market discipline: International evidence' (2012) 36(8) JBF 2285

[334] See Vahit Ferhan Benli, 'Basel's Forgotten Pillar: The Myth of Market Discipline on the Forefront of Basel III' (2016) 11(3) e-Finanse 70

function of banks is that depositors may demand more than is left over in the bank after the loans given out. This is liquidity risk. The mitigation of this risk may be by maintaining a significant pool of liquid assets to meet obligations as they arise, especially in a tight squeeze such a crisis scenario.[335] A further risk of illiquidity is the likelihood of spillage onto other banks when it occurs. Imprudent liquidity management may pose serious difficulty for banks system-wide and may evolve into a complete crumble in financial intermediation.[336] The perfect demonstration of the contagious nature of illiquidity is the spread of illiquidity during the 2007 crisis the collapse of Lehman Brothers in September 2008. The BCBS' introduction of the LCR and NSFR are to ensure there is adequate high quality liquid assets to offset crucial liquidity needs in the short term and an on-going basis respectively. [337] The intention of any introduction of liquidity standards is to ensure that banks have in store, adequate liquid assets to withstand sudden and sustained liquidity requirements such as bank runs in a crisis situation while also ensuring that banks' funding sources are liquid enough to not freeze under pressure of crisis.[338] It must be noted at this juncture that the higher the liquidity ratios that are held, the lower interest from loans will be,

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[335] See Davis, K. 'Managing Liquidity Risks. Enhancing Risk Management and Governance in the Region's Banking System to Implement Basel II and to Meet Contemporary Risks and Challenges Arising from the Global Banking System' (2014). 8 – 12 December, Shanghai, China

[336] See Gomes, T and Wilkins, C, 'The Basel III Liquidity Standards: An Update' (2013) FSR 37

[337] See Bank for International Settlements Basel Committee on Banking Supervision, 'Basel III: The Liquidity Coverage Ratio and liquidity risk monitoring tools' (January 2013) < http://www.bis.org/publ/bcbs238.pdf> accessed 28 October 2017

[338] Gongol, T. and Vodová, P. 'Liquidity Risk Regulation' (2014) 1(1) FAI 7

while low liquidity provision increases the risk of illiquidity.[339] The newly introduced LCR provides for a differentiation in funding sources. The rules are such that there is a bias in the treatment of more volatile sources as wholesale funding than other less volatile ones as retail ones. The effect of this differentiation is counterproductive as it could serve to undermine the banks' stability.[340]

The discussion on the impact Basel III capital reforms will have on both banks and the economy serve short-term goals as they were created to address the most apparent perceived cracks in the system. However longer-term will definitely require accompanying tweaking of business models, processes (which themselves must by prudently managed) to prevent possible shortage of capital and the accompanying costs. Further to this is the fear that any shortage of capital may cause contraction of the economy by a reduction in economic activities.[341] Ultimately, and beyond the reforms themselves, are the hurdles that may arise in terms of the extent of international cooperation expected in the implementation of the accord. If the responses by domestic regulators and, to an extent, the causes in terms of the build-up to the crisis in such areas as corporate governance standards, securities regulations *etc.* are anything to go by, then the implementation of the accord may suffer a similar fate as its predecessors.

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[339] See Victor Curtis Lartey, Samuel Antwi, Eric Kofi Boadi, 'The Relationship between Liquidity and Profitability of Listed Banks in Ghana' (2013) 4(3) IJBSS 48

[340] See Andrew Hartlage, 'The Basel III liquidity coverage ratio and financial stability' (2012) 111(3) MLR 453

[341] See Bill Allen, Ka Kei Chan, Alistair Milne, Steve Thomas, 'International Review of Financial Analysis Basel III: Is the cure worse than the disease?' (2012) 25 IRFA 159

4.3 Law to the Rescue?

The debate on what law is, and what its true purpose in society is has been extensively debated and argued by great and able minds so much that an addition to this is unnecessary.[342] However, this research provided a few basic functions in the first chapter.[343] There is no need to reproduce them here nor is there a need to justify them. Law, as a concept, depends heavily on its own ability to effect its own stipulations and by so doing create a sort of legitimacy in its existence, and validity. This self-justifying ability is the basis of the order law establishes and maintains in the modern society. The demonstration of its legitimacy by an ability to utilise coercion to enforce its stipulations reinforces the conviction of its subjects that it is valid.[344] Basel III is an attempt at international law, which does not conform to this resort to coercion. Even though they were not formally binding, the earlier Basel accords were adopted by member countries of the BCBS and a good number of non-member countries.[345] In any event, the implementation has always been plagued. On one hand is the non-uniformity of the implementation as states are allowed to vary the provisions they adopt and on

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342 See generally Wil Waluchow and Stefan Sciaraffa, *Philosophical foundations of the nature of law* (Oxford University Press 2013)

343 See Joseph Raz, *The authority of law: Essays on law and morality* (Oxford Scholarship Online March 2012)

344 See Mahir Muharemovic, 'Anatomy of the Law' (2017) 4 SP-JLTP 9

345 See Daniel E. Ho, 'Compliance and International Soft Law: Why Do Countries Implement the Basel Accord? (2002) 5 JIEL 647

the other is the resistance of stallholders and states alike.[346] This has created a void in the applicability of the accord.

In the search for law to fill this void the obvious choice is international law. However, by its very nature, international law does not concern itself with economic issues. The origins of international law lie in conflict; it has always catered primarily for issues of peace and the procedure to adopt in the absence of peace *i.e.* conflict situations. Changes are beginning to emerge and its ambit is spreading to bi-lateral or geographical promotion of mutual economic prosperity by way of treaties. But these trade and investment treaties more or less merely remove matters from being resolved by diplomacy to the certainty of rulings or judgements of tribunals.[347] These are basically the extent to which legalization is applicable to international economic law.[348] There is no treaty in place for financial crisis response or regulation of crisis.[349]

The BCBS is an example of a body that exists and exercises powers to make international law. The BCBS is so noted for this power and its acts (accords) that command relatively high compliance such that writers have branded the regulations that result from it as 'Basel Brand'. The BCBS, which comprises

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[346] See Daniel K Tarullo *'Banking on Basel: The Future of International Financial Regulation'* (Peterson Institute of International Economics 2008)
[347] See Todd Allee and Clint Peinhardt, 'Delegating Differences: Bilateral Investment Treaties and Bargaining Over Dispute Resolution Provisions' (2010) 54 ISQ 1
[348] See Axel Berger, 'The Politics of China's Investment Treaty-Making Program', in Tomer Broude, Marc L Busch, Amelia Porges (eds), *The Politics of International Economic Law* (Cambridge University Press 2011)
[349] Eric J Pan, 'Challenge of International Cooperation and Institutional Design in Financial Supervision: Beyond Transgovernmental Networks'(2010) 11 CJIL 243

central bank heads of a comity of nations, exemplifies the informal, exclusive but dominating informal setting under which international law has evolved. This 'new governance' model completely negates the traditional top-down, direct and control model. Another characteristic of this model is that the actors are usually non-state stakeholders or informal institutions which taking take advantage of their informality to make these laws on an ongoing basis in response to changes that arise and this mobile accumulation increases the store of knowledge in that sector or field.[350] Hence, some describe the BCBS as a transnational regulatory network. These are informal multilateral fora consisting contemporary representatives representing states' regulatory agencies to help facilitate 'multilateral cooperation on issues of mutual interest within the authority of the participants.'[351]

A few sceptics of the classification of international law as 'real' law hold that by its fundamental nature, international law is capable of just a negligible power of independent influence over state action or inaction.[352] A long litany of unaddressed high profile violations of treaties seems to suggest international law is barely worthy of the tag law. However, the passage of time' pivotal incidents' and the emergence of new knowledge have led to a rethink of what the law

350 See Robert F. Weber, 'New Governance, Financial Regulation, and Challenges to Legitimacy: The Example of the Internal Models Approach to Capital Adequacy Regulation' (2010) 62 ALR 783

351 Pierre-Hugues Verdier, 'Transnational Regulatory Networks and Their Limits' (2009) 34 YJI 113

352 See Harlan Grant Cohen, 'Finding International Law: Rethinking the Doctrine of Sources' (2007) 93 ILR 65

consists in the international sense. Hence a rethink has emerged of the traditional, hard-line conception of international law based heavily on the doctrine of sources with its ‘focus on consent and formality’ and an overemphasis on treaty creation has given way to conceptions that emphasize an alternative to the creation of truly international law.[353]

4.4 Conclusion

The efficacy of the accord itself, irrespective of the responses from and views of academics, state level policy makers, researchers, and other commentators, depends ultimately on how much the reforms reflect solutions to the actions and omissions that constitute the causes of the crisis. In addition, there should be an unambiguous reflection of improvements on the preceding accords which will itself show an understanding and reflection of changes in financial practices and regulation. The need for this clear improvements is underscored by the perceived shortcomings in the areas of stringency of its capital adequacy reforms, the relative high cost-benefit ratio of implementing the reforms, the neglect of provisions regarding too big to fail institutions, and the poor reach of the reforms in the area of systemic risk.[354] Fears regarding the reforms being no more than

[353] Harlan Grant Cohen, ‘Finding International Law: Rethinking the Doctrine of Sources’ (2007) 93 ILR 65

[354] See Camdemir Baltali and Joeseph Tanega, ‘BASEL III: DEHYBRIDISATION OF CAPITAL’ (2011) 8(1) JLB 1; Stefan Schwerter, ‘Basel III’s ability to mitigate systemic risk’

mere ‘rhetoric’ in the area of improvements on Basel II also underscore the need for the Basel III to be real and tangible improvement on its predecessor.[355] Finally, the stringency of its reforms may generate exorbitant costs.[356] The hope of the BCBS is that the reforms become more than sterile improvements on Basel II and not a potential recipe for a future asset bubble.[357]

Understanding of the crisis remains somewhat unsettled and regulatory responses are usually modelled on causal connections with past economic events and future anticipation. Hasty introduction of sweeping reforms before ascertaining the reforms are targeting the correct causes is a waste of time and gross neglect of an important factor. The BCBS and its work[358] which should be a blessing seems more like a burden by consistently coming short of targets for a variety of reasons prominent among which is uniformity and eagerness in terms of implementation. This is hardly surprising since certain states which had accepted the earlier Basel requirements had been put in a disadvantage where non-compliant states were. And further to this is the fact that the more the restrictions in banking, the lower profits will be. The greater the powers a financial institution has, the more it’ll take on tasks that are profitable. So regulation

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(2011) (4) Journal of Financial Regulation and Compliance 337; Ranjit Lall, ‘From failure to failure: The politics of international banking regulation’ (October 2012) 19(4) RIPE 609

[355] See Imad Moosa and Kelly Burns, ‘BASEL III AS A REGULATORY RESPONSE TO THE GLOBAL FINANCIAL CRISIS’ (2012) 10(1) IJABER 31

[356] See Sarah Padgett, ‘The Negative Impact of Basel III on Small Business Financing’ (2013) 8(1) Entrepreneurial business law journal 183

[357] Rudin, Joshua, ‘Basel III: the banking band-aid?’ (2012) 6(2) BJCFCL 621

[358] See Bank for International Settlements, ‘Basel Committee Charter' (Updated 30 December 2016) < https://www.bis.org/bcbs/charter.htm> accessed 23 November 2017

decreases profitability.[359] And as international banks are part of the private sector, it is easy to imagine they will resist to the extent they are capable of.

As globalization, financial innovation, and technology advancement continue, the reforms will require more international coordination. The threat in this is the discountenance of macroeconomic considerations. The monetary system contributed to this crisis just as much as the structure and regulation of the existing financial system but the reach of Basel III does not cover. Macro-economic policies, especially wrong ones like those in place before the crisis, may impose undue stress/pressure on financial markets leading to stress and financial crises. Financial crises lead to economic woes and further macro-economic policies which may require loosening the grip of regulation or disposing of them altogether, are required to fix economic woes. Hence a holistic view is needed to ensure success. It may be that monetary policy changes are desirable to prevent a financial crises - even more so than direct introduction of financial regulation. [360]

It is not all bad. As far as responses go Basel III is a good start. There needed to be a response. Any response would be better than none at all. Howbeit, the accord will benefit from ongoing monitoring and adjustments which are needed to address the lessons from the crisis and tackle systemic risk. This is not a call for further regulation. The area is as complex as it could be and further

[359] See Joel P Trachtman, 'The International Law of Financial Crisis' (2010) 104 ASIL 295
[360] *ibid*

regulation will not help – more so if the new regulations turn out to complex. Fixing complex banking by instituting equally complex regulation will not help. Theoretically, this is unsound. In reality, crisis shows us in bright colours that it is unwise. The role of financial regulation is simply to set reasonable limits within which the players should play.[361]

[361] See Stefan Schwerter, 'Basel III's ability to mitigate systemic risk' (2011) 19(4) JFRC 337; Andrew G Haldane, 'Capital Discipline' Remarks by , Executive Director, Financial Stability Based on a speech given at the American Economic Association, Denver (9 January, 2011)

CONCLUSION

This research has examined Basel III to determine its ability will live up to its aims to protect the global economy from another crisis of the magnitude of the global financial crisis. The research also examines the role of law in the regulation of financial crises at the global level and how law could contribute to this task. The subject matters in the discussions herein are law, regulation, international banking, financial crises, and international financial regulation.

The discussions reveal how International banking, in some form or other, has been around for well over one millennium. Its growth ties closely with maritime trade and the contribution of enterprising European families who established presence and practices in leading financial cities. While modern international banking is a mixture of practices and devices developed over centuries and has become very important in the global financial architecture, attempts to regulate international banking only began in earnest in the 1970s with the creation of the Basel Committee on Banking Supervision (BCBS) which was set up in response to a series of heretofore bank crashes and scandals.[362] The committee's primary

[362] See Patricia A McCoy, 'Musings on the seeming inevitability of global convergence in banking law' (2000-2001) 7 CILJ 433; Emmanuel N. Roussakis, GLOBAL BANKING: ORIGINS AND EVOLUTION (1997) 37(4) ACFSP 45; Roy C Smith and Ingo Walter, *Global Banking* (3rd edn, University Press Scholarship 2003)

remit is setting standards for internationally active banks. In addition, the committee tackles crises that originate from or affect international banking.[363]

An international bank is one that carries out banking functions in more than one country. Being that these banks are an important part of international finance and their importance continues to grow especially as liberalisation encourages innovation in finance and advancements in information and communications technology continues, their stability is of crucial importance to global financial stability. Apart from being primary a source of funds and information, international banks are active in the financial markets of the countries where they operate. This local level participation may be a conduit for the transfer of risk or contagion. Systemic risk therefore, is the primary motivation for attempts to regulate international banking as well as the primary driver of any form of international financial regulation. [364]

The fear of the outbreak and spread of financial crisis informs most financial regulation. A financial crisis is a sudden crash in a financial system that impairs its functionality. Some symptoms are a drop in asset value and panicked withdrawal of funds from financial institutions. Debate as to whether there is an in-built tendency in economies to crash as a corrective measure after a period of excesses or whether crises represent nothing more than the effect of interference

[363] Charles Goodhart, *The Basel Committee on Banking Supervision A History of the Early Years, 1974–1997* (CUP 2011)
[364] Hasman, Augusto, 'A CRITICAL REVIEW OF CONTAGION RISK IN BANKING' (2013) 27(5) JES 978

in an otherwise self-regulating economy is still ongoing.[365] The global financial crisis of 2007 is a reflection of the complexity of modern finance. The causative factors of the crisis are myriad and unsettled but the ultimate catalysts in the form of the bubble that developed around practices in sub-prime lending in the United States, together with an ever-growing financial globalisation, points to an interconnectedness in the financial sphere of the world that increases the likelihood of systemic crises.[366] The global financial crisis and the economic meltdown represent an instance of the correction in Minsky's hypothesis.[367]

Basel III was released to shore up internationally active banks against failure by beefing up their capital requirements and introducing liquidity buffers. It is a truism that regulation is beneficial in checking the outbreak and spread of financial crisis through international banking but Basel III, even though a step in the right direction, will neither prevent another global financial crisis nor guarantee financial stability. International banking regulation will always lag behind advancements in international banking. Banking is a day-to-day activity and devices are developed to either deal with challenges or to break into new frontiers, while so far the BCBS, even though it tends to keep track of

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[365] See Nouriel Roubini and Stephen Mihm, *Crisis Economics: A Crash Course in the Future of Finance* (Penguin Books 2010); Hyman P. Minsky, *Stabilizing an Unstable Economy* (McGraw-Hill, 2008); F A Hayek, *The Fatal Conceit: The Errors of Socialism* (University of Chicago Press 1991); Charles P Kindleberger, *Manias, Panics, and Crashes: A History of Financial Crises* (Wiley 2005) 4

[366] See Farrar, J. H., & Parsons, L., 'Globalization, the GFC and paradigm shift' (2013) 32(12) BFSPR 14

[367] See L Randall Wray 'Minsky's Money Manager Capitalism and the Global Financial Crisis' (2011) 40(2) IJPE 5; Nouriel Roubini and Stephen Mihm, *Crisis Economics: A Crash Course in the Future of Finance* (Penguin Books, 2010)

developments in the sector, usually and has so far been reactionary in its regulatory efforts. Again, the occurrence of financial crises is inevitable and so more focus should be on early containment than prevention. The magnitude or subtype of crisis may vary but the mere occurrence is certain.[368] This argument is based partly on the financial instability hypothesis of Hyman Minsky as well as research in investor behaviour.[369] However, the debate on the theorization of financial crises is still unsettled and at every given point an influential writer or research gains traction and hold sway until a subsequent crisis swings momentum away onto a new and more appealing description or theory. In practice however, the introduction of new regulation trails far behind financial innovation. Furthermore, there are established behavioural economics principles such as greed, loss aversion, herding etc. which affect the actions of financial market participants. This combines with the lag between regulation and innovation to ensure the occurrence of future crises.[370]

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[368] See Claessens, S and Kose, M A, 'Financial Crises: Explanations, Types, and Implications' (2013) (IMF WP/13/28); Brunnermeier, M., *Asset Pricing Under Asymmetric Information: Bubbles, Crashes, Technical Analysis and Herding* (Oxford University Press 2001)

[368] See Stephen G Cecchetti, Marion Kohler, and Christian Upper, 'Financial Crises and Economic Activity, (August 2009) available from <http://www.bis.org/publ/othp05.pdf> accessed 3 October 2017; Kenneth J Meier, *Regulation: Politics, Bureaucracy, and Economics* (St. Martin's Press 1985); Stephen G Cecchetti, Marion Kohler, and Christian Upper, 'Financial Crises and Economic Activity, (August 2009) <http://www.bis.org/publ/othp05.pdf> accessed 3 October 2017; Kenneth J. Meier, *Regulation: Politics, Bureaucracy, and Economics* (St. Martin's Press 1985)

[369] See Ekanshi Gupta, Preeti bedi, and Poonam lakra, 'Efficient Market Hypothesis V/S Behavioural Finance' (April 2014) 16(4) JBM 56

[370] See Rudin, Joshua, 'Basel III: the banking band-aid?' (2012) 6(2) BJCFCL 621; Carmen M. Reinhart and Kenneth S. Rogoff, 'Financial and Sovereign Debt Crises: Some Lessons Learned and Those Forgotten' in Stijn Claessens, M Ayhan Kose, Luc Laeven, and Fabian Valencia (eds) *FINANCIAL CRISES Causes, Consequences, and Policy Responses*(IMF 2014)

Basel III is a step forward but the BCBS is condemned to a reflexive relationship with crises. If we acknowledge regulation as a viable response to financial crisis to either contain its spread or assuage its effects and hold that financial crises are inevitable in the present global financial structure, then the natural conclusion would be that there is the likelihood of another crisis and another Basel accord in response to that.[371]

The role of law in a given state is fundamentally different from the concept of law at the international level. Law barely exists at the international level and the reach of international law as it is will not satisfy the needs law of international financial regulation. Regulation differs from law as the law includes the means of enforcement of both legal rules and regulation and is the totality of the machinery that creates a relationship that enables regulation and its enforcement. However, international law is incapable law also stands as an arbiter in instances where legal rules, as opposed to regulation that may be voluntary, clashes with the collective expectations of the society.[372]

As the world trudges forward in search of a stable and productive financial architecture, should the world simply await the next global crisis and release

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[371] See Peihani, Maziar, 'The Basel Committee on Banking Supervision: a post-crisis assessment of governance and accountability' (2014) CFPJ1

[372] See Robert F. Weber, 'New Governance, Financial Regulation, and Challenges to Legitimacy: The Example of the Internal Models Approach to Capital Adequacy Regulation' (2010) 62 ALR 783; Pierre-Hugues Verdier, 'Transnational Regulatory Networks and Their Limits' (2009) 34 YJI 113; Bronwen Morgan and Karen Yeung, *An Introduction to Law and Regulation: Texts and Materials* (CUP 2007); Ogus, A., *Regulation: Legal Form and Economic Theory* (Hart Publishing 2004) Ioannis Glinanvos, *Redefining the Market-State Relationship Responses to the Financial Crisis and the future of regulation* (Routledge 2014)

another accord in response? Suggestions abound about introducing fundamentally different measures for international financial regulation. These have ranged from calling from a new body to embracing the treaty dependence of international law and even to structural changes in the BCBS. Perhaps if the composition of the BCBS were expanded to include members from more than the present 26 and involved other professionals apart from central bank heads. Even though there are compelling reasons for the continued existence of the undemocratic standard setting activities of the BCBS. These includes that the G-10 nations are arguably the most experienced in terms of ‘regulation of large, complex financial markets, which makes them the most obvious sources of sound financial laws’ and very few outside of this group have the expertise to establish an institution like the BCBS. Moreover, these G-10 members have more at stake not only as a result of the investments they must have in these institution but also because the much touted integration and interconnectedness of banks and markets in that cadre. As a matter of fact, lesser economies tend to depend heavily on the stability of these more developed nations to help in their development agenda. These factors tend to have made the continued existence of the BCBS a success.[373] Notwithstanding, let’s assume a new agency is formed with list of flexible but relevant areas for regulation open enough to accommodate nuances which may require special treatment. Financial

[373] See Chris Brummer, ‘How International Financial Law Works (and How it Doesn't)’ (2011) 99 GLJ 257

institutions are run by people whose emotions seep into their decisions whether intentionally or unwittingly. This could be human psychology. Without needing enforcement powers, this body would still empowered to point out questionable practices and bring them to public knowledge and scrutiny. The result would be the erring economy of party may resort to fix the issue or publicly prove innocence as nobody likes to be blamed for untrue allegations and investors are likely to withdraw therefrom and cost the erring party a lot. Furthermore, the regulators may be forced to address the issues since they will be public in the first place.[374] Also the erring party may be tempted to investigate the accusation and fix the issues if they have merit. The public opprobrium of mismanagement, incautious attitude to possible complications, and the stain of impropriety if they ignore these allegations will force the errant to act. The plan is to ensure globally, there is cautious and timely effort to avoid a crash. The hope now is that the BCBS become more representative of the realities of the divergences both in microeconomic orientation and peculiar economic needs and objectives of countries of the world. Also, the more representative committee should be engaged in the drawing up of a more reflective accord that each country should strive for. Also, there should be a measure of regulatory flexibility to enable each

[374] Carrie Barron, 'False Accusations, Scapegoats, and the Power of Words' *Psychology Today* (Feb. 17, 2014), <https://www.psychologytoday.com/blog/the-creativity-cure/201402/falseaccusations-scapegoats-and-the-power-words> accessed 23 November 2017 ("Being publicly accused of a crime one did not commit could lead a person to jump off a bridge. Once the information is out there, defending yourself, clearing your name, fighting suspicion and tolerating disdain is a horrible predicament. People with little information can form strong opinions and take unwarranted retaliatory action from expulsion from the clan to spreading the false word.").

country achieve the ends of the accord by its own means. Also, the creation of a machinery[375] for the investigation of practices and products worldwide to allow for tailor-made statements for each country would be an advantage. If these are done, a bridge connecting regulators, the public and bankers will be built. Flaws will be checked before they cause problems and public participation may offer pressure for better governance of finance and help police crises better.

[375] See Ivan Chaykovskiy, 'Deregulating the Inadequate Basel Accords: Future-Proofing Financial Regulations in an Age of Global Crises' (2016) 25 CJICL 77

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