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GLOBAL FINANCE IN CRISIS

THE POLITICS OF INTERNATIONAL REGULATORY CHANGE

EDITED BY ERIC HELLEINER, STEFANO PAGLIARI AND HUBERT ZIMMERMANN

Global Finance in Crisis

The severity of the current global financial crisis has revealed major weaknesses in the international architecture for prudential financial regulation.

From the vantage point of the key powers in global finance, including the United States, the European Union, Japan, and China, this highly accessible book brings together leading scholars to examine current changes in international financial regulation. They assess whether the flurry of ambitious initiatives to improve and strengthen international financial regulation signals an important turning point in the regulation of global finance. The text:

- Examines the kinds of international reforms that have been implemented to date and patterns of international regulatory change.
- Provides an analysis of change across a number of financial sectors, including the regulation of hedge funds, derivatives, credit rating agencies, accounting, and banks.
- Offers an explanation of contemporary regulatory developments with reference to inter-state power dynamics, domestic politics, transgovernmental networks, and/or transnational non-state forces.

Providing the first systematic analysis of the international regulatory response to the current global financial crisis, this ground-breaking volume is vital reading for students and scholars of international political economy, international relations, global governance, finance, and economics.

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The politics of international regulatory change

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Routledge
Taylor & Francis Group
LONDON AND NEW YORK

Centre for the Study of Globalisation and Regionalisation

First published 2010
by Routledge
2 Park Square, Milton Park, Abingdon, Oxon, OX14 4RN

Simultaneously published in the USA and Canada
by Routledge
270 Madison Avenue, New York, NY 10016

Routledge is an imprint of the Taylor & Francis Group, an informa business

This edition published in the Taylor & Francis e-Library, 2010.

To purchase your own copy of this or any of Taylor & Francis or Routledge's collection of thousands of eBooks please go to www.eBookstore.tandf.co.uk.

British Library Cataloguing in Publication Data
A catalogue record for this book is available from the British Library

Library of Congress Cataloging-in-Publication Data
Global finance in crisis: the politics of international regulatory change /
edited by Eric Helleiner, Stefano Pagliari, and Hubert Zimmermann.
p. cm. – (Routledge/Warwick studies in globalisation)
Includes bibliographical references.
1. Finance–Government policy–Case studies. I. Helleiner, Eric, 1963–
II. Pagliari, Stefano. III. Zimmermann, Hubert.
HG173.G6327 2010
332′.042–dc22 2009032561

ISBN 0-203-85750-X Master e-book ISBN

ISBN 13: 978-0-415-56437-3 (hbk)
ISBN 13: 978-0-415-56438-0 (pbk)
ISBN 13: 978-0-203-85750-2 (ebk)

ISBN 10: 0-415-56437-9 (hbk)
ISBN 10: 0-415-56438-7 (pbk)
ISBN 10: 0-203-85750-X (ebk)

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Preface

International financial regulation is not a topic that usually generates enormous public interest. But the global financial crisis that began in late 2007 changed all that. Suddenly, the issue became headline news as the political leaders of the G20 countries placed financial regulatory reform at the top of the agenda in their inaugural summit meetings. This volume analyzes the content of the international regulatory reform agenda to date (mid-2009) and attempts to explain politically why it has taken the shape that it has. The contributors also present some preliminary judgments about the overall significance of the reforms that have been launched so far. While some believe that the severity of the crisis is generating quite important regulatory transformations, others think the changes have been quite minimal given the severity of the crisis. Whether subsequent developments will lead any of the contributors to change their minds about these judgments remains to be seen.

Like so many financial institutions in the lead-up to this crisis, we have incurred a number of large debts in preparing this volume. We are very grateful to all the contributors to this volume for their enthusiasm for this project, for their insightful analyses, and for working so efficiently to some very tight deadlines. We also thank the Centre for International Governance Innovation for supporting and hosting the workshop in June 2009 at which the first drafts of these chapters were presented and discussed. Thanks also go to David Kempthorne, Bessma Momani, and Jason Thistlethwaite for their participation in the workshop and comments, as well as to Nadine Hasslöwer, Johannes Sieben, and Marc Wittkamp for their work on the preparation of the manuscript. And finally, we are grateful to Len Seabrooke and Routledge for their interest in this project and support for its speedy publication. While our debts are many, we hope the quality of this volume will be accepted as a fair payoff. In the world of ideas, creditors are usually more forgiving than in the world of finance.

Eric Helleiner, Waterloo
Stefano Pagliari, Waterloo
Hubert Zimmermann, Düsseldorf
July 2009

List of abbreviations

ADB	Asian Development Bank
AFC	Asian Financial Crisis
AIG	American International Group
AIMA	Alternative Investment Management Association
AMF	Asian Monetary Fund
ASEAN	Association of South-East Asian Nations
BCBS	Basel Committee on Banking Supervision
BIS	Bank for International Settlements
CAR	capital adequacy ratio
CBI	Confederation of British Industry
CBRC	China Banking Regulatory Commission
CC	Comparative Capitalisms
CCP	central counterparty
CDS	credit default swap
CDU	Christlich-Demokratische Union
CEBR	Centre for Economics and Business Research
CEBS	Committee of European Banking Supervisors
CEIOPS	Committee of European Insurance and Occupational Pensions Supervisors
CEO	chief executive officer
CESR	Committee of European Securities Regulators
CFA	Chartered Financial Analyst
CFTC	Commodity Futures Trading Commission
CGFS	Committee on the Global Financial System
CME	Coordinated Market Economy
CMI	Chiang Mai Initiative
CMIM	Chiang Mai Initiative Multilateralized
CPE	Comparative Political Economy
CRA	credit rating agency
CRO	chief risk officer
CSFI	Centre for the Study of Financial Innovation
CSU	Christlich-Soziale Union

DBL	Drexel Burnham Lambert, Inc.
DBLG	Drexel Burnham Lambert Group
ECB	European Central Bank
EEC	European Economic Community
EMEAP	Executives' Meeting on East Asia Pacific Central Banks
EP	European Parliament
EUSA	European Union Studies Association
FAS	Financial Accounting Standards
FASB	Financial Accounting Standards Board
FAZ	Frankfurter Allgemeine Zeitung
FCL	Flexible Credit Line
FDIC	Federal Deposit Insurance Corporation
FSA (UK)	Financial Services Authority (United Kingdom)
FSA (Japan)	Financial Services Authority (Japan)
FSAP	Financial Service Action Plan
FSAP	Financial Sector Assessment Program
FSB	Financial Stability Board
FSF	Financial Stability Forum
FT	Financial Times
FVA	Fair Value Accounting
GAAP	Generally Accepted Accounting Principles
GATT	General Agreement on Tariffs and Trade
GDP	Gross Domestic Product
HBOS	Halifax Bank Of Scotland
HFSB	Hedge Fund Standard Board
HLIs	Highly Leveraged Institutions
IAASB	International Auditing and Assurance Standards Board
IAIS	International Association of Insurance Supervisors
IAS	International Accounting Standards
IASB	International Accounting Standards Board
IASC	International Accounting Standards Committee
IBFed	International Banking Federation
IFRS	International Financial Reporting Standards
IIF	Institute of International Finance
IKB	Deutsche Industriebank
IMF	International Monetary Fund
IOSCO	International Organization of Securities Commissions
IPE	International Political Economy
IR	Investor Relations
IRB	internal ratings-based
IRC	incremental risk charge
ISDA	International Swaps and Derivatives Association
JGB	Japanese Government Bond
LB	Landesbank
LDP	Liberal Democratic Party

LME	Liberal Market Economy
LTCM	Long Term Capital Management
MiFID	Markets in Financial Instruments Directive
MIT	Massachusetts Institute of Technology
MOF	Ministry of Finance
NGO	Non-Governmental Organization
NPL	non-performing loans
OCC	Office of the Comptroller of the Currency
OECD	Organization for Economic Cooperation and Development
OTC	over-the-counter
OTS	Office of Thrift Supervision
PBC	People's Bank of China
PWG	President's Working Group
RCC	Resolution and Collection Corporation
RIPE	Review of International Political Economy
RMB	Renmimbi
S&L	savings and loans
SEC	Securities and Exchange Commission
SLF	Short-term Liquidity Facility
SME	Small and Medium Enterprises
SOCBS	state-owned commercial banks
SPD	Sozialdemokratische Partei Deutschlands
SZ	Süddeutsche Zeitung
TCE	tangible common equity
TSB	Trustee Savings Bank
UN	United Nations
VaR	value-at-risk
VoC	Varieties of Capitalism
WB	World Bank
WTO	World Trade Organization

1 Crisis and the reform of international financial regulation[1]

Eric Helleiner and Stefano Pagliari

What began in the summer of 2007 as a problem in a relatively unknown segment of the US housing finance market has very quickly turned into the most severe global financial crisis since the 1930s. The impact of this crisis has escalated far beyond its point of origin, affecting countries around the world, and spilling over from the financial system into the real economy. The implications of this shock are wide-ranging and still difficult to fully understand. In this book, we explore one of the most important consequences so far: the influence of the crisis on the international regulation of financial markets.

The severity of the global financial crisis has revealed major weaknesses in the international architecture for prudential financial regulation that has been constructed since the mid-1970s.[2] Policymakers have responded with a flurry of ambitious initiatives to reform international standards and strengthen the international financial regulatory regime. How has international financial regulation changed in response to the crisis to date? What explains the blitz of international regulatory initiatives we have witnessed to date in response to this crisis? Are we facing an important turning in the regulation of global finance?

This book brings together scholars of the politics of international financial regulation to address these questions from a number of different perspectives. The first part of the book analyzes change across a number of sectors of global finance, including the regulation of banks, credit rating agencies, accountancy, hedge funds, and derivatives. The second part examines the international regulatory response from the vantage point of key powers in global finance in Europe, the US, and Asia. The contributors to both parts also embrace a number of distinct theoretical approaches for understanding international financial regulatory change. Taken together, the book presents the first detailed political analysis of the international regulatory response to the global financial crisis which started in 2007.

We begin this introductory chapter by describing in broad brush strokes three key patterns of international regulatory change witnessed so far in response to the crisis: (i) an expansion of the perimeter of international regulation, (ii) efforts to strengthen its institutional architecture, and (iii) a departure from a trend over the past decade or so of delegating regulatory and supervisory responsibilities to private market actors. We then outline three distinct analytical lenses which the contributors to this volume use to explain these international regulatory changes: inter-state power, domestic politics, and transnationalism. We conclude by outlining the disagreement among the authors about the broader significance of the international regulatory initiatives launched so far.

What has changed?

How has international financial regulation changed in response to the crisis to date? To answer this question, it is helpful to first review the evolution of international regulation from the mid-1970s up until the current crisis. There was no founding act setting the basis for the existing international prudential regulatory architecture; it evolved instead in an incremental and *ad hoc* manner, and usually in response to various crises. The story of this evolution has been told expertly elsewhere and we will not repeat it here (see for example Davis and Green 2008). Instead, our objective is to summarize three key themes of the story in order to establish benchmarks against which to measure change since the current crisis began.

Evolution from the mid-1970s to the current crisis

The first theme has been a gradual expansion in the range of issues covered by the international financial regulatory regime. International regulatory coordination first took place in the banking sector in the mid-1970s through the creation of a committee of national banking supervisors that came to be called Basel Committee on Banking Supervision (BCBS). After formalizing the division of responsibilities in the supervision of international banks in the 1975 Basel Concordat, the BCBS created the Basel Capital Adequacy Accord of 1988 (Basel I) to define minimum capital standards for international banks, and then updated it between 1998 and 2004 (Basel II). Regulatory coordination soon extended to securities markets and related sectors such as credit rating agencies via the International Organization of Securities Commissions (IOSCO) created in 1983, as well as to insurance markets via the International Association of Insurance Supervisors (IAIS) created in 1994. In 1990, central banks of the same G10 countries that constituted the membership of the Basel Committee also created the Committee on Payment and Settlement Systems (CPSS) which produced some core principles for "systematically important payments systems" as well as (jointly with IOSCO) for securities settlements systems and central counterparties.

In the wake of the international financial crises of the late 1990s, the perimeter of the prudential financial regulation expanded further to include corporate governance, accounting, and auditing standards. The Organisation for Economic Cooperation and Development (OECD) drafted in 1999 its "Principles of Corporate Governance". In the accounting sphere, the International Accounting Standards Board (IASB) – a private body created in 2001 – established the International Financial Reporting Standards (IFRS) that have been now been embraced by over 100 countries, including the European Union (since 2005) and increasingly the US. Another private sector body – the International Auditing and Assurance Standards Board (IAASB) – emerged as the most relevant standard-setter in the auditing sphere. The standards of these three bodies – as well as those of the BCBS, IOSCO, IAIS, and CPSS – were increasingly promoted across the world by the G7 and international financial institutions after the late 1990s.

A second important theme in the evolution of the international prudential regulation has been that the setting of these standards has taken place in a relatively fragmented, weak, and exclusive institutional context. While postwar multilateral trade negotiations have been conducted under the single framework of the GATT/WTO, international financial regulation developed within the much more fragmented alphabet soup of institutions noted above. To be sure, there were some efforts to address the fragmentation before the current crisis. In 1996, the BCBS, IAIS, and IOSCO created the "Joint Forum" to discuss issues of overlapping concern across banking, insurance, and securities markets. Three years later, the Financial Stability Forum (FSF) was created to bring together in one place for the first time all the relevant international standard setters (the BCBS, IAIS, IOSCO, IASB, CPSS), international economic organizations (the IMF, WB, OECD, BIS, the ECB, the Committee on the Global Financial System), as well as key national financial authorities. The Bank for International Settlements (BIS) has also played an increasingly central position within the patchwork of sectoral regulatory bodies, housing the BCBS, the IAIS, the CPSS, the Joint Forum, and the FSF. Despite these developments, the fragmentation of the institutional context of international financial regulation remained considerable.

The international financial regulatory regime also lacked supranational institutions with the kind of power that the WTO has. Proposals to create such institutions have been consistently rejected by policymakers in favor of international institutions whose formal roles are confined primarily to facilitating networks of informal cooperation, information-sharing and consensus formation. The implementation of financial regulation and supervision continues to be firmly located at the national level, with most international financial regulatory agreements simply taking the forms of "best practice" standards, "memorandum of understanding", general "framework", and "principles" which are not legally binding between regulators, do not require ratification by legislatures, and allow significant flexibility of implementation at the national level (see for example Kahler and Lake 2009). While the trade regime has been characterized by a trend towards greater "legalization" since the Uruguay Round, international financial regulatory agreements remain examples of "soft law" – with the important exception of financial regulation within the European Union (Goldstein *et al.* 2000; Singer 2007: 9–10).[3]

International financial regulation has also been developed in an institutional context which has been more exclusive than that for international trade. To be sure, some of the international financial standard-setters, such as IOSCO, have a broad country membership which comes close to matching the WTO's. But others, such as the BCBS, CPSS, and FSF, were very narrowly constituted before the current crisis. Despite the adoption of its standards around the world, the BCBS included only industrialized countries as of 2007: the G7 countries plus Benelux, Spain, Sweden, and Switzerland. The CPSS's membership was restricted to the G7 countries, Belgium, the Netherlands, Singapore, Hong Kong, Sweden, and Switzerland, while the FSF included just the G7 countries, Australia, Hong Kong, the Netherlands, Singapore, and Switzerland. Even within the more widely representative IOSCO, the key regulatory initiatives stem from its Technical Committee that had members from only the G7 countries, Australia, Hong Kong, Mexico, the Netherlands, Spain, and Switzerland. In short, the financial regulatory regime remained characterized by a clear distinction between "rule-takers" and "rule-makers".

The third important theme in the evolution of international prudential regulation relates to a change in its content in the decade or so before the crisis: the assignment to private market actors of an increasingly significant role in the regulation and supervision of financial markets. In some contexts, this trend manifested itself through the endorsement and legitimization by the FSF and G7 of standards set by private actors, such as the accounting and auditing standards drafted respectively by the IASB and IAASB, or the codes of best practices for the hedge fund industry set by hedge fund managers' groups. Another manifestation was that regulators began to shift part of the responsibility for monitoring markets into the hands of private investors themselves by requesting private and public actors to publicly disclose more information regarding their activities. The Basel II agreement even elevated this "market discipline" to one of its three pillars of regulation, alongside formal capital requirements and supervision. That agreement also allowed large banks to use their own information and risk-management schemes to determine the amount of reserve capital to put aside for credit risk and assigned credit rating agencies a formal role in credit risk assessment for banks of all kinds. In sum, in the words of the former head of the BIS Andrew Crockett, a "paradigm shift" in the thinking behind prudential policies led authorities to "increasing efforts to work with, rather than against, the grain of market forces" (Crockett 2002: 977).

Change since the crisis began

How has the post-2007 crisis influenced these trends and patterns of international financial regulation since the mid-1970s? Very soon after the outbreak of the crisis, a plethora of reports and regulatory initiatives offering diagnoses of the crisis and presenting recommendations were published by national regulatory agencies, financial industry associations, and international standard-setting bodies (see Eleni Tsingou's discussion in Chapter 2). The Financial Stability Forum coalesced this extensive body of work into an internationally-coordinated response, releasing in April 2008 a road-map of international regulatory reform involving more than 60 recommendations (FSF 2008a). This wide-ranging policy agenda was quickly endorsed by the G7 and then subsequently refined by the FSF and other standard-setting bodies in the lead up to the first-ever G20 leaders summit in November 2008 (FSF 2008b).

At the Washington summit, the G20 leaders made the issue of international regulatory reform the most prominent issue on their agenda (G20 2008). In addition to endorsing much of the work of the technocrats, they set out priorities for the reform agenda with a tight deadline of 31 March 2009. These priorities were largely met by the time of the second G20 leaders summit in London in early April, which then set further priorities with specific deadlines for the various technocratic bodies to meet (G20 2009). Many of the London summit's priorities on regulatory issues had been developed by two G20 working groups, each co-chaired by a developed and developing country representative, which presented very detailed reports and recommendations, alongside those of the FSF (FSF 2009a; G20 Working Group 1 2009; G20 Working Group 2 2009).

Various changes to international prudential regulation have been implemented as of mid-2009 as a result of these developments. Since banks were at the centre of the current crisis, policymakers have devoted much attention to bank regulation, including the reform of risk management calculations, the development of liquidity management rules, and higher capital requirements on trading books, securitized products, and off-balance sheet activities (see Tony Porter in Chapter 4). But there has also been an important extension of the perimeter of international regulation into new issue areas. At the London summit, the G20 leaders endorsed for the first time a set of international principles – developed by the FSF – for pay and compensation for significant financial institutions, and financial supervisors were tasked with their enforcement (FSF 2009c). Derivatives and hedge funds – two sectors whose regulation had been left to the private sector – were also brought under the official international regulatory umbrella for the first time (see our discussion in Chapter 5). Before the crisis, the regulation of credit rating agencies had been only a marginal issue, but the G20 leaders now insisted that all agencies whose ratings are used for regulatory purposes would be subject to a regulatory oversight regime consistent with a revised IOSCO code which had previously been only voluntary (IOSCO 2008a; see Porter in Chapter 4). More broadly, the G20 leaders have also tasked the IMF and FSF with the job of producing guidelines for national authorities "to assess whether a financial institution, market, or an instrument is systemically important" in order that regulation and supervision be extended to these entities (G20 2009: 3).

In addition to further extending the perimeter of international financial regulation, the G20 leaders attempted to strengthen its institutional basis. They did this partly by establishing collaborative "supervisory colleges" for all major cross-border financial institutions. Much more dramatic, however, was the announcement at the London summit of a major reform of the FSF – now renamed Financial Stability Board (FSB) – to transform it into one of the central pillars of global financial governance. The FSB was assigned the job of collaborating with the IMF in conducting early warning exercises as well as setting guidelines and supporting the creation of the supervisory colleges. It was also tasked with undertaking "joint strategic reviews of the policy development work of the international Standard Setting Bodies to ensure their work is timely, coordinated, focused on priorities, and addressing gaps" (G20 2009: 1). The standard setting bodies were also required to report to the FSB on their work in order to provide "a broader accountability framework" for their activities (FSF 2009d: 2). Finally, all FSB members agreed to implement twelve key existing international standards and codes, and to undergo periodic peer reviews. To perform all these tasks, the FSB has been created with a somewhat more complex structure than the FSF, including new institutional layers above the informal discussion occurring in the plenary meetings. The FSB has been given an enlarged secretariat in Basel, promised a full-time Secretary-General, and a Steering Committee and three Standing Committees (for Vulnerabilities Assessment, Supervisory and Regulatory Cooperation, and Standards Implementation) have been created.

The institutional foundations of the international regulatory regime have also been made somewhat more inclusive of developing countries (see Table 1 and Walter in Chapter 10). One sign of this change was the simple fact that the G20 leaders as a whole were now setting priorities for international regulatory reform, in contrast to the aftermath of the East Asian crisis when this role was undertaken by the G7. With the G20's encouragement, IOSCO's Technical Committee, the BCBS, and CPSS also invited a number of systematically important developing countries as new members.[4] The IASB also guaranteed geographical diversity on its Board for the first time in a manner that guaranteed developing country representation.[5] Most important, however, was the expansion of the membership of the FSF/FSB just before the London Summit to include all G20 countries (Spain and the European Commission were also included). Before the expansion, there were two classes of countries: the G7 each had three representatives (finance ministry, central bank, and supervisory authority), whereas the other five member countries (Australia, Hong Kong, the Netherlands, Singapore, and Switzerland) were only allowed one. With the new 2009 expansion, three classes of countries were created: the BRICs (Brazil, China, India, Russia) joined the G7 countries with three representatives each, while Australia, Mexico, the Netherlands, Spain, South Korea, and Switzerland were now assigned two, and everyone else was left with one (Argentina, Hong Kong, Indonesia, Singapore, Saudi Arabia, South Africa, and Turkey).[6]

The process of institutional reform should not be overstated. Regulators have continued to rely on networked forms of governance and most of the new international regulatory initiatives remain non-binding, allow significant flexibility of implementation at the national level, and do not delegate enforcement or implementation authority to a third party. There have been only two small signs of a possible departure from the long-standing reliance on soft law. The first is the requirement that membership in the FSB is dependent on implementation of key international standards. Second, at their London summit, the G20 leaders asked the FSB to develop "a toolbox of measures to promote adherence to prudential standards" among non-cooperative jurisdictions (G20 2009: 5). But the willingness of the G20 to deploy this toolbox to promote worldwide compliance and implementation remains to be seen.

The final change in international financial regulation to date has been with respect to the public–private balance. In sectors where self-regulation had been

Table 1 Major global financial regulatory standard setting institutions: Country membership as of July 2009 (new country members since September 2008 in bold and capitalized)

	G20	*FSB*	*BCBS*	*IOSCO technical committee*	*CPSS*
Argentina	x	**X (1)**	**X**		
Australia	x	x (2)	**X**	X	**X**
Belgium			x		x
Brazil	x	**X (3)**	**X**	**X**	**X**
Canada	x	x (3)	x	x (2)	x
China	x	**X (3)**	**X**	**X**	**X**
France	x	x (3)	x	x	x
Germany	x	x (3)	x	x	x
Hong Kong		x (1)	**X**	x	x
India	x	**X (3)**	**X**	**X**	**X**
Indonesia	x	**X (1)**	**X**		
Italy	x	x (3)	x	x	x
Japan	x	x (3)	x	x	x
Luxembourg			x		
Mexico	x	**X (2)**	**X**	x	**X**
Netherlands	*	x (2)	x	x	x
Russia	x	**X (3)**	**X**		**X**
Saudi Arabia	x	**X (1)**	**X**		**X**
Singapore		x (1)	**X**		x
South Africa	x	**X (1)**	**X**		**X**
South Korea	x	**X (2)**	**X**		**X**
Spain	*	**X** (2)	x	x	
Sweden			x		x
Switzerland		x (2)	x	x	x
Turkey	x	**X (1)**	**X**		
UK	x	x (3)	x	x	x
US	x	x (3)	x	x (2)	x

* While Spain and the Netherlands are not full time members of the G20, they were invited to the G20 Leaders Summits in Washington in November 2008, and in London in April 2009.

actively fostered by public authorities over the past decade – such as derivatives, hedge funds, and credit risk management by banks – officials are now bringing regulation under greater public control. In areas where the enforcement of international standards had been delegated to voluntary efforts and market pressures – such as credit rating agencies – policymakers are also assuming the task of monitoring and enforcing compliance. This trend is also apparent in the accounting realm where the G20 has encouraged the private standard-setting body, the IASB, to accept greater public oversight. In January 2009, the IASB responded by announcing the creation of a new international monitoring board to appoint the trustees who oversee its operations. The members of this board are public authorities: the US Securities and Exchange Commission (SEC), Japan's Financial Services Agency, the European Commission, and IOSCO's Emerging