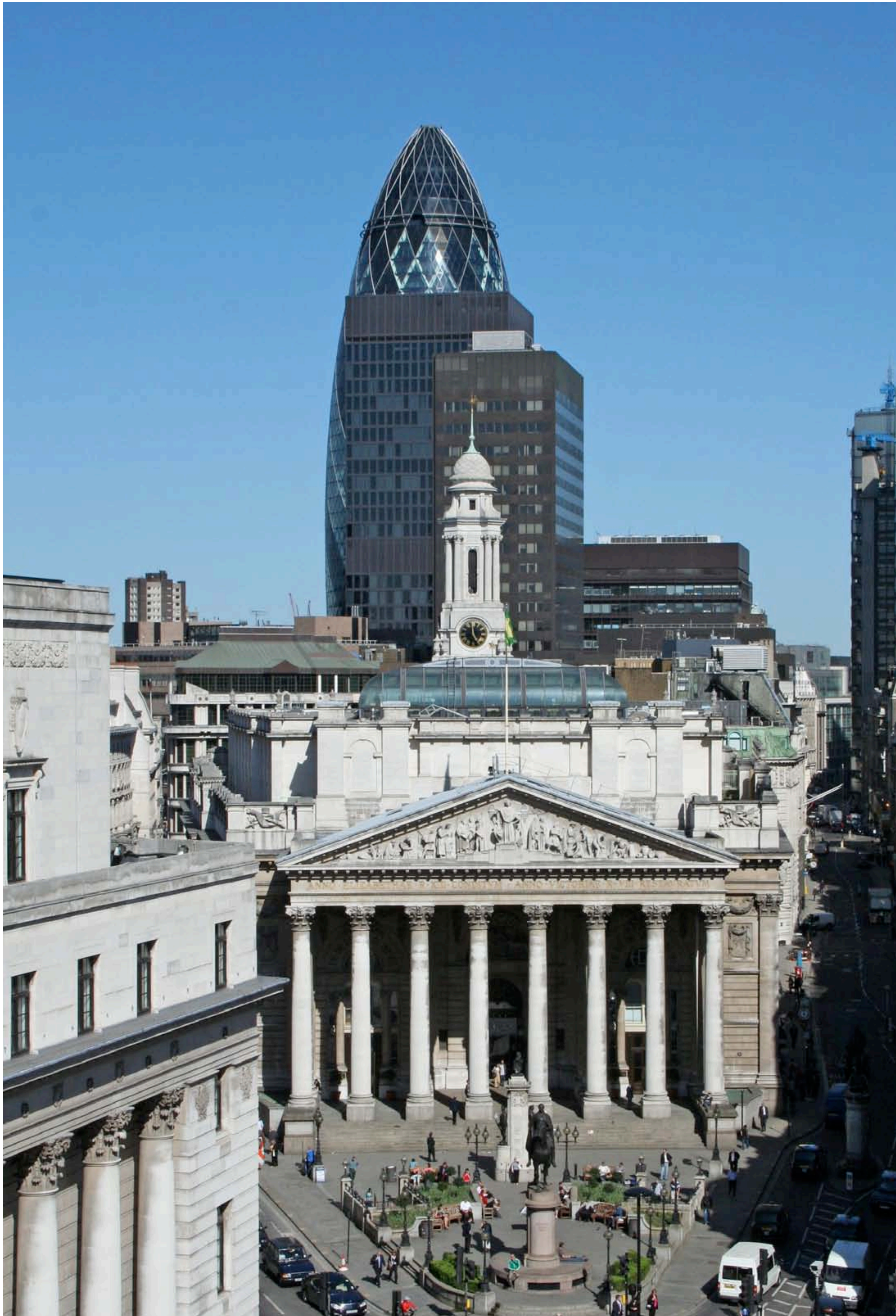
Inaugural Lecture, Charterhouse Square, 23 March 2011, 6:30 pm
by Professor Rosa M. Lastra

The Quest for International Financial Regulation

Good evening and thank you very much for coming.

An inaugural lecture provides an opportunity to talk about the themes and subjects which endear us to our academic work. In my case, these themes are international law, financial regulation, central banking, the interaction between law and economics and the lessons of history. It also provides an opportunity to realise how grateful one should be to the people and institutions that have helped us in the journey of our lives. I would therefore like to start by giving thanks to my family, to my friends and colleagues, to my students - past and present - and to my mentors, in particular Charles Goodhart, truly an intellectual father. A special tribute goes to the memory of those who have already left us and whose influence helped shape who we are. My gratitude extends of, course, to Professor Simon Gaskell, Professor Philip Ogden, Professor Virginia Davies and to Spyros Maniatis, Director of the Centre for Commercial Law Studies. My time at Queen Mary University of London has given me precious and happy memories and I remain most appreciative of the support I have received over the last fifteen years.



With the efficient help of the Events team at Queen Mary, I chose a picture for the invitation to this lecture that combines the old and the new in the City of London: the old Stock Exchange and the Bank of England in the front, and the Gherkin[1] in the background. The symbolism of this picture is helpful to understand the evolution of financial markets and their regulation. This combination of old and new is also symbolic of the nature of academia: passing on knowledge (the Latin meaning of *tradere*, to hand down to posterity) and discovering new horizons. It is this mix of **tradition** – teaching – and **innovation** – research that makes academia so fascinating.

My subject today, **the quest for international financial regulation**, looks into the future of finance and it does so by considering both the present and the past. The past, because history matters; institutions and laws are creatures of their times. [In the words of Jorge Santayana, 'those who cannot remember the past are condemned to repeat it']. The present, because the issues surrounding banking and financial reform are no longer only the domain of the specialist: after the financial crisis, they have come to the forefront of economic and policy debate. In 1873, Walter Bagehot (author of Lombard Street and editor of the Economist) wrote that the Money Market 'could be spoken of in plain words, and that it was the writer's fault if what he said was not clear.' My challenge today is to address this subject to an audience that combines the specialist and non-specialist and to try to do it in plain words.

The basic tenet of this lecture is that financial markets have become much more international in recent decades, while their regulation, supervision and - if necessary - resolution remain constrained by the domain of domestic jurisdictions. The disconnection between global markets and national law was highlighted and threatened to cause serious problems following the sudden and disorderly closure of Lehman Brothers in September 2008. **This lecture argues that it is urgent and important to devise adequate international structures and international norms to govern financial markets.** The presentation is structured around three main parts. The **first** part deals with the rationale of regulation. The **second** part discusses the evolutionary nature of financial markets and institutions. And the **third** part considers the emerging *lex financiera* and the emerging international financial architecture.

[1] The Gherkin or 30 St Mary Axe is a symbol of architectural innovation in the City of London. St Mary Axe was a medieval parish whose name survives on the street it formerly occupied, St Mary Axe. The church itself was demolished in 1561. The name derives from the combination of the church dedicated to the Virgin Mary and a neighbouring tavern, which prominently displayed a sign with an axe image.

Before going into the substance of today's lecture, let me make a brief reference to an important methodological issue that features in my research: the need for effective inter-disciplinary dialogue and, in particular, the dialogue between law and economics. I believe **the law can provide order, clarity and rationalization to the study of money and finance, as well as attention to detail.** Of course, I am aware though that trying to combine the legal perspective (logically coherent) with the economic approach (empirically based) is not an easy task. Stigler wrote in his *Memoirs of an Unregulated Economist*: 'One cannot communicate effectively with other people unless one uses the language to which they are accustomed'. The challenge remains to establish such communication, at least in the field of social sciences, reaching out to other disciplines from the established credibility one forges in a given field of specialization.

1. THE RATIONALE OF REGULATION

Money and finance play a key role in everyone's life. Harry Potter, a character beloved by my children, kept the money his late parents had left him in a vault at Gringotts Wizarding Bank.

> Gringotts is the only known bank of wizards and is operated primarily by extremely greedy goblins. Wizards and witches keep their money and valuables in vaults that are protected by very complex and strong security measures. A fictional system of currency is used by the wizards of the United Kingdom. As explained by JK Rowling in 'Harry Potter and the Philosopher's Stone' there are 17 silver Sickles to a gold Galleon, and 29 bronze Knuts to a Sickle.

This passage, which explains basic banking concepts to children (though the irony behind a monopoly bank, greedy bankers, and complex security will not be lost to many in the audience), goes some way to illustrate that we all have an intuitive understanding of what money and finance are. We all recognise the importance of money – that is, a commonly accepted means of exchange and payment and a unit of account – in order to be able to buy and sell things. Without money, an economy would revert to barter (exchanging goods or services directly for other goods or services). Money can be also a store of value, which helps explain the history of banks. In the words of Ricardo, *the distinctive feature of the banker begins when he uses the money of others; as long as he uses his own money he is only a capitalist*. We all understand what a monetary debt is, and that being a debtor (or creditor)

entails a number of rights and obligations.[2] Confidence and trust are preconditions for a market economy to function efficiently (the term credit comes from the Latin *credere*: to trust, to believe), and such trust that underlies all transactions, that is the foundation of enterprise and development, is supported by a legal framework. That **markets need rules** to function well has been argued by Ronald Coase and Douglass North, both Nobel Laureates. But long before Coase and North, the importance of the law for functioning markets had been recognised. Adam Smith, the founding founder of Economics as an autonomous subject, wrote in 1776:

> Commerce (...) can seldom flourish long in any state which does not enjoy a regular administration of justice, in which the people do not feel themselves secure in the possession of their property, in which the faith of contracts is not supported by the law, and in which the authority of the state is not supposed to be regularly employed in enforcing the payment of debts from all those who are able to pay.

The law, after all, is about setting boundaries for personal and collective behaviour. But beyond the basic laws that support a market economy and provide stability, continuity and predictability of contract and property rights, **the case for banking and financial regulation** requires additional justification. It is the existence of market failures and deficiencies, notably negative externalities and information asymmetries that provides the rationale of regulation. Externalities or spillovers are the costs to society of banking failures. And, indeed, the costs to society of a crisis are very large – as we know from recent experience – and, by far, exceed the private costs to individual financial institutions; that is a why a key aim of regulation should be to internalize these externalities. Information asymmetries or deficiencies – a feature of the services industry in general – refers to the fact that the provider of the service knows much more than the consumer of the service. In banking these problems are particularly acute and the phenomenon of bank runs is well known (the image in the 'Mary Poppins' film of the little boy triggering a bank run offers a good and simple example). The aim of banking and financial laws is to protect individuals (depositors, investors, policy-holders), to ensure the smooth conduct of the business (fair, efficient and transparent markets) and to safeguard the payment system and the stability of the financial system at large, preventing and containing systemic risk and systemic crises.

[2] In the words of Philip Wood, the Holy Grail of financial law is to protect both the people at the polar ends of financial assets: the debtor and the creditor.

The question then arises: why international regulation? The quest for international law in money and finance is a logical response to the increasing globalization of financial markets. It is also a response to the need to prevent and contain contagious systemic risk, a risk that does not respect geographic boundaries. The crisis showed that national financial markets cannot be looked in isolation. A fragmented global regulatory and accounting regime gives rise to regulatory arbitrage ('forum shopping'), loopholes and shadow institutions and markets; it also increases transaction costs and can lead to financial protectionism. Incompatible or conflicting rules from country to country increase the regulatory costs and can create new risks. Regulatory competition can also lead to a race to the bottom. And since international problems emerged as a consequence of domestic failures, an extra argument for international regulation is that it can be a backstop to domestic regulation.

Though the financial crisis was global, the solutions to the mounting problems were mostly national. Some of these solutions – including unprecedented liquidity assistance and massive government support and intervention – were quite extraordinary and, in the absence of adequate laws, emergency legislation or new rules were expeditiously introduced in several countries. Using an analogy with fire departments, while every effort was made to extinguish the fire during the crisis, in the aftermath of the financial crisis we need to re-examine the fire regulations and to consider how well (or how badly) the institutions did. In many cases we may conclude that the adequate response is not necessarily more regulation, but better supervision and enforcement or greater transparency or better international coordination. We should also beware of the excesses of regulation and the dangers of over-regulating a given sector or type of institutions, creating incentives for businesses to move outside the regulatory framework. **Any regulatory perimeter brings its own shadows and loopholes**. We must also be mindful of the question of competition. Regulation and liberalization are not always companions; at times, they are antagonists.

In order to understand what making rules international means, and why such rules are needed, let us briefly review the notions of **sovereignty, power and governance.**

Sovereignty is the supreme power within a territory, the territory of the nation state. Thus, sovereignty has a territorial dimension, and the government is the political institution in which sovereignty is embodied. Sovereignty forms part of the fundamental principles of international law and is a key organizing concept of international relations. But it is a

principle rooted in history. The modern understanding of the attributes of sovereignty was developed in the Renaissance. Indeed, politics operated without this organizing principle in the Middle Ages.

When it comes to modern financial markets, sovereignty is an inadequate principle to deal with financial conglomerates, complex groups and, generally, with cross border institutions and markets. It is not a good principle to deal with crisis management either, nor with the home/host country divide. Indeed, like a tsunami that does not respect territorial borders, the effects of a financial crisis spread beyond geographic frontiers. You cannot fight it only with national measures. In some parts of our modern life we need to move beyond national sovereignty. This has happened already in some regional areas, such as the European Union, where countries have been ready to make sacrifices in terms of national sovereignty for the sake of European unity. And it happens whenever countries sign international treaties.

Power is diffused. It is exercised by a variety of actors including international organisations, multinational corporations, non-governmental organizations, and the civil society too. The political and economic stage is now crowded with new actors who operate across borders as well as within them. And in this stage, financial institutions have become important holders of power and agents of governance given their key role in the allocation of capital.

Financial markets transcend national boundaries. And so do financial stability and systemic risk. It may actually be in the best interests of countries to pool sovereignty in some areas. Drawing again on the lessons of history, it was in the context of World War II that countries were ready to make the sacrifices needed in terms of sovereignty by signing a number of international treaties that gave rise to international organizations such as the United Nations, the International Monetary Fund and the World Bank. John Maynard Keynes had wisely stated that in order to win the war we needed to 'win the peace'. It was this understanding that also inspired Henry Morgenthau (then US Treasury Secretary) to proclaim in the opening remarks of the Bretton Woods conference in New Hampshire in July 1944 that 'prosperity like peace is indivisible'. Neither Keynes nor Morgenthau were thinking only in territorial/national terms: they were thinking in international terms. And we also need now to think in international terms to solve some of the problems of our times. [The very spirit of University is universal].

This international frame of mind does not imply a negation of sovereignty in all areas of our life. Indeed, sovereignty remains a key organizing principle and a useful one in the context of the Nation State. We are all citizens of a given country, though some of us may enjoy double nationality (my own children – present here today – enjoy the benefits - and challenges - of growing up in an international family). And a substantial number of issues – for instance fiscal issues – are still decided at the national level. Some decisions are best taken at the local level, while it makes sense for others to be taken supra-nationally or internationally. The doctrine of multi-layered governance, which discusses the allocation of powers at the national, regional and international levels, provides a template to address some of these issues. The challenge is to identify the criteria under which financial regulatory powers should be allocated (who decides what) and the different layers that are needed.

Financial markets need to rely on different levels of governance. An analogy with football (soccer) can be instructive in this regard. There are domestic leagues, ruled by national football associations, there is in Europe a Champions League governed by UEFA, and finally – though this is a competition among countries not clubs – there is FIFA and the World Cup. Some institutions play locally, while others compete in the European or global stage.

We need to identify the functions (or sub-functions) that require a supra-national or international structure and the functions that are best left at the national level. When it comes to financial markets, there are three key functions that are necessary to achieve the elusive goal of financial stability and these are: regulation (or rule-making), supervision (risk control, monitoring and compliance) and crisis management (lender of last resort, deposit insurance, resolution, insolvency). And let us remember the basic tenet of this lecture – the disconnection between international markets and national law. A global banking and financial system requires some binding international rules, efficient supervision, and an international system for the resolution of conflicts and crises. **Effective enforcement** though remains the greatest challenge at the international level, since enforcement mechanisms have traditionally been nationally based, a logical extension of the principle of sovereignty. But we need to find new ways of enforcement. In the current process of globalisation, the state is finding it increasingly difficult to enforce its laws against global actors such as multinational corporations and criminal organisations; tax laws are a case in point. Resolving conflicts is also diverging from the state's judicial machinery to private bodies through the increasing popularity of arbitration as an alternative dispute resolution mechanism. Even in the area of

policing, the state is enlisting the private sector in the fight against crime. Money laundering control systems and the reporting duties they impose on financial institutions are an examples of this shift towards private policing.
The other major challenge to advance towards international solutions is, of course, the fiscal issue, the lack of ex ante burden sharing arrangements in a crisis.

2. THE EVOLUTION OF FINANCIAL MARKETS AND INSTITUTIONS

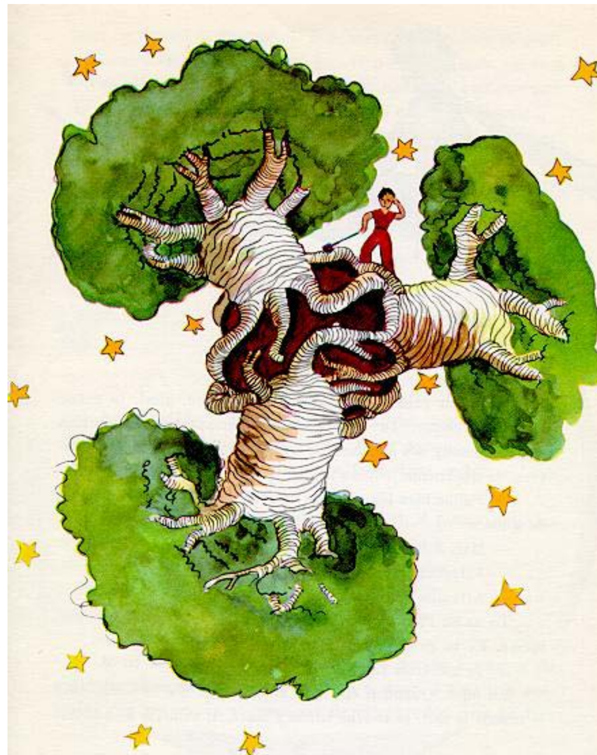
Having examined the notions of power and sovereignty and the rationale of regulation, we will now discuss **the evolution of financial markets**. Not so long ago, most banks were fairly uncomplicated institutions operating nationally, under the umbrella of the central bank,[3] taking deposits and granting loans [the 3-5-3 rule: take deposits at 3%, loan them out at 5% and go home/play golf at 3pm].

Globalization has changed the traditional understanding of financial markets and has led to the emergence of multinational banks, financial groups and new instruments and markets that operate across jurisdictions. Financial globalization has been fostered by financial innovation, the technological revolution, the integration and liberalization of markets, the mobility of people and capital and other factors. But the global financial market is not a huge global homogenous market. It is more like a spider's web or a radial web with multiple interconnections and linkages,[4] in which local markets permeate each other and in which a few players dominate the scene. The size or importance of some of these players (the term SIFIs or systemically significant financial institutions is now in vogue) is a source of concern globally and nationally[5]. The dangers of SIFIs remind me of the image of the baobabs in The Little Prince:

> *There were some terrible seeds on the planet that was the home of the little prince, and these were the seeds of the baobab. (...) A baobab is something you will never be able to get rid of if you attend to it too late. It spreads over the entire planet. (...) And if the planet is too small and the baobabs are too many, they split it into pieces. (...)* After explaining how he cleaned the seeds of the baobabs everyday

[3] In the particular case of the big British banks in the XIXth century, most international banking was in the banks' home country colonies, as Geoffrey Wood pointed out to me.
[4] Andrew Haldane has looked at the lessons that ecology, epidemiology and genetics provide in order to understand financial networks and complex financial systems.
[5] If banks are able to borrow at artificially low rates because creditors do not believe that they will be allowed to fail, this encourages moral hazard.

he added: *'Sometimes, there is no harm in putting off a piece of work until another day. But when it is a matter of baobabs, that always means a catastrophe. I knew a planet that was inhabited by a lazy man. He neglected three little bushes...'*



So, as the little prince described it to me, I have made a drawing of that planet. I do not much like to take the tone of a moralist. But the danger of the baobabs is so little understood, and such considerable risks would be run by anyone who might get lost on an asteroid, that for once I am breaking through my reserve. (...) I say plainly, 'watch out for the baobabs'.
'The Little Prince' by Antoine du Saint-Exupéry

Watch out for systemic risk! That should surely be a shared objective by both bankers and their regulators. Globalization has magnified the impact and geographic outreach of systemic risk. **And the globalization and liberalization of financial markets have proceeded at a much faster pace than the development of an appropriate international legal and institutional framework.**

We still rely to a large extent upon national institutions. Amongst them, the central bank continues to play a key role in the monetary and financial system. Of course, central banking has evolved significantly throughout its relatively short history, from the time in which the Swedish Riksbank (1668) and the Bank of England (1694) were set up, to central banks in

contemporary times. While the original rationale for the establishment of the first central banks was to be a bank that was awarded privileges by the Government to issue currency and that was expected to finance the Government needs (mostly in war time), this rationale has changed over time. The Federal Reserve System (the Fed) was founded in 1913, following the banking crisis of 1907, to safeguard the soundness of banks and to fulfil other objectives. Vera Lutz Smith (a student of Hayek) explained in her excellent book, 'The Rationale of Central Banking' in 1936 that the twin mandate of central banks was stable money and sound banking (today we say monetary stability and financial stability). However, the Bundesbank was set up in 1957 primarily as a monetary institution to preserve price stability (hyperinflation during the inter-war period had left a long-lasting dislike for inflation amongst the German public and politicians). The advent of central bank independence as a means to achieve price stability consolidated the role of central banks as monetary institutions in the 1990s and beginning of the XXIst century. During this time - and often in connection with other trends (notably the advent of EMU in Europe and the transfer of supervision away from the central bank), central banks – with a few exceptions – gave primacy to a price stability oriented monetary policy and often neglected financial stability considerations. The Bundesbank model of the central bank as a monetary policy institution became the functional model for the European System of Central Banks when it was established in 1999. The ECB was conceived in the Maastricht Treaty as a monetary authority and the treaty provisions are clear both as to the primacy of the price stability mandate and as to the independence of the institution.

The financial crisis 2007-2009 – a rude awakening in so many areas – brought the importance of the financial stability mandate of central banks back to the fore, in particular their lender of last resort role.[6] And in the European context, the events of the last three years have stretched to the limit what the European Central Bank can do under the Treaty and have exposed the deficiencies of institutional design. For example, with the adoption in May 2010 of the controversial Securities Markets Programme to purchase government bonds, the ECB entered into unchartered territory. The no-bail out clause, the sovereign debt problems in Greece and other peripheral EU Member States, fiscal constraints, uncoordinated national measures, and other banking and financial problems - from Iceland to Ireland - have resulted in a number of

[6] The financial crisis also exposed the limitations of too narrow a focus. In line with Goodhart's law (any observed statistical regularity will tend to collapse once pressure is placed upon it for control purposes), the measurement of inflation largely ignored asset prices, in particular house prices, thus being unable to identify and combat the 'elephant in the room', that is a large asset price bubble that eventually burst in August 2007.

measures, reform packages and initiatives, which can be considered as patches or as solutions, depending on one's point of view. The creation in June 2010 of the European Financial Stability Facility (EFSF) and the European Financial Stabilization Mechanism (EFSM) – 'bail-out' facilities for Greece – is a partial response ('muddling through') to a bigger problem, and that is the weakness of the 'E' of EMU, the weakness of its economic/fiscal pillar. The recent establishment of a new EU supervisory structure, with the European Systemic Risk Board and the three supervisory authorities (the European Banking Authority, the European Securities and Markets Authority and the European Insurance and Occupational Pensions Authority) is an attempt to address the 'trilemma' of financial supervision (a term coined by Dirk Schoenmaker, drawing on Niels Thygesen, to refer to the fact that it is difficult to achieve simultaneously a single financial market and financial stability while preserving a high degree of nationally based supervision). These changes are also symptomatic of an underlying trend, which has been referred to by some as the federalisation of EU financial law. In the long run, we must remember though that institutions and laws cannot survive without societal legitimacy, without the support of the general public. This is the greatest challenge for the goal of European integration.

3. THE EMERGING LEX FINANCIERA AND THE DEBATE ABOUT A WFO

Globalization and regionalization (the latter in particular in the EU) have challenged the traditional law-making process. The financial crisis exposed the limitations of relying upon a loose network of soft-law standard setters and an inadequate system of resolution of financial crises. In order to understand the development of the emerging ***lex financiera*** it is useful to offer some reflections about the evolution of law.

Formal law has often been born out of the development of informal law. This is not a new phenomenon. It is a recurrent feature in the history of law. The evolution of international law and of commercial law, to cite two relevant examples, provides clear evidence in this regard. The primary sources of international law are conventional law (treaty law), customary law and the general principles of law, as recognised by Article 38 of the Statute of the International Court of Justice. Customary international law results when states follow certain practices generally and consistently. Customary law, however, can evolve into conventional law. Indeed, important principles of customary international law have become codified in the

Vienna Convention of the Law of the Treaties, thus acquiring the characteristic of 'conventional law'.

The birth and development of formal commercial law was influenced by the medieval *lex mercatoria*, that is by the mercantile codes and customs which reflected the usages of trade, the international maritime and commercial practice at the time. Many of the uncodified usages of trade that constituted the *lex mercatoria* eventually became formal law.[7]

The emerging *lex financiera* is similar to the *lex mercatoria* in its international character. The development of international financial law has been a slow and patchy phenomenon because of three reasons: (1) the lack of a clear legal mandate; (2) a reactive rather than a proactive character; and (3) the vested interests national governments have in the supervision and regulation of their financial sectors. The lack of a clear legal mandate raises important issues of legitimacy and accountability. The reactive nature, the fact that we appear to always be fighting the last war haunts regulation. And the national vested interests are again behind the reluctance to further liberalise and integrate financial markets.

Some may argue that certain national laws can be exported or transplanted into other jurisdictions on the basis of their intrinsic superiority (the case for common law is often made in finance). That is surely one way in which the *lex financiera* can progress. But there are other ways of achieving legislative convergence, such as rule harmonization via conventions, model laws, soft-law rules or standards, or the centralization of regulatory functions in a common authority to which responsibility in this area is transferred. International financial regulation so far has proceeded through the harmonization route, and has done so via soft law. Soft law as opposed to hard law is informal and does not rely on traditional mechanisms of enforcement. Over time though we should expect a degree of formalisation of the emerging *lex financiera* in line with the evolution of law generally.

The regulatory function at the international level is shared by a variety of actors, including formal international organizations (such as the IMF), informal groupings of an international

[7] Sir Roy Goode recalls in his writings that the *lex mercatoria* or law merchant (which was international rather than English and which was administered by its own mercantile courts) was given full recognition by the common law courts (absorbed in the common law itself). The fertility of the business mind and the fact that a practice which begins life by having no legal force acquires over time the sanctity of law are key factors to which the commercial and financial lawyer must continually be responsive.

character such as the Financial Stability Board, the Basel Committee on Banking Supervision, the International Organization of Securities Regulation (IOSCO) and the International Association of Insurance Supervisors (IAIS), professional associations – such as the International Swaps and Derivatives Association, ISDA – and other entities. International financial soft-law is often a ‘top-down’ phenomenon with a two-layer implementation scheme. The rules (e.g., the Basel capital rules) are agreed by international financial standard setters and national authorities must implement them in their regulation of the financial industry. The financial intermediaries are the ‘final’ addresses of those rules. Standards and uniform rules, however, can also be designed by the financial industry itself. Self-regulation, by definition, has a ‘bottom-up’ character, comprising rules of practice, standards, master agreements, usages as well as rules and principles agreed or proposed by scholars and experts.

The greatest limitation of international financial soft law is its lack of effective enforcement. It is only by their adoption into national law that such laws typically become enforceable. Observance is to soft law what enforcement is to hard law. Yet, the imposition of sanctions in the case of non-observance remains a formidable challenge. One way of tackling this problem could be the conditioning of market access on the basis of compliance with some international rules.

In any case, we need to foster better observance of the standards to preserve competitive equality amongst nations; we need a mechanism for ensuring the consistent application of global financial rules; and we need a forum to bring disputes when standards are not observed, which brings us back to the institutional debate.

Institutions and laws are creatures of their times. In the words of Justice Oliver Wendell Holmes, a page of history is worth a volume of logic. And our times need a new order. We live in a family of nations and we have public international law to regulate the relations between nation states as well as a set of international organizations to govern such relations.[8]

[8] The ‘School of Salamanca’ is the name applied to a group of Spanish jurists, theologians and philosophers who created a body of doctrine on natural, international and economic law, rooted in the intellectual work of Francisco de Vitoria, who started teaching in Salamanca in 1526 on the *catedra de prima*, the most important chair of theology at the University. The role of the School of Salamanca in the development of early monetary theory has been documented in the work of Marjorie Grice-Hutchinson. While at the LSE, Marjorie came under the influence of Friedrich von Hayek, who urged her to study the manuscripts of this group of Spanish scholars

Some areas of international law are quite developed, for example the law of the sea. In the field of international economic law, the three main pillars of economic relations between States – money, trade and foreign investment – are supported by a different legal regime. The regime in trade is multilateral with the WTO (World Trade Organization) providing an adequate system of international rules and dispute settlement. The regime in foreign investment is mostly bilateral (and what glues it together is arbitration). The regime in finance still relies mostly on national law and soft law.[9] As acknowledged, the International Monetary Fund was conceived in the 1940s as an international monetary authority but it was one with a very particular and rather narrow remit; once the fixed exchange regime (the so-called 'par value system') was abandoned in the 1970s, the IMF lost a large part of its original role. In finance we have a 'black hole' with few formal international rules and no adequate system to deal with cross border crisis or conflicts. We may think there has been a proliferation of rules, but in fact we have very few formal international rules. Why this 'black hole'?[10] This is due, in part, to the belief – widespread before the crisis – that financial markets are best left to their own devices and that therefore soft law was sufficient. Indeed, the fact that the legal framework appeared to be lagging behind or even not to play a major role in the development of international finance was considered by many as a rather good state of affairs pre 2007 (even though at the national level, financial markets are heavily regulated). And this 'black hole' is also due to the reticence that Nation States have to make the sacrifices that are needed in terms of national sovereignty to agree upon international solutions. Additionally, there are also serious legal and fiscal constraints, notably the lack of *ex ante* burden sharing arrangements. (And, 'he who pays the piper, calls the tune...'). But things can change very rapidly; indeed, events in recent months have reminded us of how the wind of change can topple regimes and structures in a matter of weeks. It took a major crisis – the great financial crisis of 2007-2009 – to shatter some of the pre-crisis assumptions.

A step-by-step approach is needed in the quest for international financial regulation. Where to start? As always in any industry, with the worst case scenario, that is with resolution and insolvency. <u>The quest for international law in finance should indeed commence with an</u>

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from the 16th and early 17th century. Her monograph, School of Salamanca. Readings in Spanish Monetary Theory, 1544-1605, was published by Clarendon Press, Oxford in 1952.

[9] When it comes to immigration, countries typically exercise their sovereignty in full (regime based on unilateralism); the only norm that can be said to exist (apart from the treatment of political refugees) is the sovereign right to exclude all foreigners.

[10] As explained in a special issue of the Journal of International Economic Law of 2010 (co-edited with John Jackson and Thomas Cottier).

appropriate system for cross border resolution and insolvency. This should be the number one policy priority, the key economic and legal issue to be solved. Financial institutions may claim to be global when they are alive, but they become national when they are dead. In the aftermath of Lehman Brothers, no one wishes another chaotic resolution. The alternative, a 'bail-out' package, is equally unpalatable. There is however, a viable solution between chaos and bail-out and that is an orderly resolution. We must reach an international agreement on the definition and understanding of bank insolvency, similar to the international agreement [soft law] on bank capital. We need adequate harmonization of bank insolvency rules and regimes, as well as effective coordination between insolvency proceedings involving different jurisdictions.

By analogy with the WTO's dispute settlement, which is a central pillar of the multilateral trading system, in the field of international finance we need to devise appropriate mechanisms for the settlement of financial disputes. We also need better macro-prudential supervision (monitoring the health of the forest and not just the health of individual trees) to identify systemic risk.[11]

The question then arises, do we need a World Financial Authority (WFO), and if so, who are the candidates for the job and what competences should it have? The debate about a possible WFO needs to address the issues of accountability, legitimacy, functions, expertise (adequate personnel) and resources. The functional debate is important because a WFO (or several WFOs) should not become some sort of global regulatory Leviathan. For example, if we agree that we need rules on cross-border resolution, or rules with regard to capital movements, or guidance on renumeration, who is going to enforce such rules? We lack an effective mechanism to ensure the consistent application of global financial rules. The functions that are needed in the pursuit of financial stability at the national level, namely regulation, supervision and crisis management (including lender of last resort), provide a template of what is needed at the international level.

There are several candidates for the WFO job (or jobs): the IMF, the BIS, the WTO, the Financial Stability Board and other standard setters, such as the Basel Committee on Banking

[11] In 1999, Peter Cooke wrote: 'Outside the supervisor's window, there is a kaleidoscope of financial markets and institutions and range of services – all interlinked to a greater or lesser degree. Each regulator, national or sectoral, only sees a part of this kaleidoscope and cannot be sure he controls all that he can see.'

Supervision, IOSCO and IAIS. When it comes to the supervisory and crisis management function the IMF is uniquely qualified. The IMF can monitor the compliance with standards and rules through its surveillance function and can provide countries with the incentive to observe those standards through the design of conditionality (carrots and stick). The IMF also has the know-how when it comes to sovereign debt workouts [indeed, it is now inserted in the EU process], as well as the financial capacity to act as international lender of last resort, and also has the experience in understanding the relationship between banking crises and sovereign debt crises, as well as adequate resources and personnel. The BIS could also assume an enhanced role in crisis management, since it acts as a bank for central banks, and could also play a role in the formalisation of the standard setting process. As for the FSB, though it is singled out as the pillar of the emerging international financial architecture by many experts, the FSB is an informal committee, whose role in international financial stability and in the process of setting international standards has been endorsed by the G-20. However, it lacks real powers. In terms of resources, personnel, formal legitimacy and accountability, it has some way to go before it could act as a formal WFO.

And we now come to the end of this lecture. By way of concluding observations let me point out the following:

The crisis has shown that the pursuit of the private interest is at times greatly misaligned with the pursuit of the common good and that, with cross border banks and financial institutions, national solutions alone or uncoordinated national solutions are not enough to combat systemic risk.

Philip Wood once wrote: 'Financial law is our creature and we tell it what to do'. What should we tell it? First, the future of financial law and regulation should reflect the overlapping jurisdictions that represent the reality of international finance: the national, the European (or regional) and the international dimensions. Secondly, though soft-law rules have filled the vacuum left by the absence of formal international law in this area, greater formalisation of the emerging *lex financiera* is needed over time. Thirdly, in the quest for international financial regulation we need a combination of general principles (such as non discrimination or transparency) – which represent a mix of ethics and efficiency that withstand the passage of time – with more prescriptive technical rules that can be adjusted to new circumstances with flexibility. In accordance with the principle of subsididarity some

global standards may be not only impractical but undesirable. There are a number of concepts – credibility, confidence, fairness – that should permeate through different layers of regulation and influence the behaviour of bankers and financiers. Regulation should be designed in good times, when rapid credit expansion and exuberant optimism cloud the sound exercise of judgment in risk management, rather than in bad times, in response to a crisis. The biblical story of Joseph (behind dynamic provisioning) offers instructive lessons in this regard. We must also remember that markets are part of the solution since it is well functioning markets that generate growth. Regulation should not stifle financial innovation and should allow for competition to continue to prosper.

The fear of failure ought to return to banking and finance. Risk is at the essence of finance and, by definition, risk brings return but risk also entails failure. We need market discipline in regulation, but we also need market discipline in protection. No institution should be too big to fail. Capitalism relies on the lure of wealth and the discipline imposed by the fear of bankruptcy. As Lee Buchheit put it in his testimony to the House of Lords:

> The fundamental principle of the capitalist system is that within the constraints of the law, and regulation if it is a regulated entity, every enterprise is free to pursue its affairs as it sees fit. No one guarantees that you will not fail, but by the same token, no one places any artificial constraint on your ability to succeed. The sanction that capitalism imposes on imprudence, incompetence, some times bad luck, is failure. It is the brooding presence of that sanction that keeps managers on their toes, that keeps them acting in a prudent way.

The financial crisis has triggered a revolution in regulatory thinking. For markets to prosper, markets need rules and international financial markets need international rules. We need an effective system for the cross border resolution of banks and other financial institutions, and in order to achieve it, we need international law. The question of who will enforce it remains a daunting challenge, though the IMF is well placed to adopt a role as a ‘global sheriff’ with regard to international financial stability. The quest for international law in financial regulation does present complex and difficult challenges. But since the world’s economic and financial problems will not solve themselves, I will finish this lecture echoing Einstein’s words: ‘We can’t solve problems by using the same kind of thinking we used when we created them.’

Thank you very much.