

# Setting the rules: private power, political underpinnings, and legitimacy in global monetary and financial governance

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This article in the special issue complements that by Benjamin Cohen on the diffusion of power in the international monetary system.<sup>1</sup> Cohen argues that there has been a steady diffusion of power in the monetary domain, both among the states of the system and from states to societal actors. This article will focus less on the monetary system and more on the domain of financial markets and on this phenomenon of a diffusion of power in favour of private actors. Building on Cohen, the article takes as its starting point one of the most salient changes in the global financial system in recent decades, namely the significantly enhanced power of private market agents as private involvement in emerging international policy processes has strengthened. These policy processes have ranged from transnational policy networks and public–private partnerships to self-regulatory regimes that formulate general rules as well as designing specific outcomes for both state and non-state actors. They have shaped a system of market-based governance that has been increasingly built on the wide recognition and prevalence of private authority in the public domain.

Empirical studies have sought to demonstrate how and why private market agents have acquired a rule-making role and how they have influenced the policies and institutions of global financial order.<sup>2</sup> Many observers have reacted essentially positively to enhanced private power in global financial governance, and to the extent that they have looked at normative issues they tend to focus on whether increased private sector influence has improved issue-specific policy efficiency and promoted financial market stability. Proponents of enhanced private sector

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<sup>1</sup> Benjamin J. Cohen, 'The international monetary system: diffusion and ambiguity', *International Affairs* 84: 3, May 2008, pp. 000–00.

<sup>2</sup> See e.g. Walter Mattli and Tim Büthe, 'Global private governance', *Law and Contemporary Problems* 68: 3/4, 2005, pp. 225–62; Tony Porter, 'Private authority, technical authority and the globalisation of accounting standards', *Business and Politics* 11: 2, 2005, pp. 1–30; Timothy Sinclair, 'Private makers of public policy', in Adrienne Heritier, ed., *Common goods* (New York: Rowman & Littlefield, 2002), pp. 279–92; Eleni Tsingou, 'Transnational policy communities and financial governance', CSGR working paper 111/03, Centre for the Study of Globalisation and Regionalisation (University of Warwick, 2003).

involvement in rule-setting in global financial governance see these developments as an essential mechanism enabling public authorities to pursue their tasks more efficiently in an ever more integrated world economy in which national capacities to provide such collective goods as market regulation or crisis management have been dramatically weakened.<sup>3</sup>

Economic efficiency and financial stability are certainly central to the international financial system. National policies have been rendered less effective at ensuring either in the face of increasing cross-border integration. However, the changing nature of business influence on governance has raised questions about the accountability and legitimacy of private authority in international economic relations. This is the focus of our article: how the enhanced rule-making power of private actors has altered the political underpinnings of global financial order and what might be seen as the normative prerequisites for an efficient *and* legitimate governance of global finance. It is argued here that the positive, benign perspectives on private sector involvement are based on narrow understandings of private business authority in global financial governance. A more appropriate point of departure for an attempt to comprehend the issue lies in a broader and more systematic consideration of the normative dimensions of authority and legitimacy that are integral to the global financial architecture and yet too seldom discussed.

The central claim of this article is that financial globalization has considerably bolstered the position of private actors, rendered regulators more dependent on market interests, and strengthened the power of private agents to shape and set rules. These developments, often encouraged by states themselves,<sup>4</sup> have increasingly aligned financial governance with the preferences of powerful market players, transforming the notion of the public interest in the international financial domain and posing fundamental problems of exclusion and democratic deficit. The prevalence of private interests in rule-making processes undermines the establishment of an accountable and legitimate financial order. This implies that the process of global financial governance needs to be more inclusive, with outcomes representing a wider range of interests, and that policy processes where private market agents threaten or manifest capture must be rendered accountable to a broader public.

The article advances this central proposition by drawing upon the literature on democratic legitimacy in global governance. It posits that the effective governance of the global financial system derives from the accountability of the system per se: that those who make rules at the global level should be held answerable to those broadly affected, especially where there are substantial risks of negative externalities such as financial crisis. Using the standard distinction between the input and

<sup>3</sup> See e.g. William R. Cline, 'The role of the private sector in resolving financial crises in emerging markets', paper prepared for the National Bureau of Economic Research conference on 'Economic and financial crises in emerging market economies', 19–21 Oct. 2000, Woodstock, VT; Anne-Marie Slaughter, 'Governing the global economy through government networks', in Michael Byers, ed., *The role of law in international politics* (Oxford: Oxford University Press, 2000), pp. 177–205.

<sup>4</sup> The argument has been best developed in Eric Helleiner, *States and the re-emergence of global finance* (Ithaca, NY: Cornell University Press, 1994); Geoffrey R. D. Underhill, 'Private markets and public responsibility', in Geoffrey R. D. Underhill, ed., *The new world order in international finance* (London: Macmillan, 1997), pp. 17–49.

### *Setting the rules*

the output side of legitimacy, the article argues that while an outcome perceived as broadly efficient and legitimate is the ultimate test, a relatively inclusive policy process on the input side is more likely to lead to such an outcome, including a reassessment of the underlying policy norms themselves. This implies a third 'phase' or element of legitimacy which the literature on global governance tends to ignore: the *accountability* phase. In all, a tight and integrated consideration of these three phases and their interrelationships is likely to enhance the political underpinnings and legitimacy of the global financial order.

In the light of this argument, the article provides an analysis of the current challenges that enhanced business power has posed to global financial governance. It examines the normative consequences of the growing ability of private market agents to set rules in the process of international banking and securities regulation centred on the Basel II agreement of the Basel Committee (BC) on Banking Supervision and the International Organization of Securities Commissions (IOSCO). The analysis demonstrates that the system of governance embodied in these two prominent transnational regulatory organizations, whose dominant members are not fully accountable to social groups outside these entities, is significantly flawed in terms of the input, output and accountability 'phases' of legitimacy.

### **Private power, rules and the legitimacy of global governance**

To advance the central proposition of this article, it seems appropriate to start by analysing concepts of legitimacy in relation to multilevel governance in the global financial order. Legitimacy may be defined as 'a property of a rule or rulemaking institution which itself exerts a pull towards compliance on those addressed normatively because those addressed believe that the rule or institution has come into being and operates in accordance with generally accepted principles of right process'.<sup>5</sup> Bernstein contends that the best way to view the relevance and importance of legitimacy in global governance is through a sociological perspective. In this view, legitimacy is concerned with the social construction of intersubjective beliefs in a defined political community and will be rooted in accepted norms of social justice if forms of democratic accountability of decision-makers to those affected prevail.<sup>6</sup> Thus defined, it confers on individuals and institutions the authority to make rules and exercise power within a given domain of activity and is crucial to effective governance at any level of analysis. When political communities in a cross-border context accept rules as legitimate, they are motivated to comply with these rules by an internal sense of obligation rather than by the fear of retribution or self-interested calculation, both of which are more costly and tend to have only ephemeral effects.<sup>7</sup>

<sup>5</sup> Thomas Franck, *The power of legitimacy among nations* (New York: Oxford University Press, 1990), p. 24.

<sup>6</sup> Steven Bernstein, 'The elusive basis of legitimacy in global governance', working paper GHC 04/2 (Hamilton: McMaster University Institute on Globalization and the Human Condition, 2004).

<sup>7</sup> See Ian Hurd, 'Legitimacy and authority in international politics', *International Organisation* 53: 2, 1999, pp. 379–408.

The legitimacy of political choices and governance thus derives from shared norms linked to the accountability of decision-makers to social constituencies and individuals. Achieving these conditions is considerably easier where a well-integrated and well-defined community with a shared history has developed shared norms over time, and lines of accountability are well institutionalized and understood. Over time, the legitimacy of authorities becomes less dependent on 'specific' support or short-term performance-related legitimacy, and a reserve of 'diffuse' support will build up that enables legitimacy to survive poor performance in the shorter run.<sup>8</sup> This is more difficult to achieve at the global level; yet as the cross-border integration of the monetary and financial system intensifies, the effectiveness of domestic governance is increasingly undermined. This presents new challenges to the effectiveness and eventually also the legitimacy of reliance on solely national-level policies. The development of global governance presents a potential solution to the problem,<sup>9</sup> but legitimacy is fragile: there is a weak sense of defined political community, accountability is underdeveloped, and citizens/constituencies may be poorly represented and distant from decision-making processes, which means that diffuse support is likely to be in short supply. The system will rely on successful short-term outcomes in line with broad constituency preferences; yet these constituencies may well be so poorly represented as to render outcomes in line with a sufficient range of preferences unlikely.

In the international system, the legitimacy of global governance can be enhanced if states and authoritative transnational actors are responsible to broad publics upon whose lives their decisions have an impact,<sup>10</sup> and if outcomes eventually correspond to widely shared norms. Those in authority must to some degree *represent* the interests of the ruled, or an accountability gap emerges as a crucial problem. The impact of this gap on the legitimacy of global governance can be comprehended better by using the distinction between the *input* and *output* sides of legitimacy,<sup>11</sup> and what is referred to here as the *accountability* phase; the most important consideration is the relationship between these three phases of legitimacy. The input side refers to the decision-making process and the extent to which the interests of the broader community are included. The output side concerns results: the capacity of rule-makers to produce outcomes which resolve problems and achieve collective goals in line with accepted and shared preferences or norms of the community.

An uneasy relationship between the input and output phases underpins legitimacy: if the output is perceived as legitimate, the process by which it is arrived at may not matter much, while consistently poor outcomes (e.g. financial crisis) may undermine a legitimate process. A highly legitimate process may consistently produce poor results which undermine diffuse legitimacy, whether or not decision-makers

<sup>8</sup> David Easton, *A systems analysis of political life* (New York: Wiley, 1965), pp. 265, 273.

<sup>9</sup> Michael Zürn, 'Global governance and legitimacy problems', *Government and Opposition* 39: 2, Spring 2004, p. 286.

<sup>10</sup> Robert Keohane, 'Global governance and democratic accountability', in David Held and Mathias Koenig-Archibugi, eds, *Taming globalisation* (Cambridge: Polity, 2003), pp. 130–59.

<sup>11</sup> See Fritz W. Scharpf, *Governing Europe* (Oxford: Oxford University Press, 1999); Klaus Dieter Wolf, 'Private actors and the legitimacy of governance beyond the state', in A. Benz and Y. Papadopoulos, eds, *Governance and democracy* (London: Routledge, 2004), pp. 200–227.

### *Setting the rules*

can substantially influence the circumstances in which they operate. That said, a democratic process with input from those who bear the costs of decisions is more likely to lead to acceptance of poor results over time; legitimate input *and* output are most likely to contribute to strengthening diffuse support. In particular, a more representative and transparent input side is more likely to lead to output reflecting norms which are perceived as legitimate. This is because input-side interaction is closely linked to how the sense of community and accountability is defined, and over time should help a sense of community to emerge as outcomes correspond better to an accepted set of norms around particular issues.<sup>12</sup>

However, there is a third phase of legitimacy which the literature on global and regional governance often ignores: this is the *accountability* phase.<sup>13</sup> This concerns the (democratic) accountability of global policy processes *and* outcomes to the broad range of constituencies that are affected by the output phase, beyond the rather narrow, often technical, policy communities which currently participate in decision-making. More effective accountability across the multilevel institutions of financial governance would lead to a more thorough assessment of outcomes and their distributional impact. Ultimately, accountability processes should function so as to facilitate the inclusion of new and wider constituencies as participants in the input phase. At the moment, the only effective (if highly imperfect) means of holding decision-makers accountable is Keohane's 'external accountability' in which a pluralistic accountability system works through such means as disseminating information affecting the reputation of individual and corporate actors, through protest, and through the activity of civil society NGOs;<sup>14</sup> nevertheless, Keohane discusses ways in which accountability could be enhanced, potentially bringing new issues into the rule-making process, such as possible mechanisms of compensation for those disadvantaged by outcomes. Thus there emerges a circular relationship among these three phases of legitimacy, where problems or shifts in one phase may lead to sustained pressure for change in one or both of the others.

It is clear that input, output and accountability, while analytically distinct, are intertwined with the legitimacy of global governance in a close causal relationship. Thomas Risse establishes the relationship in a theoretical model that blends internal and external accountability with the input and output sides of legitimacy.<sup>15</sup> Input legitimacy is most likely to be ensured if powerful states, intergovernmental institutions and private actors in global governance prove internally accountable to their citizens, member countries or shareholders *and* externally accountable to the countries and people that their decisions affect. Output legitimacy is also an

<sup>12</sup> However, focused interests (e.g. business interests) are likely to prove easier to organize in the first place (see M. Olson, *The logic of collective action: public goods and the theory of goods* [Cambridge, MA: Harvard University Press, 1965]); they also have considerable structural and organizational resources relative to other interests and consequently operate on the transnational level with greater facility than other organized constituencies with countervailing power at the domestic level.

<sup>13</sup> A notable exception is Robert Keohane, 'Accountability in world politics', *Scandinavian Political Studies* 29: 2, 2006, pp. 75–87.

<sup>14</sup> Keohane, 'Accountability in world politics', pp. 79–80.

<sup>15</sup> Thomas Risse, 'Transnational governance and legitimacy', in Benz and Papadopoulos, *Governance and democracy*, pp. 79–199.

important function of external accountability. Only when the above-mentioned decision-making entities are responsible for how their decisions affect the lives of people outside their own bounds can the problem-solving capacity of governance arrangements be enhanced and their desired policy objectives rendered congruent with a broad range of interests.

The cases considered below will reveal that the input, output and accountability elements of legitimacy are problematic in contemporary financial governance, starting with an input-side where wider constituencies are poorly represented, particularly in developing countries. Private agent preferences have dominated the representation of interests in decision-making, producing outputs at variance with the broader political and economic imperatives of developing countries—and some developed country constituencies as well. Low levels of internal and external accountability prevail, reducing the capacity of other constituencies to challenge either the input or the output phase of the process.

A legitimate system of financial governance therefore requires representative input that balances a range of public and private interests. In the emergent financial order private agent preferences dominate the representation of interests in decision-making, with little representation of wider constituencies. Policies liberalizing domestic financial systems have promoted cross-border market integration, yielding a system characterized by a high degree of capital mobility.<sup>16</sup> This process of financial globalization has accompanied a change in the balance of power between public authority and private market interests and an accompanying transformation in the notion of the public interest that defines the financial order.

An appropriate point of departure for understanding how this has happened may be found in a re-examination of the structural power argument that focuses on the constraining effects of private investment decisions on government decision-making.<sup>17</sup> This proposition has recently been extended to consider the openness of national economies to international trade and capital flows and the greatly strengthened structural power of private business against the backdrop of global market integration. Quite apart from the issue of costs or benefits, financial integration and interstate competition for capital help to explain both the increasing passive influence of private market agents on government decisions within relatively closed economies and their power to actively shape and set national and international rules in a globalized economic system.<sup>18</sup>

This enhancement of the structural power of private business through cross-border integration has been driven largely by private interests in the first place, in the process constraining the capacities of both national governments and international organizations to shape substantive outcomes in financial governance. Most governments have responded by adopting policies which reflect mobile agents' preferences and reinforce the market orientation of economic governance, thus aiming to enhance both growth and stability. Private market actors have thereby

<sup>16</sup> Benjamin Cohen, *The geography of money* (Ithaca, NY: Cornell University Press, 1999); Helleiner, *States and the re-emergence of global finance*.

<sup>17</sup> A classical statement of the argument is Charles E. Lindblom, *Politics and markets* (New York: Basic Books, 1977).

<sup>18</sup> See Doris Fuchs, *Business power in global governance* (Boulder, CO: Lynne Rienner, 2007).

## Setting the rules

gained a stronger position and voice within the national and international political economies, often at the expense of broader domestically based constituencies. Authorities have also reacted by adopting market-oriented approaches to regulation, supervision and corporate risk management, where private firms are responsible for risk management through complex mathematical models implemented under the approval of supervisory agencies.<sup>19</sup> The information and expertise crucial to the operation of the process remain in the possession of firms, a resource which supervisors admit they cannot match. This relative disarmament of public authorities means that private market interests increasingly define supervisory standards; policies concerning the safety and soundness of the financial system are thus dominated by the preferences of those private market-makers who stand to benefit from it most.

Furthermore, financial firms and their associations have close and relatively exclusive relationships with regulatory agencies, with frequent delegation of authority to self-regulatory processes. Most often statutorily independent from politicians and other state institutions, regulatory agencies work in close communion with private associations and financial firms, a relationship reinforced by common professional norms, the specialized and technical nature of expertise in the financial sector, and the shared need to maintain public confidence in the financial system itself. These symbiotic relations, prevalent across the leading economies of the G7,<sup>20</sup> provide private interests with not only the opportunity to influence the nature of financial governance, but also the potential to capture regulatory processes. It is often difficult clearly to define the public interest, as distinct from the particularistic claims of private market actors in relation to the financial system.<sup>21</sup>

With their control over knowledge and expertise and the cross-border expansion of business, powerful private actors have become the key players in emerging transnational policy processes and are in a strong position to set the agenda for national and global financial policies. The transnational cooperative regimes governing banking and securities markets, for instance, have been characterized not only by the exclusiveness and narrowness of their policy deliberations but also by their virtual separation from accountable political processes. The problem of weak accountability in international regulatory regimes is further exacerbated by their frequent recourse to self-regulation. As a result, the transnational financial structure is increasingly regulated not by states but by private institutions centred on the financial markets.<sup>22</sup> Lacking a global governance mechanism to discipline

<sup>19</sup> Some analysts cast serious doubts on whether market-based supervisory methods will lead to stability at all: see e.g. Avinash Persaud, 'Sending the herd off the cliff edge', winner of Jacques de la Rosière essay competition, Institute for International Finance (Washington DC, Dec. 2000).

<sup>20</sup> Andrew Baker, *The Group of Seven finance ministries, central banks, and global financial governance* (London: Routledge, 2005).

<sup>21</sup> Underhill, 'Private markets and public responsibility'; Geoffrey R. D. Underhill, 'The public good versus private interests in the global financial and monetary system', *International Comparative and Corporate Law Journal* 2: 3, 2000, pp. 335–59.

<sup>22</sup> Philip Cerny, 'International finance and the erosion of state policy capacity', in Philip Gummet, ed., *Globalisation and public policy* (Cheltenham: Edward Elgar, 1996), pp. 96–9; Tony Porter, 'The transnational agenda for financial regulation in developing countries', in Leslie Elliott Armijo, ed., *Financial globalisation and democracy in emerging markets*, (London: Macmillan, 1999), pp. 91–116.

self-interested behaviour, these institutions have become instruments of private interests rather than of the public good.<sup>23</sup>

Finally, decisions made in relatively unaccountable policy processes are often aimed at *increasing* the levels of internationalization and marketization of economic policy-making, benefiting those private market interests best able to respond to the new market opportunities. Where national policy-makers cede regulatory power to public-private networks and private transnational institutions, or participate in international regimes whose policy agenda lies beyond their control, there are serious questions to be raised about the overall accountability of international decision-making entities themselves. The processes which regulate and govern the financial markets have become separated from traditional means of accountability as well as from the influence of broader social constituencies. These accountability problems diminish the likelihood that decisions made by public-private arrangements and private regimes will be regarded as politically legitimate. Thus the emerging system of financial governance in which private interests have tended to prevail is flawed in terms of input legitimacy.

This unrepresentative policy process shaping international financial market governance would matter little were it not for the high output-side stakes in terms of potential negative externalities for states and their societies, as the current 'sub-prime' financial crisis illustrates. It has been argued above that decisions concerning the financial order are fundamental not only to the way in which markets are structured but also to the distribution of relative costs and benefits among both social groups and states in the international system. They also affect the capacity of states to shape their political economies in line with broad democratic preferences. This suggests that the output side of the legitimacy of global financial governance is also flawed, and the lack of accountability mechanisms at the global level provides little opportunity for a review of either the input or the output sides of the equation. While financial markets may be more integrated and regulatory standards more harmonized, these outcomes have been achieved at the cost of financial system instabilities, macroeconomic adjustment difficulties and weakened credibility of democratically elected governments among the majority of the populations they rule.<sup>24</sup>

### **The cases: private power and the governance of global banking and securities markets**

The article now examines two case-studies, on international banking supervision and securities market regulation respectively, showing how enhanced private power has altered the political underpinnings of global financial order. These two cases are

<sup>23</sup> How the Basel Accord was created to respond to the rent-seeking demands of private financial firms in leading industrial nations is well documented in Thomas Oatley and Robert Nabors, 'Redistributive co-operation: market failure, wealth transfers, and the Basle Accord', *International Organisation* 52: 1, 1998, pp. 35–54.

<sup>24</sup> See Philip Cerny, 'Globalisation and the erosion of democracy', *European Journal of Political Research* 36: 2, 1999, pp. 1–26; Susan J. Pharr, Robert D. Putnam and Russell J. Dalton, 'A quarter-century of declining confidence', *Journal of Democracy* 11: 2, 2000, pp. 5–25.

### *Setting the rules*

selected for several reasons. First, both are of central importance to the emerging global financial architecture. Second, the financial governance functions involved have migrated out of the national domain and developed multilevel, indeed global-level, characteristics. Third, both banking supervision and securities regulation have in the postwar period generally involved public–private sector interaction at the domestic level, and the transnationalization of each policy process allows us to correlate the emergence of multilevel governance to potential observable shifts in the balance of public against private authority in the policy process. Furthermore, a range of existing studies have characterized public–private interaction in the BC and IOSCO as largely benign or positive, a proposition from which this chapter differs. On these grounds, an analysis of these two cases should shed light on the challenges to legitimacy posed to global financial governance by growing private authority.

### *International banking supervision*

The case of international banking supervision, which has been primarily structured around the Basel Committee (BC) on Banking Supervision, provides an example of how cross-border integration and emerging transnational policy processes have rendered private authority more influential than many sovereign members of the global financial system. The BC was founded in 1974 and consists of the banking supervisor from the central bank of each G10 member country (currently in fact 13).<sup>25</sup> The BC quickly gained a reputation for ‘Olympian’ detachment as guardian of the public interest, with an institutional culture of strict secrecy and relative insulation from public and private institutions of government and market. Global financial integration was in its early stages and the strong ‘public domain’ of the postwar Bretton Woods era in financial systems governance underpinned the committee’s role and decision-making processes. The conclusion of the Basel Capital Adequacy Accord (B-I) in 1988 was the crowning achievement of the BC and occurred with little formal consultation with ‘outside’ interests, private or otherwise.<sup>26</sup>

Doubtless, until the negotiation of the Market Risk Accord amending the 1988 B-I agreement, the BC did operate in a considerably more detached manner than is the case today. However, Olympian detachment and insulation from the traditional politics of government lobbies obscured a more prosaic reality. The relatively closed and exclusionary national financial policy communities, with central banks and autonomous regulatory agencies at their core, were often characterized by

<sup>25</sup> If this is not the banking supervisor, then there is an additional representative of the national supervisory agency, though this does not add an extra ‘vote’ and the committee anyway operates on a consensus basis. The 13 members are Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, Netherlands, Spain, Sweden, Switzerland, the UK and the US. For more on the history of the BC, see J. D. Wood, *Governing global banking* (Aldershot: Ashgate, 2005).

<sup>26</sup> Capital adequacy refers to the amount of liquid or near-liquid capital reserves a bank must put aside to ensure its continuing soundness in the event of rapid withdrawal of deposits. Capital reserves are measured as a percentage of total bank assets: hence capital adequacy ratios. For more details, see analysis in Underhill, ‘Private markets and public responsibility’, pp. 23–8.

'business corporatism' and the delegation of public authority to private agencies via self-regulation.<sup>27</sup> This close relationship between regulatory agencies and their constituencies still characterizes the regulatory process today, and is in fact enhanced by the 'Olympian' distance of central banks and other autonomous agencies with supervisory responsibilities from the rough and tumble of traditional policy-making in democratic governments, for example in trade negotiations.

While the BC might appear to deliberate in Olympian detachment, national central banks and financial supervisors developed policy in close cooperation with a small community of private interests which shared more with their 'principals' than with other sectors of the economy and society. Cross-border integration meant regulatory bargains reached at the national level had to be adapted, and B-I achieved this in relation to capital adequacy. The outcome of the agreement meant some national banking sectors had to raise substantial amounts of new capital, sharply affecting the cost of their lending.<sup>28</sup> Calls were made for the BC to consider more closely the relative impact of its decisions on the banking sector in different countries. The result was the emergence of more BC consultation with the private sector, including with the Institute for International Finance (IIF) based in Washington.<sup>29</sup> This process expanded with the committee's 1993 proposals to amend B-I to include risks associated with bank securities markets.<sup>30</sup>

This at first informal and unprecedented consultation process with the IIF began when the institute issued a position paper sharply criticizing the 1993 BC document for 'fail[ing] to create sufficient regulatory incentives for banks to operate more sophisticated risk measurement systems than those necessary to meet the regulatory minimum',<sup>31</sup> meaning it failed to stimulate the use of internal control mechanisms. A well-circulated and authoritative paper by Dimson and Marsh argued that such mechanisms were more effective than the committee's proposed approach, and this added to the pressure to revamp the proposal.<sup>32</sup> Two consecutive new consultative documents embraced the approach advocated by the IIF.<sup>33</sup> The pressure had worked; but the committee's new and soon to become formal interlocutor was hardly representative of the range of interested parties which would be affected by the amended accord. There was no emerging market representation in the BC,<sup>34</sup> and the process did not extend beyond the traditionally close relationships between banks and regulators. Situated at the transnational

<sup>27</sup> See William Coleman, *Financial services, globalisation and domestic policy change* (London: Macmillan, 1996); Michael Moran, 'Theories of regulation and changes in regulation', *Political Studies* 34: 2, 1986, pp. 185–201.

<sup>28</sup> Oatley and Nabors, 'Redistributive co-operation'.

<sup>29</sup> The IIF was originally formed as a consultative group of major US and European banks during the debt crisis of the 1980s, and became a more broadly based organization representing some 350 member banks worldwide.

<sup>30</sup> See Basel Committee, 'The supervisory treatment of market risks', consultative paper, 1993.

<sup>31</sup> Institute for International Finance, *Report of the Working Group on Capital Adequacy* (Washington DC, 1993), cited in *Financial regulation report*, Dec. 1993, p. 3.

<sup>32</sup> Elroy Dimson and Paul Marsh, *The debate on international capital requirements* (London: Corporation of London Research Project Report 8, 1994).

<sup>33</sup> Basel Committee, 'Proposal to issue a supplement to the Basel Capital Accord to cover market risks', 1995, and 'An internal model-based approach to market risk capital requirements', 1995.

<sup>34</sup> The IIF membership did eventually include some emerging market financial institutions, and the BC eventually began an 'outreach' process involving emerging market economies.

### *Setting the rules*

level, the emerging policy community was arguably even further removed from traditional lines of democratic accountability in the policy-making process.

Following the successful translation of IIF preferences into committee policy, the IIF–BC relationship became formalized in regular practice as the committee began to consider a new capital adequacy accord (B-II) in the face of persistent criticisms of B-I's treatment of credit risk, which had remained unchanged. In fact, the private sector began playing an even stronger agenda-setting role than in the past. The review of B-I began with a study group of the Group of Thirty, a body resembling a think-tank whose members were drawn from the public/official and private institutions in the financial sector; many had held prestigious appointments in both. The group issued a report on systemic risk in the changing global financial system.<sup>35</sup> In the foreword to the report, Paul Volcker, chairman of the G30, eulogized the role of global banks in the development of international regulatory frameworks and emphasized collaborative efforts between these institutions and their supervisors as an effective and broadly acceptable contribution towards the process.<sup>36</sup>

The report also observed that management controls should play a central role in the supervision of financial systems and that 'core' financial institutions should take the initiative to develop a new system along with 'international groupings of supervisors'. In essence, financial globalization had rendered the supervisory process increasingly difficult and placed it beyond the reach of national supervisors. The conclusions of the report implied that regulatory agencies should rely more on the private institutions that they supervised and that these institutions themselves would accept the responsibility to improve the structure of, and the discipline imposed by, their internal control functions and risk management mechanisms.<sup>37</sup>

Here lie the origins of the market-based supervisory approach contained in the three pillars of B-II.<sup>38</sup> In 1998 the IIF issued its own report specifically urging the BC to update B-I on the basis of banks' market-based internal rating approach.<sup>39</sup> Although the BC invited consultations on its three sets of proposals for B-II, the IIF remained the principal interlocutor, and comments came overwhelmingly from financial institutions in Europe and North America, as well as, to a lesser extent, from officials from agencies, a few academics, chambers of commerce and industry producer associations.<sup>40</sup>

<sup>35</sup> G30, 'Global institutions, national supervision, and systemic risk', study group report (Washington DC, 1997). The report includes the names of study group participants and members of the Group itself (pp. 47–8).

<sup>36</sup> G30, 'Global institutions', p. ii.

<sup>37</sup> G30, 'Global institutions', p. 12.

<sup>38</sup> The three pillars consist of minimum capital requirements, supervisory review of capital adequacy, and public disclosure and market discipline. Under the three-pillar system, bank supervisors will no longer be exclusively responsible for the supervisory process and for specifying levels of capital adequacy; rather, bank owners and risk managers, supervisors and market forces combine to oversee banks. For a more technical discussion, see Basel Committee, 'Overview of the new Basel Capital Accord', consultative document, 2003.

<sup>39</sup> IIF, 'Recommendations for revising the regulatory capital rules for credit risk', report of the Working Group on Capital Adequacy (Washington DC, 1998).

<sup>40</sup> See committee website section on comments on proposals at <http://www.bis.org/bcb/caccomments.htm> (comments on second consultative document) and <http://www.bis.org/bcb/cp3comments.htm> (comments on third consultative document): accessed 2 April 2008.

While a claim that the BC in the mid- and late 1990s was a victim of policy capture might be exaggerated, there is little doubt that the BC and its member institutions are far more likely to take into account the articulated preferences of private sector interlocutors in developed countries than the interests of developing country supervisors and their corresponding financial sectors. The long-institutionalized relationship between regulators and the regulated in financial supervision, which approximates conditions of capture, had developed at the transnational level by the mid-1990s. And B-II derived directly from an agenda set by proposals from the private sector.

It is not surprising that the advantages of the accord accrue to those large banks best able to operate the advanced internal rating-based systems permitted under special circumstances by the accord. According to the BC's own estimates, this 'advanced' approach will tend to lower their regulatory capital and reduce the cost of their lending operations relative to their smaller brethren using the 'standard' approach,<sup>41</sup> and banks (and clients) using the latter will find their capital reserves more likely to rise, hurting their competitive position. The 'standard' approach relies on external credit rating agencies (e.g. Moody's, Standard and Poor's). Claims on highly rated clients require lower capital charges, which negatively affects the many low- or non-rated small banks and SME clients, even though they are not necessarily riskier,<sup>42</sup> and are certainly less significant in systemic terms. B-II thus implies a clear relative capital cost disadvantage for both rated and unrated banks specializing in lending to (low-/unrated) SMEs.

Developing countries were largely excluded from the BC policy-making process, and the situation for unrated banks or their clients in these countries is worse yet: for otherwise creditworthy entities within those countries, capital costs are set to increase relative to B-I.<sup>43</sup> Developing country submissions to the BC identified this as a problem, arguing that some banks and corporations in developing countries were sounder than the sovereign and that the ratings of the banks and corporations should be considered separately from that of the sovereign and based on the real risks of lending to a specific bank or corporation.<sup>44</sup> Yet their pleas were ignored. B-II thus has negative implications for the cost of capital for developing countries, which is likely to mean a reduced quantity of lending to these borrowers. A final problem with specific implications for developing countries concerns high compliance costs generated by the complicated risk management procedures and mechanisms of B-II. Complexity raises the relative compliance costs more for smaller and less sophisticated banks, erecting barriers to entry and hindering competition. Again, this especially affects banks in developing countries, which tend to be smaller and less sophisticated, putting them at a competitive

<sup>41</sup> Basel Committee, Results of the Fifth Quantitative Impact Survey (QIS 5), (Basel: Bank for International Settlements, 2006), pp. 5–11 and table 5.

<sup>42</sup> See e.g. submissions on <http://www.bis.org/bcbs/cp3comments.htm> by the Austrian banking industry, the German Bankenfachverband, the European Co-operative Banks, the World Council of Credit Unions or the Kredittilsynet-Norges Bank (Norwegian central bank).

<sup>43</sup> Basel Committee, QIS 5, pp. 21–3.

<sup>44</sup> See e.g. submission of the central bank of Belize (<http://www.bis.org/bcbs/cp3/belcenban.pdf>) and of Burundi (<http://www.bis.org/bcbs/cp3/burcenban.pdf>), accessed 2 April 2008.

### *Setting the rules*

disadvantage relative to large banks from developed countries even though the risks involved are not necessarily greater.

B-II may not even enhance the safety and soundness of the financial system it is supposed to protect, because it may enhance the procyclicality of lending (thereby potentially reinforcing market volatility), again a particular problem for developing countries. B-II's reliance on asset price and ratings market signals may produce objective assessments of individual banks, but whether the aggregation of good individual practices leads to stability at the systemic level is more doubtful. If a wide range of banks responds simultaneously and in the same way to perceived market trends—as reflected in prices and ratings in the market—downturns and upturns may be reinforced as banks downgrade or upgrade clients on a large scale. This issue may be of particular concern for emerging markets, whose asset prices and ratings are already more volatile than those of developed countries. It could make their external financing more volatile and domestically lead to more extreme business cycles.

Extensive quantitative analyses provide evidence that B-II implies higher capital adequacy requirements, in particular for small banks located in developing and emerging market countries.<sup>45</sup> Their clients are most likely to see their capital costs rise and access to external financing decline. These analyses also demonstrate that B-II has an adverse impact on the cost and volume of capital flows to some lower-rated developing countries, although the effects *on average* are small. Importantly, they establish that the procyclicality of capital flows to developing countries may increase with the use of internal ratings by internationally active banks. More pronounced fluctuations in the availability of external financing would be a very unfortunate outcome, given that developing countries already suffer from volatile capital flows.

While B-II may contribute to the general efficiency of the global financial markets, then, its effects are skewed, and what may be efficient for international banks involves costs for developing countries as well as for some social constituencies in developed ones, notably SMEs. In the end, it is valid to ask: Efficiency *for whom?*—and in this sense the contribution of B-II to global financial market efficiency and to the quality of supervision may be called into question. The clear implication of this analysis is that if BC standards have such an obviously global impact as the BC itself claims, and as the evidence noted here suggests, affecting the terms of competition among financial institutions, the cost of capital and the stability of capital flows, a committee more representative of the broader interests of the global community is required, and one with an accountability mechanism which connects the input and output phases with continuing attempts at reforming global financial governance.

<sup>45</sup> See e.g. Robert Bailey, 'Basle II and developing countries', working paper 05-71 (Development Studies Institute, London School of Economics, 2005); Stijn Claessens, Geoffrey Underhill and Xiaoke Zhang, 'The political economy of Basle II: the costs for poor countries', *World Economy* 31: 3, March 2008, pp. 313-44; Andrew Powell, 'Basle II and developing countries', working paper 3387 (Washington DC: World Bank, 2004).

### *IOSCO and transnational securities regulation*

In the process of transnational securities regulation, as in the process of international banking supervision, the role of private actors in the governance of the regulatory regime has greatly strengthened as global market integration has proceeded. Transnational regulation has been dominated by powerful corporate interests; developing countries and many social groups in developed countries are underrepresented, and yet bear the costs as well as reaping the benefits of these rules. This rather exclusionary process has included a low level of accountability to broader, external constituencies affected by the design and implementation of regulation. IOSCO member regulators, whose relationship to government may be characterised as 'arm's length', have been more accountable to self-regulatory organizations (SROs) and private market participants than to traditional government oversight mechanisms, yielding a poorly defined sense of broader public interest and community in international regulatory developments.

IOSCO was founded in 1984 in a market environment in which national regulators alone could no longer cope.<sup>46</sup> Members are official national securities regulators, usually autonomous government agencies mandated by legislation,<sup>47</sup> supplemented by 'associate' members (e.g. important official securities regulators at subnational/provincial level, or other market authorities which work closely with the 'national' regulator) and 'affiliate' members, which are SROs, securities exchanges or trade associations with self-regulatory responsibilities. The affiliate members do not vote but are considered crucial to the IOSCO policy-making process. IOSCO also maintains contacts with international organizations involved in financial architecture issues, such as the OECD, the IMF and the multilateral development banks.

The close relationship between official regulators and SROs is particularly important to our argument: most official regulators retain full legal powers of supervision and regulation, yet operate by delegating to SROs composed of private member firms.<sup>48</sup> Equally significant, IOSCO works in close consultation with private international regulatory bodies such as the World Federation of Exchanges (WFE; formerly the International Federation of Stock Exchanges) or the International Capital Markets Association, a self-regulating association of dealers on primary and secondary international capital markets.<sup>49</sup>

As a result of these linkages, IOSCO considers itself a non-governmental international organization.<sup>50</sup> IOSCO officials consistently stress the importance of

<sup>46</sup> The account of IOSCO up to the mid-1990s draws upon Geoffrey Underhill, 'Keeping governments out of politics', *Review of International Studies* 21: 3, 1995, pp. 265–6; idem, 'Private markets and public responsibility'.

<sup>47</sup> This could involve a division of a national finance ministry, a self-regulatory institution (e.g. a stock market) or even a central bank. See IOSCO website section on membership and other rules at <http://www.iosco.org/lists/index.cfm?section=general>, accessed 2 April 2008.

<sup>48</sup> For example, the US Securities and Exchange Commission delegates to the National Association of Securities Dealers and the relevant stock exchanges.

<sup>49</sup> A merger of the International Securities Markets Association and the International Primary Markets Association. See ICMA website at, <http://icmagroup.org>, accessed 4 April 2008.

<sup>50</sup> Underhill, 'Keeping governments out of politics', p. 261.

## Setting the rules

incorporating industry inputs into the standard-setting process in order to focus on policy matters of relevance to practitioners and industry bodies.<sup>51</sup> Proposals are thus developed in close consultation with IOSCO's SRO Consultative Committee (SROCC, founded in 1989). Technological and product innovations have made regulators heavily dependent on industry expertise for the skills involved in formulating rules. This closely knit transnational policy community constitutes a typical case of Michael Moran's 'esoteric politics',<sup>52</sup> wherein an elite group works out the management of its own vital interests without wider public involvement.

Many IOSCO functions are delegated outright to private sector associations and think-tanks. For example, IOSCO has relied almost entirely upon the International Accounting Standards Board (IASB) for developing and harmonizing accounting standards, a process crucial to facilitating the globalization of securities trading and the levelling of the playing field for major market players.<sup>53</sup> In the late 1980s IOSCO vested the Group of Thirty with the authority to deal with clearance and settlement issues in international securities markets;<sup>54</sup> in 1993 the G30 issued the first major report on derivatives regulation and has since played a leading role in shaping an international framework for regulating derivatives markets.<sup>55</sup> In short, IOSCO members form the hub of a constellation of private industry associations and SROs with a private sector membership. This increases its acceptance by the industry, but it also means that the IOSCO input phase is relatively closed.

The primary goal of IOSCO has been to provide globally the regulatory benefits of the domestic level, chiefly by harmonizing cross-border securities market regulation.<sup>56</sup> The Technical Committee (TC) of 15 developed market members (in consultation with the SROCC) is the chief forum for achieving these aims,<sup>57</sup> with particular emphasis on multinational disclosure and accounting, regulation of secondary markets and market intermediaries, enforcement and the exchange of information, investment management and, more recently, corporate governance.<sup>58</sup> These efforts and their fruits over the years have had a major impact by fostering and accelerating the global integration of securities markets. IOSCO has also had broader political economy and welfare effects on a range of constituencies. These effects are beneficial where improvement of domestic financial governance in weak financial systems is concerned, but also involve costs where cross-border markets and the volatile (especially) short-term capital flows associated with securities

<sup>51</sup> IOSCO, *Annual Report*, 2004, pp. 14–15; *Annual Report*, 2005, pp. 11–12; *Annual Report*, 2006, p. 5.

<sup>52</sup> Moran, 'Theories of regulation and changes in regulation', *Political Studies* 34: 2, 1986, pp. 185–201.

<sup>53</sup> IOSCO, *Annual Report*, 2005; W. S. Vaughan and Sonja Felderhof, 'International mineral resource and mineral reserve classification and reporting systems', *Annual Institute Proceedings, Rocky Mountain Mineral Law Foundation* Vol. 48, 2002, p. 9–1.

<sup>54</sup> See Tsingou, 'Transnational policy communities and financial governance'.

<sup>55</sup> E. Tsingou, 'The governance of OTC derivatives markets', in P. Mooslechner, H. Schuberth and B. Weber, eds, *The political economy of financial market regulation* (Aldershot: Edward Elgar, 2006), pp. 168–90.

<sup>56</sup> Paul Guy, 'Regulatory harmonisation to achieve effective international competition', in Richard Edwards and Harold Patrick, eds, *Regulating international financial markets* (Dordrecht: Kluwer, 1992); IOSCO, *Annual Report*, 2006, p. 18.

<sup>57</sup> Guy, 'Regulatory harmonisation', p. 293; Mexico recently became the first emerging market member of the TC.

<sup>58</sup> IOSCO, *Annual Report*, 2006, pp. 6–9.

markets are extended to crisis-prone emerging markets, given the tendency of capital to flow 'uphill' from developing to developed country markets.<sup>59</sup> Capital market openness may have negative consequences for financial development and therefore growth in lower-income countries.<sup>60</sup>

In the late 1980s international equity offers and securities dealings were limited by the costs of significant cross-country regulatory differences. Much of IOSCO's energy was thus devoted to regulatory harmonization (disclosure, clearing and settlement arrangements, fraud and bankruptcy standards, market transparency) in order to lower costs and encourage market integration. If the most developed segment of the market were properly internationalized, the argument ran, more thoroughgoing harmonization across national borders would follow.<sup>61</sup> The development of open transnational markets would lead to more efficient capital markets and thus economic growth. Behind this rationale lay the advancement of private and particularistic interests. Saturated US markets led investment bankers and institutional investors to seek overseas expansion to markets where they might also have a competitive edge, including Europe and the fast-growing East Asian economies. Regulatory convergence to establish international (largely American) standards within the IOSCO policy community would accomplish this goal, and would also enhance the role of private interests in the transnational policy processes.<sup>62</sup>

Efforts at regulatory convergence are once again centred on the TC and its five standing committees representing developed country members. While recognizing that any changes would have to be consistent with the legal mandates of the member organizations, IOSCO pushed for a single common prospectus for the leading securities exchanges, similar disclosure requirements and harmonious clearing arrangements.<sup>63</sup> On these matters, IOSCO actively incorporated the proposals made by the G30 and the WFE.<sup>64</sup> In the mid-1990s, the TC began work on a comprehensive set of international securities market regulations that would form a code of conduct for global market integration. The committee's work advanced in close cooperation with the SROCC, global private sector associations such as the WEF, IASB and the G30, and market participants.<sup>65</sup> The result was the promulgation in 1998 of the 30 'Objectives and Principles of Securities Regulation', a revised version of which was published in 2003 along with a comprehensive implementation 'methodology'.

The 30 principles were aimed at three main objectives—investor protection, market efficiency and transparency, and the reduction of systemic risks<sup>66</sup>—all with

<sup>59</sup> Eswar Prasad, Raghuram Rajan and Arvind Subramanian, 'The paradox of capital', *Finance and Development* 44: 1, March 2007, pp. 16–19.

<sup>60</sup> S. H. Law and P. Demetriades, 'Openness, institutions, and financial development', working paper WEF0012, World Economy and Finance Research Programme (London: Economic and Social Research Council of the UK, 2006).

<sup>61</sup> These issues are detailed in IOSCO, *International Equity Offers*, 1989; *Annual Report*, 1991; *Annual Report*, 1992.

<sup>62</sup> Beth Simmons, 'The international politics of harmonisation', *International Organisation* 55: 3, 2001, pp. 589–620; David Zaring, 'International law by other means', *Texas International Law Journal* 33: 2, 1998, pp. 281–330.

<sup>63</sup> Underhill, 'Keeping governments out of politics', pp. 265–6.

<sup>64</sup> See IOSCO, *International Equity Offers*, 1989; *Annual Report*, 1991.

<sup>65</sup> IOSCO, *Annual Report*, 1999.

<sup>66</sup> IOSCO, *Objectives and Principles of Securities Regulation*, 2003.

### *Setting the rules*

a view to reducing the risks and costs to major firms of cross-border securities trading and issuance and further accelerating capital market integration. This of course heightened the need for national governments to develop the institutions of multilevel governance further in order to cope with the outcome, and brought a series of differentiated costs and benefits to the various players of the global financial system.

More recently, the rising incidence of financial fraud in the late 1990s and early 2000s has led IOSCO to focus on corporate governance standards. Following major corporate failures, IOSCO formed the Securities Fraud Task Force to strengthen corporate governance, emphasizing the link between good corporate governance and strong securities markets. IOSCO first endorsed the OECD Principles of Corporate Governance and prioritized the protection of minority shareholders and the independence of board members,<sup>67</sup> and then launched a major policy programme of corporate reforms and institutional change along those lines.<sup>68</sup> Senior IOSCO officials argued that good corporate governance was integral to internationally acceptable principles of sound capital market regulation,<sup>69</sup> and few would argue to the contrary. Nonetheless, their emphasis was consistent with the interests of private actors within and beyond the IOSCO policy community who promoted convergence on the basis of the 'shareholder value' model and who would initially benefit in competitive terms from the adjustments this would impose on others.<sup>70</sup>

The TC essentially designed the standards, and while the Emerging Markets Committee (EMC) played a consultative role, much of the discussion concerned the implementation and not the content of the standards.<sup>71</sup> The further integration of emerging market and developing economies into the global financial system was one of the objectives in this regard, and adjustment to the standards would be costly for some countries. Whether or not there was evidence that such further integration would assist development prospects, failure to adopt the standards might send negative signals to potential investors and creditors in developed countries.

IOSCO regards its crowning achievement to be its multilateral system of Memoranda of Understanding (MOU), developed in 2002. Replacing a system of bilateral deals, the multilateral MOU aims to speed up the commitment of national securities regulators to the IOSCO Principles, in particular the exchange of information and cross-border enforcement of market regulations,<sup>72</sup> both essential ingredients of functional transnational markets. In 2005 the organization took the process a step further by achieving all-member endorsement of both the Principles and the MOU as the core international regulatory standards to reduce

<sup>67</sup> IOSCO, *Annual Report*, 2005, pp. 12–12; *Annual Report*, 2006, p. 6.

<sup>68</sup> IOSCO, *Annual Report*, 2006.

<sup>69</sup> Jeremy Cooper, 'Corporate governance', paper presented to the OECD–ADBI 8th round table on capital market reform in Asia, Tokyo, 11–12 Oct. 2007; IOSCO, *Annual Report*, 2005; *Annual Report*, 2006.

<sup>70</sup> Andreas Nölke, 'Transnational private authority and corporate governance', in Stefan A. Schirm, ed., *New rules for global markets* (London: Palgrave Macmillan, 2004), pp. 212–42; Michael Useem, 'Corporate leadership in a globalising equity market', *Academy of Management Executive* 12: 4, 1998, pp. 43–59.

<sup>71</sup> IOSCO, *Annual Report*, 2005; *Annual Report*, 2006.

<sup>72</sup> IOSCO, *Annual Report*, 2004, pp. 8–10; *Annual Report*, 2006.

systemic risk, and to enhance both investor protection and market efficiency, with firm targets in terms of implementation and expansion of the network of signatories by 2010.<sup>73</sup>

While the IOSCO policy process has enjoyed a substantial degree of autonomy from typical norms of accountability in (democratic) governance, it has had relatively little independence from the private interests it supervises and works with. Members and firms alike have shared a commitment to market-based integration and governance. Private sector control of crucial specialized knowledge in a dynamic market context has increased the dependence of regulators on particularistic interests. The system of membership has been far from open, despite the broad impact of IOSCO's policies, and this implies flawed input.

There have also been problems on the output side. Regulatory convergence has accelerated the transnationalization of segmented national financial systems, opening developing countries to often volatile short-term capital flows and imposing important adjustment burdens on weak legal and regulatory systems. Rapid changes in the mode of financial and corporate governance in the direction of market principles may destabilize the often delicate institutional and political underpinnings of developing societies. Increased capital mobility has made macroeconomic policy management difficult and constrained the ability of developing states to implement the fiscal and welfare policies often crucial to political legitimacy,<sup>74</sup> thus playing a part in the regular outbreak of crises. As in the Basel case, the output has been most beneficial to those who designed the policies in the first place, with important potential costs for more vulnerable constituencies, particularly in developing countries. There remains no institutionalized process to shift IOSCO's debate on convergence and harmonization of financial governance reform to a broader forum.

## Conclusion: in search of normative underpinnings for global financial order

This article represents a financial markets case of Cohen's theory of diffusion of power from states to societal actors, in particular the major financial intermediaries. The central proposition is developed in two case-studies and posits that the current patterns of global financial governance, in which private market agents have demonstrated a capacity to set public policy agendas, have failed on both the input and output criteria of legitimacy. Input from broader social constituencies has been at best limited, and while there have been benefits, constituencies have often paid a considerable price in terms of externalities. Interacting public and private actors have not been held responsible to those outside their jurisdictions

<sup>73</sup> See IOSCO website, <http://www.iosco.org/about/index.cfm?section=history>, accessed 2 April 2008. For a broader discussion of how non-governmental regulatory bodies influence capital flows through their coercive power, see Susanne Soederberg, 'The promotion of Anglo-American corporate governance in the south', *Third World Quarterly* 24: 1, 2003, pp. 7–27.

<sup>74</sup> One of the most up-to-date discussions of this issue is Geoffrey Underhill and Xiaoke Zhang, eds, *International financial governance under stress* (Cambridge: Cambridge University Press, 2003).

## *Setting the rules*

and policy spheres who have borne the costs of decisions. Thus the accountability element of legitimacy in global financial governance has proved highly problematic, and much of the problem relates to the way in which private actors have exercised their active power in the rule-making process.

The two cases raise two important normative issues concerning the political underpinnings of global financial order. First, the domination of global financial supervision and regulation by private actors has significant distributional consequences. The overall outcome in terms of efficiency and stability has been mixed, bringing a range of important yet unequally distributed benefits, but also instability and crisis for many societies to a degree that has led to challenges to the process of global governance itself. The cross border integration of securities markets is central to the current 'sub-prime' crisis after all. Second, the influence of private actors on the input side has not only rendered public authorities dependent on the information and expertise provided by these actors but also consistently aligned public policy objectives with private sector preferences. This has raised fears that the enhanced rule-setting power of private interests may have severely undermined the authority of public actors to formulate financial and regulatory policies in line with the broader public interest, a situation approximating policy capture. Crisis prevention becomes more difficult while the costs of crisis management and resolution may be borne by a broad range of public constituencies.

One obvious solution to the problem lies in the enhancement of constituency representation in global financial processes through a range of principles, such as broadening membership of the Basel Committee<sup>75</sup> or the IOSCO Technical Committee.<sup>76</sup> In other institutions such as the IMF or World Bank, greater account could be taken of population size and minority rights principles in voting systems. By pooling sovereignty and attenuating the raw exercise of private corporate power through cooperative financial governance, enhanced representation and commensurate improvements in accountability can alleviate some of the legitimacy deficits at the same time as helping individual states to confront the tensions created by financial globalization.<sup>77</sup> Any such project is likely to run into fierce opposition from transnational corporate interests, which most enjoy the benefits and freedoms of global markets. Equally important, cooperative governance and the required abrogation of national prerogatives may be the most difficult hurdle (especially for the strong) to cross in the development of (democratic) institutions of accountability at the global level. These difficulties, however, should not diminish the potential advantages of change, given that current efforts at reforming global financial architecture have failed to address the problems identified in the previous section.

In the end, some resolution is needed of the socio-political tensions and legitimacy problems on the domestic front associated with international regulatory

<sup>75</sup> e.g. a substantial enhancement of the current Basel 'outreach' process for emerging market economies.

<sup>76</sup> There are some signs that this may happen, as Mexico recently became the first IOSCO TC member.

<sup>77</sup> Some of these points are taken up in the literature on 'cosmopolitan democracy' as a global solution to the democratic deficit caused by economic globalization: see e.g. James Bohman, 'International regimes and democratic governance', *International Affairs* 75: 3, 1999, pp. 499–513; David Held, *Democracy and the global order* (Stanford, CA: Stanford University Press, 1995), pp. 267–82.

*Geoffrey R. D. Underhill and Xiaoke Zhang*

processes, as are legitimate forms of global financial governance. But even on efficiency grounds there are gains to be made. Had global financial supervisors and regulators been less responsive to the priorities of the private sector pressing for autonomy in the domain of risk management, they might have imposed greater costs on those who played relatively fast and loose with sub-prime mortgage securitization and other instruments where the dividing line between risk and uncertainty is less than clear. Current trends in the supervisory treatment of risk management, market innovation and the evolution of cross-border integration appear headed in the opposite direction; still, the current crisis may yet provide renewed incentives for a review of the situation.