Chapter 5

Sources of Financial Regulation

The first four chapters of this book are devoted to establishing the need for bank regulation. Chapters 1 explores the traditional and changing nature of the business of banking. Chapters 2 examines the fragility of a bank's promise to pay depositors on demand and Chapter 3 explores how banks form an interconnected system of mutual financial obligations. Chapter 4 considers how governments protect society from the risks explored in Chapters 2 and 3 through the formation of the financial safety net. This chapter serves to segue between the preceding discussion of the broad foundations for bank regulation and the remainder of the book, which will examine how banks are actually regulated. We have seen that the study of market failures is relatively abstract, involving several theoretical constructs. In contrast, the study of regulation itself is rather concrete. Most forms of regulation are readily identifiable. The sources of regulation include both domestic/national laws (laws that apply to activities within the jurisdiction of a sovereign nation) and international laws (agreements between sovereign nations). This chapter provides an overview of the sources of bank regulation.

In general, law falls into two basic categories: public law and private law. Public law addresses the relationship between the government and individuals/firms—e.g., law that gives the government the power to imprison an individual for the sale of illegal drugs. Private law addresses the relationship between private individuals/firms and other private individuals/firms—e.g., law that allows a consumer to sue a manufacturer for injury caused by a product defect. With regard to the regulation of banks, the primary, although not exclusive, focus is on public law, i.e., laws that give the government the power to regulate banks and their activities. Such laws, enacted by the legislative bodies of the nation, are binding. Failure to abide by such laws can result in liability or sanctions imposed by a government agency or a court of law. Judicial opinions can also be a source of binding authority if those opinions affect the rights of future parties. A feature of common law jurisdictions is the concept of *stare decisis* (Latin for "to stand by the decision"). Under this doctrine, courts must follow the legal principles established under prior case law when considering new cases involving similar facts. In civil law jurisdictions, *stare decisis* is not formally recognized and, similarly, neither is the concept of courts serving as a source of law. Civil law jurisdictions look exclusively to statutes and codes to derive the law. Of course, the distinction between common law and civil law jurisdictions should not be thought of as absolute since, in reality, many jurisdictions operate with features of each.

Other standards of law are more discretionary in nature. These standards often derive from efforts of specialized groups to coordinate or improve the law, either domestically or internationally. While such standards are not binding in a formal sense unless enacted into law by a sovereign nation (and thus are often referred to as *soft law*), they can serve as a powerful tool in the development of formal regulation. With regard to the regulation of financial institutions, soft law international standards play an increasing role in the regulation of banks and are a focus of our examination of global regulation.

National Laws

Each country has a hierarchy of laws. The country's constitution is the supreme law of the land and is typically written in terms of the broad structure and obligations of the government and the rights of the individuals. In the United States, the federal system of government, i.e., a system in which sovereignty is divided between a central government and territorial subdivisions—has led to many constitutional law disputes over the power to regulate banks. For example, every law student in the United States reads *McCulloch v. Maryland*, a case decided in 1819 in which the United States Supreme Court adopted a broad interpretation of the federal government's powers under the United States Constitution. The Court found that the State of Maryland had violated the Constitution when it attempted to impose a tax on banks operating within Maryland that were chartered under federal law but not on banks that were chartered under Maryland law. While constitutional debates over the power of the federal government to preempt state bank regulation continue in the United States today, most bank regulation is derived from statutes enacted by the legislative body. Examples include the National Bank Act of 1864, which created the Office of the Comptroller of the Currency in the United States, and the Bank of England Act of 1946, which nationalized the Bank of England in the United Kingdom.

While much of the regulation of banks is derived from statutes, often statutes are written in fairly broad terms and require implementation. Generally, government agencies are established to implement the statutes. Agencies' implementation of statutory provisions may be formal, in the form of binding agency rules or regulations, or the implementation may be informal, in the form of interpretations or guidance.[1] For example, the United Kingdom's Financial Services and Markets Act 2000 (FSMA) provides a general framework for the regulation of the financial industry. The FSMA's structure envisions that the Financial Services Authority will fill in the details. While agency regulations often carry the force of law without further legislative approval, this does not mean that agencies have unfettered discretion in writing regulations. In the United States, for example, agencies must go through a process of public notice and comment prior to implementing new regulations. Moreover, final regulations are subject to review by a court and, generally, may be set aside under administrative law principles if the court finds them arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with the law.[2] Through this process of judicial review, courts can also serve as a source of law.

Similar to the standards of law that are discussed later in the international context are the more domestically oriented *model* statutes or codes. A model code, like the Uniform Commercial Code in the United States, is not law unless adopted by a legislative body. Groups of experts or special interest groups draft model codes with the hope of reforming existing law or providing the basis for harmonizing the laws of several state or local jurisdictions. Some model codes have been tremendously successful in shaping law. Others have had relatively little influence.

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[1] Government agencies also serve as enforcers of the law; i.e., they make certain that those individuals and institutions within the scope of the relevant laws are complying with those laws.

[2] 5 U.S.C. § 706(2)(a).

International Law

Like a nation's laws, international law is derived from various sources. Perhaps the most obvious source of international law is the treaty. A treaty is much like a contract between countries. A treaty may be called a convention or protocol or covenant. Nevertheless, these are essentially all international agreements. Under the 1969 Vienna Convention on the Law of Treaties, an international agreement is one "concluded between States in written form and governed by international law." International law can also be established through international custom. Under Article 38 of the Statute of the International Court of Justice, custom is "evidence of a general practice accepted as law."[3]

One might conclude that international agreements would serve as the best means for establishing new international law. In practice, however, this has not always been true. Particularly with regard to regulating financial markets, international agreements have not been the major source of international law. Instead, the soft law standards, i.e., nonbinding norms, have emerged as a more common means of establishing international standards for financial markets. Soft law standards might be negotiated between governments or by private bodies. Despite the technically nonbinding nature of soft law, it has often been effective in establishing international standards.[4] In other words, despite the fact that soft law is nonbinding, countries often comply with soft law standards. This can be true even when a country's representatives were not involved in the creation of the soft law standards.

Why do countries bother complying with nonbinding standards? The answer to the question of compliance with soft law is complex and in some cases the analysis differs little from the question of compliance with hard law. One clear difference between compliance with soft law versus hard law standards is that the traditional methods for enforcement of legal standards, i.e., resort to the court system, is not typically available in enforcing soft law standards. Still, many of the factors relevant to compliance with soft law standards are also relevant to hard law standards. Weiss (2000) identified four areas that effect soft law compliance: (1) characteristics of the activity involved, e.g., "the fewer the number of actors involved, the easier to regulate, and the more positive the effect on the benefit-cost ratio of complying" (Weiss 2000, p. 547); (2) characteristics of the agreements, i.e., "[f]or countries to comply

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[3] Note that in addition to international agreements and international custom, Article 38 of the Statute of the International Court of Justice recognizes "general principles of law recognized by civilized nations" as a third source of international law. And finally, Article 38 identifies "judicial decisions and the teachings of the most highly qualified publicists of the various nations, as a subsidiary means for the determination of rules of law."

[4] Of course, some of these soft law standards, if implemented over a long period of time, could form the basis of customary international law.

with both hard and soft law, they must feel the obligations are equitable" (Weiss 2000, p. 547); (3) the international environment, i.e., pressures exerted from "international conferences, global media and public opinion, international nongovernmental organizations, international financial institutions, and international organizations" (Weiss 2000, p. 549); and (4) factors involving the countries, i.e., "such parameters as the country's previous actions concerning the subject of the agreement, history and culture, physical size and variation, and the number of neighboring countries; fundamental factors such as the economy, political institutions, and attitudes and values; and proximate factors such as administrative capacity, leadership, nongovernmental organizations, and knowledge and information." (Weiss 2000, p. 550).

As we will discover throughout the remainder of this book, international standards have become increasingly important in the regulation of banks. Not only are such standards important to the operations of internationally active banks, but international standards have also begun to influence domestic-oriented regulation as well. The following overviews the sources of international bank regulation, beginning with international agreements between States followed by an outline of the international groups engaged in developing soft law standards for bank regulation. The chapter concludes with a discussion of the emerging means of implementing international standards, i.e., compliance.

International Agreements

While international agreements are binding, international agreements vary considerably in the nature and extent of their proscriptions. In other words, a treaty can be written in very broad terms (making enforcement difficult due to ambiguity), or it may set forth fairly specific requirements. In terms of bank regulation, few international agreements address directly the regulation of banks (the European Union (EU) treaties are an important exception and are discussed later). Treaties, however, may contain provisions that impact the regulation of banks indirectly. For example, the Articles of Agreement that establish the International Monetary Fund (IMF) provide, among many other things, that the IMF shall oversee each member's compliance with its general obligations.[5] This provision and others form the legal support for IMF initiatives like the Financial Sector Assessment Program, discussed later.

Perhaps the most important international agreements regarding bank regulation were formed with the establishment of the European Communities and the

[5] Article IV, Section 1(ii) of the Articles of Agreement of the International Monetary Fund, provides that each member is obligated, among other things, to "seek to promote stability by fostering orderly underlying economic and financial conditions and a monetary system that does not tend to produce erratic disruptions."

European Union. Because much of the impetus for a unified Europe has been economic, the treaties and other agreements leading up to and establishing the European Union have had a direct impact on bank regulation at the national level and have prompted extensive examination of bank supervision from a supranational perspective. One of the objectives of the European Communities has been to create a unified internal market, including a single European market in financial services. Thus, a substantial body of European law has developed to ensure uniform regulatory standards among Member States. For these reasons, European law will be a consideration throughout the book, and the sources of European law are outlined later in this chapter.

The founding Treaties of the European Communities and the European Union are conventional instruments of international law, created through negotiation between the Member States. However, European law differs from conventional international treaties in two major respects. First, it has long been recognized by Member States' courts that the Treaty provisions are capable of direct effect, in the sense that they create rights that are enforceable in national courts. Such rights are enforceable by individuals against the state, and between individuals. Second, EC law has also been held to have primacy over national law. This is not quite the same thing as *supremacy*, where national laws carry precedence over local laws in a federal system, because the European Court of Justice lacks the power to strike down national legislation as contrary to the Treaties. It can merely offer interpretations of the relevant European law, leaving to national courts to decide whether or not the domestic law in question is consistent with that interpretation. Nonetheless, it is an established feature of Community law that where a Community norm comes into conflict with a national norm, the Member State (including its judiciary) are under an obligation to apply the Community norm.

Community secondary legislation, which will be our primary focus, is derived from the treaties and can take various forms:

- *Regulations,* which are binding in all EU Member States without the need for any national implementing legislation.
- *Directives,* which bind Member States to achieve certain objectives within a time frame but leave the national authorities the choice of form. Directives must be implemented in national legislation in accordance with the procedures of the individual Member States.
- *Decisions,* which are binding on those to whom they are addressed. Thus, decisions do not require national implementing legislation. A decision may be addressed to any or all Member States, to enterprises, or to individuals.
- *Recommendations* and *opinions,* which are not binding.

Similar to Treaty articles, it is established law that secondary legislation, in the form of regulations, is directly effective and creates rights that natural or legal persons may seek to enforce in national court proceedings either against the Member State or against other private parties. Directives, the most common form of Community secondary legislation for the regulation of financial services, are also capable of giving rise to direct effect in proceedings by an individual against a Member State, but not between individuals.

EC secondary legislation is the outcome of a complicated process that involves three separate Community institutions. Legislation begins as a proposal for the European Commission, the executive body of the Community. The proposal must then be approved by a majority of Member States voting in the Council of Ministers (a body that brings together the relevant government ministers from each of the Member States). Member States exercise votes that are approximately weighted according to their population size. The proposal must also be approved by a simple majority of the European Parliament, members of which are directly elected by the electorates of each of the Member States. Most financial services legislation is adopted as a measure relating to the European Internal Market and is therefore subject to the co-decision procedure under Article 251 EC, which gives the European Parliament an equal say with the Council of Ministers and the ability to amend proposed legislation.

INTERNATIONAL STANDARDS (SOFT LAW)

Following is a discussion of the major international groups and financial institutions that are involved in setting standards for the financial industry. It is important to keep in mind, however, that various ad hoc groups can also play a role in standard setting. For example, the "Gs," e.g., G-8, G-10, G-20, etc., are created by various governments to serve as a forum for consensus building.[6] These groups often complement the work of the international groups described in this chapter.

The membership and tasks of the groups described here are often overlapping. Moreover, the effectiveness of such groups in achieving effective standards is not uniform. Some groups, like the Basel Committee, have emerged as a type of quasi international regulatory body, whereas other groups have not enjoyed similar success.

[6] The Group of Twenty, for example, was established to bring together systemically important industrialized and developing economics and is composed of the finance ministers and central bank governors of 19 countries: Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, Mexico, Russia, Saudi Arabia, South Africa, South Korea, Turkey, the United Kingdom, and the United States. The European Union is the 20th member.

In an important paper on the supervision of international finance, Evans (2000, p. 10) observes that "[e]ach of these bodies provides a forum for supervisors to get to know each other, exchange information, and set standards. All seek to operate by consensus. … None have formal powers to censure let alone impose sanctions on members, but are able to exert, with variable success, informal peer pressure."

Basel Committee on Bank Supervision (BCBS or Basel Committee)

The Bank for International Settlements (BIS), located in Basel, Switzerland, is a bank owned by the central banks or monetary authorities of 49 countries, and is sometimes called *the central banker's central bank*. The aim of the BIS is to promote monetary and financial stability. The BIS does so by providing a forum for discussion and coordination among central banks. The BIS also functions as a bank to central banks and international organizations.

The BIS serves as the location for the Basel Committee on Banking Supervision (Basel Committee or BCBS). The Basel Committee[7] describes itself as follows:[8]

> *The Basel Committee, established by the central-bank Governors of the Group of Ten countries at the end of 1974, meets regularly four times a year. It has about thirty technical working groups and task forces which also meet regularly. …*
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> *Countries are represented by their central bank and also by the authority with formal responsibility for the prudential supervision of banking business where this is not the central bank. …*
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> *The Committee does not possess any formal supranational supervisory authority, and its conclusions do not, and were never intended to, have legal force. Rather, it formulates broad supervisory standards and guidelines and recommends statements of best practice in the expectation that individual authorities will take steps to implement them through detailed arrangements—statutory or otherwise—which are best suited to their own national systems. In this way, the Committee encourages convergence towards common approaches and common standards without attempting detailed harmonisation of member countries' supervisory techniques.*
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> *The Committee reports to the central bank Governors of the Group of Ten countries and seeks the Governors' endorsement for its major initiatives. In*

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[7] The Committee's members come from Australia, Belgium, Brazil, Canada, China, France, Germany, India, Italy, Japan, Korea, Luxembourg, Mexico, the Netherlands, Russia, Spain, Sweden, Switzerland, the United Kingdom, and the United States.

[8] Description can be found at http://www.bis.org/bcbs/history.htm.

addition, however, since the Committee contains representatives from institutions which are not central banks, the decisions it takes carry the commitment of many national authorities outside the central banking fraternity. These decisions cover a very wide range of financial issues. One important objective of the Committee's work has been to close gaps in international supervisory coverage in pursuit of two basic principles: that no foreign banking establishment should escape supervision; and that supervision should be adequate. To achieve this, the Committee has issued a long series of documents since 1975.

In 1988, the Committee decided to introduce a capital measurement system commonly referred to as the Basel Capital Accord. This system provided for the implementation of a credit risk measurement framework with a minimum capital standard of 8% by end-1992. Since 1988, this framework has been progressively introduced not only in member countries but also in virtually all other countries with active international banks. In June 1999, the Committee issued a proposal for a New Capital Adequacy Framework to replace the 1988 Accord. The proposed capital framework consists of three pillars: minimum capital requirements, which seek to refine the standardised rules set forth in the 1988 Accord; supervisory review of an institution's internal assessment process and capital adequacy; and effective use of disclosure to strengthen market discipline as a complement to supervisory efforts. Following extensive interaction with banks and industry groups, a final consultative document, taking into account comments and incorporating further work performed by the Committee, was issued in April 2003, with a view to introducing the new framework at end-2006.

Over the past few years, the Committee has moved more aggressively to promote sound supervisory standards worldwide. In close collaboration with many non-G-10 supervisory authorities, the Committee in 1997 developed a set of "Core Principles for Effective Banking Supervision," *which provides a comprehensive blueprint for an effective supervisory system. To facilitate implementation and assessment, the Committee in October 1999 developed the* "Core Principles Methodology."

In order to enable a wider group of countries to be associated with the work being pursued in Basel, the Committee has always encouraged contacts and cooperation between its members and other banking supervisory authorities. It circulates to supervisors throughout the world published and unpublished papers. In many cases, supervisory authorities in non-G-10 countries have seen fit publicly to associate themselves with the Committee's initiatives. Contacts have been further strengthened by an International Conference of Banking Supervisors which takes place every two years.

The Basel Committee has had a profound impact on the regulation of banks' capital. The capital requirements put into place by the Basel Committee will be explored extensively in Chapters 9 and 10. The Basel Committee has also played an important role in developing standards and best practices on other technical issues in bank regulation as well as laying down the principles that govern international cooperation between bank supervisors. The Basel Concordat, the first document issued by the Committee in 1975, concerned the allocation of supervisory responsibilities for internationally active banks and placed the onus firmly on the supervisory authority responsible for licensing the bank (the *home* authority) for ensuring its financial soundness and prudent operation on a global basis. The Concordat also set out the responsibilities of the supervisory authorities in other countries in which the bank may be operating (the *host* authorities), especially in respect of their ability and willingness to share information with the home country authority. The Concordat has since been amended several times, most recently in 1992. In 1997, the Basel Committee issued its *Core Principles for Effective Banking Supervision* ("Core Principles") that set forth 25 core principles designed as a global standard for prudential regulation. The Core Principles will be discussed at various points throughout the remainder of the book.

International Organization of Securities Commissions (IOSCO)

The International Organization of Securities Commissions (IOSCO) has a broad membership. The securities commissions of 102 countries are ordinary members. IOSCO was created to promote high standards of regulation, to facilitate exchange of information, to establish standards for international securities transactions, and to promote enforcement of standards. In 1998, IOSCO issued its *Objectives and Principles of Securities Regulation,* which sets forth 30 principles of securities regulation, all of which are derived from three objectives: to protect investors; to ensure that markets are fair, efficient and transparent; and to reduce systemic risk.

International Association of Insurance Supervisors (IAIS)

Like IOSCO, the International Association of Insurance Supervisors (IAIS) has a broad membership. Insurance supervisors of some 100 countries are represented, and in 1999 IAIS invited insurance professionals to join as observers. The aim of the IAIS is to promote cooperation among supervisors, set standards, provide training, and coordinate work with regulators from other financial sectors. In 1997, IAIS issued its *Insurance Core Principles*, which includes 17 core principles of insurance for an effective supervisory system.

The Joint Forum

The Joint Forum was established in 1996 under the auspices of the Basel Committee, IOSCO, and IAIS. The Joint Forum is unique in that is it composed of representatives from each of the three traditional financial sectors, i.e., banking, securities, and insurance. The Joint Forum facilitates information exchange between supervisors within and between financial sectors. Its mandate involves the study of issues common to the three sectors and relevant to regulating financial conglomerates. The Joint Forum has issued a number of reports, the most recent of which dealt with credit risk transfer.

International Association of Deposit Insurers (IADI)

The International Association of Deposit Insurers (IADI) seeks to promote international cooperation and facilitate communication among deposit insurers. Its members include representatives from deposit insurers from around the world. The IADI has drafted discussion papers on various topics, most recently on the subject of the resolution of failed banks.

Committee on Payment and Settlement Systems (CPSS)

The Committee on Payment and Settlement Systems (CPSS) is a forum for central banks and, therefore, its focus is on monetary and financial stability. The CPSS is hosted by the BIS and is a forum for the G-10 central banks. The CPSS provides a means for central banks to coordinate their payment system responsibilities and has published several sets of standards. For example, the CPSS has developed *Core Principles for Systemically Important Payment Systems*.

International Accounting Standards Board (IASB)

The International Accounting Standards Board (IASB) is dedicated to developing high-quality and enforceable global accounting standards. The IASB's Board includes representatives from nine countries who work in cooperation with national accounting standard setters to achieve convergence. IASB's standards are published in pronouncements called *International Financial Reporting Standards*.

Organisation for Economic Cooperation and Development (OECD)

The Organisation for Economic Cooperation and Development (OECD) is composed of 30 member countries. Its broad purposes encompass both economic and social issues. The OECD's recent work in establishing *Principles for Corporate Governance* will be discussed in Chapter 6.

Financial Action Task Force (FATF)

The Financial Action Task Force (FATF), established by the G-7 in 1989, seeks to protect the global financial system from money laundering and terrorist financing.

Currently, the FATF has 33 members, and its Secretariat is located at the OECD. The FATF has developed 40 recommendations for combating money laundering and nine special recommendations to address terrorist financing. The FATF monitors its members' progress in implementation of the recommendations through both self-assessment and mutual evaluations. The FATF also promotes its recommendations to nonmember countries. The work of the FATF will be discussed in Chapter 13.

International Monetary Fund (IMF)

The International Monetary Fund (IMF) is a specialist agency of the United Nations, created in 1945 and governed by its 184 member countries. The IMF's purposes include promoting world trade, stable exchange rates, and orderly international payment systems.[9] Given these purposes, the IMF's main focus is on macroeconomic, i.e., overall economy, performance and financial sector policies. The IMF's concern with financial sector policies is of particular relevance to the subject of bank regulation.

The IMF is often confused with the World Bank (the International Bank for Reconstruction and Development). While the World Bank's work is complementary to the IMF's, the World Bank was created to promote long-term infrastructure development, e.g., investments in education, health, public administration, agriculture and environmental and natural resource management. In contrast, the IMF does not provide financing for particular sectors but rather assists its members in overcoming short-term balance of payments difficulties.

Financial Stability Board (FSB)

The Financial Stability Board (FSB), originally the Financial Stability Forum, was established in 1999 to improve coordination and information exchange between the national authorities[10] responsible for systemic stability, international financial institutions, and other international organizations. As a major part of its coordination effort, the FSB published its *Compendium of Standards* that compiles the various standards that are widely accepted as good practices within the financial community. The Compendium highlights 12 core standards such as the OECD's *Principles of Corporate Governance* and the Basel Committee's *Core Principles of Effective Banking Supervision*, discussed earlier and again later in the book. The FSB has also published several reports responding to the Global Financial Crisis, including *Recommendations for Addressing Procyclicality in the Financial System*, *Principles of Sound Compensation Practices*, and *Principles of Cross-Border Cooperation in Crisis Management*.

[9] Article I of the Articles of Agreement of the International Monetary Fund.

[10] Australia, Canada, France, Germany, Hong Kong SAR, Italy, Japan, Netherlands, Singapore, Switzerland, the United Kingdom, and the United States.

INTERNATIONAL COMPLIANCE

As discussed previously, the issue of national compliance with *nonbinding* international standards is, by definition, tricky (although compliance with binding standards is no walk in the park either). Traditionally, simple peer pressure was the engine of compliance. As suggested in the following excerpt from a paper by Evans (2000, pp. 17–18), peer pressure has proved insufficient, forcing the emergence of new systems of compliance.

> *The traditional approach to compliance was to assume that all members of a particular club, such as Basel or IOSCO, would comply with the club's own rules; that supervisors would bring to colleagues' attention their own experiences of interpreting the rules; and that the tour de table and informal contacts would provide a kind of peer review. This traditional approach broke down either when some members did not apply the rules … or when there were marked inconsistencies in the way countries applied the rule. … There was also a problem of applying the rules worldwide: IOSCO has a very wide membership… , but a small secretariat and no political will to enforce rules amongst all members. IAIS … is in a similar position, and inhibited by its members' relative unfamiliarity with collective action. The Basel Committee has tried to go beyond its own very limited membership through informal contacts with supervisors worldwide, and its growing willingness to assume a leadership role—for example in the development of core principles. …*
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> *The last two years have seen a growing, but far from complete, acceptance by supervisors and by the international financial community generally that the standard-setting role of the international supervisory bodies needs to be complemented by arrangements for assessing compliance with standards. Peer review has been tried by both Basel and IOSCO. This brought to bear the expert judgment of experienced supervisors, but was abandoned after several trials. The results were disappointing, partly because of a reluctance to commit the necessary resources and to provide the necessary confidentiality, but also because a willingness to pass judgment on the arrangements in colleagues' jurisdiction could inhibit the good bilateral relations between supervisors needed to pass supervisory information both ways.*

While pure peer pressure can still form a powerful basis for compliance with international standards, other incentives for compliance have emerged. In this context, the role of the private sector, especially the credit rating agencies such as Standard & Poor's, Moody's, or Fitch, has become very important. Both in rating individual bank debt and in rating sovereign debt issued by countries, the rating agencies take into account the strength and quality of bank regulatory systems. Compliance with the recommendations of bodies like the Basel Committee has formed an important part of that assessment. Thus, the greater the degree of a country's compliance with the Basel standards, the more highly rated its debt is likely to be and the lower will be the interest rates it has to pay for borrowing in international financial markets. Although the quality of banking supervision is only one factor among many that the rating agencies take into account, it has arguably become more prominent since the financial crises of the late 1990s in a number of countries.

For developing countries, the incentive for compliance can be even greater to the extent that, for example, the IMF conditions its financial assistance on enhancing compliance with international standards. The usefulness of this type of incentive is obviously limited in that it affects only those countries in need of financial assistance from the IMF, and those countries may not be the same countries that involve the greatest risk to world financial markets. Given the limitations of the traditional peer pressure and conditional assistance, the IMF and World Bank have introduced an alternative compliance mechanism.

In 1999, the IMF and World Bank introduced the Financial Sector Assessment Program (FSAP) that seeks to identify strengths and weaknesses in a country's financial sector. Under the program, compliance with standards and codes is assessed and is reported in Reports on the Observance of Standards and Codes (ROSC). According to the IMF,[11]

> *ROSCs summarize the extent to which countries observe certain internationally recognized standards and codes. The IMF has recognized 12 areas and associated standards as useful for the operational work of the Fund and the World Bank. These comprise accounting; auditing; anti-money laundering and countering the financing of terrorism (AML/CFT); banking supervision; corporate governance; data dissemination; fiscal transparency; insolvency and creditor rights; insurance supervision; monetary and financial policy transparency; payments systems; and securities regulation; AML/CFT was added in November 2002. Reports summarizing countries' observance of these standards are prepared and published at the request of the member country. They are used to help sharpen the institutions' policy discussions with national authorities, and in the private sector (including by rating agencies) for risk assessment. Short updates are produced regularly and new reports are produced every few years.*

Over 100 countries/areas have ROSC available on the IMF website. It is important to note, however, that the ROSC are published "at the request of the member

[11] Definition found at http://www.imf.org/external/np/rosc/rosc.asp.

country," which means that each country decides whether the results of the report will be publicly available. However, to the extent that the ROSC are discussed at IMF board meetings, the agenda of which is publicly available, there is informal pressure to "request" publication. The only sanction for failure to comply with the associated standards is negative publicity. Such publicity has the potential to provide a form of market discipline; i.e., a country in noncompliance with certain standards may find its financial institutions disadvantaged in world financial markets, and this may also feed into assessments by the credit rating agencies. Of course, this sort of market discipline is available only when there is international support for the standards applied. The remainder of the book will focus on the content of such standards. In the instances in which international consensus has been achieved, such standards for regulation will be emphasized. In the absence of international standards, we will undertake some comparative analysis of how different countries seek to address those particular areas of regulation.

REVIEW QUESTIONS

1. Commentators often observe that, with rare exception, lawmakers pass banking laws only during a period of financial crisis. Why is this so?
2. What are the pros and cons of the use of hard law versus soft law in the creation of international standards for bank regulation?
3. What factors make an international group successful in serving as a standard-making body?
4. Why have treaties not been a major source of international law regulating banks?
5. Why would a country, e.g., a developing country, seek to comply with soft law standards developed by an international group if that country was not a member of the group?
6. How does the market, as opposed to the government, provide incentives for compliance with soft law international standards?

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