Book review, *Law and Financial Markets Review,* November 2012:

Emilios Avgouleas, *Governance of Global Financial Markets. The Law, the Economics, the Politics.* Cambridge University Press, Cambridge UK, 2012, 477 p., £85.
ISBN 978-0-521-76266-3

This timely, comprehensive study of the use and abuse of global financial governance argues that financial innovation, i.e. the 'knowledge revolution' (p. 3, 85, 150 *et seq*) which shaped financial markets in tandem with liberalisation policies and technological developments, has been insufficiently understood and badly mismanaged. This is, the author claims, the underlying cause of the 'Global Financial Crisis' (GFC) that began in 2007. New financing techniques, the opening up of capital markets and information technology have been the main drivers of the financialisation of the global economy in the past three decennia. Together they set off a 'financial revolution' (p. 3, 90, 138-142, 150 *et seq*), which created opportunities for double digit profits, but also the - hidden or ignored - potential for massive fraud, rent seeking, multi digit losses and disastrous impairment of both the financial infrastructure and the economy it was supposed to serve. The analysis is plausible, except perhaps for the name of the crisis: 'North-Atlantic' would have been more appropriate as it originated in this region, which, moreover, assumed pre-2007 that such crises were characteristic of 'emerging markets', or 'the periphery' (Mexico, South-America, Japan, Asia, Russia).

The author's starting assumption is that open markets, financial innovation and technology are inherently 'neutral' conditions. If well managed, he maintains, they can - and should - affect the global economy in a less reckless and more equitable way. The core question he sets out to research is how the potentially distributional benefits of modern finance can be realised while the risks are well understood *and* properly managed. The results, based on insights of institutional economics (Douglas North), political science and legal scholarship, lead to a concrete proposal: a treaty-based governance structure for global financial markets that would 'provide global finance operators with welfare enhancing norms of behaviour, even in the absence of any threat of enforcement' (p. 15).

The book is structured in three parts. Each one is subdivided in chapters that inform the line of argument, but can also be read as mini-monographs in their own right. This is helpful, because a considerable degree of (technical) detail is needed for the reader to grasp the vastness and complexity of the subject. Substantial footnotes testify, moreover, to the thorough research underpinning this study, as well as to its place in the debate, in academia and elsewhere, on how to protect the elusive 'global public good' which is 'financial stability'. My only regret is that the references were not systematised in a bibliography.

Part I, 'Financial markets and financial crises', opens with an explanation of the basic functions, instruments and - institutional and ideological - conduits of finance (chapter 2). It then examines the causes of the GFC that set in with the first hints of a liquidity squeeze in mid-2007 (chapter 3). The author highlights the 'interplay between innovative finance, technology and open markets' that linked 'previously disparate and independent parts of the global financial markets into a homogeneous, interconnected and interdependent system'. These developments also exacerbated a pre-existing 'too big to fail' problem (p. 90). Systemic risk could build up across the financial sector because of deficient understanding and management of risks by the market, policy-makers and regulators alike (p. 91). Adding to the usual suspects blamed for management failure (regulatory capture, perverse incentives, 'markets know best' doctrine), the author observes that the financial revolution 'stretched the cognitive capacity of regulators and policy-makers as well as that of many market actors' (p. 92). Differently put, financial markets became 'too complex to comprehend', just as financial companies and products grew 'too complex to depict' (Henry Hu) or 'too complex to price' (Andrew Haldane).

Part II, 'The evolution of governance structures for international finance' (chapters 4 and 5), first reviews the history of the institutional organisation of monetary, trade and financial arrangements from the end of World War II up till the present. The Bretton Woods agreements of 1944 opened up trade, provided for currency parities, but restricted capital flows - seen as destabilising - and therefore did not include tools to regulate them. The arrangements lasted until 1971-1973. Around that time, transnational regulatory networks (TRNs) began crystallising in an attempt to address the increasing risks of cross-border finance. In response to the Asian crisis of 1997, a 'New International Financial Architecture' (NIFA) was launched by the International Monetary Fund (IMF), which introduced a degree of monitoring standards at the international level (p. 187). A red thread throughout the narrative is the broadening mandate of the IMF, a Bretton Woods institution at its origin, which became flanked post-2008 by an expanded group of heads of state (the G20) and a strengthened global standard setter, the Financial Stability Board (FSB).

Chapter 5 offers a critical evaluation of network structures for international financial regulation, i.e. 'soft law', as against treaty-based hard rules such as they exist for trade. Since the 1990s, informal transnational cooperation between regulators, heavily dependent on private sector input, has been touted for its flexibility and low cost. But what seems to work in 'normal times' may well break down in a crisis. To give a few examples: the author joins Pierre-Hugues Verdier in arguing that domestic preferences pull TRNs apart, and thus block optimal global public policy (p. 226). Similarly, business preferences hinder private actors in developing optimal standards. The 'quasi-regulatory role assigned to private actors' has led to input based on fragmented knowledge, because private actors lack the incentive to gather data that cover 'areas beyond their immediate business needs' (p. 228-230). This is an astute observation, and it resembles one of the reasons why the FSB is currently coordinating efforts to establish a global 'legal entity identifier' for financial markets (LEI). The benefits of a LEI, a 'global public good', are collective, which means that private incentives for setting it up are low.

The author's proposal, worked out at the end of Part III, is *not* to abandon TRNs or private sector cooperation, but to incorporate the 'effective parts' in a new global governance regime. The first two chapters of Part III, 'Regulatory reform and a new governance model for global financial markets', prepare the ground with a general analysis of ongoing or already implemented reform in the U.S. and the EU (chapter 6), and more in particular (chapter 7), attempts to curb 'too big to fail', which include the newly installed or developing regimes to resolve systemically important financial institutions and infrastructure (payment and settlement, clearing). The main weakness of these reforms, the author argues, is that they still 'provide very limited comfort' when it comes to the supervision and resolution of large cross-border financial groups. Moreover, they lack a unified structure for managing risks that emerge from unpredictable interaction of financial innovation and global market forces (p. 429).

All this is hard to refute. The question is whether the proposed solution will provide the necessary relief. The new global governance regime (the subject of chapter 8) would be hierarchical and multilayered, held together by a shared body of underlying regulatory values and legal principles (p. 256-258; reference to Rolf Weber). At its centre would be a 'formal international law structure' resting on four pillars of equal status: the IMF as systemic risk regulator; the FSB as micro-prudential supervisor for global systemically important financial institutions (G-SIFIs); a 'regulation and knowledge management body overseeing the TRNs' in the legal *personae* of the Organisation for Economic Cooperation and Development (OECD) and the Bank of International Settlements (BIS); and, finally, a global resolution authority which would be responsible for cross-border resolution of financial groups.

Building such a regime is, as the author recognises, a tall order, for a variety of political, juridical, and technical reasons. Getting all parties to the treaty to agree on shared regulatory values would be challenging, for a start. Some of them, such as financial stability, and consumer and investor protection, may be beyond dispute. But poverty reduction (p. 15, 32-35, and 438-439) might be controversial in this context. Access to microfinance can help fund small businesses, on condition the loan sharks are kept in check. However, it is less certain that 'free and open capital markets', in the light of their fragility-enhancing potential, are the 'only' way to secure this access (p. 34, 430), or even the best way (p. 458). What happened in the secondary mortgage market - first created in the U.S. around 1970 to promote home ownership - i.e. widespread fraud in the originate-and-distribute process, should caution against the financialisation of microloans. Giving such loans low risk weights in regulatory capital, as the author suggests (p. 438-439), would make them vulnerable to manipulation as banks would have an incentive to create excessive demand. And regulators do not have the eyes, teeth or funds to reign in the production chain.

A more general point about 'free and open' capital markets, which the author wishes to protect, is that they have become less self-evident as an objective in post-GFC global policy. A quiet paradigm shift has occurred in recent years. Both the FSB and the IMF now consider capital controls appropriate instruments for the macroprudential tool kit (2011). Such instruments have shown their worth before, most recently in the 'retrenchment' of Asian countries after the 'Asian crisis' of the late 1990s. This strengthened their resilience, precisely, during the current one (Carmen Reinhart; Ravi Balakrishnan *et alii* 2012).

But then, the author might reply, isn't this learning curve exactly why the IMF and the FSB are the right choice for being part of a formal global governance structure? *De facto*, and under pressure of the continuing crisis, they already are moving into position, just as the European Central Bank (ECB), under similar pressure, is taking on a role that is not unambiguously provided for in the EU treaties. He would have a point. However, scores of legal and technical hurdles remain, whether there will be a global treaty or not, for instance with regard to data collection and information exchange. The author's remarks are sketchy on the subject (e.g. p. 436, 441) and do not clarify (yet) how the new global governance structure would help tackling these problems, which are as central as they are complex. A 'mandate to co-operate in full' is begging the question: how would this work in practice?

Even if the details can be hammered out - and solid work is underway in the U.S., the EU, and transnational organisations, to develop standards, templates and governance structures for handling financial data for supervisory purposes (e.g. the above mentioned LEI) - there may come a point where understanding and controlling the 'financial revolution' no longer is a question of sharpening the analysis, refining the models, and improving public and private risk management, but of simplifying the object of attention of both supervisors and the supervised. Financial markets, institutions or infrastructure, which look 'too complex to depict' may in fact be 'too complex to exist', (Henry Hu, Gillian Tett), or at least 'too dangerous to permit' (Richard Fischer). Formulated this way, the cognitive incapacity of both public and private parties, diagnosed in this book, raises a parallel set of queries about the structure and size of the financial sector, especially when linked to research that finds thresholds beyond which there can be 'too much finance' (Jean-Louis Arcand *et alii*).

Chapter 7 addresses some of these queries. Here the author reviews the legislative attempts in the U.S. and EU to contain 'too big to fail', as well as relevant policy initiatives of the FSB, IMF and the Basel Committee on Banking Supervision (BCBS). The objective is clear: ending 'moral hazard', i.e. the implicit expectation that taxpayers will clean up if the business goes bust. The (proposed) measures vary from capital surcharges and enhanced supervision for SIFIs, funding with loss bearing capital (CoCos), ringfencing utility or trading units, prohibiting 'proprietary trading' by deposit taking institutions ('Volcker rule'), planning for recovery or resolution ('living wills'), to special resolution regimes in case all else has failed. Some of these measures indirectly affect bank size, such as the Volcker rule (p. 352, *et seq*) and capital requirements. Others aim at clarifying corporate structure, such as ‘living wills’. These contingency plans are meant to avoid that a company, once it is about to fail, would be 'too complex to permit orderly and cost-effective resolution' (p. 374, BCBS). A ringfence does both, ‘downsizing’ and clarifying, but is not favoured by the banks. This is why it will probably take time, and intense debate, before the trading ringfence recommended by the Liikanen commission would be anchored in EU law.

The Liikanen commission was established by European commissioner Michel Barnier after this book went to press. As the author mentions in his Preface, reform is taking place ‘at rapid pace and at all levels’, which makes it hard to keep up with. The book represents a giant effort to do so. It is 'too rich to review' in a few pages, and deserves to be read with care. Importantly, it provokes debate, which is perhaps one of its finest features.

Marleen Wessel
Department of Constitutional and Administrative Law,
University of Amsterdam