

# **Sabino Cassese**

## **Introduction<sup>1</sup>**

I. The financial crisis and global regulatory governance. This problem raises three sets of questions:

1. which of the pre-existing global regulations failed and why?

2. which measures have been taken by global regulatory regimes to overcome the crisis and what kind of global regulatory regime is likely to be the result of this crisis?

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3. how a new global regulatory regime is being established? Which is the balance between global and national rules?

I shall not address these questions, but I shall only try to articulate them, by way of introduction.

II. Which of the pre-existing global regulations failed and why?

A conspicuous body of global financial regulation pre-existed to the present crisis.

There are banking, securities, accounting and credit rating regulations. It is important to

make a diagnosis: what kind of regulatory failure did the crisis reveal?

a.the quality of regulation: was it insufficient (in the sense that there were gaps - for example, lack of regulation on financial derivatives and credit rating agencies – or inadequate – Basel II was providing for not enough capital), or pro-cyclical?

b.the regulator: did it have a conflict of interest (for example, the Basel Committee)? Was it captured by the regulated?

c.the procedural arrangements: was there lack of participation?

d.compliance: was the regulation ineffective? Was there a deficit of oversight?

III. What kind of global regulatory regime is likely to be the result of this crisis?

a. a “collective discipline” (The Economist, *No going back*, May 15<sup>th</sup>, 2010), not just national, nor only supra - national or global is being established;

- b. the European 750 billion euro “Special Purpose Vehicle” (“Fund for the Stabilization of the Euro” / “European Financial Stability Facility-EFSF”) imposes on the borrowers obligations of “good behaviour” and sanctions misbehaviour;
- c. old institutions are strengthened: the Financial Stability Forum has become Financial Stability Board;
- d. new institutions are on their way: De Larosière proposal for a new authority for banks, insurance and securities;

e. new standards are strengthened or established: the European Regulation for Credit Rating Agencies calls the Committee of European Securities Regulators – CESR, together with national regulators, to assess implementation and to establish sanctions; standards for managers compensation are introduced;

f. national policies include not only bail-outs, stimulus programs, regulation of financial derivatives and compensation practices, macro-prudential regulation and

budget cuts, but also proposals for the global space, like raising international regulatory standards and improving international cooperation (see US Treasury, *Financial Regulation Report* 2009);

- g. a global financial architecture and global standards are emerging, to re-balance the asymmetry between global financial markets and national regulation. The Financial Stability Board and the OECD have made proposals for this global financial architecture at the global level

(See FSB, *Modernisation of the global financial architecture – global financial stability*, and OECD, *Declaration on propriety, integrity and transparency in the conduct of international business and finance*). Similar efforts are made at regional level in the Eurozone by the European Council and by the European Central Bank.

- h. “Having saved the banks, governments now find themselves under the wary eye of the markets”: the need to “rescue the

rescuers” (The Economist, May 29<sup>th</sup>, 2010).

IV. How a new financial global regulatory system is established?

In his influential article, "The Nineteenth-Century Revolution in Government: A Reappraisal," (1958) Oliver MacDonagh attempted the Irish historian to build a model that would explain the genesis of the "governmental revolution" in Britain during the middle of the nineteenth century. The model is in five stages. The *first* was usually

triggered by the exposure of some outrageous social evil (e.g. child labor, accidents in the mines) followed by demands for a remedy. Resistance was encountered from the endangered interests, but the usual result was not inaction; rather, a weak compromise. In the *second* stage, new revelations were publicized, indicating that the original evils remained untouched by the earlier legislation which lacked an enforcement mechanism. These discoveries led to the *third* stage, the appointment of central administrators who gradually gained expertise in their fields and

became a vocal force in favour of additional legislation and greater centralization. In the *fourth* stage these centralized bureaucrats began to view their mission as a permanent one. They substituted a dynamic for a static concept of administration, wherein they would play a leading role in closing loopholes and "tightening the screws." *Finally*, in the ultimate stage, these bureaucrats became convinced of the idea of scientific expertise and adopted a more or less conscious Fabianism.

Something similar is on the way now at a global level. Let me briefly sketch the example of the regulation of Credit Rating Agencies:

a. first stage: 2004 International Organization of Securities Commissions – IOSCO Code of Conduct (“Fundamentals for Credit Rating Agencies”), based on the “comply or explain” principle (obligation to publish rating methodologies and to separate ancillary services);

- b.second stage: 2006 US Credit Rating Agency Reform Act: regulation of conflict of interest and of issuing of credit ratings;
- c.third stage: 2007 IOSCO and CESR reports on Credit Rating Agencies compliance with IOSCO Code on ancillary services;
- d.fourth stage: 2008: the Code is extended to rating of derivatives;
- e.fifth stage: 2009: the Financial Stability Forum urged Credit Rating Agencies to comply and asked national authorities to monitor implementation;

f. sixth stage: the Financial Stability Board and the G20 urged to establish registration;

g. seventh stage: 2009 European regulation regulating registration, conflict of interest, disclosure, surveillance, sanctions at the European and at the national level;

h. eight stage: UE Commission proposal to establish a European oversight body over Credit Rating Agencies (European Securities and Markets Authority – ESMA).