INTERNATIONAL BANKING AND FINANCE LAW SERIES

From Crisis to Crisis

The Global Financial System and Regulatory Failure

Ross P. Buckley & Douglas W. Arner

Wolters Kluwer
Law & Business

From Crisis to Crisis

The Global Financial System and Regulatory Failure

Ross P. Buckley
Douglas W. Arner

Wolters Kluwer
Law & Business

Published by:
Kluwer Law International
PO Box 316
2400 AH Alphen aan den Rijn
The Netherlands
Website: www.kluwerlaw.com

Sold and distributed in North, Central and South America by:
Aspen Publishers, Inc.
7201 McKinney Circle
Frederick, MD 21704
United States of America
Email: customer.service@aspenpublishers.com

Sold and distributed in all other countries by:
Turpin Distribution Services Ltd.
Stratton Business Park
Pegasus Drive, Biggleswade
Bedfordshire SG18 8TQ
United Kingdom
Email: kluwerlaw@turpin-distribution.com

Printed on acid-free paper.

ISBN 978-90-411-3354-0

Printed and Bound by CPI Group (UK) Ltd, Croydon, CR0 4YY.

To Rashelle and Chantal

About the Authors

Ross P. Buckley is a Professor in the Faculty of Law at the University of New South Wales, Sydney, Australia, and Fellow, Asian Institute of International Finance Law, University of Hong Kong.

Douglas W. Arner is the Director of the Asian Institute of International Financial Law and a Professor in the Faculty of Law at the University of Hong Kong, and a Visiting Research Fellow, University of New South Wales.

Ross and Douglas co-edit Kluwer's *International Banking and Finance Law Series* (along with JJ Norton) and with others co-convene the International Financial and Monetary Law Research Network.

Ross is also founding Series Editor of Kluwer's *Global Trade Law Series*, and Douglas is also a founding Series Editor of Edward Elgar's *Asian Commercial, Economic and Financial Law and Policy Series.*

Each have consulted to a range of banks, financial institutions and government departments in a wide range of countries.

List of Abbreviations

ABS	Asset Backed Securities
AECM	Aggregate Effective Currency Mismatch
ASEAN	Association of Southeast Asian Nations
BCBS	Basel Committee for Banking Supervision
BIS	Bank for International Settlements
BPS	Basis Points
BRIC	Brazil, Russia, India and China
CACs	Collective Action Clauses
CCPs	Central Counterparty Clearinghouses
CDO	Collateralized Debt Obligations
CDS	Credit Default Swaps
CFPB	Consumer Financial Protection Bureau
CFTC	Commodities Futures Trading Commission
CGFS	Committee on the Global Financial System
CLO	Collateralized Loan Obligations
CPSS	Committee on Payment and Settlement Systems
CRA	Credit Rating Agencies
CTT	Currency Transaction Tax
DSU	Dispute Settlement Understanding
ECB	European Central Bank
EESA	Emergency Economic Stabilization Act
EU	European Union
EUR	Euro
FAS	Financial Accounting Standards
FAT	Financial Activities Tax
FATF	Financial Action Task Force on Money Laundering
FCL	Flexible Credit Line

FDIC	Federal Deposit Insurance Corporation
FHFA	Federal Housing Finance Agency
FSAP	Financial Sector Assessment Program
FSF	Financial Stability Forum
FSOC	Financial Stability Oversight Council
FTAF	Forward Term Auction Facility
FTT	Financial transaction tax
GAAP	Generally Accepted Accounting Principles
GAO	Government Accountability Office
GATS	General Agreement on Trade in Services
GATT	General Agreement on Tariffs and Trade
GBP	Great Britain Pound
GDP	Gross Domestic Product
GFC	Global Financial Crisis
GLBA	Gramm-Leach-Bliley Financial Modernization Act
GSE	Government Sponsored Enterprises
HBOS	Halifax Bank of Scotland
HERA	Housing and Economic Recovery Act
HIPC	Highly Indebted Poor Country initiative
IADI	International Association of Deposit Insurers
IAIS	International Association of Insurance Supervisors
IASB	International Accounting Standards Board
IBRD	International Bank for Reconstruction and Development
ICSID	International Centre for Settlement of Investment Disputes
IDA	International Development Association
IEO	Independent Evaluation Office of the International Monetary Fund
IFC	International Finance Corporation
IFI	International Financial Institutions
IMF	International Monetary Fund
IMFC	International Monetary and Financial Committee
IOSCO	International Organization of Securities Commission
IRB	Internal Models-Based
ISDA	International Swaps and Derivatives Association
ITO	International Trade Organization
LDC	Less Developed Countries
LIBOR	London Interbank Offered Rate
LTCM	Long Term Capital Management
MAP	Mutual Assessment Process
MDB	Multilateral Development Banks
MDGs	Millennium Development Goals
MFN	Most-Favoured Nation
MIGA	Multilateral Investment Guarantee Agency
MMoU	Multilateral Memorandum of Understanding
NAB	New Arrangements to Borrow

NFC	Non-bank Financial Companies
NGO	Non-Governmental Organisation
ODRF	OTC Derivatives Regulators' Forum
OECD	Organisation for Economic Co-operation and Development
OPEC	Organization of Petroleum Exporting Countries
OTC	Over-the-Counter
OTS	Office of Thrift Supervision
PBOC	People's Bank of China
PRGF	Poverty Reduction and Growth Facility
PRSPs	Poverty Reduction Strategy Papers
ROSCs	Reports on the Observance of Standards and Codes
RTC	Resolution Trust Corporation
S&L	Savings and Loan
SAP	Structural Adjustment Policies
SDR	Special Drawing Rights
SDRM	Sovereign Debt Restructuring Mechanism
SEC	Securities and Exchange Commission
SIFI	Systemically Important Financial Institutions
SIV	Structured Investment Vehicles
SNB	Swiss National Bank
SOAS	School of Oriental and African Studies
SPV	Special Purpose Vehicle
SRF	Supplemental Reserve Facility
TARP	Troubled Assets Relief Plan
TRIPS	Trade Related Aspects of Intellectual Property Rights
UNICEF	UN International Children's Education Fund
UNCTAD	United Nations Commission on Trade and Development
UNCTC	United Nations Centre on Transnational Corporations
UNECLA	United Nations Economic Commission for Latin America and the Caribbean
UNEcoSoc	United Nations Economic and Social Council
UNICEF	UN International Children's Education Fund
USD	United States Dollar
WaMu	Washington Mutual
WIPO	World Intellectual Property Organization
WTO	World Trade Organization

Preface

> Something is wrong with the global financial system. One might think the system would shift money from rich countries, where capital is in abundance, to those where it is scarce, while transferring risk from poor countries to rich ones, which are most able to bear it . . . The current global financial system does none of these things.[1]
>
> Joseph Stiglitz,
> Nobel Laureate in Economics,
> former World Bank Chief Economist,
> in 2003.

It is a mistake to think that our international financial system was designed to deal with today's international capital flows. It was not.

When in 1944 John Maynard Keynes and Harry Dexter White proposed three international organisations to guide and assist the international economy, the international financial system was utterly different to the one we have today. Nations existed largely as financial islands. Capital flows between them were miniscule by contemporary standards.[2] Capital controls were in place between national economies to regulate and often prevent transnational capital flows.

Today finance is perhaps our most globalised activity. The price of credit in the United States affects the interest rates offered to home buyers in Australia or England. A currency crisis in Thailand affects share prices in Turkey and Hungary. The economic collapse of Russia sends the values of the thirty-year U.S. Treasury

1. J. Stiglitz, 'Dealing With Debt' (2003), 54.
2. Total debt flows were USD 13.4 billion in 1970, USD 272 billion in 2000 and USD 647 billion in 2006: *Global Development Finance 2002* (Washington DC, World Bank, 2002), 246 and *Global Development Finance* 2007, available at <http://siteresources.worldbank.org/INTGDF2007/Resources/3763069-1179948748801/GDF07_completeFinal.pdf>.

Bond to unprecedented highs. A sub-prime lending crisis in the United States freezes capital markets around the world. These changes have come about principally due to capital account liberalisation, the process by which barriers to capital flows between nations are eliminated and financial globalisation thus facilitated.

This book focuses upon why we have a system that is so crisis prone and deficient for debtors and creditors alike, and what can be done about it.

Hundreds, perhaps thousands, of books have been written on the international financial system in the wake of various financial crises, most recently the global financial crisis of 2008. What sets this book apart is not its topic, but the perspective from which it is approached. For this is a book by two lawyers, and, in Frank Partnoy's words, 'lawyers and legal academics are largely absent from the debate about financial crises. The commentary is dominated by economists, many of whom unfortunately vastly oversimplify or even misunderstand the role of law in . . . crises'.[3]

Partnoy's complaint is an important one.

Lawyers need to become more involved in working to enhance the global financial system. Law schools need more scholars teaching and researching international finance law. Around the world, law schools that believe they must teach international trade law, do not teach international financial law. Yet financial flows far exceed trade flows. At the same time, international financial transactions represent a far greater proportion of the practice of most major law firms than do trade transactions. Moreover, international finance, when it goes wrong, brings appalling suffering to the poorest citizens of poor countries, and as we have seen of late, can bring rich countries to the brink of bankruptcy. International financial law is important; it is only neglected because it is not understood.

We have written this book for several reasons. One is to address this widespread lack of understanding, hopefully with an accessible and interesting book. Another is to provide a general introduction to the international financial system and its regulation to assist students studying the topic. A third reason is to articulate our view of the system as one that works much to the detriment of poor nations and the benefit of rich nations, and in particular to the detriment of the poor within poor nations and the benefit of the rich within rich and poor nations alike.

In general, this book seeks to learn from history. For, as John Kenneth Galbraith said, '[h]istory has a way of repeating itself in financial matters because of a kind of sophisticated stupidity'.[4] If this book seeks anything, it seeks to work against this sophisticated stupidity for mistakes in global finance sacrifice the lives of thousands and the futures of millions.

Ross Buckley, Sydney, Australia
Douglas Arner, Hong Kong

3. F. Partnoy, 'Why Markets Crash and What Law Can Do about It' (1999–2000), 741.
4. J. Galbraith, *The Sunday Times*, 25 Oct. 1987. The more well known, similar quotation is from George Santayana, 'Those who cannot remember the past are condemned to repeat it': Santayana, *Life of Reason* (1950–1956), vol. I, ch.xii

Acknowledgements

We and the publisher would like to thank the publishers of the following books and journals for their permission to use herein parts of the material written by us and published in the following chapters and articles:

Arner and Buckley: 'Redesigning the Architecture of the Global Financial System', (2010) 11 *Melbourne Journal of International Law*, 1–55.

Arner: 'The Global Credit Crisis of 2008: Causes and Consequences' (2009) 43 *The International Lawyer* 91–136; 'The Global Credit Crisis and the Financial Stability Board: Hardening the Soft Law of International Financial Regulation?' (2009) 32 *University of New South Wales Law Journal* 488–513 (with M. Taylor); 'Adaptation and Resilience in Global Financial Regulation' (2011) 89(5) *North Carolina Law Review* 101 (2011).

Buckley: 'The Dodd–Frank Wall Street Reform and Consumer Protection Act: An Outsider's Perspective' (2011) *Journal of Corporate Law Studies* (with G. North); 'Improve Living Standards in Poor Countries: Reform the International Monetary Fund' (2009) 24 *Emory International Law Review* 119–146; 'The Bankruptcy of Nations: An Idea Whose Time Has Come' (2009) 43 *The International Lawyer* 1189–1216 republished as 'The Bankruptcy of Nations: Let the Law Reflect Reality' (2010) 29(6) *Banking & Financial Services Policy Report* 1–17; 'IMF Policies and Health in Sub-Saharan Africa', in *Global Health Governance: Crisis, Institutions and Political Economy*, Kay & Williams (eds) (London: Palgrave Macmillan, 2009) (with J. Baker); 'How to Strengthen the International Financial System by Improving Sovereign Balance Sheet Structures', (2006) 2 *Annals of Economics and Finance*, 257 (with P Dirou); 'Why Some Developing Countries Are Better Placed than the International Monetary Fund to Develop Policy

Responses to the Challenges of Global Capital' (2006) 15 *Tulane Journal of International and Comparative Law* 121; 'Iraqi Sovereign Debt and Its Curious Global Implications', in *Beyond the Iraq War: The Promises, Perils and Pitfalls of External Interventionism*, Heazle &d Islam (eds) (London: Edward Elgar, 2006), 141; 'The Role of the Rule of Law in the Regulation of Global Capital Flows', in *Globalisation and the Rule of Law*, Zifcak (ed.) (Oxford: Routledge, 2005), 140; 'Why Are Developing Nations So Slow to Play the Default Card in Renegotiating Their Sovereign Indebtedness?' (2005) *Chicago Journal of International Law* 347; 'How the International Financial System, to Its Detriment, Differs from National Systems, and What We Can Do About It' (2004) 34 *Hong Kong Law Journal*, 321; 'Do Cry for the Argentines: An Analysis of Their Crisis' (2003) 17 *Banking & Finance Law Review* 373; 'The IMF's Proposal for a Sovereign Debt Restructuring Mechanism: An Australian Assessment' (2003) *Australian Journal of International Law* 1; 'The Fatal Flaw in International Finance: The Rich Borrow and the Poor Repay' (Winter 2002/2003) XIX No. 4 *World Policy Journal* 59; 'A Tale of Two Crises: The Search for the Enduring Lessons of International Financial Reform' (2001) 6 *UCLA Journal of International Law and Foreign Affairs* 1; 'An Oft-Ignored Perspective on the Asian Economic Crisis: The Role of Creditors and Investors' (2000) 15 *Banking and Finance Law Review* 431; 'The Role of Capital Controls in International Financial Crises' (1999) 11 *Bond Law Review* 231; 'The Facilitation of the Brady Plan: Emerging Markets Debt Trading from 1989 to 1993' (1998) 21 *Fordham International Law Journal* 1802; 'The Transformative Potential of a Secondary Market: Emerging Markets Debt Trading from 1983 to 1989' (1998) 21 *Fordham International Law Journal* 1152.

We would also like to thank Jonathon Baker, Peter Dirou, Gill North and Michael Taylor for allowing us to reuse some of the material from the articles listed above written jointly with them, and also for our research assistants Lara Hall and Anita Wise whose efforts contributed much towards getting this manuscript finished and it being less late than it would have been without their assistance.

Finally, thanks are due to Simon Bellamy of Kluwer for his encouragement of this project, and his patience.

Summary of Contents

Table of Contents