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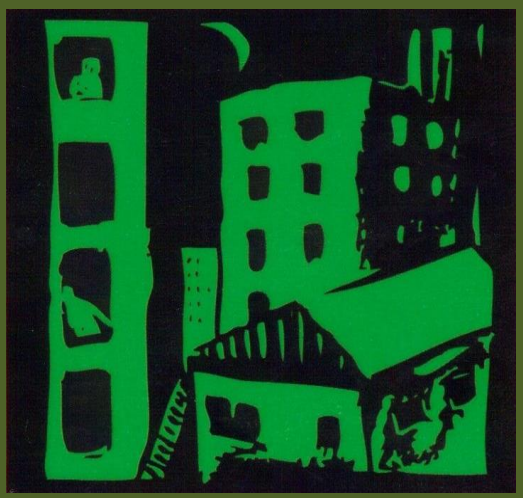

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THE GLOBAL FINANCIAL REGULATORY SYSTEM AND THE RULE OF LAW : AN APPRAISAL OF THE REGULATORY PROCESS UNDER BASEL III

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ABSTRACT

The efficacy of the existing international financial regulation and adoption of an institutionalised form of regulation are among the global financial governance issues which have been well addressed by scholars in the field. The less investigated but directly related and worth considering issue is the impact of the contemporary global financial governance system on fundamental values like the rule of law. This article examines this less explored yet worth investigating issue with a focus on Basel III, namely, how far does the regulatory process under Basel III, as it stands today, inhibit or foster the rule of law. Soft law, informal groups of this regulatory network and the regulatory process are analyzed in the light of the relevant elements of the rule of law. The article shows that the accountability deficit and lack of inclusive governance in the Basel III regulatory system have inhibited the advancement of the rule of law which should have been fostered to build legitimacy in this regulatory system.

Key words: accountability, Basel III, global financial governance, participation, rule of law, soft law

I. INTRODUCTION

The growing interdependence of financial markets following the removal of restrictions on financial flows after World War II necessitated the establishment of a global communication and cooperation network.[1] The need for the establishment of such a network to develop common standards and facilitate cooperation to solve global banking problems became an important global agenda after the bankruptcy of the Herstatt Bank in Germany in 1974.[2] This incident illustrated a clear interdependence problem in global banking which required a global solution. In response to this and related problems in the financial market, the G10[3] established an informal forum for cooperation. The governors of the central banks of the G10 countries formed the Committee on Banking Regulations and Supervisory Practices whose name was later changed to the Basel Committee. The objective of the Basel Committee is to ensure global financial stability through improved banking supervision. The Committee has reached a set of agreements which are usually referred to as Basel accords. Thus far, it has produced three accords: Basel I, II and III. The Committee's standards are not legally

[1] Schmukler SL "Benefits and risks of financial globalization: challenges for developing countries" (World Bank Group 2004) available at http://siteresources.worldbank.org/DEC/Resources/BenefitsandRisksofFinancialGlobalizationSchmukler.pdf (accessed 09 April 2019).

[2] Schenk CR "Summer in the city: the 1974 international banking crisis in London and its implications for regulatory reform" (University of Glasgow 2011) available at http://www.erim.eur.nl/fileadmin/erim_content/documents/1974_Crisis_and_Response_15_Nov.pdf (accessed 09 April 2019).

[3] Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, Switzerland, the United Kingdom and the United States

binding as it is not established by a treaty or other form of legal instrument. The standards are also developed through an informal law making process. Thus, Basel accords can be considered as international soft law. However, Basel standards are being complied with worldwide as the banking regulatory network has partnered with formal international organizations which can provide implementation incentives.

Basel I standards set minimum capital requirements and risk weighing guidelines. Basel I was, however, criticized for being less risk sensitive as it focused on credit risk and omitted operational risk. Its standards were also less clear. Basel II was introduced to fill the gaps in Basel I. Basel II developed Basel I standards in a more detailed manner. It also established standards which require the holding of capital for operational risk. Serious questions were, however, raised about Basel II as it failed to ease the 2008 global financial crisis. Basel II was also criticized for allowing banking institutions to use their own risk assessment methods in determining the minimum capital they need to hold. The deficiencies of Basel II worsened the global financial crisis, and that led to Basel III. The Basel III accord incorporates tougher standards as it was developed in response to the global financial crisis.

Basel III standards are backed by politically and financially powerful groups which work toward their full enforcement. However, the informalities associated with this regulatory process could undermine the rule of law, a value that has become increasingly important in global governance and whose elements will be discussed in part two. This study concentrates on the consistency of this regulatory process with the rule of law. The rule of law is vital in building the legitimacy of public power exercised by regulatory bodies. The ideals of the rule of law in general and accountability and participation in particular promote multilateralism and prevent unilateral and plurilateral control over global governance. They do so by enabling the weak to collectively counterbalance the influence exerted by the powerful states. The rule of law, therefore, consists of fundamental ideals indispensable to limit the exercise of public power at a global level. Its absence would lead to uncertainties. That in turn hinders regulatory stability. As the Basel III regulatory process is inherently informal, its adherence to the ideals of the rule of law is disputable. The rules of the game in an informal global regulatory system would allow those who have the political and financial powers to shape governance in their favour as there are no established limits which could prevent this. This study shows that the regulatory process under Basel III is not consistent with the principles of accountability and participation and thus undermines the rule of law.

While the debates on the cooperative/functional and institutional approaches to the global financial regulatory reform have been intense, the interplay between the Basel III regulatory process and the rule of law remains underexplored. The functionalists, including Stijn Claessens, Laura Kodres and Matthew Turk, focused on explaining whether the existing global financial regulatory system is effective in stabilizing global banking. They rely on output legitimacy (efficiency) and not the rule of law to justify this regulatory system. The institutionalists, on the other hand, focused on authorization of the global financial regulatory bodies as a means to make the

regulatory system effective in stabilizing global banking. To be precise, both the functionalists and institutionalists focused on making the regulatory system more effective in stabilizing global banking and did not provide much insight about power controlling mechanisms in general and accountability and participation in particular. This article aims at narrowing this gap by appraising the Basel III regulatory process in the light of the principles of accountability and participation which are the core elements of the rule of law.

The main methods employed in this study are doctrinal analysis and legal theory. Accordingly, the regulatory process under Basel III is analyzed through the lens of the rule of law whose theoretical foundations are sketched in part four. However, appraising the regulatory process under Basel III in the light of the rule of law cannot be fruitful without involving at least findings from the disciplines of political science and finance. This study has thus used relevant inputs from these disciplines.

This study, therefore, evaluates the Basel III regulatory process against the principles of accountability and participation which are identified, in part four, as the most relevant ideals of the rule of law for the purpose thereof . Given the complexity and multi-faceted nature of the rule of law and its elements, part two is entirely devoted to clarify and come to an operational understanding of this concept. This article has seven parts. The next part presents a literature review of the subject. Part three explains the methods and approaches employed by this study. Part four explores the competing conceptions of the rule of law and identifies the relevant ideals of the rule of law for the purpose of this study. Part five presents the regulatory process under Basel III. This regulatory process is appraised in the light of the relevant ideals of the rule of law in part six. Finally, part seven contains concluding remarks.

2. THE CONCEPT OF THE RULE OF LAW

2.1 The rule of law: what is it?

The rule of law is a golden concept to which we make reference oftentimes but it does not have a universally accepted definition. It is a notion that guides law and order. Yet, there is no clear understanding about its content. That is why scholars like Thomas describe it instead of suggesting a definition.[4] Acknowledging the history of the rule of law in different legal systems and hence the diverse views thereof, Costa and Zolo refrained from proposing a precise taxonomy of the meanings of the rule of law stating that "such a task would require complementing our analysis with the bulk of current constitutional and administration sciences".[5] Similarly, scholars like Chesterman approached the rule of law not by suggesting a definition but by distinguishing it from

[4] Thomas J "Understanding rule of law / supremacy of law and underlying obstacles in Turkey and around the world" (Conference proceedings paper International Congress on Constitutional Law 2010) available at http://hukuk.meliksah.edu.tr/uploads/hukuk/kullanici_images/file/MUHFD-C_2-S_1_14.pdf (accessed 28 April 2018).

[5] Costa P & & Zolo D *The rule of law: history, theory and criticism* (Springer 2007) at ix.

"rule of man" and "rule by law" which do not meaningfully control the power of the ruler.[6] Chesterman asserted that "the content of the term 'rule of law' remains contested across both time and geography".[7] The rule of law does not have a defined list of elements. Thus, its content varies depending on the type of conception we adopt.

The principles of the rule of law require, as the American Bar Association states it, "government of law and not men".[8] Of course, the rule of law cannot be separated from men/women, as law making, interpretation, enforcement, and respect therefor would not function in a vacuum. The rule of law is thus about the ideals which guide us in meeting the objectives we want to achieve.[9] Despite the lack of a universally accepted definition of the rule of law, there are well developed conceptions of, and approaches to, the rule of law. An investigation into the content of the rule of law usually starts with the formal/procedural and substantive conceptions of the rule of law.[10] The focus of the formal conception of the rule of law is on "instrumental limitations" on the exercise of power.[11] Such conception of the rule of law does not judge the content of a law and is not, therefore, concerned with whether the law is bad or good. The formal conception of the rule of law is also referred to as procedural rule of law as it defines the rule of law through procedural ideals like accountability, participation, predictability, prospective application of law, openness, adjudication of disputes through an impartial body, clarity, and stability.

On the other hand, the substantive theories of the rule of law go beyond the view held by the formalists. These theories approach the rule of law as based on justness of content and consider it as "the application of reason to reality in order to maintain a just and stable legal order".[12] According to these theories, the rule of law entails constitutionalism to limit power through reason.[13] Thus, the substantive conceptions of the rule of law would require substantive justice. Some scholars claim that the rule of law consists of both substantive and procedural ideals. For Rachel Belton, for example, the rule of law consists of its substantive ideals as ends and its procedural aspects as means.[14] For scholars like Paul Craig, the rule of law is primarily concerned with procedure while it also involves substantive facets.[15] The argument that the rule of law

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[6] Chesterman S 'An international rule of law?" (2008) 56 *Am J Comp L* 1.

[7] Chesterman (2008) at 12.

[8] American Bar Association (ABA) *What is the rule of law?* (ABA Division for Publications 2007) at 4 available at https://www.americanbar.org/content/dam/aba/migrated/publiced/features/Part1DialogueROL.authcheckdam.pdf (accessed 14 July 2018).

[9] ABA (2007) at 4.

[10] Chesterman (2008) at 12.

[11] Chesterma (2008) at 12.

[12] Sellers M "An introduction to the rule of law in comparative perspective" in Sellers M & Tomaszewski T (eds) *The rule of law in comparative perspective* (Springer 2010) at 4.

[13] Sellers (2010) at 4.

[14] Belton R K *Competing definitions of the rule of law: implications for practitioners* (Carnegie Papers Rule of Law Series 2005) at 1-8.

[15] Craig P "Formal and substantive conceptions of the rule of law: an analytical framework (1997) *PL* at 467-87.

consists of substantive ideals in addition to the procedural ones needs to be seriously questioned if the term "the rule of law" has to render a useful function.

Considering the lack of clarity regarding the rule of law due to the competing conceptions, Paul Craig suggested that public lawyers and others interested in research involving the rule of law choose between these conceptions.[16]The substantive conception of the rule of law in particular is not yet clear enough, though some mention human rights as examples. The most striking problem with the substantive conception of the rule of law is that the determination of the badness/justness of a particular law would lead to the use of infinite substantive ideals thereby denying a functional use of the rule of law. Such conception of the rule of law would virtually extend its scope to all the substantive ideals which could be used to test the validity of laws. According to Joseph Raz, the rule of law should not be confused with other virtues like human rights, democracy, equality, and justice.[17] A given legal system may, therefore, be judged not only based on the rule of law which is procedural but also other virtues. Joseph Raz has listed the ideals of the rule of law which can be summarized in simple terms as : accountability under the law; prospective application of law; predictability; stability; clarity; openness; and participation in regulatory process.[18] According to him, a legal system has to comply with such procedural ideals to be in compliance with the rule of law.[19] The substantive definition of the rule of law does not offer such an independent use of the rule of law and other values to evaluate a legal system. Such a definition virtually puts all the substantive values under the umbrella of the rule of law. That in turn gives a misleading meaning and scope to the rule of law.

This article, therefore, upholds the procedural conception of the rule of law and thus considers it as a principle composed of procedural ideals. Such ideals will be used in evaluating the regulatory process under Basel III. Adoption of the procedural conception of the rule of law should not, however, be equated with rule by men. The former limits power while the latter allows uninhibited use of power. A procedural conception of the rule of law should not also be considered as ignorant about substantive justice as such conception does not preclude the use of other values mentioned above to evaluate a law.

Many works have a combined list of both procedural ideals which constitute the rule of law in the sense that it is employed in this work and other substantive values which form part of the substantive conception of the rule of law. The latter cannot, therefore, be considered as the ideals of the rule of law based on the conception adopted in this article. It is, therefore, indispensable to pick the procedural ideals and set aside the substantive values. What scholars have identified as substantive and procedural ideals of the rule of law have, for instance, been later embraced by the World Justice Project as universal principles constituting the rule of law. The World Justice

[16] Craig (1997) at 487.

[17] Raz J *The authority of law: essays on law and morality* 2nd ed (Oxford University Press 2012) at 212.

[18] Raz (2012) at 211.

[19] Raz (2012) at 211.

Project has listed principles which can generally be summarized as: government limited by the law; clear and just law; even application of law; participatory law making; protection of fundamental rights; and resolution of disputes by an independent organ.[20] These are ideals which are referred to as the principles of the rule of law by scholars like Rachel Belton.[21] Such a list cannot, however, be maintained as some of its elements are incorporated based on the substantive conception of the rule of law, which is not tenable as discussed above. The definition developed by the UN Secretary-General in 2004 also consisted of elements which mirror the principles mentioned above.[22]

The relevant procedural ideals that could be derived from the discussion in this part can be summarized as: accountability under the law; prospective application of law; participation; independent determination of disputes; predictability; stability; and clarity in regulatory process. The remaining (human rights and just/good law) are substantive values concerned with the justness of the content of laws. As the substantive definition of the rule of law is not upheld in this study for reasons discussed before, these substantive values are not the elements of the rule of law. This study is, therefore, concerned with the procedural ideals (the elements of the rule of law) listed above as it aims at appraising the regulatory process under Basel III in the light of the rule of law.

Given the limited time and space, it is difficult to appraise the regulatory process under Basel III in the light of all the elements of the rule of law. Choosing the most relevant ones for the purpose of this article is, therefore, indispensable, and the authors hope that future researchers will complement this study. With this in mind, accountability and participation are chosen as the most important elements of the rule of law for the purpose of this study. There is no treaty based multilateral body with a constitutionalized mandate on global banking regulation. As the Basel III regulatory system lacks a constitution which defines its functions and structure, its consistency with the principle of accountability is disputable. In the absence of formally defined functions and structure, it is quite difficult to understand who is accountable to whom, let alone fully enforce accountability mechanisms. A related issue is that the global financial regulation under Basel III is dominated by informalities. Informal regulation is prone to influence by those with stronger economic and political power. This would make it imperative to evaluate the regulatory process under Basel III in the light of the notion of participatory regulatory process which is one of the elements of the rule of law.

The elements of the rule of law employed in this study are, therefore, accountability and participation. This does not mean that other elements of the rule of law are irrelevant or of little importance. The selection of the two elements should be understood in the light of the limited scope of this study and their relatively greater importance in the regulatory process under Basel III.

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[20] Belton (2005) at 1-8.

[21] Belton (2005) at 3-6. See also http://democracyweb.org/node/63 (accessed 28 April 2018).

[22] UN, Report of the United Nations Secretary-General report on the rule of law and transitional justice in conflict and post-conflict societies S/2004/616 (2004) at para. 6.

2.2 Accountability

The concept of accountability is obscure. While it has become an important tool to build the legitimacy of an agent both at national and global levels, lack of a clear definition has made its practical use difficult. Understanding its international dimension is even more difficult as the actors and the ways of interaction among the actors are more complex and dynamic compared to their counterparts at national levels. The global financial regulatory system under Basel III is a good example of a complex web of actors where determining the role of the principle of accountability is quite difficult. The Basel Committee, the G20, the International Monetary Fund (IMF), the World Bank (WB), national governments, and some influential regional entities are involved in the administration of Basel III and constitute a complex web of governance. While global governance is getting more complex, the principle of accountability has not shown a parallel advance. The obscurity of the concept has made it difficult to provide a comprehensible definition which can be applied in multi-faceted regulatory set-ups.[23]

Cognizant of the incomprehensibility of the notion of accountability, Robert Wolfe insisted that the concept of accountability is explained based on the purposes it serves rather than its technical merits.[24] Accountability may also be considered as either a political or legal notion depending on the particular mechanisms employed to make an agent accountable.[25] The concept of accountability cannot, thus, be easily formed in the abstract. However, it is generally acknowledged that this concept requires an agent to justify his/her/its actions and also to be subjected to scrutiny, which could result in the imposition of a sanction, by the principal or other entities on behalf of the principal.[26]

Robert Keohane has also explained the concept of accountability :

> "An accountability relationship is one in which an individual, group or other entity makes demands on an agent to report on his or her activities, and has the ability to impose costs on the agent."[27]

He has identified two types of accountability based on the nature of the accountability relationship: institutionalized/authorized accountability and informal arrangements of accountability.[28] In institutionalized accountability, the principal entities have the right to hold their agent accountable and there is a corresponding obligation imposed on the

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[23] Drake A *Civil society and WTO accountability* IISD-ENTWINED (Geneva 9 May 2009) at 2.

[24] Wolfe R *Who is accountable at the World Trade Organization?* Conference paper International Studies Association (Montreal 19 March 2011) at 8.

[25] The World Bank *Accountability in governance (Governance and Public Sector Management, WB 2006) at 1-5 available at http://siteresources.worldbank.org/publicsectorandgovernance/Resources/AccountabilityGovernance.pdf (accessed 15 May 2018).

[26] Drake (2009) at 2-4.

[27] Keohane R *Global governance and democratic accountability* (Duke University 2002) at 12. See also Grant R "Accountability and abuses of power in world politics" (2005) 99 *American Political Science Review at* 29-43.

[28] Keohane (2002) at 12 ; Grant (2005) at 29-43.

agent. In other forms of accountability, the principals aspire to hold their agent accountable claiming a right to do so while the agent does not recognize such a right. Such forms of accountability are loose and do not constitute accountability proper. The rule of law is a tool to limit power. Accountability, being an element of the rule of law, imposes obligations on an agent to limit its power. This gives a corresponding right to the principals to hold their agent accountable. In this article, accountability should, therefore, be understood to mean institutionalized accountability.

The debates about the mechanisms of institutionalized accountability revolve primarily around accountability through constitutionalism and representation.[29] First, institutions are governed by, and accountable to, their constitutions. Constitutions do not simply establish institutions. They define the boundaries within which the institutions function by setting the institutional structure, objectives and core functions.[30] Global regulatory bodies are bound by such constitutional limits. The second mechanism of accountability – accountability through representation – is highly contested when it comes to its application at the international level, though it is not completely irrelevant.

Woods and Narlikar asserted that accountability through representation is proved to be inadequate even at domestic levels since voters normally use polls not for the purpose of holding their representatives accountable, but rather to express their loyalty or keenness to a set of future policies designed by parties.[31] Applying this mode of accountability to hold informal forums like the Basel Committee accountable is even more questionable as no public power is formally delegated to them.

There are also accountability mechanisms which are usually termed "horizontal accountability".[32] Woods and Narlikar have identified "transparency, evaluation, compliance monitoring, and enforcement of the limits, rules and norms as to the exercise of official power" as the existing mechanisms of horizontal accountability.[33] The last one – enforcement of the established limits on the exercise of power – could also be considered as the enforcement of constitutional accountability as regulatory bodies are constitutionally bound by such limits. The remaining three mechanisms of horizontal accountability could be recapitulated as transparency and review because evaluation and compliance monitoring appear as review when they are employed as accountability mechanisms. It should be noted that constitutional and horizontal accountability mechanisms are closely related to each other. Accountability to constitutional principles does not function in a vacuum. Its enforcement needs horizontal accountability mechanisms particularly in global governance where democratic accountability can hardly be used to enforce it. In the light of the discussion in this part, this study uses constitutional and horizontal accountability mechanisms.

[29] Woods N & Narlikar A "Governance and the limits of accountability (2001) 53 *International Social Science Journal at* 569-583.

[30] Woods & Narlikar (2001) at 569-583.

[31] Woods & Narlikar (2001) at 574.

[32] Woods & Narlikar (2001) at 574.

[33] Woods & Narlikar (2001) at 574.

2.3 Participation

Participation in the formation and implementation of the rules and adjudication process in a given governance system is one of the core elements of the rule of law. Accountability and other elements of the rule of law cannot be enforced effectively in the absence of participation. The definition of the rule of law given by the UN Secretary-General seems to be cognizant of this fact when it clearly stated that "participation in decision making is one of the elements of the rule of law". Other definitions of the rule of law, as discussed above, have also referred to this element of the rule of law by using general terms like open or participatory regulatory process. Decision making in the regulatory process under Basel III takes place at the stages of formulation and implementation of the rules and review process. Thus, "participation in decision making" comes into play at all these stages.

The meaning of participation differs based on the type of participants, the entity in which they participate, and the objective of a particular form of participation. Broadly speaking, there are three categories of participation, namely, "public, social and individual participation".[34] Public participation comes into the picture when a governance system engages the public in its regulatory process, while social and individual participation appear in "collective activities" and "individual choices as parts of daily life", respectively.[35] The focus of this article is on public participation because participation as an element of the rule of law aims at limiting the exercise of public power through participatory governance. Participation has become one of the important tools to build legitimacy in global governance. Its role in the Basel III regulatory process is thus examined in this article, bearing in mind its growing importance at the global level .

An important question here will be : who has the right to participate in decision making in the regulatory process under Basel III. States are the first bearers of the right to participate in this regulatory process based on "the all-affected principle" of democratic governance that requires "the participation of all addressees in the decision-making process".[36] However, the conception that considers international governance only as an intergovernmental process is obsolete and does not correspond with contemporary governance which increasingly recognizes other participants. In terms of international law making, for example, other participants are playing a crucial role producing norms with global effect. Arnold Pronto explained this stating that "international law is made in a large number of fora, including a variety of multilateral processes, tribunals and the organs of international organizations".[37] Moreover, though

[34]Pathways through Participation *What is participation? Towards a round earth view of participation* Briefing paper no1 (2009) at 1 available at http://pathwaysthroughparticipation.org.uk/wp-content/uploads/2009/09/Briefing-paper-1-What-is-participation.pdf (accessed on 15 May 2018).

[35] Pathways through participation (2009).

[36]Alexander K, Lorez K, Zobl M & Thürer D *The legitimacy of the G20 – a critique under international law* (University of Zurich 2014) at 10.

[37] Pronto A "Some thoughts on the making of international law" (2008) 19 T*he European Journal of International Law* at 601-616.

States continue to be the principal producers of international law, other participants, including international organizations, NGOs and expert individuals, join them and influence the process.[38]

Furthermore, actors with a legitimate interest come into play at the stages of implementation and adjudication of international law. As implementation and adjudication of international law have an intrusive effect, a multitude of actors whose interests are substantially affected by global decisions are being recognized as legitimate participants. International law is expanding the scope of its constituencies by progressively accommodating substantially affected entities. The World Bank Inspection Panel, which has been established to reach communities affected by projects funded by the Bank, is a good example of this. On the other hand, the participatory right of NGOs and expert individuals is not yet well defined under international law. There is a reluctance to give this right a legal status, while the informal involvement of NGOs and individual experts in global regulatory processes is ever expanding.

In the light of the discussion above, evaluating not only the participation of States but also other actors in the regulatory process under Basel III would be indispensable. Accordingly, the scope of the article is extended to include appraising the involvement of financial institutions in the regulatory process.

3. GLOBAL FINANCIAL REGULATORY PROCESS UNDER BASEL III

3.1 Transition to Basel III

The micro-prudential approaches to global financial regulation and the softer standards under Basel I and II were proved inadequate to respond to systemic financial crisis. Thus, a more responsive framework which integrates both micro- and macro-prudential approaches and sets higher standards became compulsively necessary following the global financial crisis. As a result, Basel III came into the picture with the aim to strengthen the financial system at both individual institution and systemic levels through an integrated approach and stricter standards.[39]

It is, therefore, in response to the financial crisis felt globally in 2008 that the Basel Committee introduced its third Basel accord (Basel III) in 2010.[40] The Basel III framework is a comprehensive accord consisting of reform measures tailored to strengthening the financial system through tougher regulation, strict supervision, and well defined risk management of the globalized banking sector.[41] As a publication by PwC's Financial Services Institute stated , Basel III's objective is "a future of more capital, more liquidity, and lower risk".[42] To achieve this objective, Basel III has set

[38] Pronto (2008) at 601-616.

[39] Kumar S, Rohit V & Kumar J *Basel III: the way forward.* White Paper (Infosys 2012) at 1-2.

[40] Kumar et al (2012) at 1.

[41] Financial Services Institute (of *PwC*) *The new Basel III framework: navigating changes in bank capital management* (Financial Services Institute 2010) at 3.

[42] Financial Services Institute (2010) at 3 .

higher standards regarding capital requirements, risk-weighted assets, minimum capital ratio requirements, and capital buffers.[43] The revised "liquidity coverage ratio" (LCR)[44] and the "net stable funding ratio" (NSFR)[45] which were issued in 2013 and 2014, respectively, are also important components of Basel III. The LCR requires banks to have sufficient stock of high-quality and unassailable liquid assets which can immediately be converted, in private markets, into cash to respond to liquidity needs in the short run, ie "for a 30 calendar day liquidity stress scenario".[46] The NSFR, on the other hand requires banks to have "a stable funding profile in relation to the composition of their assets and off-balance sheet activities".[47]

The tougher standards on capital requirement under Basel III would increase the barriers to join the banking sector, and that in turn benefits already existing ones. The tougher the capital requirements the smaller the number of newcomers and thus the less the competition will be.[48] On the other hand, the bigger financial institutions – "systematically important banks" – will incur an extensive loss as they will face a relatively higher capital requirement, and that in turn would inhibit the growth of such banks.[49] Basel III's tieing up effect on scarce capital necessary for growth in developing countries and the harmonization process are also controversial.[50] The harmonization process under Basel III could even drag down better standards in countries like India.[51]

Due to recurring controversies and ever changing circumstances in the volatile global financial system, the Basel Committee has continued with its customary task of refining Basel III guidelines and scheduling and rescheduling their implementation. The revisions made in 2013 (LCR), 2014 (NSFR) and 2016 ("Revisions to the Basel III Leverage Ratio Framework [52]) are notable examples of the continuous modification process. Though the implementation of Basel III was scheduled from 2013-2015 and started in 2013, many of its components went through continuous review processes, and such changes extended implementation until 2018 and then again to 2019.[53]

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[43] Financial Services Institute (2010) at 3. See also Kumar et al (2012) at 2.

[44] http://www.bis.org/publ/bcbs238.htm (accessed 13 May 2018).

[45] http://www.bis.org/bcbs/publ/d295.htm (accessed 13 May 2018).

[46] The Basel Committee *Basel III: The liquidity coverage ratio and liquidity risk monitoring tools*, (Bank for International Settlements 2013) at para 14.

[47] The Basel Committee *Basel III: the net stable funding ratio* (Bank for International Settlements 2014) at para 1.

[48] http://marketrealist.com/2014/09/shortcomings-basel-3-accord/ (accessed 13 May 2018).

[49] http://marketrealist.com/2014/09/shortcomings-basel-3-accord/ (accessed 13 May 2018)

[50] http://marketrealist.com/2014/09/shortcomings-basel-3-accord/ (accessed 13 May 2018) . See also The Basel Committee *Assessment of Basel III risk-based capital regulations – India* (Bank for International Settlements 2015) at 5.

[51] http://marketrealist.com/2014/09/shortcomings-basel-3-accord/ (accessed 13 May 2018) ; The Basel Committee (2015) at 5.

[52] The Basel Committee *Revisions to the Basel III leverage ratio framework* (Bank for International Settlements 2016).

[53] http://www.isda-iq.org/2015/10/16/the-basel-iii-timeline/ (accessed 19 May 2018).

3.2 Basel III regulatory process

In any regulatory process, what comes first is the formulation of norms. A discussion on the regulatory process under the Basel III accord has, therefore, to start with the manner in which the accord was formulated. The Basel III framework has been developed through an informal international law making process. Before an agreement is reached by the Committee on new rules, extensive preparatory works are handled by assigned subgroups, and such subgroups provide draft proposals.[54]As Jonas Niemeyer put it, "much of the practical decision-making takes place in the committee's subgroups".[55] Once concrete proposals are ready, they are released for public consultation so that interested groups can comment on them.[56] Most of the Basel III proposals were released for public consultation.[57] After the preparatory work was done following the 2008 financial crisis, the Basel Committee issued a document on global banking regulation – Basel III – in December 2010 subsequent to the endorsement of such document by the G20 in November 2010 in Seoul.[58] The Committee then issued a revised version of Basel III in 2011.[59] The Basel III standards were, therefore, developed by an informal forum through a process which does not require the traditional procedures of international law making.

Thus, one of the main features of the global banking regulatory system is the lack of governance based on formally established common obligations. As global financial regulation is an area where the tension between the need for international governance, on the one hand, and domestic policy choice, on the other, is very high, informality has become the hallmark of international financial regulation. Voluntarism and limited capacity in policy management are inherent to the Basel Committee and are the main reasons which have made the process of formulation of the Basel III framework informal.[60]

Though its status is not yet defined under public international law, the informal law making process is on the rise. As Ramses Wessel put it, "international organizations and informal international regimes are engaged in normative processes that, de jure or de facto, impact on states and even on individuals and businesses".[61] Joost Pauwelyn has also claimed that "to define a legal order as limited to legally binding norms only is too

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[54] Niemeyer J "Basel III – what and why?" *SverigesRiksbank Economic Review* 1 (2016) at 61-93.

[55] Niemeyer (2016) at 63.

[56] Niemeyer (2016) at 63.

[57] M. Peihani M *Basel Committee on banking supervision: a post-crisis analysis of governance and legitimacy* (unpublished PhD thesis, the University of British Columbia, 2014) at ii.

[58] http://www.bis.org/bcbs/history.htm (accessed 06 July 2018).

[59] http://www.bis.org/publ/bcbs189.htm (accessed 06 July 2018).

[60] Donnelly S "Informal international lawmaking: global financial market regulation" in Berman A, Duquet S, Pauwelyn J, Wessel R Wouters J (eds) *Informal international lawmaking: case studies,* (Torkel Opsahl Academic EPublisher 2012) at 193.

[61] Wessel R "Informal international law-making as a new form of world legislation?" (2011) 8 *International Organizations Law Review* at 253–265.

narrow" while leaving the legal status of informal international law making for further scrutiny.[62] The informal international law making process manifests itself in terms of "output, process or the actors involved".[63] It produces standards/guidelines as opposed to traditional sources of international law like treaties. Informal networks and not international organizations are coordinators of the process. The actors involved in such networks are also not diplomats. The process of informal international law making is also usually exclusionary as its architects are the groups with greater political and financial power. Informality is inherent in the international banking regulatory system. This regulatory system, therefore, shares the features of informal international law making.

Though the Basel Committee has expanded its membership following the financial crisis, most of the developing countries are still outsiders. In response to the financial crisis, the G20 Members held a series of summits to set the directions towards improved post-crisis global financial governance.[64] An institutional facility which can coordinate the reform process was deemed so indispensable that the Financial Stability Board (FSB) was created for this purpose.[65]As Jeffery Atik has stated , "the FSB directed much of the design and spirit of Basel III, although the formal proposals resulted from the Basel Committee".[66] The Basel Committee is not a formal international organization and has no capacity to propose legally binding rules. The central bank governors of the members of the Basel Committee, and not , are the main actors in the process. Such a "soft-law standard-setting method" is considered as "an alternative form of international law making without cumbersome treaty making rules".[67]

The second stage where informalities are seen in the regulatory process under Basel III is implementation. To begin with, as Basel III is a set of voluntary standards, its enforcement depends primarily on national governments. As Daniel McDowell has stated , "the lack of an enforcement mechanism threatens the nascent agreement's prospects".[68] Such lack of an enforcement mechanism which is a reflection of the soft law nature of global financial governance led to the emergence of the G20 "as an executive coordinator".[69] The G20 has taken the leading role in global financial

[62] Pauwelyn J *Informal international lawmaking: mapping the action and testing concepts of accountability and effectiveness.* Working paper Center for Trade and Economic Integration (Geneva 2011) at 3-9.

[63] Pauwelyn (2011) at 3-9.

[64] Atik J "EU implementation of Basel III in the shadow of the euro crisis" (2014) 33 *Review of Banking & Financial Law* at 283-341.

[65] Atik (2014) at 309.

[66] Atik (2014) at 309.

[67] *Segura-Serrano A* "International economic law at a crossroads: global governance and normative coherence" (2014) 27 *Leiden Journal of International Law* at 677 – 700.

[68] McDowell D "Basel III represents test for US, G-20 *World Politics Review* (28 September 2010) available at http://www.worldpoliticsreview.com/articles/6527/basel-iii-represents-test-for-u-s-g-20 (accessed 23 May 2018).

[69] Lee E *Basel III and its new capital requirements, as distinguished from Basel II*. University of Hong Kong Faculty of Law research paper no 2014/046 (2014) at 5.

governance in general and banking regulation in particular after the global financial crisis. This forum has become the de facto global administrative body responsible " to set standards and monitor enforcement, compliance and aid recovery".[70]

That there is no formally established international body to enforce Basel III standards would mean that States, particularly G20 Members, have to police the conduct of each other to ensure compliance with these standards. It should, however, be noted that the Basel Committee and the G20 have partnered with influential formal international organizations, including the IMF and the WB, to ensure effective implementation of Basel III.

The third stage in an ordinary regulatory process is review. This aspect of a regulatory process has become an important accountability instrument in global administration as accountability through representation cannot cope with such administration which has become more dynamic. Unlike international organizations like the WTO, the global networks coordinating the regulation of the financial market, including the G20, FSB and Basel Committee, can hardly establish a dispute settlement mechanism as the global financial market problems are systemic. Thus, judicial review could not be presented as an accountability mechanism in global banking regulation. Yet there are other review mechanisms, including evaluation and compliance monitoring, which can be used to ensure accountability. The global banking regulatory system managed by the G20 and Basel Committee in partnership with international organizations including the IMF and WB manifests features of global administration. Therefore, this regulatory system should be held accountable through review mechanisms.

The Basel Committee has established a reporting process aimed at periodically reviewing Basel III's implications for banks and it has been publishing the results of its monitoring exercise since 2012.[71] It released its latest Monitoring Report in March 2016. This reporting system is a technical assessment process rather than a proper review . As the latest Monitoring Report itself stated, the Committee prepares its reports based on data "obtained by voluntary and confidential submissions from individual banks and their national supervisors".[72] The IMF and WB also have a joint assessment program which evaluates compliance with Basel standards as part of the wider financial sector assessment process. It should, however, be noted that these review processes aim to ensure compliance by financial institutions and supervisory authorities with Basel standards. They do not aim to hold the global banking regulators like the Basel Committee accountable. There are no formal evaluation and compliance monitoring mechanisms which are established for this purpose.

[70] Lee (2014) at 5.

[71] http://www.bis.org/bcbs/publ/d354.htm (accessed 25 May 2018).

[72] The Basel Committee**Basel III monitoring report* (Bank for International Settlements March 2016) at 1.

3.3 Basel III as a global financial regulatory framework

Basel III instruments are produced by the Basel Committee which is a forum that has no formal capacity to adopt rules with binding force. The standards and guidelines adopted by the Basel Committee are, however, being complied with by its members and many non-member countries across the world. This soft law financial regulatory framework is seen "as more coercive than traditional theories of international law predict".[73] The standards developed by this regulatory system are more than what we traditionally perceive as soft law. These standards "reflect mutual commitments made after intense negotiations, and taken together, they contain both incentives for compliance and at least the suggestion of meaningful sanctions for non-compliance".[74]

The Basel Committee has gradually emerged as an international banking regulatory body as its collaboration with other international organizations has enabled it to implement its standards worldwide. As René Urueña has stated, "the Basel Committee has engaged in de facto global financial regulation, a move that should have reasonably triggered the need for legitimacy and opened spaces for subjectivation".[75] The global banking regulatory system has an influential network which can ensure implementation of Basel III even in a more effective way than traditional public international law is enforced. This informal network has brought strategically important international organizations including the IMF and WB on board. As Peter Hajnal put it, the IMF and WB are "in the inner circle of observers at both the G20 summit and finance ministers' levels" and they are regular participants of the meetings held by the G20 central bank governors.[76] The two institutions are also members of the FSB which was created by the G20 to monitor the global financial system.[77]

As discussed above, the financial sector related IMF and WB conditionalities have facilitated worldwide implementation of Basel III standards. Emerging market banks are becoming increasingly important to the financial markets and investors of developed markets. Worldwide application of Basel III standards is, therefore, seen as indispensable to ensure a healthy global financial market. Basel III standards have been designed primarily with the US and EU financial markets in mind and are found to be inappropriate for emerging markets.[78] However, the ever increasing global financial market interdependence has become a driving force towards worldwide regulation of the banking sector through these standards.[79]As Mayra Valladares explained , in the existing global financial stability assessment regime, "a key metric of a bank's financial health is how well it is coping with adherence to financial regulations, such as Basel

[73] *Segura-Serrano (2014) at 689-691.*

[74] Segura-Serrano (2014) at 690.

[75]Urueña, *No citizens here: global subjects and participation in international law* (MartinusNijhoff Publishers 2012) at 264.

[76] Hajnal, *The G20: Evolution, Interrelationships, Documentation,* (Routledge 2014) At 55-66**.**

[77] http://www.fsb.org/about/fsb-members/ (accessed 26 May 2018).

[78] Willis B "Basel III bank rules will damage developing countries" (*Newsmax* 15 June 2012). http://www.newsmax.com/InvestingAnalysis/Basel-Bank-Rules-developing/2012/06/15/id/442468/

[79] Valladares M*Basel III: can it be implemented in emerging markets?* (MRV Associates 2012) at 1.

III".[80] One of the core subjects in the joint IMF and WB Financial Sector Assessment Program (FSAP) is compliance with Basel standards. That is why this assessment program went through significant changes following the global financial crisis[81] which has resulted in Basel III.

What can be understood from the Basel III implementation process and a complete set of regulators involved in the global banking regulatory system is that such a system has emerged as a global administrative system. It is in recognition of this fact that René Urueña came to the conclusion that "while the initial regulatory practices of the Basel Committee simply outsourced subjectivation to domestic regulatory agencies, recent practices show developments towards subjectivation".[82]If this system can be considered as a global administrative system, an important question that will follow is whether it adheres to procedural norms, such as, accountability and participation, which are necessary for the exercise of public power by global bodies to be legitimate. The following part aims to address this question.

4. THE REGULATORY PROCESS UNDER BASEL III AND THE RULE OF LAW

4.1 Financial explanations underpinning the existing banking regulatory system and the quest for institutionalisation

The financial explanations that justify the existing regulatory system under Basel III are closely linked to the financial causes of the 2008 global financial crisis. Though a complex set of factors which cannot be exhausted here was identified as the cause of the crisis, failures in the financial sector itself were identified as the major causes of the crisis. As a report produced by a task force commissioned by the International Organization of Supreme Audit Institutions made clear, "failures in the financial system, particularly in the US, were at the root of the problem" and the crisis which started in the US "spread through financial and real economic channels to the rest of the world".[83] The subprime mortgage lending practices of Freddie Mac and Fanny Mae led to the crisis as there was uncalled for confidence in these private companies due to their peculiar status which is attributable to their being government sponsored initiatives established by federal law.[84] The first round of actions by the Federal Reserve including

[80] Valladeres (2012) at 1.

[81] https://www.imf.org/external/np/exr/facts/fsap.htm (accessed 26 May 2018).

[82] Urueña (2012) at 265.

[83] Norgren C *The causes of the global financial crisis and their Implications for supreme audit institutions* (International Organization of Supreme Audit Institutions 2010) at 17.

[84] Hamilton J "Did Fannie and Freddie cause the mortgage crisis?" Available at https://seekingalpha.com/article/85146-did-fannie-and-freddie-cause-the-mortgage-crisis (accessed 06 April 2019).

liquidity and money market funds were found not to be sufficient, and that led to adoption of new laws and measures under the Bush administration.[85]

The huge sum of money banks released to the real estate market "pushed up the prices of houses along with the level of personal debt as interest had to be paid on all the loans that banks made".[86] This eventually made the debts unpayable and led to the crisis as banks faced the danger of going bankrupt and started limiting their lending.[87] The then risk assessment methods used by the banks and banking supervision mechanisms are also identified as factors responsible for the crisis.[88] In terms of regulation, lack of focus on macro-prudential financial regulation has been found to be the cause the crisis.[89] The traditional regulatory approach – the micro-prudential approach – which aimed to improve the welfare of individual financial institutions did not prevent the crisis at a systemic level.

Basel III is designed with the causes of the crisis in mind. The informalities that are inherent in the existing banking regulatory system are, therefore, justified based on the complex nature of global financial problems. Addressing these problems has become very challenging and led to intense controversy over the regulatory approach that the international banking regulatory system should adopt. Those who want to maintain the status quo, like Matthew Turk, claim that the "interdependence problems of finance" are so complex and different in their nature from problems related to, for example, global trade.[90] The main argument is that "monitoring breaches of international financial agreements is extremely complicated as global finance is affected by spillovers between states that are systemic and diffuse, rather than bilateral".[91] To be precise, this claim rejects institutionalisation of the global financial regulatory system and prefers informal governance to ensure close cooperation.

Other scholars suggest that institutionalisation is essential to make the global financial regulatory system stable.[92] This is missing as the regulatory system is inherently informal. The existing regulatory system lacks legitimacy to defend an interventionist regulatory approach required to handle crisis.[93] Legitimacy might be claimed based on output (efficiency) in the global financial regulatory system. However,

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[85] Reyes A "The financial crisis five years later: response, reform, and progress in charts" available at https://www.treasury.gov/connect/blog/Pages/The-Financial-Crisis-Five-Years-Later.aspx (accessed 06 April 2019).

[86] http://positivemoney.org/issues/recessions-crisis/ (accessed 28 May 2018)..

[87] Priewe J "What went wrong? Alternative interpretations of the global financial crisis" in Dullien S, Kotte D, Márquez A & Priewe J (eds) *The financial and economic crisis of 2008-2009 and developing countries,* (United Nations 2010) at 28.

[88] Priewe (2010) at 28.

[89] http://www.economist.com/news/schoolsbrief/21584534-effects-financial-crisis-are-still-being-felt-five-years-article (accessed 29 May 2018).

[90] Turk M "Reframing international financial regulation after the global financial crisis: rational states and interdependence, not regulatory networks and soft law" (2014) 36 *Michigan Journal of International Law* at 110-112.

[91] Turk (2014) at 112.

[92] Davies H "Global financial regulation after the credit crisis (2010) 1 *Global Policy* at 186-189.

[93] Alexander et al (2014) at 15-20.

such form of legitimacy requires "generally accepted principles" established through participatory norm development[94] which is missing in the global financial regulatory system as explained in the previous part. A global regulatory system cannot, therefore, be legitimate simply because it is efficient. In simple terms, a global regulatory system can hardly be defended without at least an acceptable degree of legitimacy. The global financial regulatory network has, therefore, evolved into a global administrative system, as discussed in part 5, while it lacks legitimacy.

As long as the financial regulatory system has demonstrated features of global administration, failure to build legitimacy in such a system would deny non-participating States protection from financial imperialism. It is true that the global problems of finance are more complex than, for example, trade related issues. However, considering these problems as completely unreachable through a constitutionalized regulatory system is unwarranted. In any event, the financial regulatory system has to adhere to global administrative norms as it has evolved as a global administrative system.

One of the main arguments in favor of informal international law making is that it serves as "a device for minimizing impediments to cooperation".[95] The central explanation here is that improving the global banking regulatory system's effectiveness in stabilizing global banking would require a corresponding reduction in accountability and participation. Needless to say, improved cooperation is an important tool to ensure effectiveness in governance. This does not, however, answer the following question: is a regulatory process which is accountable and participatory ineffective by definition? Accountability and participation are necessary to build legitimacy in a global administrative system. A global administrative system which is not accountable and participatory would face a big challenge while mobilizing the leading participants' human and capital resources towards realization of its objectives. Smooth implementation of global policies is, of course, one of the reasons behind the growing move towards improving the legitimacy of global regulators through an accountable and participatory regulatory process. As David Harland stated, "international administration, at its most effective, would combine the legitimacy of broad international and national support with the capacities of lead-nation resources".[96]

4.2 Accountability in the regulatory process

To begin with, it is quite difficult to demonstrate that the existing global banking regulatory system complies with the core ideals of the rule of law. This regulatory system is led by informally established ad hoc groups which comprise governments and financial institutions as their members. This regulatory system is not founded or based on a treaty, charter or other form of legal instrument. The rule of law requires

[94] Alexnder et al (2014) at 7-10.

[95] Lipson C "Why are some international agreements informal?" (1991) 45 *International Organization* at 495-538.

[96] Harland D "Legitimacy and effectiveness in international administration" (2004) 10 *Global Governance* at 15-19.

accountability in its institutionalized form. The banking regulatory system under Basel III does not demonstrate structural and operational qualities which can ensure institutionalized accountability. The system has not yet developed a formal constitution which defines its boundaries, structure, functions, objectives and procedures. As explained in part 4, constitutional accountability requires formally established boundaries to which a regulatory system is held accountable.

Though the Basel Committee has a Charter with constitutional characteristics, it cannot be used as an effective constitutional accountability mechanism given the fact that it does not impose legal obligations and is meant to control an informal group. Needless to say, the Charter contributes to the advancement of accountability in the Basel III regulatory system. Among others, it has defined the responsibilities of the Committee and some of its key officials. The Charter has also determined procedures for the appointment of the Chairman, Secretariat and Secretary General. Though there is a serious lack of clarity, as will be explained, the Charter has also devised the Committee's structure and decision making procedures. However, what if this informal group – the Basel Committee – sets aside a principle incorporated under the Charter while discharging its functions and thus fails to be accountable to its "constitution"? It is while attempting to answer this question that one realizes that the Basel III regulatory system has not yet embraced constitutional accountability proper. As discussed in part 4, enforcement of constitutional accountability relies on horizontal accountability mechanisms – transparency and review – which are largely ignored by the Basel III regulatory system , as discussed below in this part.

Transparency is an important component of good governance in general and accountability in particular. We cannot, therefore, think of accountability in its appropriate sense in the absence of transparency. Transparency "requires openness in decision-making and ultimately constitutes a prerequisite for every type of observation, control and influence by outsiders".[97] The executive body of Basel III regulatory system – the G20 – does not adhere to this requirement. As an informal group, it employs procedures which stand against the principle of transparency. The G20 undermines transparency as "the summit meetings are held behind closed doors, protocols are not published and preparatory consultations with non-members scarcely exist".[98] There is no also clear criteria for becoming a member of this group.[99]

There is also a transparency deficit in the Basel Committee despite some positive developments. The Basel Committee has shown some laudable progress while developing the Basel III standards, for example, by opening up its proposals for public comment. The "public consultation process" set up under section 17 of the Committee's Charter which was adopted by the Group of Governors and Heads of Supervision (GHOS) in 2013 requires the Committee to open up its policy proposals for public consultation. As indicated above, the Committee is also required to disclose decisions of

[97] Alexander et al (2014) at 14.

[98] Alexander et al (2014) at 14.

[99] Smith G *G7 to the G8 to the G20* (The Trilateral Commission plenary meeting, Washington 8-10 April 2011) at 8.

public interest. It is not, however, clear which decisions are decisions of public interest. It could be argued that such decisions are those related to "standards, guidelines and sound practices" as developing such policy instruments is the core responsibility of the Committee as stated under section 8 of the Charter. In any case, as Maziar Peihani stated, "what 'public interest' is and when a decision takes on such a characteristic are questions that fall within the unbounded discretion of the Committee".[100]

The Charter also lacks clarity on the composition of the GHOS. It is not clear, for example, whether one jurisdiction can have more than one representative at GHOS meetings. It is also not clear if observers can be represented at such meetings. There is also no consistency on publishing information on the groups of the Committee. While the Committee has published the members of the Basel Consultative Group on its website,[101] similar information is not published regarding the remaining groups. The Committee's decision making procedures also remain non-transparent. Decisions are made at the rule formulation and implementation stages. The process of formulation and implementation of Basel III standards is inherently informal and such informality makes it very difficult to realize transparency as an accountability mechanism. Much of the Committee's work is done by invisible groups whose decision making procedures are not disclosed to the public. There are also no rules which require, for example, disclosure in advance of the agendas and meeting dates of the Committee . The Charter has also not set deliberation procedures. Moreover, the Charter does not say anything about the participation of non-member and non-observer constituencies in its decision making process. The Committee's practice has also demonstrated a transparency deficit. It holds meetings behind closed doors, already held meetings are not regularly disclosed, and details of its deliberations are mostly confidential unless a press statement is made following agreement on a particular policy.[102]

What is clear about decision making under the Charter is that the Committee makes decisions by consensus. This would mean that all members should agree or there should, at least, be no disagreement. However, this negotiation opportunity can be manipulated and may not effectively rectify the transparency problems discussed above. As explained in part 5, the Committee is dominated by member institutions (from the US and Europe) who have the human and financial capital to convince a disagreeing member to agree or at least not to disagree. The Committee has also undermined transparency by excluding a significant number of States from its decision making process; this has a serious implication for the excluded constituencies' access to information. Needless to say, participation in decision making is an important mechanism to access information and better understand a regulatory process.

Realizing the second important element of accountability – review – in an inherently informal regulatory system is also quite challenging. The regulatory system under Basel III has not yet developed formal review mechanisms which can fill the

[100] Alexander et al (2014) at 105.

[101] http://www.bis.org/bcbs/membership_bcg.htm (accessed 15 June 2018).

[102] Peihani (2014) at 105.

accountability deficit in the system. While the global banking regulatory network has emerged as a global administrative body, its informality has effectively prevented the establishment of formal review mechanisms. Neither the Basel Committee reporting process which was introduced in 2012 nor the joint assessments administered by the IMF and WB have developed into formal review mechanisms. No State or institution can be subjected to these review mechanisms and the whole process is voluntary. Nor can these informal assessments be used to hold the global banking regulatory network accountable. They are rather meant to facilitate compliance with Basel standards through evaluation of the conduct of the banking sector worldwide.

While the global banking regulatory system reviews , at least informally, the banking sector's compliance with its standards through the reporting and assessment processes, it has not established formal review mechanisms which can make it accountable to those affected by its decisions. Though assessment procedures like evaluation and compliance monitoring have become important horizontal accountability mechanisms in global administration, they are not yet institutionalized in the Basel III regulatory system. As accountability mechanisms, these assessment procedures do not only review the activities of a regulatory system; they impose sanctions as well. Such formal review mechanisms could not be easily realized in a regulatory system which is not constitutionalized. There is also no formal hierarchy among the groups forming the Basel III regulatory network. The formal hierarchy in international organizations, like the WTO, for example, enables the units higher in the hierarchy to review and, if needed, change the decisions of the lower units. Those units that are higher in the hierarchy are more participatory, and thus the internal review process ensures more inclusive and accountable governance.

4.3 Participation in the regulatory process

The global banking regulatory system has reshuffled itself, following the global financial crisis, to embrace more members. The Basel Committee has expanded its membership to 28 jurisdictions as discussed in part 5. This has turned countries like China which had been "rule-takers" in Basel I and II to rule-makers in the Basel III regulatory system.[103] As Chao Xi has stated, "China has been actively involving itself in the formulation, development and implementation of Basel III".[104] The inclusion of emerging markets as members of the Basel Committee is, therefore, seen as a positive move to enable such markets to participate in the regulatory process starting from the rule formulation process.[105]

[103] Xi C "From rule-taker to rule-maker: China's changing roles in banking regulation' in Weiss F & Kammel A (eds) *The changing landscape of global financial governance and the role of soft law* (Brill 2015) at 12-14.

[104] Xi (2015) at 13.

[105] Chey H *Changing global financial governance international financial standards and emerging economies since the global financial crisis* (The Centre for International Governance Innovation, new thinking and the new G20, paper no 1 February 2015) at 1.

However, most of the emerging markets and a number of developed ones are not yet participants in the regulatory system's decision making process while they are subjected to the norms developed by this regulatory system.[106]As LiYamin and Wang Hao have put it, "reform of international financial architecture remains limited, and it retains market-oriented characteristics and adjustment mechanisms".[107] Such a market-oriented membership expansion approach has denied a significant portion of the world's population a decision making role in global financial governance. Membership expansion in this regulatory system does not, therefore, aim to build legitimacy through participatory governance. The G20, which is the executive coordinator of global banking regulation, is seriously criticized for proclaiming itself as "a leading international economic policymaking body without any formal legal mandate or consent by non-G20 member countries who are subjected to its norms and standards".[108]

The G20 justifies itself by claiming that its members constitute "around 90 percent of global gross national product, 80 percent of world trade as well as two-thirds of the world's population".[109] However, this claim is contrary to the generally accepted principles governing the global economic order. The UN General Assembly has consistently proclaimed the importance of participatory governance and equity in the global economic order.[110] General Assembly Resolution 6/3201 has declared "broadest cooperation based on equity" and "full and effective participation on the basis of equality" as governing principles of global economic regulation.[111] General Assembly Resolution 63/189 has also affirmed the importance of "the right to international economic order based on equal participation in the decision-making process" to build a just global order.[112]

In terms of non-State stakeholder involvement in the decision making process of global governance, the global banking regulatory system could be considered as somehow embracive. The governors of the central banks of participating States are at the centre of the regulatory process. This would make the banking sector an active participant in decision making on global banking regulation. Banking professionals have, therefore, direct access to the regulatory process and they are developing standards under the auspice of the Basel Committee. Though the ultimate backers of the process of standard setting in global financial governance are the States, the financial sector, which has better expertise, is exercising substantial power.

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[106] Alexander K*Rethinking stakeholder participation in global governance.* Conference paper Global Financial Governance (Geneva 26-27 February 2015) at 15.

[107] Yamin L & Hao W "China and emerging economies in global financial governance: legitimacy, accountability and democracy" (2016) 21 *J Shanghai Jiaotong Univ (Sci)* 21 (2016) at 199-203.

[108] Alexander et al (2014) at 2-5.

[109] Alexander et al (2014) at 13.

[110] Alexander (2015) at 12.

[111] UN General Assembly Resolution 6/3201: Declaration on the establishment of a new international economic order (UN General Assembly, A/RES/S-6/3201, 1974) at ss 4-6.

[112] UN General Assembly Resolution 63/189: Promotion of a democratic and equitable international order (UN General Assembly, A/63/430/Add.2, 2008) at s 4.

As Ross Buckley and Douglas Arner have explained , "international standard-setting" in global financial regulation is "largely of a technocratic nature".[113] Basel III standards are, therefore, developed by the banking sector itself which is governed by such standards. While the participation of the banking sector is appreciable given the growing importance of non-State actors in global governance, the exclusion of developing markets and the domination of the Basel Committee by financial institutions from the developed markets have made the process unduly technocratic, and denied consideration of the interests of developing markets.

The global banking regulatory system, therefore, involves States as executive coordinators under the auspice of the G20, and non-State stakeholders as standard setters through the Basel Committee. It has, however, failed to adopt a participatory governance approach. As discussed above, the great majority of States is excluded from the forum which acts as the executive coordinator of global financial governance, and the Basel Committee membership expansion is market oriented and selective. This does not rhyme with the growing interdependence and globalization of financial markets. As Daniel Bradlow has stated , the global financial governance reforms made following the global financial crisis "have not kept up with the pressure created by the rapidly growing role of the emerging economies in the international financial and economic systems".[114] A participatory governance approach is, therefore, essential in global banking regulation and there should be a shift from market oriented to rule based membership expansion in the relevant regulatory forums including the G20 and Basel Committee.

5. CONCLUSION

The interdependence problems in the global financial market became the subject of global governance owing to their ever-growing universal impact following the removal of restrictions on financial flows. While these problems evolved into global governance issues over half a century ago, the global financial governance system is not yet constitutionalized. This governance system introduced Basel III in response to the 2008 global financial crisis refining its previously developed standards. The Basel III regulatory process is led by an informal regulatory network. Thus, informality is one of the salient features of this regulatory process. Such a regulatory process poses challenges to the rule of law as there are no established limits on the powers exercised by the regulatory network. This article has addressed the consistency of the Basel III regulatory process with the rule of law by appraising this regulatory process in the light of the principles of accountability and participation. This part accentuates the main

[113] Buckley R & Arner D *From crisis to crisis: the global financial system and regulatory failure* (Kluwer Law International 2011) At 77.

[114] Bradlow D "Rethinking global financial governance reform" *The World Financial Review (4 January 2012) available at http://www.worldfinancialreview.com/?p=2439 (accessed 15 June 2018).

findings of this study about the consistency of the Basel III regulatory process with the rule of law. It then presents the policy implications of these findings. Finally, it presents the limitations of the study and the need for further investigation of the subject.

Though Basel III is not a legally binding framework and was meant to be achieved through cooperation, the regulatory process under this framework has demonstrated features of coordination which require a lot more than voluntary collective actions. The Basel Committee has eventually become the global supervisory body over global banking following the global financial crisis. This Committee is backed by powerful informal groups like the G20, and international organizations including the IMF and WB. The IMF and WB conditionalities have become important Basel III implementation mechanisms. Such a network of politically and financially influential groups has, therefore, facilitated worldwide application of Basel III. Thus, the Basel III regulatory process has evolved into a global administrative system.

While the Basel III regulatory system has emerged as a global administrative system, it has not yet embraced the relevant ideals of the rule of law which are necessary to build its legitimacy. The analysis of the Basel III regulatory process in the light of the principles of accountability and participation showed that it lacks the institutional and operational qualities necessary to ensure the rule of law. The informality inherent in the regulatory system has inhibited the advancement of the principles of accountability and participation in the system.

Constitutional accountability is undermined in the Basel regulatory system as it has not yet developed a formal constitution which defines its functions, structure and objectives.[115] Though the Basel Charter has incorporated principles on the structure and functions of the Committee, it does not impose legally binding obligations and lacks established horizontal accountability mechanisms which can ensure enforcement of constitutional accountability. Horizontal accountability mechanisms - transparency and review – are undermined by the informality inherent in the Basel III regulatory system. Though there are some improvements introduced through the Charter of the Basel Committee, lack of clarity, decision making by invisible groups through publicly unknown procedures, and informal implementation process have undermined transparency. Evaluation and compliance monitoring are also not institutionalized in the regulatory system. Therefore, this regulatory system does not provide a formal guarantee for adherence to the principle of accountability through transparent decision making and a review process.

These accountability mechanisms are also largely ignored in practice. The G20 and the Basel Committee which are at the hub of the Basel III regulatory system undermine transparency as they hold their meetings behind closed doors, details of their deliberations are mostly confidential, and membership is not based on defined criteria. Though the Basel Committee has made some progress while developing Basel III by opening up its proposals for public comment, its decision making process has remained non-transparent. Basel III was developed through an informal law making

[115] Peihani (2014) at 1-15.

process which does not guarantee transparent norm formulation. Lack of formal enforcement mechanisms has also undermined transparency by inviting influential groups within the regulatory network, like the G20 and IMF, to use their political and financial powers to ensure compliance.

The Basel III regulatory process has also been in contradiction of the second relevant element of the rule of law – participation.[116] Though some reforms have been made following the global financial crisis to embrace more members, they were market oriented. Such a membership expansion approach coupled with the lack of membership criteria have made participation in the regulatory process very selective. This in turn has excluded a significant portion of the world's population from decision making in global banking regulation. Member jurisdictions themselves are also not equally represented in the Basel Committee decision making process as this Committee is dominated by member institutions from over-represented jurisdictions, namely, the US and Europe.

The Basel III regulatory process has, therefore, undermined the rule of law as it is inconsistent with the principles of accountability and participation which are the core elements of the rule of law. The rule of law limits public power principally by making a regulatory system accountable and participatory. The accountability deficit and lack of inclusive governance in the Basel III regulatory system have inhibited the advancement of the rule of law which should have been fostered to build legitimacy in this regulatory system.

The elements of the rule of law discussed in this study – accountability and participation – have become important instruments in building legitimacy in global regulatory systems. A regulatory system that ignores such elements of the rule of law can hardly be defended. Though the interdependence problems of global finance are intricate and thus require innovative ways of governance, relying on an non-constitutionalized and inherently informal regulatory system leads to uncertainties. Exercising public power through this informal regulatory network which is not subject to the rule of law would enable those who have controlled the regulatory network to pursue their interest through unconstrained power. The non-participants do not have the opportunity to collectively control this regulatory system while they are subjected to its standards. This does not accord with the growing interdependence among financial markets across the globe. Such form of governance also does not recognize the growing importance of accountability and participation in global administration. Hence, it sets a bad precedent for the role of the rule of law in global governance.

The Basel III regulatory process should, therefore, embrace the rule of law to ensure that the exercise of public power in global banking regulation is subject to control. Efficiency alone cannot justify this regulatory system as legitimate existence based on output requires, as a threshold, generally accepted principles which can guarantee that power will not be misused. As the Basel III regulatory system has evolved into a global administrative system, it should adopt and adhere to the principles

[116] Peihani (2014) at 1-15.

of accountability and participation to build its legitimacy. This would, of course, require institutionalisation of the system as it is the informality inherent therein which has undermined the rule of law.

Lastly, it should be noted that the subject of this article requires further and more comprehensive investigation. The article has examined the Basel III regulatory process in the light of only two elements of the rule of law using a methodology which has not involved integrated interdisciplinary research due to the limited human resources, time and space. Further investigation of this subject using more, if not all, of the elements of the rule of law through an integrated interdisciplinary research can produce better results. Moreover, the findings of this study invite an important question which has to be answered through further research : how should the Basel III regulatory system be subjected to the rule of law ? Therefore, the methodological limitations and the findings of this study suggest further investigation of the subject to fill the gaps and address further aspects of the topic.

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