# BOMBAY'S TRYST WITH THE CITY ON RHINE

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ABSTRACT

Basel Committee on Banking Supervision, an informal committee based in Switzerland, formulates minimum banking standards, which are touted as the best practices in banking worldwide. These standards have been adopted in most nations of the world despite being framed through a process that involves a select group of nations. India became a member of this Committee after the Great Financial Crisis of 2007-08. This paper aims to understand the regulatory regime created by the Committee and concludes by enumerating its relationship with India.

At its peak, the pollution levels in New Delhi, the capital city of India, were recorded up to the maximum measurable level of air pollution.[1] This led to a situation of public emergency[2] as the level of pollution rose to fifty times the level deemed safe by the World Health Organisation. The reasons for the surge in pollution levels in the capital city include ten million active vehicles on its roads, a boom in the manufacturing and construction industries, power plants using coals and

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[1] On the first two weeks of Nov., 2019, the Air Quality Index or the AQI reached upto 500. Data obtained from National Air Quality Index website (https://app.cpcbccr.com/AQI_India/) managed by the Central Pollution Control Board, Ministry of Environment, Forests and Climate Change.

[2] Press Trust of India, *EPCA declares public health emergency in Delhi-NCR*, THE ECONOMIC TIMES, Nov. 1, 2019; Press Trust of India, *Public health emergency declared in Delhi-NCR*, THE TELEGRAPH INDIA, Nov. 1, 2019.

most importantly, crop stubble burning in the neighbouring states of Punjab and Haryana.[3]

One of the actions proposed to curb the increasing levels of pollution over the years is, setting up of bio-refiners or 2G ethanol.[4] Public Sector Companies like Indian Oil Corporation, Bharat Petroleum Corporation and Hindustan Petroleum Corporation had applied for funding to set up these plants but the companies reportedly have not been able to attain financial closure. According to the senior officials of these companies, the delay or inability to attain financial closure is attributed to a regulation by the Reserve Bank of India (hereinafter '**RBI**') which caps the exposure of single borrower to 20% of their capital base.[5] RBI introduced the regulations to be compliant with its international obligation under transnational banking regime created by the Basel Committee on Banking Supervision (hereinafter '**Committee**'). The standard introduced by the Committee in 2014 lays down a supervisory framework for measuring and controlling large exposures. The Committee developed this standard as a tool to limit maximum loss that a bank could face in the

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[3] Umair Irfan, *The law that's helping fuel Delhi's deadly air pollution*, VOX, Dec. 16, 2019, https://www.vox.com/science-and-health/2019/11/8/20948348/delhi-india-air-pollution-quality-cause.
[4] Donna Lee Jones, *Potential Air Emission Impacts of Cellulosic Ethanol Production at Seven Demonstration Refineries in the United States*, 60 JOURNAL OF THE AIR & WASTE MANAGEMENT ASSOCIATION, 1118–1143 (2010) *(Ethanol plants converts agricultural waste into forms of biofuels and biochemicals, aiding in avoiding combustion of such products in open air).*
[5] Kalpana Pathak & Shayan Ghosh, *North India's stubble burning woes have an RBI link*, LIVE MINT, Nov. 5, 2019, https://www.livemint.com/politics/policy/north-india-s-stubble-burning-problem-has-an-rbi-connection-11572939873441.html.

event of a sudden counterparty failure to a level that does not endanger the bank's solvency.[6]

This paper examines the transnational banking regime created by the Committee and concludes by examining India's involvement in the same.

## I. BASEL REGULATORY REGIME

The year 1974 was marred by fragile international economic order and multiple bank failures[7] attributable to that broadcasted a supervisory vacuum, ushering the governors of central banks of the developed nations[8] to seek regular cooperation.[9] Thus, materialised the Committee in Basel, Switzerland, hosted by the Bank for International Settlements (hereinafter '**BIS**'), World's most senior financial regulator.[10] The Committee was established to enhance financial stability by improving the quality of banking supervision worldwide, and to serve as a forum for regular cooperation among its members on banking-supervisosupervisionry

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[6] Basel Committee on Banking Supervision's Standards - *Supervisory framework for measuring and controlling large exposures*, BANK OF INTERNATIONAL SETTLEMENTS (April 2014), https://www.bis.org/publ/bcbs283.pdf.

[7] Such as the failure of Bankhaus Herstatt (bank), Franklin National Bank, Israeli – British Bank and Lloyds Lungano. *See* Catherine R. Schenk, *Summer in the city: banking failures of 1974 and the development of international banking supervision*, 129.540 THE ENGLISH HISTORICAL REVIEW, 1129-1156 (2014).

[8] The initial membership of the Committee included nations of G10 (Belgium, Canada, France, Germany, Italy, Japan, Netherlands, Sweden, Switzerland, United Kingdom and United States) and Luxemburg.

[9] Christopher Kobrak & Michael Troege, *From Basel to bailouts: forty years of international attempts to bolster bank safety*, 22.2 FINANCIAL HISTORY REVIEW (2015) 133-156.

[10] KAZUHIKO YAGO, THE FINANCIAL HISTORY OF THE BANK FOR INTERNATIONAL SETTLEMENTS (Routledge, 2013).

matters.[11] The Committee was instituted to set the foundations of a strong and uniform homogenous international framework to end the turmoil in banking. It was expected that the Committee would ensure smooth international exchange of capital and goods.[12]

The Committee's governance structure consists of a chair, standard setting and research based groups, and Secretariat, which is hosted at BIS. The Group of Central Bank Governors and Head of Supervision exercises oversight over the Committee and endorses its major decisions.[13] The officials sent from the member nations includes those officials who are responsible for banking supervision of their respective nations.

## A. Evolution of Standards Set By the Committee

The Latin American debt crisis of 1982 provided a much-needed push to the Committee to work towards a harmonised capital regulation to curb increasing international risks. North – American banks had lent heavily to Latin American nations and hence, were at the brink of facing severe financial consequences. International Monetary Fund (IMF) was called to intervene but the institution depended upon the contributions by the United States for bail-outs. U.S. did not favour unilateral increase in safeguards for American banks as it would not prevent crisis elsewhere

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[11] Basel Committee on Banking Supervision's History of the Basel Committee on Banking Supervision, http://www.spaeth.ru/HS20152016/artikel_14.pdf.

[12] Christopher Kobrak & Michael Troege, *From Basel to bailouts: forty years of international attempts to bolster bank safety*, 22(2) FINANCIAL HISTORY REVIEW (2015) 133-156.

[13] Major decisions for the Committee include promulgation of standards, emergency responses and expansion of membership among others.

and would be enforced to the detriment of the competitiveness of American banks. In spite of the on-going crisis, the Committee dismissed the idea of international capital standard requirement. U.S, determined to establish global minimum standards, found an ally in the Bank of England. The two nations reached an agreement regarding increased standards and invited other nations to join. This strong-armed the Committee, which then sprang into action and proposed the draft of first set of substantive standards in December 1987. This proposal was based on the US–UK agreement. The participation in discussions leading up to the final set of standards of minimum capital adequacy (hereinafter '**Basel Accords**' or '**Accords**') were carried out by the domestic representatives of the G10 nations and Luxembourg. The negotiations of the Accords were dominated by the United States. The process remained largely in the hands of participating public authorities with the Committee acting as a mediator of power imbalances between participating states.[14] No other interest group or public policy institute participated in these negotiations. The hegemony of the United States, abstractness of the issue, and a lack of transparency were the driving forces behind the first set of substantial standards being published by the Committee.[15]

The Accords introduced an international standard to compute bank's regulatory capital and, for the very first time in the paradigm of international financial regulation (hereinafter '**IFR**'), attempted to set

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[14] Christian Chavagneux, *Prudential Control: Private Rule in the Regulation of Global Finance*, 60 REVUE D'ÉCONOMIE FINANCIÈRE 5, 47-58 (2000).
[15] RICHARD ALBERTUS JOHANNES STEENVOORDE, REGULATORY TRANSFORMATIONS IN INTERNATIONAL ECONOMIC RELATIONS, (1ed., Wolf Legal Publishers, 1 July 2008).

minimum standards for banks at an international level. The purpose of Basel Accords was to reduce the risks faced by an internationally active bank. It aimed at attaining the twain objectives of strengthening soundness and stability of the international banking system, and the reduction of the competitive inequality among international banks, which arise from differences among national bank-capital regulations. The Accords were formulated to curtail and contain systemic risk,[16] and promote a sound and a stable international banking system.

The Accords set up minimum capital standards for internationally active banks. The minimum ratio of regulatory capital to total risk-weighted assets (RWA) that internationally active banks had to adhere to was 8% and this was to contain a core capital element, which was to be at minimum 4%. The 8% risk weighted average rule implied that applicable banks needed to maintain minimum regulatory capital to the extent of 8% of the risk – weighted assets and asset equivalent off-balance sheet exposures. Regulatory capital included the combination of equity, loan-loss reserves, and subordinate debt among other accepted instruments. The Accords provided for determination of risk weights of bank assets. It was a simple framework where only five categories of weights were used (0% for zero risk, 20% for low risk, 50% for medium risk and 100% for high risk). Examples of risk-weighted assets include loans and securities. Asset equivalent off-balance sheet exposures include loan commitments, standby

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[16] Basel Committee on Banking Regulations and Supervisory Practices, *Outcome of the Consultative Process on Proposals for International Convergence of Capital Measurement and Capital Standards,* BANK OF INTERNATIONAL SETTLEMENTS, 1 (July 1988), http://www.bis.org/publ/bcbs04b.pdf.

letters of credit, and obligations on derivative contracts. In this formulation, different types of assets were categorised assets according to the level of perceived risk that each type of asset represents. The total risk-weighted assets were, subsequently, multiplied by 8 per cent to determine the bank's minimum capital requirement.

The Accords covered bank's exposure to credit risks while ignoring the other types of risks. Banks face various risks that has the potential to affect its continued solvency. These include market risk, operational risk, interest rate risk and liquidity risk among others. Market risk refers to risk that originates from loss arising from the fluctuations in market prices. In the case of banks, market risk may arise due to fluctuations in prices. Operational risks arise from the risk of loss resulting from inadequate or failed internal processes, people and systems, or from external events. It includes legal risk.[17] Operational risk ranges from the physical disruption of a bank's operations by natural or human agents to a massive liability judgment entered against the bank. An increase in the interest rate is immediately problematic for the bank as it increases the cost of capital. This is a risk because the bank's assets, which are loans, have already been contracted under lower interest rates. This risk is termed as interest rate risk. Liquidity risk is an inherent risk arising out of financial intermediation. Other risks that a bank faces may include reputational or political risks. The Accords were amended in 1996 to take

[17] Basel Committee 2004d, at 144.

into account market risk by introducing an additional capital charge to cover market risk in banks' trading books.

The Accords were one of the most successful international regulatory initiative ever attempted.[18] Even though the Accords were formulated specifically for internationally active banks, its compliance transcended to include large financial institutions. The Accords provided an effective framework for banks round the globe to assess their capital adequacy and ensure their safety. The Accords partly attained its aim of promoting financial stability and helped in providing for an equitable basis for competition among internationally active banks.

These standards, however, were overly simplistic and, quickly, their weaknesses were noticeable. The Accords did not provide a method for differentiating risks in individual loans, which led to instances of regulatory arbitrage. Another fallacy was that it neglected operational risk by focusing only on credit and market risk. The Accords failed to address the activities of large, complex banking organisations. Some of the other criticism levelled against the Accords were that it lacked risk sensitivity and attempted to establish a one size-fits-all approach as the requirements under the Accords were virtually the same irrespective of the risk level, sophistication, and the activity type of the bank.

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[18] Michael S. Barr & Geoffrey P. Miller, *Global administrative law: the view from Basel*, 17 EUROPEAN JOURNAL OF INTERNATIONAL LAW 1, 15-46 (2006).

The Accords, despite aiming to attain financial stability, failed to prevent multiple crises of the 1990s.[19] The second set of substantive standards set by the Committee (hereinafter '**Basel II**') stemmed out of the inadequacies of the Accords. Development of Basel II began at the wake of the Peso Crisis of 1994 and the Asian Crisis of 1997-98, which demonstrated that banks were facing a set of complex risks, which are not limited to credit and market risks. The existing capital adequacy framework failed to capture and curb these risks. Contemporaneously, multiple international organisations like the OECD, IMF, World Bank and FSF (present FSB) promulgated international standards specifically to shape, improve, and facilitate market behaviour.[20]

The negotiators of Basel II did not come with a pre-decided agenda to the table. This was unlike the Accords, which was geared by the US-UK agreement. The second set of substantive standards by the Committee were, thus, subject to extensive negotiations.[21]

Ultimately, Basel II was published in 2004 with an objective of developing a framework that would strengthen the soundness and stability of the international banking system. Basel II was intended to have the

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[19] Some of the crisis that characterised the 1990s were the Finnish and Swedish banking crises (early 1990s), Indian economic crisis (1991), Mexican peso crisis (1994), Turkish economic crisis (1994), Asian crisis (1997-98), Russian financial crisis (1998), Argentine economic crisis (1999-2002), and Brazil crisis (1999).

[20] GEOFFREY RD UNDERHILL, JASPER BLOM & DANIEL MÜGGE, EDS. GLOBAL FINANCIAL INTEGRATION THIRTY YEARS ON: FROM REFORM TO CRISIS 115 (Cambridge University Press, 2010).

[21] DANIEL K. TARULLO, BANKING ON BASEL: THE FUTURE OF INTERNATIONAL FINANCIAL REGULATION 87, 100 (Peterson Institute, 2008). *The author notes that even though the Federal Reserve Board urged (upgrade) the Accords, it lacked a specific proposal*.

same purpose as the Accords did (system stability and competitive equalization).[22] Basel II aimed to attain this objective while maintaining sufficient consistency to ensure that capital adequacy regulation will not be a significant source of competitive inequality among internationally active banks.[23] The Basel II's market-based approach to banking supervision has a uniquely important place because, although these standards are concerned with internationally active banks, their sectorial and country coverage impact was much broader. Basel-II covered all international banking activities as well as many insurance and capital markets activities of financial conglomerates.[24] Basel II laid down a framework consisting of a three-pillar approach to banking regulations.

Continuing with the legacy of the Accords, the first pillar of Basel II (hereinafter '**Pillar I**') purported maintenance of minimum capital adequacy requirement. It introduced changes in the way certain aspects of risks and resulting capital adequacy requirements were to be calculated. The standards broadened the range of risks to include operational risk. The second set of substantive standards set by the Committee laid down

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[22] Basel Committee on Banking Supervision, *International Convergence of Capital Measurement and Capital Standards: A Revised Framework Comprehensive Version*, BANK OF INTERNATIONAL SETTLEMENTS, 144 (June 2006), http://www.bis.org/publ/bcbs128.htm.

[23] Basel Committee 2004c, *International Convergence of Capital Measurement and Capital Standards: A Revised Framework*, June 26, 2004, ¶ 4.

[24] The Committee developed a document with the International Organisation of Securities Commission (IOSCO) which laid down the treatment of trading book of a bank and this was integrated with the main text of Basel II. Thus, while capital market *regulation* falls under other (international) organisations (such as the IOSCO), much of banks' activities in capital markets is covered by Basel II. *See* Geoffrey RD Underhill & Xiaoke Zhang, *Setting the rules: private power, political underpinnings, and legitimacy in global monetary and financial governance,* 84 INTERNATIONAL AFFAIRS, 535-554 (2008).

minimum regulatory capital based on risks assigned to each component of the portfolio of the banks. It incorporated credit risk, market risk and operational risk.

Further, the standard prescribed various methods of calculating risks in each category. The three methods of calculation of credit risk, i.e., Standardised Approach, Foundational Internal Rating-Based Approach (IRB) and Advanced IRB Approach, three for the calculation of operational risk, namely, Basic Indicator Approach, Standardised Approach and Advanced Measurement Approach (ATA), and for market risk, calculation was to be undertaken by Standardised Approach and Internal risk management Models Approaches.

The innovativeness of Basel II lay in allowing banks to use their own models for assessing risk or rely on external rating agencies. The approaches that permitted either of these routes were Standardised Approach and IRB Approaches of calculating credit risk, the Advanced Measurement Approach for operational risk assessment and internal risk management Models Approach for assessment of market risk.

The Standardised Approach, which was to be used to calculate credit risk, was to derive its risk weights from an external rating agency.[25] Further, the IRB and Advanced IRB for the calculation of credit risk allowed banks to use their own ratings system and models respectively provided they met minimum prescribed criterion.

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[25] The widely used rating agencies were Standard & Poor's, Moody's and Fitch.

Advanced Measurement Approach for operational risk assessment called for regulatory capital requirement based on a bank's internal operational risk management system. Lastly, internal risk management Models Approach for assessment of market risk encouraged banks to develop their own internal models to calculate a stock, currency or commodity's market value on a case to case basis. Further, banks were encouraged to develop their own method of calculating Value at Risk (VaR) based on last five years data on a position to position basis.

Thus, the Basel II while raising complexity of the standard, established a hybrid scheme where banks were able to calculate parameters with internal models whilst the actual capital charge were determined by inserting these parameters into the model decided by the Committee.[26]

Pillar II established principles for supervisory review and purported to provide regulators better opportunity to regulate. It provided guidelines for bank's internal performance assessment procedures as laid under Pillar I. The supervisors were directed to intervene if the banks were not complying with the minimum capital requirement.

Pillar III imposed disclosure norms to facilitate market discipline. The required disclosures range from the ownership structure, risk exposures, capital adequacy and risk profile. The standard mandated the regular publication of this information; once every six months by national

[26] Mike Mariathasan & Ouarda Merrouche, *The manipulation of basel risk-weights*, 3 JOURNAL OF FINANCIAL INTERMEDIATION 23, 300-321 (2014).

banks and once a quarter by internationally active banks. Additionally, Basel II attempted to instil market discipline by mandating disclosures for assessment of risk exposure and capital adequacy of the bank by market participants. Basel II attempted to strengthen disclosure requirement by including the requirement to disclose bank's capital structure, method of calculating capital adequacy, its risk exposure and its risk assessment methods.[27]

Even before the Great Financial Crisis of 2008 (hereinafter '**the Crisis**'), the Committee was considering revising its standards. Basel II's rigid capital demands were criticised for its tendency to create pro-cyclicality effect, as it required banks to shed assets during a bad phase, which it could hold otherwise. This led to shrinkage in the activities of the bank during a turbulent time plummeting the economy into further perils. The Crisis reflected badly on the innovations of Basel II. The heart of the Crisis was default on mortgagees. This did not sit well with Basel II's reliance on external rating agencies, use of internal risk assessments and lower capital requirements for residential mortgages.[28] These external agencies failed to capture or assess accurately the risks related to innovative financial products. The Crisis highlighted excessive leverage and inadequate liquidity buffers of the banks. Further, banks had subpar governance and risk management practices.

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[27] DANIEL K. TARULLO, BANKING ON BASEL: THE FUTURE OF INTERNATIONAL FINANCIAL REGULATION 207 (Peterson Institute, 2008).
[28] *Id.* 132.

The Crisis drew the attention of the regulators towards major inadequacy in how solvency was perceived and tackled by the Committee. Both, the Accords and Basel II approached the issue of solvency of an individual institution. This ignored the phenomenon that failure of one large institution can affect or cause the failure of one or more institutions that deal with the former, a phenomenon that was at play in the Crisis where within weeks of the collapse of Lehman Brothers the entire international banking community was at the brink of collapsing on itself.

Basel III was negotiated in the backdrop of the Crisis. In the aftermath of the crisis, the Committee published two documents to explain the financial reasons behind Crisis. On and off-balance sheet leverage, weak capital ratios, and insufficient liquidity contributed to the bank's inability to absorb systemic risk and credit losses during (and before) the Crisis.[29] At the cusp of the crisis, banks were forced to decrease their leverage, which led to decrease in the prices of assets leading to losses for banks, and a decrease in the capital and credit reserve of the banks. This was accentuated by the loss of confidence on banks' solvency by market participants which, when transmitted to the rest of the financial system, led to massive losses.

In 2010, the Committee published preliminary proposals for a new set of standards to effectively respond to the Crisis. Two years after the Crisis, the Committee published Basel III which aimed at strengthening capital requirements, liquidity and risk assessment. It focused on

[29] BCBS (2010a).

improving the quality, quantity and transparency of the regulatory capital base and, for the first time introduced macro-prudential elements in banking supervision to cub systemic risk.

Various shortcomings of Basel II were addressed by Basel III. The definition of capital was revamped to enhance transparency, consistency and quality. The risk coverage of Basel III was expanded to include securitization and off-balance sheet items. Basel III while acknowledging the various shortcomings of Basel II, in particular, the issue of inaccurate risk-weights, formulated new and more restrictive and demanding requirements (like un-weighted leverage constraint or higher capital charges for sovereign debt).[30]

Basel III is an extension of Basel II Framework. It introduced new capital and liquidity standards to strengthen the regulation, supervision, and risk management for the entire banking industry. It introduced two types of liquidity requirement – banks needed to ensure that they have sufficient liquid assets to meet their requirements in the short (one month) and the long term. The short-term requirement would be fulfilled by the banks by maintaining the LCR – liquidity coverage ratio for short – term; which requires that a bank's high-quality liquid asset should be at least equal to its cash outflows for the forthcoming 30 days. To fulfil long-term requirement under this standard, banks need to maintain NSFR or the Net Stable Funding Ration which requires banks to have access to stable

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[30] Mike Mariathasan & Ouarda Merrouche, *The manipulation of basel risk-weights*, 3 JOURNAL OF FINANCIAL INTERMEDIATION 23, 300-321 (2014).

sources of funding in a long- term time-period. Further, it introduced buffers for capital conservation and countercyclical effects, and a leverage ratio. Basel III introduced further regulations for systemically important banks.[31]

## II. TRANSNATIONALISM IN BANKING

The Committee is a self-enforcing institution, which promulgates minimum banking standards at an international level. It is an example of a transnational regulatory network (hereinafter '**TRN**')[32] that does not have any formal legal personality.[33] It does not possess supranational authority and its decisions do not carry any legal force.[34] It derives its authority from the membership of sovereign states and relies on its members commitments to achieve its mandate.[35] A transnational regulatory network like the Committee functions as an alternative mode of international governance that exists in consonance with formal sovereigns and markets.

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[31] These included requirements for supplementary capital, augmented contingent capital and strengthened arrangements for cross-border supervision and resolution.

[32] As opposed to formal treaty-based international organisations, transnational regulatory networks are informal multilateral forums that bring representatives from national regulatory agencies or departments to facilitate multilateral cooperation on issues of mutual interest within the authority of the participants. *See* Pierre-Hugues Verdier, *Transnational regulatory networks and their limits*, 113 YALE J. INT'L L, 113 (2009).

[33] CHARLES GOODHART, THE BASEL COMMITTEE ON BANKING SUPERVISION: A HISTORY OF THE EARLY YEARS 1974–1997 Chapter 14 (Cambridge University Press, 2011).

[34] The rules of the Committee is enforced via soft law mechanism. *See* Robert E. Scott & Paul B. Stephan, *Self-Enforcing International Agreements and the Limits of Coercion*, WIS. L. REV. (2004), 551.

[35] *Charter of the Committee,* BANK FOR INTERNATIONAL SETTLEMENTS, https://www.bis.org/bcbs.

The Committee is not an inter-state or an international organisation. Its status is not the same as WTO or the UN. It is not conceived by a treaty or an agreement and thus, in strict terms, has no place in international legal system.[36] It functions like a private, non-governmental corporation, with its shares owned by the central banks that make up its membership.[37] The participants of the Committee are central banks and/or supervisory or regulatory authorities. The Committee carries no coercive or legal force; rather, it secures compliance owing to its members' mandates.

Historical circumstances aside, international cooperation in financial, especially banking regulations is critical because absence of such a regulatory framework would lead to a race to the bottom, implying that large banks capable of shifting their operations across border would simply begin operating from the jurisdiction with the least stringent set of regulations.

The creation of the Committee resulted in the dawn of the international financial regulatory system of the modern world. IFR relies on soft law mechanism perpetuated by informal networks. IFR differs from international trade regime as it does not rely on global coordination via treaties, agreements or formal organisations. IFR is often implemented

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[36] ANNE-MARIE SLAUGHTER, A NEW WORLD ORDER 38 (Princeton University Press, 2009).

[37] Lawrence L. Herman, *The New Multilateralism: The Shift to Private Global Regulation,* COMMENTARY NO. 360, INSTITUTE C.D. HOWE INSTITUTE (2012); Samuel P Huntington, *Transnational organizations in world politics,* 25 WORLD POLITICS 3, 334-368 (1973).

through inter-agency institutions with ambiguous legal status.[38] A reason for this occurrence is that nations do not wish to surrender their autonomy on issues of money, taxes and security. Soft law incurs lesser *sovereignty costs* because nations are not curtailed in their ability of pursuing its own national prerogatives.[39] Cooperation through soft law is preferable to unilateral action in IFR as it facilitates cross-border supervision and assistance in enforcement, and harmonises regulatory requirements, objectives that are inconceivable by means of unilateral actions of a nation.[40]

Trans-governmental relations, or sets of direct interactions among units of different governments that are not strictly controlled by the stance of the top leadership of the government, has been a functional channel used for various purposes since as early as the 1950s.[41] Under the Bretton Woods system, the central banks were *de facto* in-charge of international monetary cooperation. During this time, coordination of macroeconomic policy was sacrificed, as central banks did not wish to compromise on monetary autonomy in lieu of global cooperation.[42] The creation of the Committee, as an order of trans-governmental-ism that involves the

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[38] Rolf H. Weber, *Overcoming the Hard Law/ Soft law Dichotomy in times of (financial) Crisis*, 1 JOURNAL OF GOVERNANCE 1, (2012).
[39] Kenneth Abbott & Duncan Snidal, *Hard and soft law in international governance,* 54 INTERNATIONAL ORGANIZATION, 421-456 (2000).
[40] Pierre-Hugues Verdier, *The political economy of international financial regulation*, 88, IND. LJ, 1405 (2013).
[41] Robert O. Keohane & Joseph S. Nye, *Transgovernmental relations and international organizations,* 27 WORLD POLITICS 1, 39-62 (1974) (examples of how sub-units of different governments come together to exert influence).
[42] CLAUDIO BORIO et al., THE PAST AND FUTURE OF CENTRAL BANK COOPERATION 4, 5 (Cambridge University Press, 2008).

creation of a technical problem-solving network, revised this passivity of central banks.[43]

The Committee's existence is regarded as an experiment in international governance, which created an architecture of cross border, or global rules without treaties, diplomats and state customs could be established.[44] It has been hailed as the poster-child of how a new world where national officials cooperate to agree on common standards to solve a collective action problem via cooperation should ideally work.[45] The Committee is an example of a horizontal informal regulatory network, which exists as links between counterpart national officials across nations.[46] The main features of such a body include: firstly, autonomous status of the organisation, i.e. these organisations are not a part or have not been incorporated into any international organisation, secondly, they are not regulated by treaties, and thirdly, they exist for different reasons which may vary from information sharing to standard-setting. The Committee has styled itself as a transnational regulatory networks and prefers to work with minimum physical or legal infrastructure and a short set of objectives and bylaws.[47]

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[43] Andrew Baker, *Deliberative Equality and the Transgovernmental Politics of the Global Financial Architecture*, 15 GLOBAL GOVERNANCE, 195 (2009).
[44] David Zaring, *Legal obligation in international law and international finance,* 48 CORNELL INT'L LJ, 175 (2015).
[45] Philip Alston, *Remarks on Professor BS Chimni's A Just World Under Law: A View From the South,* 22 AM. U. INT'L L. REV., 221 (2006).
[46] ANNE-MARIE SLAUGHTER, A NEW WORLD ORDER 13 (Princeton University Press, 2009).
[47] *Id.* 48.

Patent advantages of TRNs are that it allows domestic officials to keep pace with developments in globalisation and establish relationships among the participants creating incentives for goodwill. TRNs aid fostering cooperation in creating regulatory regime through persuasion, information exchange and sharing, development of, arguably, best practices and deeper socialisation processes that cultivate trust, mutual accountability, relationships and reputational concerns vis-a-via norms of the network. It provides a platform to respond effectively and flexibly to the growing market demands and technological changes. TRNs solve the globalisation paradox, i.e., the inability of national governments to solve collective problems created by globalisation and the infeasibility of a world government by expanding global governance without creating a centralised policy making power.[48]

IFR is dominated by TRNs and soft law mechanism because the latter provides incentives for compliance while ensuring timely-action, flexibility and engagements of experts.[49] Other merits, generally, include lower cost of contracting[50] and provision of efficiency. Hard or codified international law may not be negotiated as quickly owing to multiple rounds of negotiation between heads of states, their representatives and

[48] We need more governmental intervention at a global scale but the concept of a world government is infeasible and undesirable. Even though such a government might be needed, a world government would threaten individual liberty and nations' sovereignty; *See* ANNE-MARIE SLAUGHTER, A NEW WORLD ORDER 8 (Princeton University Press, 2009).

[49] CHRIS BRUMMER, SOFT LAW AND THE GLOBAL FINANCIAL SYSTEM: RULEMAKING IN THE 21ST CENTURY 63-67 (Cambridge University Press, 2015).

[50] Chris Bummer, *Why Soft Law Dominates International Finance-not Trade*, 13(3) JOURNAL OF INTERNATIONAL ECONOMIC LAW (2010).

domestic legislatures. On the contrary, soft law mechanism provides a cheaper way for states to reach an agreement due to low bargaining costs due to its informal nature. It allows nations to not be strictly bound by the policies that have been decided at an international level. Nations have a cheap way out and the ability to cherry-pick or softly defect from its commitments.[51] TRNs, usually, work alongside the international organisations and in theory, the primary political authority still resides at the national level since the TRNs only perform the tasks that are explicitly delegated.[52]

The negotiations and the implementation of the standards also reflect the darker side of TRNs. The explicit and implicit participation at TRNs do not necessarily pursue the objective of optimal global public policy and are often governed by domestic constrains. Further, IFR may lead to distributional issues[53] when diverging interests exist[54] and adoption of a system that incentivises one-size-fits-all model of regulation may create several problems without improving the robustness of the financial system.

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[51] Kenneth W Abbott & Duncan Snidal, *Hard and soft law in international governance,* 54 INTERNATIONAL ORGANIZATION 421-456 (2000).
[52] ANNE-MARIE SLAUGHTER, A NEW WORLD ORDER 7 (Princeton University Press, 2009).
[53] In the instant case, the distributive problem refers to a situation where the Committee pursues the interest of certain member states at the cost of others.
[54] For example, the first set of standards promulgated by the Committee was, partly and allegedly, a product of coercive pressure by US and UK regulators.
*See* Pierre-Hugues Verdier, *Transnational regulatory networks and their limits*, 34 YALE J. INT'L L., 113 (2009).

### D. The Committee: Implication of Compliance

After the Crisis in 2008, G20 world leaders urged major standard-setting bodies to expand their membership to include emerging economies.[55] To regulate effectively in the global economy, clubs like the Committee had a choice of expanding or ultimately expiring. The Committee, which was an exclusive club from 1974, expanded its membership in 2009,[56] and 2014,[57] to include emerging market economies. Expansion of membership was intended to aid in enhancing the Committee's ability to carry out its core mission of strengthening regulatory practices and standards worldwide. Even though emerging economies are members of the Committee, their level of engagement not been quite at the levels of the group of developed nations that had been a

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[55] G20 DECLARATION, http://www.g20.utoronto.ca/2008/2008declaration1115.html#reform.

[56] The Committee announced expansion of membership and welcomed new members (Australia, Brazil, China. India, Korea, Mexico and Brazil) on March 13, 2009. (Press release accessed at https://www.bis.org/press/p090313.htm). Via another press release in 2009 (https://www.bis.org/press/p090610.htm), Basel expanded its membership to Argentina, Indonesia, Saudi Arabia, South Africa, Turkey, Hong Kong SAR and Singapore.

[57] The Committee's membership, at present, consists of 28 jurisdictions and 45 institutions. It includes Argentina, Australia, Belgium, Brazil, Canada, China, European Union, France, Germany, Hong Kong SAR, India, Indonesia, Italy, Japan, Korea, Luxembourg, Netherlands, Mexico, Russia, Saudi Arabia, Singapore, South Africa, Spain, Sweden, Switzerland, Turkey, UK and the USA. Observers include Chile, Malaysia, and UAE.

member of the Committee since its birth[58] owing to institutional capacity, incentives to influence at a global level and regulatory expertise.[59]

Even though the engagement levels may not be as high, developing nations are encouraged and provided incentives to adhere to best practices in the domain of IFR. IFR is dominated by TRNs and soft law mechanism because the latter provides incentives for compliance while ensuring timely-action, flexibility and engagements of experts.[60] Although in theory, IFR is manifested via soft law mechanisms, the ground reality suggests that international financial law might be harder, if not as hard as traditional public international law. The reasons for this can be attributed to reputational concerns and institutional sanctions. Compliance with best practices or standards positively portrays an institution and allows it access to markets and capital.[61] In today's era of globalisation, it is practically impossible for a nation to not adhere to international standards lest they be shunned by global markets.[62]

The Committee carries no coercive or legal force; rather, it secures compliance owing to its members' mandates and other reasons attributed

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[58] Andrew Walter, *Emerging Countries and Basel III: Why is Actor Mobilization so Low?*, UNIVERSITY OF MELBOURNE (2014), https://government.unimelb.edu.au/__data/assets/pdf_file/0007/2654431/Emerging_markets_and_Basel_III_Andrew_Walter.pdf.
[59] Emily Jones & Peter Knaack, *Global Financial Regulation: Shortcomings and Reform Options*, 10 GLOBAL POLICY, 193-206 (2019).
[60] CHRIS BRUMMER, SOFT LAW AND THE GLOBAL FINANCIAL SYSTEM: RULEMAKING IN THE 21ST CENTURY 63 - 67 (2 ed., Cambridge University Press 2015).
[61] Chris Brummer, *Why soft law dominates international finance—and not trade*, 13 JOURNAL OF INTERNATIONAL ECONOMIC LAW 623–643 (2010).
[62] DUVVURI SUBBARAO, WHO MOVED MY INTEREST RATE: LEADING THE RESERVE BANK OF INDIA THROUGH FIVE TURBULENT YEARS 289 (Penguin London 2017).

to reputational concerns, international competitiveness, peer pressure and being in the good books of institutions like the International Monetary Fund among others. Many nations adopt these standards owing to the motivation of following world's important economies, or the fear of being viewed as a signal of risk[63] or of the isolation by the international community.[64]

Albeit not being a part of the negotiating table, RBI had adopted the Accords in 1992 and the second set of substantive standards by the Committee in 2007. India is largely compliant with the standards and regulations prescribed by the Committee. In certain respects, Indian regulations are stricter than the regime created by the Committee.[65]

Such compliance comes with a multitude of ramifications. For example, the Basel capital adequacy requirement may be too high for firms in emerging economies that do not have a sufficiently developed capital market. In such scenarios, banks may either end up reducing their lending activities to reduce risk to increase costs to the consumers. Further, the priorities of emerging economies are different from those of developed nations. Emerging economies may prioritizes financial

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[63] N.S. Vishwanathan, *Basel III Implementation - Challenges for Indian Banking System*, presented at the NATIONAL CONFERENCE ON BASEL III IMPLEMENTATION, Mumbai, (2015), http://www.bis.org/review/r150917a.pdf.
Aurelio Gurrea-Martínez & Nydia Remolina. *The Dark Side of Implementing Basel Capital Requirements: Theory, Evidence, and Policy*, 22 JOURNAL OF INTERNATIONAL ECONOMIC LAW 125-152 (2019).

[64] Chris Brummer, *Why soft law dominates international finance—and not trade*, 13 JOURNAL OF INTERNATIONAL ECONOMIC LAW 623–643 (2010).

[65] Regulatory Consistency Assessment Programme (RCAP), *Assessment of Basel large exposures regulations – India* (July 2019), BANK OF INTERNATIONAL SETTLEMENTS, https://www.bis.org/bcbs/publ/d474.pdf.

inclusion through their financial regulation as opposed to investor protection, the prevention of financial crime, and the promotion of competition, market efficiency, and financial stability.[66] An unintended consequence of adopting the newer Basel standards developed after the Crisis is increased cost of maintain higher capital requirement leading to disincentive to investment in the market. This is especially true for markets that have higher risk profiles than developed markets.[67] Thus, even though India has attempted to comply with the standards set by the Committee, it is time that emerging nations like India not just get a seat at the negotiating table but also have adequate incentive to participate in the negotiating process. Indian banking sector has different demands than that of other nations.

Basel III aims at strengthening the financial sector. It imposes additional disclosure requirements, and prescribed leverage ratios, capital requirements ratios and liquidity ratios. Complying with these standards mandates banks to have higher capital reserve. This means that the banks have a lesser capacity to invest. Owing to this reduced capacity, banks tend to invest in sectors that are highly profitable which does not necessarily further the social and welfare needs of the society. In developing nations, like India, where essential industries are

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[66] Aurelio Gurrea-Martínez & Nydia Remolina, *The Dark Side of Implementing Basel Capital Requirements: Theory, Evidence, and Policy*, 22 JOURNAL OF INTERNATIONAL ECONOMIC LAW 125-152 (2019).

[67] Alberto Burchi & Duccio Martelli, *Possible Unintended Consequences of Basel III on Emerging Markets and Developing Economies: Assessment of Stressed VaR and Effects on Banks' Investment Decisions*, RISK MANAGEMENT IN EMERGING MARKETS 645-682 (2017).

underdeveloped, complying with a regulatory regime which does not prioritises investment in such industries is counter-intuitive.[68] Additionally, although compliance of Basel Standards signals positively to foreign investors, the cost of compliance with these standards, reportedly, are quite high. International financial regime and regulations need to take into account the national circumstances to be able to prescribe a truly global set of regulations.

[68] Earlier in the introduction, we witnessed how an essential industry, which would curb pollution due to agricultural waste disposal, could not secure funding owing to high standards.