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On Financial Nationalism and International Law: Sovereignty, Cooperation and Hard/Soft Governance in International Finance

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Federico Lupo-Pasini. ***The Logic of Financial Nationalism***. New York: Cambridge University Press, 2017. Pp. 306. £88.99. ISBN: 9781107189027

Abstract

The prevailing view among legal scholars over the last decade is that international financial collaboration is a resolutely cooperative venture that cannot be reduced to the interests or relative power of individual states. Moving along this line, the book under review shows that the protection of financial nationalism contributes to the creation of global systemic risks. In this review essay, I discuss the three overarching themes addressed in the book – namely, the logic of financial nationalism, the role of soft and hard law in the international governance of finance and the related problem of compliance. International financial law is still emerging as a discipline and the issues under discussion are at the heart of the ongoing debate about how to devise adequate international structures and international norms to govern markets and control systemic risks in finance. Proceeding from a critical approach to the international law of finance, I analyse the book's focus on financial nationalism and the limits of its juxtaposition with the economic logic of externalities; the case for strengthened formalization; and, finally, the extent to which the theoretical framework proposed in the book is relevant for rethinking the logic and prospect of compliance in international finance.

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1 Introduction

In the last decade, the quest for international financial regulation has increasingly captivated economists and legal scholars.[1] Financial law (for example, capital requirements for banks, rules for trading derivatives and securities or resolution mechanisms for institutions that fail) has moved to a more central place in international regulatory discussions alongside traditional topics such as trade, direct investment, and monetary exchange.[2] Legal scholars have primarily examined the rationale of international rules and discussed the inadequacy of the organizing principle of sovereignty for the regulation of cross-border financial institutions and markets.[3] The current status quo, characterized by the coexistence of national law and institutions and global financial markets, has been thoroughly surveyed.[4] Hence, scholarly attention has now turned to the emerging *lex financiera* and the normative implications of the institutional changes advocated by some for a new international economic order.[5]

In *The Logic of Financial Nationalism*, Federico Lupo-Pasini engages with the question of how to achieve global financial stability as part of an ambitious attempt to construct this new order by re-imagining the current legal architecture of finance.[6] Published at the onset of the Western nationalist resurgence, Lupo-Pasini's book is a refreshing addition to the current debate about nationalism and international law. The focus on international financial law is timely as this functional area of international economic law (IEL) faces important questions about its evolving role and effectiveness. In the aftermath of the global financial crisis of 2007–2008, it has become evident

1 See, e.g., Claessens, Laeven, Igan and Dell'Ariccia, 'Lessons and Policy Implications from the Global Financial Crisis', International Monetary Fund (IMF) Working Paper 10/44 (2010); Charnovitz, 'Addressing Government Failure Through International Financial Law', 13(3) *Journal of International Economic Law* (*JIEL*) (2010) 743; N. Roubini and S. Mihm, *Crisis Economics: A Crash Course in the Future of Finance* (2011); Hardy and Nieto, 'Cross-Border Coordination of Prudential Supervision and Deposit Guarantees', 7(3) *Journal of Financial Stability* (2011) 155; T. Cottier, J. H. Jackson and R. M. Lastra (eds), *International Law in Financial Regulation and Monetary Affairs* (2012); O. Blanchard, D. Romer, M. Spence and J. E. Stiglitz (eds), *In the Wake of the Crisis* (2012); Gadbaw, 'The Prevention of Systemic Failure as a Unifying Principle of International Economic Law', 17(4) *JIEL* (2014) 823; G. Akerlof, O. Blanchard, D. Romer and J. E. Stiglitz (eds), *What Have We Learned? Macroeconomic Policy after the Crisis* (2014); Stiglitz, 'Lessons from the Financial Crisis and Their Implications for Global Economic Policy' (2018), available at https://academiccommons.columbia.edu/doi/10.7916/d8-1b0v-m790.

2 Jackson, 'The Quest for International Law in Financial Regulation and Monetary Affairs: Introductory Note', 13(3) *JIEL* (2010) 525.

3 See, e.g., Lastra, 'Do We Need a World Financial Organization?', 17(4) *JIEL* (2014) 787, 790–794.

4 Trachtman, 'The International Law of Financial Crisis: Spillovers, Subsidiarity, Fragmentation and Cooperation', 13(3) *JIEL* (2010) 719.

5 For this observation, see, e.g., Thompson, 'Financial Regulation's Architecture within International Economic Law', 17(4) *JIEL* (2014) 807, at 808–809.

6 The concept of financial stability is somehow elusive. Often, it is described negatively as the absence of crisis. The true value of financial stability is indeed best illustrated in its absence, in periods of financial instability. During these periods, banks are reluctant to finance profitable projects, asset prices deviate excessively from their intrinsic values and payments may not arrive on time. Major instability can lead to bank runs, hyperinflation or a stock market crash. It can severely shake confidence in the financial and economic system. Cf. Reiser, 'Financial Stability', in T. Cottier and K. Nadakavukaren Shefer (eds), *Elgar Encyclopedia of International Economic Law* (2017) 251.

to most that financial markets require adequate regulation. In the absence of appropriate rules, asymmetric information, agency problems, systemic risks and bubbles can too easily overwhelm the operation of financial markets, producing boom-and-bust cycles and financial crises.[7] The more interconnected the financial system, the larger the cost of the eventual financial busts.[8] The practical question is what form financial regulation should take. This is a hard question, which obviously eschews a simple answer. Lupo-Pasini's contribution centres on the challenging relation between interconnected financial markets and financial stability, and proposes more, and more sophisticated, international cooperation. According to the author, the regulatory and supervisory powers of national authorities are no longer sufficient to address the origin of financial instability – 'at best regulators can intervene to minimize the impact in their own financial system'.[9] Hence, to remove the triggering events, 'international cooperation is necessary'.[10] The central arguments in Lupo-Pasini's book can be expressed in the form of a simple logical thread:

(i) Since the 1970s, financial systems have progressively internationalized and become interdependent to the point where a problem in one country can easily be transmitted across those systems and affect other states.
(ii) The push for deeper international integration has not always been accompanied by a parallel push for real international policy coordination and, in various circumstances, cooperation has proved impossible, or it has not led to policy convergence.
(iii) In the international law of finance, what really matters is not the protection of a social goal, but rather the safeguarding of national interest.
(iv) This logic is, however, ultimately an inefficient regulatory strategy in the long term, as it contributes to the creation of global systemic risks.
(v) The international law of finance must move from the logic of financial nationalism and focus on addressing the social costs of stability policies, rather than simply enabling their adoption.

The main contribution of Lupo-Pasini's book is its explanation of why the quest for a stable global financial system requires a change in philosophy with regard to the way in which international law addresses financial stability. Most of the solutions proposed by the literature to the challenges of global financial stability so far focus either on reducing the level of global financial integration[11] or on dismantling financial sovereignty in favour of a centralized international regulator.[12] In contrast

7 G. A. Akerloff and R. J. Shiller, *Animal Spirits: How Human Psychology Drives Economy, and Why It Matters for Global Capitalism* (2009), at 86–90; Roubini and Mihm, *supra* note 1, chs. 3 and 5.

8 D. Rodrik, *The Globalization Paradox: Democracy and the Future of the World Economy* (2011), 129.

9 F. Lupo-Pasini, *The Logic of Financial Nationalism* (2017), at 41.

10 *Ibid*., at 41.

11 Rodrik, *supra* note 8, chs. 9–10.

12 Cf., e.g., E. Avgouleas, *Governance of Global Financial Markets: The Law, The Economics, The Politics* (2012); D. Schoenmaker, *Governance of International Banking: The Financial Trilemma* (2013); Lastra, *supra* note 3, at 792–794, 797–804.

to these positions, Lupo-Pasini proposes to focus on the role of formal international law – which is sorely missing in international finance – and a new and purportedly more efficient allocation of rights and obligations among states, firms and credits.

2 Re-imagining the International Law of Finance to Safeguard Global Financial Stability

The book is conceptually divided into three distinct parts. The first part, consisting of two chapters, sets out the theoretical framework. In Chapter 1, the author discusses the role of the law in national financial systems in order to illustrate the structure of modern financial systems and the logic of externalities underpinning systemic risk regulation. The case for rules and institutions for preserving financial stability in a national financial system is based on impeccable conventional economics: in essence, when it comes to financial stability, the free market does *not* get it right.[13] Understanding the function of law in maintaining financial stability in a national financial system is, according to the author, of key importance if one wants to appreciate the role of international law in preserving financial stability in interconnected financial markets.

Against this backdrop, Chapter 2 proceeds to analyse the role of international law in the global financial system. This is a key chapter of the book. Lupo-Pasini draws a parallel between the theory of financial regulation at the state level and the regulation of finance at the international level; he explains the main threads of his argument, illustrates the logic of financial nationalism at the core of the current international law of finance and develops the theoretical framework that is extensively applied in the subsequent chapters. He suggests that in a world of interconnectedness between firms and markets, 'global financial stability is a public good whose protection requires the active contributions of all states',[14] and investigates what drives international cooperation to serve that goal and at the same time prevents it from doing so. There are two central points to note here. First, Lupo-Pasini identifies the ultimate cause of global financial instability with the very configuration of international financial law and, specifically, with a number of principles, ranging from the right to regulate to the doctrine of economic necessity, which are either corollaries or are strictly related to the founding tenet of state sovereignty.[15] Put differently, according to him, these features of the international legal order drift towards the protection of national interests and hinder inter-state cooperation for the maintenance of financial stability. As with the absence of appropriate regulation for financial firms in the domestic setting, in international law, a rigorous preservation of prescriptive jurisdiction in financial matters as a national prerogative prevents states from addressing the systemic risk their policies may trigger. The second main contention is that, from a structural angle,

13 Lupo-Pasini, *supra* note 9, at 19–34.
14 *Ibid.*, at 40.
15 I will revert to this point in Section 3 below.

the fairly poor legalization of international law of finance is highly problematic when measured against the 'public good' of financial stability. While permitting regulatory convergence without the hassle of treaty negotiation and implementation, soft law – the preferred mode of cooperation in many areas of international financial law[16] – allows states to retreat from their international commitments whenever they deem compliance detrimental to their own interests. Moreover, international financial law is weakened by an enforcement disability, for it lacks legalized systems of compliance that reduce the incentives of states to defect.[17]

The second part of the book presents four case studies on financial nationalism, which cut across different themes, from cross-border banking to sovereign debt. Their presentation is painstaking and, despite the unavoidable (and, sometimes, admittedly excruciating) financial technicalities, they are rich in stimulating suggestions about the preponderant preservation of national interest and the main legal obstacles to international cooperation in contemporary international law of finance. Chapter 3 discusses the logic of financial nationalism in the context of relations between home and host countries, with a particular focus on the question of home-country control.[18] In home-country arrangements, the jurisdiction of the 'parent bank' leads the regulation and supervision of the financial group, and foreign jurisdictions, where branches or subsidiaries are located, assume a subordinated role. This system permits the removal of one big obstacle to international financial integration, i.e. the discontinuity in national regulatory and supervisory requirements.[19] Yet, there is something more to be said about it. Despite its benefits, this model of financial integration tilts the balance in favour of the home-country jurisdiction, which is left with few, if any, incentives to consider the stability implications of cross-border banking in host countries.[20] Hence, these arrangements pose a risk for global financial stability due to the asymmetry of power between the home authorities and the host authorities.[21] Proceeding from this insight, Chapter 4 considers the challenges concerning international policy coordination regarding cross-border bank resolution. In particular, it investigates problems relating to the bailout of multinational banks, cross-border bank insolvency and international bail-ins.[22] Once again, in Lupo-Pasini's view, failures in inter-state cooperation are mainly due to the sacrifices, in terms of sovereignty, both the country in control of

[16] Brummer, 'How International Financial Law Works (and How It Doesn't)', 99 *Georgetown Law Journal* (2011) 257.

[17] Lupo-Pasini, *supra* note 9, at 50–51.

[18] *Ibid.*, at 62–89.

[19] See further Cerutti, Dell'Ariccia and Martinez Peria, 'How Banks Go Abroad: Branches or Subsidiaries?', 31 *Journal of Banking & Finance* (2007) 1669; Verdier, 'Mutual Recognition in International Finance', 52 *Harvard International Law Journal* (2008) 55.

[20] Eisenbeis, 'Home Country Versus Cross Border: Negative Externalities in Large Banking Organizations Failures and How to Avoid Them', in D. D. Evanoff, G. G. Kaufman and J. R. LaBrosse (eds), *International Financial Instability: Global Banking and National Regulations* (2007) 181.

[21] Lupo-Pasini, *supra* note 9, at 79–89 offers some anecdotal evidence to illustrate this peril.

[22] *Ibid.*, at 90–118.

the resolution procedure and the country that hosts the bank's foreign operations would have to make to achieve coordination.[23]

A telling example of how the protection of national interests may lead to global financial instability is discussed in Chapter 5, which moves the analysis to sovereign debt.[24] In approaching the question of sovereign defaults and the coordination problems in sovereign debt restructuring, Lupo-Pasini omits any discussion of the (much-debated) role of law in the relationship between the financial order and democracy.[25] What he laments, instead, is the absence of an (international) *loi d'efficacité* which could 'eliminate the risks of forum-shopping and allow an efficient restructuring that would put the sovereign back on its feet'.[26] As the argument goes, the risks concerning sovereign debt defaults ultimately stem from the general absence of international constraints on the domestic policy space, with leaves governments free to indulge in fiscal profligacy and to adopt unsustainable macroeconomic policies. Finally, Chapter 6 – which examines the problems of regulatory convergence in the context of derivatives regulation and the supervision of counterparties – further reinforces the author's argument. Over-the-counter (OTC) derivatives – a typical product of financial innovation – 'had been poorly regulated before the financial crisis and were considered one of the origins of systemic risks at national and international levels'.[27] Thus it was not a surprise that common regulation of global derivatives was at the centre of post-crisis reform debates, especially between the United States and the European Union. Overall, despite their diversity – finance is a *mare magnum* that comprises multiple and very different areas – all these problems have a common and clear root. Put simply, the second part of the book demonstrates that global financial instability cannot be explained only as a product of market inefficiencies. On the contrary, instability sometimes originates from the unwillingness or inability of nations states to coordinate their financial policies. So, Lupo-Pasini contends that at the origin of most cooperation failures is a fundamentally flawed approach to international financial law in which national interests prevail.[28]

The third and final part of the book represents the *pars construens* of the author's argument. In it, using law and economics insights, Lupo-Pasini attempts to demonstrate that, under the right circumstances, coordination is *possible*. His case for more international coordination in the form of hard law and the introduction of adjudicative

23 The case for the coordination of crisis-resolution policies and supervisory interventions among all the countries where the banking group operate was originally made long ago. In an 1888 *Harvard Law Review* (*HLR*) essay on cross-border bankruptcy, John Lowell wrote: 'It is obvious that . . . it would be better in nine cases out of ten that all settlements of insolvent debtors with their creditors should be made in a single proceeding, and generally at a single place.' See Lowell, 'Conflict of Laws as Applied to Assignments of Creditors', 1 *HLR* (1888) 259, at 264.

24 Lupo-Pasini *supra* note 9, at 119–149.

25 For an informed article addressing the issue of sovereign debt from this angle, see Goldmann and Steininger, 'A Discourse Theoretical Approach to Sovereign Debt Restructuring: Towards a Democratic Financial Order', 17(5) *German Law Journal* (*GLJ*) (2016) 709.

26 Lupo-Pasini *supra* note 9, at 149.

27 *Ibid.*, at 152.

28 *Ibid.*, at 89, 117–118, 147–148, 173.

mechanisms to settle financial disputes is presented in four chapters. At the outset, Chapter 7 examines the centralization of regulatory and policy functions into a supranational financial authority, with a specific reference to the European Banking Union, described as the most advanced example of centralization in financial matters. After discussing the limits of centralization, Lupo-Pasini's working assumption becomes clearer: 'Whereas [. . .] global financial stability can be achieved only by constraining the policy space of national authorities or by tackling the transmission channels of financial instability [. . .], the internalization of externalities of domestic policies does not necessarily require' extreme solutions such as 'the reduction of financial sovereignty, the creation of a centralized supervisory bulldozer, or the balkanization of the global financial systems along national lines'.[29] What this precisely means is revealed in the final three chapters, in which Lupo-Pasini moves from an analytical account to a normative one.

This normative account begins with a discussion of compliance in international finance, which is presented in Chapter 8. Here, the analysis becomes a bit bland and, frankly, unimaginative: what troubles Lupo-Pasini is that in the absence of binding rules and external mechanisms, which are 'a central enforcer in international law',[30] compliance of states with the international rules (of finance) is the exception: it can only be expected if (in the jargon of the discipline) the gain from defection is lower than the gain from compliance.[31] Accordingly, Lupo-Pasini advocates for a strengthened hard law approach to international finance based on the empowerment of those foreign stakeholders – states or private actors – that have the greatest interest in a state's compliance with its financial commitments and, it goes without saying, the creation of a dispute settlement system that threatens retaliation in case of non-compliance. I return to these issues below, though one may already see that Lupo-Pasini undervalues the complexities and, also, the potential of the articulation and de-formalization of contemporary international law. Chapters 9 and 10 refine this position by proposing a different path to financial integration, which the author labels 'regulatory passporting', coupled with the use of adjudicative mechanisms to settle financial disputes. In essence, regulatory passports consist of bilateral agreements on financial policies and market access. In Lupo-Pasini's view, by subordinating market access to the adoption of binding commitments on financial policies (between home and host countries), regulatory cooperation will be enhanced and the recourse to financial nationalism reduced.[32] Concerning financial disputes, Chapter 10 discusses the logic of adjudication in international finance and the prospect for the establishment of international financial courts addressing, in particular, the problem of sovereign debt. The author proposes that we focus on the rules on standing and remedies as critical elements in

29 *Ibid.*, at 197.

30 *Ibid.*, at 214.

31 It is no secret that this is the standard law and economics answer to the question of compliance. See, e.g., E. A. Posner and A. O. Sykes, *Economic Foundations of International Law* (2012), at 125–139.

32 Lupo-Pasini, *supra* note 9, at 227–259.

the functioning of courts.[33] The main reason for this is that these rules decide who is entitled to initiate dispute settlement and what can be reasonably expected in case of a positive judgement, which, in turn, 'influences the level of external pressure to which national regulators will be subject when applying international financial laws or formulating financial policies'.[34]

This summary reflects the ambition of Lupo-Pasini's work and hints at the breadth of its argument. In the following sections, I focus on three overarching themes shaping Lupo-Pasini's reasoning, namely, financial nationalism and the adoption of law and economics to address it, the role of soft and hard law in the international governance of finance and the related problem of compliance. International financial law is still emerging as a discipline, and the issues under discussion are at the heart of the ongoing debate about how to devise adequate international structures and international norms to govern financial markets and control systemic risks in finance. Proceeding from a critical approach to the international law of finance,[35] I will therefore specifically analyse Lupo-Pasini's focus on financial nationalism and the limits of its juxtaposition with the economic logic of externalities; the case for strengthened formalization; and, finally, the extent to which the theoretical framework proposed in the book is relevant for rethinking the logic and prospect of compliance in international finance.

3 Financial Nationalism, the Logic of Externalities and International Law

It is commonplace today to observe that nationalism is back, and on a massive scale. Everyone knows this. But the situation is taken for granted. Like air, nationalism is both ubiquitous and elusive. It permeates international relations, governments' policies and people's feelings. It can be seen as both a conservative and a revolutionary force threatening the status quo. However, there is a lack of clarity on what defines nationalism today. In common parlance, nationalism is used as a Weberian 'ideal type', broadly opposed to globalization and international cooperation.[36] In journalistic accounts it is sometimes conflated with populism.[37] The general public often does

33 *Ibid.*, 260–286.

34 *Ibid.*, at 261.

35 Critical in the sense of identifying and deconstructing twinned conceptual oppositions and tensions (for instance, between sovereignty and international cooperation, form and substance or formality and informality) underlying the transformations of international (financial) law.

36 In Weber's own words: 'An ideal type is formed by the one-sided accentuation of one or more points of view and by the synthesis of a great many diffuse, discrete, more or less present and occasionally absent concrete individual phenomena, which are arranged according to those considerably emphasized viewpoints into a unified analytical construct.' See M. Weber, *The Methodology of Social Science* [1913–17], ed. and trans. E. A. Shils and H. A. Finch (1997), at 90.

37 Broadly defined, populism is an ideology that seeks to represent 'the people' against an elite. It promotes majoritarianism and rejects institutions that restrain the supposed will of the majority. Cf. C. Mudde and C. R. Kaltwasser, *Populism: A Very Short Introduction* (2017), at 6. Populism is not a unitary concept, either. For a survey of its different contemporary manifestations, see Tushnet, 'Varieties of Populism', 20(3) *GLJ* (2019) 382.

not distinguish between its different manifestations (political, cultural, economic, etc.). Nor is the current diminishing appetite of nation states for joining new international agreements or for remaining in established ones (read: the backlash against international law and institutions) earnestly differentiated from more intense forms of past nationalism and closures, except in some notable works.[38] Scholars in our field are rather confident in their ability to recognize nationalism and to avoid being taken in by it. After all, many 'international lawyers have learned to think of states as 'the enemy', and that 'international is good and the national is bad'.[39] Yet, a stringent binary logic – either the nation or the globe – is incompatible with the complexities of today's world. We have only an imprecise understanding of what nationalism means today, why it is seemingly proliferating or what implications it has for the daily working of an interconnected world. In turn, we lack a conscientiously developed appreciation of what international law can feasibly do to stem the tide of nationalism in the different fields where it is (or visibly seems to be) on the rise. A possible starting point for a better understanding is to acknowledge that both cosmopolitan and nationalist ideas are always *historical* and *political*, and so is their relationship with international law.[40] Furthermore, globalization and nationalism are not only contrasting, but also exceptionally complex, phenomena. Nationalism, in particular, is a versatile and narrow ideology that can take diverse forms and have different implications on politics, society, economy, law and culture.[41] This is why works such as Lupo-Pasini's book are important. They look at one specific and concrete manifestation of today's nationalism, define its logics and its relations with international law and then investigate whether there is room for new or different international rules and institutions to address the problems this manifestation causes.

In Lupo-Pasini's view, 'financial nationalism' is, from a legal perspective, a legitimate, but highly inefficient and risky, policy that tries to maximize domestic financial or economic interests over the objective of global financial stability, even if this leads to a suboptimal policy at the global level. What is truly interesting, however, is how Lupo-Pasini explains the logic of financial nationalism and, particularly, the role that international law plays in such an account. As observed in the previous section, he argues that when cooperation between different countries does not occur voluntarily, global financial instability can be the result of *governance failures*, of which market failures are mere epiphenomena. Hence, a reductive examination of 'global financial stability based only on systemic risk theory would probably fail to understand the fundamental aspect at the core of any global financial crisis: the role of international

[38] Crawford, 'The Current Political Discourse Concerning International Law', 81(1) *Modern Law Review* (2018) 1.

[39] Van Der Meersche, 'Interview: Martti Koskenniemi on International Law and the Rise of the Far-Right', *Opinio Juris* (10 December 2018), available at https://bit.ly/3gVhRDM.

[40] Koskenniemi, 'The Politics of International Law', 1(1) *European Journal of International Law* (*EJIL*) (1990) 4, at 4–13. Suffice it to recall that international law evolved as a nationalist state-building enterprise in the 1870s when it combined the effort to spread liberal legislation in Europe with a certain formal imperialism.

[41] Cf. E. J. Hobsbawm, *Nations and Nationalism since 1789: Programme, Myth, Reality* (2nd ed., 1990).

cooperation'.[42] By contrast, as Lupo-Pasini argues, the very configuration of the international law of finance fails to incentivize states to take due account of the global implications of their policies and to give some of their sovereignty away for the sake of global financial stability (or, as he puts it, 'to internalize the social cost of their actions'[43]). To explain why this is so, Lupo-Pasini makes a blunt comparison between the classic economic argument in support of financial regulation in a domestic financial system and the approach of international law to financial stability. The rationale for financial regulation in a domestic system is a simple one. It assumes that in an unregulated market financial firms would take too many risks. Given that modern financial systems are structured as networks made up of a constellation of diverse but highly interconnected entities, regulation is to force financial firms to internalize the social costs of their actions;[44] what in conventional economics is known as 'the logic of externalities'. At the domestic level, banks are thus subject to a panoply of prudential and supervisory rules, like capital and liquidity regulation, or special resolution regimes.[45] When we consider an interconnected global financial system, however, the logic of externalities does not fully apply to states. Rather, we see that states are not subject to binding rules that would force them to consider the external costs of their policies.

What is proposed here is clear. Standard economic theory is used to analyse why states do not cooperate to preserve global financial stability. The protection of financial nationalism contributes to the creation of global systemic risks and incentivizes states to adopt unsustainable domestic policies. There is supposed to be no conceptual difference between how to deal with financial stability at the domestic level and at the global level. There follows, in my view, a key declaration by Lupo-Pasini, already mentioned above: 'global financial stability is a *public good* whose protection requires the active contributions *of all states*.'[46] From a legal perspective, global financial instability can 'be described as a financial threat originating from events *outside* the jurisdiction of national regulators'.[47] The maintenance of global financial stability confronts states with different challenges to those faced by national regulators. However, the rationale for both national and international financial regulation would remain identical. Hence, *mutatis mutandis*, the regulatory response should be, at least in general terms, alike too:

> If the maintenance of financial stability requires the internalization of externalities [at the domestic level], it logically follows that, even at the international level, the protection of financial stability should be based on the same principle. States participating in an international financial system should be required to internalize the externalities of their actions.[48]

42 Lupo-Pasini, *supra* note 9, at 40.

43 *Ibid.*, at 3.

44 On the theory of financial regulation, cf., e.g., M. Dewatripont and J. Tirole, *The Prudential Regulation of Banks* (1993), esp. at 31–45; Lewis, 'Incongruent Incentives in Banking Supervision: The Agent's Problem', 23 *Journal of Economics* (1997), 17; Schwarcz, 'Controlling Financial Chaos: The Power and Limits of Law', 3 *Wisconsin Law Review* (2012) 815.

45 See J. Armour et al., *Principles of Financial Regulation* (2016), at 50–98.

46 Lupo-Pasini, *supra* note 9, at 40 (emphases added).

47 *Ibid.*, at 41 (emphasis in the original).

48 *Ibid.*, at 58.

Thus, Lupo-Pasini contrasts the logic of financial nationalism with the logic of externalities, which essentially implies a sacrifice, also by states, of policy space. In his book, international law has a central role in both the *diagnosis* of financial nationalism and the *prescriptions* for the protection of global financial stability. Let me begin with the diagnosis.[49]

I am not entirely persuaded by the book's somewhat simplistic assimilation between private actors in domestic financial markets and states in interconnected financial markets. If nothing else, the respective *raisons d'être* of states and financial firms are immensely distant and so are their policies. Still, Lupo-Pasini's work bridges a gap in so far as it constitutes the first book-length study dedicated to understanding why the logic of financial nationalism at the core of the current international law of finance originates in various legal principles and doctrines that are intimately connected to state sovereignty and have the ultimate goal and/or effect of protecting the strict bond between the state regulators and their citizens.

This analysis is a contribution in itself. Experts are rightly concerned about 'the huge chasm that has developed between the reach of financial markets and the scope of their governance'.[50] Among legal scholars, Lupo-Pasini is certainly not alone in arguing that sovereignty is an inadequate principle when financial markets transcend national boundaries and so do systemic risks.[51] However, his work is the first that, by elaborating on previous scholarship[52] and using a law and economics approach, explains in depth why in the law of international finance the goal of stability often gives way to its opposite: the logic of financial nationalism. Lupo-Pasini uses the principal–agent model to conceptualize the bond between regulators and their citizens and to illustrate the behaviour of different national authorities in the formulation of financial policies and, more generally, the problems of cooperation for the protection of global financial stability. From a policy viewpoint, the ultimate effect of the principal–agent relation that binds policymakers to their citizenship is that it creates a *barrier to cooperation*, as it forces financial regulators to focus their actions on the protections of institutions and consumers located *within their jurisdictions* and to ignore whether such policies produce negative spill-overs to other countries, as well as all other *external* factors, unless they bear a direct consequence on their domestic markets. In turn, this increases the risk of global financial instability, defined by the author as the '*negative externality of globally Pareto-inefficient domestic policies*'.[53] Other coordination problems for international financial cooperation arise out from the difficulties in accommodating different regulatory preferences and goals.

49 I offer more in-depth reflections on the prescriptive claims in Sections 4–5.

50 Rodrik, *supra* note 8, at 129.

51 See, e.g., Avgouleas, *supra* note 12, at 5–10; Lastra *supra* note 3, at 792–793.

52 Cf. D. A. Singer, *Regulating Capital: Setting Standards for the International Financial System* (2007); S. Gleeson, *International Regulation of Banking: Capital and Risk Requirements* (2nd ed., 2012); Verdier, 'The Political Economy of International Financial Regulation', 88 *Indiana Law Journal* (2013) 1405.

53 Lupo-Pasini *supra* note 9, at 45 (emphasis in the original). 'Pareto efficiency' is considered as a minimal notion of efficiency that does not necessarily result in a socially desirable distribution of resources. It is simply a statement of the impossibility of improving one variable without harming other variables in the subject of multi-objective optimization (also termed Pareto optimization).

Think, for example, about the case of international bailouts: ideally, the host and home authorities should cooperate in resolving the cross-border banks, as this would reduce the overall resolution costs, minimize creditors' losses and protect financial stability. Whether or not they do it heavily depends on the 'sovereignty costs' attached to the bailout in terms of financial disbursement and increased public pressure during the crisis.

However, in Lupo-Pasini's account, the ultimate cause of these commonly recognized obstacles to coordination in international finance lies in the very configuration of international law of finance. In the tradeoff between national interest and global financial stability, 'international law largely drifts toward the protection of national interests and financial sovereignty'.[54] It does so through a different set of principles (mainly corollaries of the principle of state sovereignty), legal doctrines and some structural elements such as the scarcity of formal binding rules in international finance. More specifically, since international law regards each state as sovereign, in the sense that it is presumed to have full authority to act not only internally but at the international level,[55] states can obviously decide their economic policy and legitimately refuse to coordinate with other states. The *right to regulate*, one of the purest expressions of financial sovereignty, 'is the quintessential example of financial nationalism'.[56] It grants states the fundamental freedom to decide their policy priorities and, if a state so chooses, not to regulate. Lupo-Pasini argues that, in an interconnected global financial system, the right to regulate is particularly risky because it could create dangerous regulatory discontinuities, with states, for example, adopting lax financial regulations or allowing a too-big-to-fail domestic financial institution to go bankrupt even if these actions produce global systemic risks. Likewise, the *right to isolate*, another corollary of the principle of sovereignty, gives states the power and freedom to suspend the process of financial integration and limit capital mobility. If not properly controlled, the right to isolate could give rise to stability wars, i.e. 'regulatory wars' between different national financial authorities in the context of a banking crisis that arises from the inability of financial authorities to coordinate on a common optimal strategy. Another long-standing principle of international law at stake is *economic necessity*. It broadly allows states to suspend the application of an international treaty to avert threats to their economic stability. Yet, the same principle might lend itself to abuse, which inevitably leads to a poor outcome. A suggestive case, discussed at length with reference to the abrupt Icelandic financial crisis of 2007, concerns cross-border supervisory cooperation.[57] When confronted with a case of a bank insolvency, a

[54] *Ibid.*, at 52.

[55] J. Crawford, *The Creation of States in International Law* (2nd ed., 2006), at 32–33, 40–44.

[56] Lupo-Pasini *supra* note 9, at 52.

[57] As an European Free Trade Association (EFTA) member and part of the European Economic Area, Iceland has to adopt almost all EU legislation related to the Single Market. One of the peculiarities of the home-country control model in the EU is its extension to deposit insurance schemes. Thus, according to EU law, home states have the primary responsibility to supervise home banks' foreign branches and, also, to protect local depositors, even if located in another country. Cf. Directive 94/19/EC of the European Parliament and of the Council of 30 May 1994 on deposit-guarantee schemes, OJ 1994 L 135.

country may indeed deviate from the law and decide to guarantee only local and national depositors without backing up foreign ones.[58] Moreover, if interpreted as a blank cheque that allows states to escape international obligations, economic necessity could create moral hazards. To be clear, in contemporary international law, the precise contours of economic necessity vary with the legal sources.[59] Certain treaty clauses, in particular, allow States to suspend the application of a treaty when an unforeseen circumstance prevents it from performing its obligations. These necessity norms take many forms, from 'balance of payments' exceptions, to 'state of necessity' or '*force majeure*.'[60] Despite their extensive use, there is hardly any uniformity in their formulation, ambit of application and interpretation.[61] Whereas certain clauses, like those on balance of payments, formulate very specific conditions, others are generic provisions that simply refer to the presence of a situation of grave and imminent peril or harm.[62] When no stringent condition is attached, states might be incentivized to borrow on international markets or indulge in risky and unsustainable fiscal policies. By doing so, they would transfer onto their partners the economic costs of their reckless policies.[63] Finally, the absence of legalization – defined as binding laws, detailed rules and compliance mechanisms – and the excessive power of national courts in the context of sovereign debts further hinder international financial cooperation.

These considerations point to the core of Lupo-Pasini's claim: Proceeding from a law and economics approach, he concludes that the contemporary international law of finance does not incentivize states to coordinate their action, and leaves them with excessive room to deviate. I share the author's interest in the manner in which international law addresses finance. Like him, I believe we need to engage with the regulatory challenges posed by the stability of interconnected financial markets, which has

[58] Despite the obligations deriving from its EFTA membership, just one day before declaring the insolvency of Landsbanki on 6 October 2008, the Icelandic government passed a law in which it guaranteed that in the event of a bank insolvency the deposit insurance fund would cover only local Icelandic depositors but not foreign ones. Iceland invoked the protection of its essential economic interests, a position upheld by the EFTA Court, which accepted Iceland's view that backing up the Icelandic Deposit Insurance Fund would have turned a banking crisis into a sovereign debt crisis. Cf. Case E-16/11, *EFTA Surveillance Authority v. Iceland*, [2013] EFTA Ct Rep 4, ITL 052 (EFTA 2013), 28 January 2013, paras 124–180.

[59] Excellent analyses of the troublesome application of the *force majeure* and 'necessity' justifications, as crystallized in Articles 23 and 25 of the 2001 ILC Draft Articles of Responsibility of States for Internationally Wrongful Acts (in ILC, *Report of the International Law Commission on the Work of its Fifty-Third Session*, UN GAOR, 56th Sess. Supp. No. 10.43, UN Doc. A/56/10 (2001)), in respect of unforeseen economic crises are offered, respectively, by Paddeu, 'A Genealogy of *Force Majeure* in International Law', (82)1 *British Yearbook of International Law* (2012) 381, at 458–460, and Kurtz, 'Adjudging the Exceptional at International Investment Law: Security, Public Order and Financial Crisis', 59 *International and Comparative Law Quarterly* (2010) 325, at 334–338.

[60] For an overview, see A. Viterbo, *International Economic Law and Monetary Measures* (2012), at 220–225, 346–353.

[61] Sloane, 'On the Use and Abuse of Necessity in the Law of State Responsibility', 106 *American Journal of International Law* (*AJIL*) (2012) 447.

[62] The clause may even be self-judging, i.e. the invoking state does not need to demonstrate the presence of a peril. See, e.g., Kurtz *supra* note 59, at 365–370.

[63] Lupo-Pasini, *supra* note 9, at 132–140.

become even more manifest with the global crisis of 2007–2008 and its prolonged aftermath. And, like Lupo-Pasini, I believe that states and scholars should move beyond simply rehearsing arguments about the opportunity of cooperation and instead start with a more profound understanding of the ultimate reasons why contemporary international law tends to safeguard national interests in finance. While sharing his starting points, interest and, for the most part, diagnosis, I am less sure that Lupo-Pasini's rigid use of standard law and economics theory offers the best way forward. His analysis, in fact, eludes a key point. I concede that it offers a host of good arguments, but the emphasis on the performative character of rules and other classics of law and economics – the logic of externality, the efficient pursuit of common goods, the design of an apropos system of threats and incentives, etc. – leads Lupo-Pasini to ignore the distributive significance of law.[64] In particular, his emphasis on the juxtaposition of financial nationalism and the logic of externalities obscures how new international rules, by calling into question state sovereignty to secure global financial stability, would structure and legitimate new forms of authority.[65] It is one thing to show that certain corollaries of state sovereignty favour financial nationalism, but that begs the question of a new allocation of power between different levels of governance entities in the world. This is what John Jackson's notion of 'sovereignty-modern' was all about.[66] And this is why, when confronted with the question of global financial stability, scholars are still divided into two main camps: those who argue that we cannot have deep economic integration, national sovereignty and democratic politics all at once,[67] and those who, assuming that a certain level of regulatory coordination among states must exist, contend that financial markets need to rely on different levels of governance and strive to identify the functions (or sub-functions) that require a supra-national or international structure and the functions that are best left at the municipal level.[68] As effectively put by Kennedy, 'law not only regulates things, it creates them. The history of political and economic life is therefore also a history of institutions and laws'.[69] With this in mind, one can understand the implications of international financial regulation: different societies, organized around different political systems, may well have distinct preferences and needs with regard to what

[64] In this sense, Lupo-Pasini's work follows on the heels of those who have developed a purely instrumental account of the use of law in the defence of particular interests or preferences.

[65] See D. Kennedy, *A World of Struggle. How Power, Law and Expertise Shape Global Political Economy* (2018), at 10–14; and, specifically, for finance, Rodrik *supra* note 8, at 264.

[66] Following Jackson's notion of 'sovereignty-modern', we should disaggregate and break down the complex array of sovereignty concepts and examine particular aspects in detail and with precision to understand what is actually at play. See Jackson, 'Sovereignty-Modern: A New Approach to an Outdated Concept', 97 *AJIL* (2003) 782.

[67] This position is voiced by Rodrik, *supra* note 8, at 200–201, who maintains that a new global financial order must be constructed on the back of a minimal set of international guidelines and with limited international coordination.

[68] See, e.g., Lastra *supra* note 3, at 793–797; Charnovitz, 'Addressing Government Failure Through International Financial Law', 13(3) *JIEL* (2010) 743.

[69] Kennedy, 'International Legal Theory: Law and the Political Economy of the World', 26(1) *Leiden Journal of International Law* (2013) 7, at 8.

they desire from a financial system. For example, some states may value financial stability over financial innovation and will desire a tighter regime of regulation, willingly giving up some financial innovation. Others will promote greater financial innovation and may prefer a lighter regulatory touch.[70] The general point is that any discourse on the reimagination of international financial law and institutions must make explicit its implications, particularly in terms of domestic policy space, authority vested upon different actors and new modes for their interaction. Such an understanding can inform proposals for reform. Such problems constitute the kernel of the ongoing debate on the role and prospect of international financial law.[71] And, yet, in Lupo-Pasini's discussion about the determinants of financial nationalism, they remain largely in the background. This holds also true for his normative claims, which I address in the following sections.

4 Hard and Soft Law in International Finance

At first glance, Lupo-Pasini's prescriptions for addressing the social costs of financial stability policies seem as clearly articulated as his diagnosis of the causes of financial nationalism. Yet, the normative claims of the book constitute its most tortuous aspect. Adhering to a rational choice theory of international law, Lupo-Pasini assumes that states respond to punishments and incentives like any other entity. Therefore, 'the problems of financial instability can be solved by increasing the role of international law in preventing the externalities of a state's action, and by allocating, more efficiently, rights and obligations among different actors'.[72] He argues that binding international law should be used in addressing the problems of cooperation: a novelty in the world of finance, considering that informality is the constitutive element of most of international financial law.[73] According to the book, at the centre of the compliance problem in international finance lies the question of soft law.

Lupo-Pasini is obviously not the first to advance an approach based on an increased role of binding international rules to address problems of cooperation and compliance.[74] The core tenet of literature on the economics of international law, which started in earnest with the works of scholars such as Andrew Guzman and Joel Trachtman, is that by creating a system of threats and incentives that discourages unilateralism, binding international norms and credible remedial mechanisms can address the classic compliance problem of international law.[75] Rosa Lastra, too, among others,

70 Rodrik, *supra* note 8, at 260–266.

71 See, e.g., Lastra *supra* note 3, at 791.

72 Lupo-Pasini *supra* note 9, at 197.

73 Brummer, 'Why Soft Law Dominates International Finance and Not Trade', 13(3) *JIEL* (2010), 623.

74 See, e.g., Slaughter, 'International Law and International Relations: Millennial Lectures', 285 *Recueil de Cours* (2001) 9, at 45–47, characterizes institutionalist theory of international relations as a paradigm which believes in the ability of international cooperation to achieve collective goals by international treaties and international organizations which diminish the possibility of cheating.

75 Cf. J. P. Trachtman, *The Economic Structure of International Law* (2008), at 208–271; Guzman, 'A Compliance-Based Theory of International Law', 90 *California Law Review* (2002), 1823. See also Koh, 'Why Do Nations Obey International Law?' 106 *Yale Law Journal* (1997), 2599.

contends that in international finance, the dichotomy between international markets and national laws and policies can be best tackled by the internationalization in the form of 'hard' international law, which emanates from international treaties.[76] In short, Lupo-Pasini's contribution in this regard is the idea that international financial law should move towards international treaties linked to a compulsory dispute settlement system, in which the rules of standing for both states and investors are used to strategically pressure domestic regulators into adopting globally cooperative policies. As observed in Section 1 above, this idea is set out in Chapter 8 and then developed in two further chapters addressing regulatory passporting and dispute resolution.

Chapter 8 is mainly concerned with demonstrating that, whereas what is sometimes referred to as the 'legally subliminal' level[77] has worked in the field of prudential regulation,[78] the legal literature has so far failed to examine the issue of compliance with regard to the other main (and neglected) elements of finance: supervision and crisis resolution. Lupo-Pasini examines compliance with soft law in these latter fields and concludes that in the absence of binding rules and robust compliance mechanisms, 'compliance would arise only if the welfare costs of global stability do not exceed the costs that the same measures required to ensure domestic stability'.[79] He then advances his own proposal for a more effective international regulatory framework. Consistently with the rest of the book, he makes wide use of law and economics insights applied to international law by other scholars.[80] Lupo-Pasini's proposed system has three key elements. The first element is empowerment of foreign stakeholders – both foreign states and private actors – who have an interest in the state's compliance with international financial rules. Roughly, those actors must be granted the possibility of 'hav[ing] voice over the domestic polices of other countries'[81] through the attribution of rights normally created with international treaties. The second element is the creation of a dispute-settlement system that uses those rights to threaten retaliation in the event of non-compliance. Thus, in the event of a breach, the international rules grant foreign states and even private entities the power to adopt retaliatory measures or to impose penalties up to a level that would induce compliance. Finally, Lupo-Pasini argues that it is essential to give the afore-mentioned 'rights to the most appropriate titleholder',[82] i.e. those who will be prone to exert their rights. Accordingly, 'the role

[76] Lastra, *supra* note 3, at 797–805. Hence, she calls for a 'World Financial Organization', modelled after the WTO, where one treaty-based organization – presumably, the IMF – would act as the primary international standard setter for financial regulation. However, this prospect seems impractical and highly unlikely. See C. Brummer, *Soft Law and the Global Financial System: Rule-Making in the 21st Century* (2nd ed., 2015), at 329–333.

[77] The term is gratefully borrowed from S. C. Neff, *Friends but not Allies: Economic Liberalism and the Law of Nations* (1990), at 145–146.

[78] See, recently, Milano and Zugliani, 'Capturing Commitment in Informal, Soft Law Instruments: A Case Study on the Basel Committee', 22(2) *JIEL* (2019) 163.

[79] Lupo-Pasini, *supra* note 9, at 214.

[80] Cf., e.g., Dunoff and Trachtman, 'Economic Analysis of International Law'. 24 *Yale Journal International Law* (1999) 1; Posner and Sykes, *supra* 31, ch. 9.

[81] Lupo-Pasini, *supra* note 9, at 215.

[82] *Ibid.*, at 216.

of international law is to enable the mobilization of those interest groups that have the greatest impact on the welfare of other states'.[83] In Trachtman's theory, to which Lupo-Pasini explicitly anchors his own proposal, these collective entities are the so-called 'global coalitions' of domestic and foreign interest groups that join forces to shape the decision of a state on compliance or non-compliance.[84]

Such, in brief, is the gist of Lupo-Pasini's proposal. The general impression is, however, that the author shies away from clearly pointing out how the system he conceptualizes could be framed in law and how it should operate in practice. For one thing, even when he tests this approach, his analysis ends with rehearsing why compliance based on informal law is, in certain areas of finance, unsatisfactory, rather than elucidating the substantive and procedural rules of the suggested alternative mechanisms based on global coalitions. Above all, the upshot of the system postulated in the book is a significant sacrifice in terms of state sovereignty. Therefore, one would have expected Lupo-Pasini to discuss more clearly and critically the pragmatic incentives for states – especially the most powerful ones – to accept such a loss of autonomy in critical areas of their financial and fiscal policy.[85] In light of the painstaking diagnosis offered in Chapters 2 to 6, a far deeper and more systematic reflection on how to shape international financial treaties for the purposes of achieving more financial coordination and minimizing the risks for global financial stability would have been necessary. Yet, the author makes such an effort only in relation to the adoption of the so-called 'regulatory passports'. For the reader, it is disorientating to be left without more precise answers regarding the specific contents of the obligations assumed by states and the rights attributed to foreign actors in new international financial treaties.

Another issue, noted here only briefly, is that a fresh look at international financial law after the global financial crisis of 2007–2008 reveals a more complex framework of supervision and (to a lesser extent) crisis management than Lupo-Pasini suggests. In the thirteen years since the crisis, the regulatory apparatus of the international financial system has become significantly more robust.[86] To name but a few: the Financial Stability Board (FSB), established under the G-20, and the Basel Committee on Banking Supervision have spent considerable effort in developing an international regulatory framework for bank resolutions.[87] Monitoring processes have proliferated at the FSB, the International Organization of Securities Commissions (IOSCO) and, notably, the oldest standard setting body, the Basel Committee.[88] Moreover, the last

83 *Ibid.*, at 217.

84 Trachtman, 'International Law and Domestic Political Coalitions: The Grand Theory of Compliance with International Law', 11 *Chicago Journal of International Law* (2010–2011) 127.

85 In the author's words: 'To reduce systemic risk, regulators require banks to limit their leverage or their concentration of exposures. Yet, the same regulatory rationale does not apply to sovereigns. [. . .] In a situation of financial integration, the protection accorded by fiscal sovereignty simply increases the moral hazard of sovereigns in taking up too much debt.' See Lupo-Pasini *supra* note 9, 128.

86 See extensively Brummer, *supra* note 77, ch. 2.

87 Cf. 'Effective Resolution Regime and Policies: Implementation', Financial Stability Board, available at https://bit.ly/3jEIu1u.

88 See further Thompson, *supra* note 5, at 812–817; Brummer, *supra* note 76, at 97–98.

version of the Basel Capital Accords (Basel III), widely considered the most effective example of non-binding financial standards, complements markedly and strengthens minimum capital requirements and liquidity standards for financial institutions.[89] Again on supervision, the US Dodd–Frank Act (and subsequent Securities and Exchange Commission and Commodity Futures Trading Commission regulations) as well as dozens of EU Directives and Regulations have been largely operationalized to implement G-20 commitments.[90]

Despite all these developments, legal scholars, especially those with a positivist bent, have argued that international financial law does not qualify as 'law', given the absence of a centralized, coercive authority – a global government in effect – to implement its dictates. By the same token, the common tendency among international lawyers to overlook international financial law reflects an incomplete understanding of soft law – both of its impact on financial markets and of the distinctive institutional ecosystem in which it operates.[91] My take is that Lupo-Pasini's discussion on hard v. soft law is no exception. *The Logic of Financial Nationalism* tends to underemphasize the role of international institutions in promulgating and backing global financial standards. The resulting proposal, instead, routinely relies on fairly old-fashioned ideas of solving the world's problems through treaties without really engaging with the practicalities and theoretical challenges to stake out a more nuanced understanding of international financial law. The fixation on form – which in Lupo-Pasini's approach seems a logical output of his rigid adherence to a rational-based theory of international law[92] – leads to disregarding that, substantively, soft law can be as good, or vice versa as flawed, as its hard law counterpart.[93] The same fixation can lead scholars to underrate certain advantages of soft law – notably, its adaptability to uncertainty, a topical example of which is the decision taken on 27 March 2020 by the Basel Committee to defer Basel III implementation in order to increase the operational capacity of banks and supervisors to respond to Covid-19.[94] What is more, a rigid juxtaposition between hard and soft law fails to pinpoint the design features that can bolster, as well as reduce, the effectiveness of international financial law,[95] a question I concisely examine below.

89 For a critical assessment, see T.J. Schoenbaum, *The Age of Austerity: The Global Financial Crisis and the Return to Economic Growth* (2012), at 118–121.

90 Brummer, *supra* note 76, at 276–325.

91 *Ibid.*, at 3–7.

92 On the limits of the explanatory power of a rationalist approach to international law used for institutional design, when not coupled with an analysis well founded in international law doctrine, see Van Aeken, 'To Do Away with International Law? Some Limits to "The Limits of International Law"', 17(1) *EJIL* (2006) 289.

93 See, e.g., Abbot and Snidal, 'Hard and Soft Law in International Governance', 54(3) *International Organizations* (2000) 42, at 441–444.

94 Press Release, 'Governors and Heads of Supervision Announce Deferral of Basel III Implementation to Increase Operational Capacity of Banks and Supervisors to Respond to Covid-19', *BIS* (27 March 2020), www.bis.org/press/p200327.htm.

95 I made this general point in Borlini, 'Soft law, soft organizations e regolamentazione "tecnica" di problemi di sicurezza pubblica e integrità finanziaria', 2 *Rivista di diritto internazionale* (2017) 356, 381–386.

5 A Framework for Compliance in International Financial Law

Since the 1990s, compliance has become one of the most debated topics in the international law literature.[96] As Lupo-Pasini's central ambition is to propose a legal framework for reducing 'the proclivity of national regulators for defection' and 'guarantee[ing] obedience to' international financial norms,[97] one might ask whether his proposed framework is relevant and useful for rethinking the issue of compliance in international financial law and for addressing the problems of international coordination and global instability. I shall discuss this question by addressing the author's most original contribution in the matter – the so-called 'regulatory passports'. Lupo-Pasini's argument is based on a theory of incentives, in which the 'regulatory passport' functions as a normative bridge between the financial liberalization agenda and the financial integration goal. Lupo-Pasini's basic insight is that the rights of firms and investors to trade or invest in a foreign jurisdiction should be subordinated to – and be accompanied by – the adoption of tailor-made bilateral agreements on financial policies between the home and host regulators that oblige the parties to link market access to the adoption of a binding regulatory framework for financial stability. In so doing, much like international trade treaties facilitating export interests, regulatory passports would mobilize 'the domestic interests that are more likely to drive the behavior of governments toward financial cooperation: large financial institutions with strong export and investment interests'.[98] In terms of content, this idea openly draws on the adoption of a Code of Conduct on financial stability by national financial authorities covering prudential regulations, crisis resolutions and home-host supervisory arrangements proposed by the International Monetary Fund (IMF) in 2009.[99] The difference is, of course, the legal vehicle: regulatory passports are conceived as part of binding and reciprocal international agreements, which would grant their parties market access only by agreeing to a binding regulatory framework that promotes financial stability, e.g. by virtue of a binding crisis-resolution regime or a code on sovereign borrowing.

To what extent will the long-standing debate on compliance with international financial norms benefit from the concept of regulatory passports, as proposed by Lupo-Pasini? My discussion of such potential 'spillover' has to remain tentative and general, but two points can be made. The first point is pragmatic: it draws on the same incentive-based approach that lies at the foundation of Lupo-Pasini's proposal. Focusing on

[96] See, e.g., Chayes and Handler Chayes, 'On Compliance', 27 *International Organization*, (1993) 175; A. Chayes and A. Handler Chayes, *The New Sovereignty: Compliance with International Regulatory Agreements* (1995); Abbott, 'International Relations Theory; International Law, and the Regime Governing Atrocities in Internal Conflicts', 93 *AJIL* (1999) 361; Guzman, *supra* note 78, at 1823; Koh, *supra* note 75, at 2599.

[97] Lupo-Pasini, *supra* note 9, at 226.

[98] *Ibid.*, at 226.

[99] International Monetary Fund, 'Initial Lessons from the Crisis' (6 February 2009), available at https://www.imf.org/en/Publications/Policy-Papers/Issues/2016/12/31/Initial-Lessons-of-the-Crisis-PP4315.

norm generation and institutional form (for dispute settlement), Lupo-Pasini attempts to reframe the law of international finance through economic analysis. He returns to the fundamental issue of *why* states should give away sovereignty in the financial field, viewing it anew by applying and extending the analytical tools of law and economics scholars. In the end, it is a matter of finding the right incentives: 'By leveraging on the desire of states to access foreign markets and reap the benefits of international capital, regulatory cooperation on financial stability can be enhanced and made more resilient to financial nationalisms.'[100] However, what conditions are both economically and legally necessary for the constitution of an effective incentive system to comply with new international norms is highly contextual, i.e. it is, among others, bound to what interested states have already secured, in practice, from previous international trade and investment treaties. On the face of it, Lupo-Pasini's proposed rationale for states to enter into binding international agreements on financial convergence resembles the logic for states to enter into international trade or investment treaties. Notwithstanding the ostensible similarities, however, readers familiar with the law and economics theory of international law may find aspects of this analogy surprising: notably, Lupo-Pasini does not seem to consider that, at present, for several states, especially those whose financial policies weigh the most in terms of global financial stability, the prospect of expanding market access and investment protection through new agreements is rather slim. As the author rightly underscores, 'economic integration has been construed, at least outside the European Union, as the legalization of export and foreign investment interests'.[101] But when this particular *do-ut-des* is already legalized, the political bargain at the basis of regulatory passports should be centred on a different mutual exchange of concessions. Unless a new economic incentive is provided, there is no apparent reason for states to move from financial nationalism to coordination. All this is of relevance for the debate on compliance with international financial rules. Lupo-Pasini probably points us in the right direction: a sizeable economic incentive is needed for states to accept a reduction in their regulatory autonomy. And yet this conclusion should be developed by incorporating into the analysis what interested states have already secured through other forms of international economic integration (e.g. market access).

The second point is more systemic and concerns the structure of international financial law. Lupo-Pasini's proposals for a strengthened compliance turn out, in the end, to be quite short-sighted. But let us not to be too harsh: They are short-sighted in interesting ways, and we can understand quite a lot about how international financial law works by examining how and where Lupo-Pasini went astray. As noted above, he claims that treaties, coupled with ad hoc adjudication systems, constitute the only appropriate means of providing states with an economic incentive for compliance. In so doing, however, Lupo-Pasini neglects to examine the broader institutional environment in which international financial law operates, and instead embraces the

[100] Lupo-Pasini, *supra* note 9, at 230.

[101] *Ibid.*, at 253.

pervasive view that soft law is necessarily 'non-binding' (i.e. ineffective).[102] One might indeed argue that the degree to which an instrument is coercive, or effective, is less a matter of obligation than enforcement.[103] In this respect, Lupo-Pasini contends that compliance with international financial standards is mainly explained by the reputational costs of violations, adding that the theory of reputation does not work in fields other than prudential regulation. But the reputational factor is only part of the story. International efforts to regulate the financial sectors, in fact, have been the result of organizations bringing together domestic regulators in so-called regulatory networks. The authority of these standard-setting institutions stems primarily from their technical expertise. However, the fact that their members are the same regulators who are responsible for issuing and applying financial regulations within their domestic jurisdiction plays, without a doubt, an important role in making the agreed standards effective. Perhaps more importantly, and despite the fact that such standards are not legally binding, supervision procedures have also been devised to ensure that they are put into action.[104] In other words, soft law is sometimes coupled with hard procedures and backed up by 'soft sanctions',[105] including significant market or institutional consequences that can themselves exert discipline.[106] And, here, as Brummer has demonstrated, international financial regulation, though not emanating from traditionally binding sources, is indeed sustained by a range of often complex enforcement technologies that make it more coercive than traditional theories of international law predict.[107]

These considerations are tentative. They suggest that at least some elements of Lupo-Pasini's framework provide useful perspectives to the debate on compliance in international financial law. Lupo-Pasini raises a valid point when he opines that states will discount the costs of defection relative to the likelihood of detection and, hence, that a substantial incentive is needed for them to comply with international financial norms. Conversely, by relying on traditional, hard-law instruments, he offers a simplistic cure – one that fails to account for the functional paradox of international financial law, which combines elements of formal, hard law and the gradual development of enforcement techniques, and operates in a distinctive institutional ecosystem dominated by soft law.

[102] Regarding international financial law, see, e.g., Lastra, *supra* note 3, 793.

[103] Pauwelyn, Wessel and Wouters 'When Structures Become Shackles: Stagnation and Dynamics in International Lawmaking', 25(3) *EJIL* (2014) 733.

[104] Specialized international institutions such as the Basel Committee are using expert monitoring and peer review. Also, 'hard law' organizations, such as the IMF, the World Bank (WB) and the Bank for International Settlements, advance these efforts in a supporting or monitoring capacity. The FSB, in coordination with the IMF and the WB, has adopted some of the most important promulgations of the standard-setting bodies as basic principles to which every member of the FSB is expected to subscribe.

[105] Over the long run, uncooperative, self-interested regulators can expect to lose the assistance of other actors within the international financial system. Countries that fail to follow an international regulatory consensus, such as a tightening of risk-based capital requirements for banks, jeopardize their financial sector's access to foreign markets.

[106] For an outstanding analysis of the different supervisory and compliance mechanisms in international financial law, see Brummer, *supra* note 76, at 143–161.

[107] *Ibid.*, at 162.

6 Conclusion

The prevailing approach among legal scholars over the last decade has been to view international financial collaboration as a resolutely cooperative venture that cannot be reduced to the interests or relative power of individual states.[108] Moving along this line, *The Logic of Financial Nationalism* claims that the protection of financial nationalism contributes to the creation of global systemic risks. Even more fundamentally, it contends that the ultimate cause of global financial instability is the very configuration of international financial law and, specifically, a number of principles and legal doctrines, which are either corollaries or strictly related to state sovereignty. Each area analysed by Lupo-Pasini (regulation, supervision and crisis resolution) provides examples that highlight different dimensions of financial nationalism. The picture drawn out is impressive. And yet, despite the appetite for theories that explain it all, the relationship between state sovereignty and modern financial markets eschews an easy answer. For one thing, regulators often differ in what they view as acceptable risks. Where they agree, their conduct can converge on ineffective standards, which are then internalized by firms and the greater economy.[109] More importantly, financial regulation involves various trade-offs. By way of example, some poor countries may want to use their financial system more actively in a developmental way, by allowing financial cross-subsidization or directed lending.[110] Others may consider this approach too interventionist and prefer more market-based systems. And both choices are defensible on a priori grounds.[111] Further, in international financial law, even merely 'sectorial' innovations may have major distributive implications. The institution of a multilateral debt-restructuring mechanism with a dedicated sovereign debtor's court is a good example. Granted, the establishment of such an institution could address the organizational problems currently faced by creditors during a restructuring, and also replace national courts as the only avenues for creditors' litigation.[112] However, economic literature shows that, under certain circumstances, creditors abuse the lack of proper governance in developing countries by lending to them under murky financial arrangements.[113] Not surprisingly, this may lead to corruption, misuse of public resources and, ultimately, macroeconomic instability.[114]

108 See Slaughter and Zaring, 'Networking Goes International: An Update', 2 *Ann. Rev. L. Soc. Sci.* (2006) 211, at 215–217.

109 Whitehead, 'Destructive Coordination' 96(2) *Cornell Law Review* (2011) 323, at 326–327.

110 I cannot but note that, when discussing the prospect of what seem to be radical forms of financial convergence, legal scholars often mention only in passing the related implied loss of fiscal sovereignty.

111 Rodrik, *supra* note 8, at 262–266.

112 Lupo-Pasini, *supra* note 9, at 283–286; Lastra *supra* note 3, at 798–799.

113 See, e.g., C. M. Reinhart and K. S. Rogoff, *This Time Is Different: Eight Centuries of Financial Folly* (2009); Panizza, Sturzenegger and Zettelmeyer, 'The Economics and Law of Sovereign Debt and Default', 47(3) *Journal of Economic Literature* (2009) 651.

114 A recent loan to Mozambique is a case in point. Mozambique received a loan for US$760 million, which was never approved by the Parliament, and the financial terms of which required the government to repay a staggering US$1.7 billion to US$2.2 billion. While the loan was granted for systemic improvements of the domestic fishing industry, reports allege that it was used instead for military equipment. See Jones, '"Outrageous" Mozambique Debt Deal Could Make 270% Profit for Speculators', *Jubilee Debt Campaign* (7 November 2018), available at https://jubileedebt.org.uk/blog/outrageous-mozambique-debt-deal-could-make-270-profit-for-speculators.

Difficulties in reconciling global financial stability and the preservation of sovereignty in the financial/economic realm therefore remain. And, like it or not, the challenge of coordination is and will likely continue to be addressed mainly through soft law promulgated by international standard-setters. Viewed dynamically these forms of soft legalization offer strategies for individual/collective learning and rapid adaptation to new risks. International law in this area must indeed 'have the capacity to observe, analyze and adapt as necessary. Normal methods of making international law by custom or treaty are likely to be too slow, and too politically charged, to be feasible'.[115] Thus, some degree of delegation of powers to regulatory agencies appears necessary. Further, upon close inspection, international financial law can be 'harder' than its soft-law quality suggests. Yet, even soft financial law is no panacea. Ironically, it is where soft financial law is effective that the problem of legitimacy arises.[116] Also, in the long term, other reforms will likely have to be made as international financial law becomes an increasingly critical element of the global financial system. Other works suggest some good starting points for future research. For one, more robust monitoring is needed. Here, existing institutions can be improved by making compliance with global inspection and surveillance processes mandatory, and the information gained from monitoring more useful and utilizable for investors and regulators alike.[117]

[115] Trachtman, *supra* note 4, at 740.

[116] See extensively A. L. Newman and E. Posner, *Voluntary Disruptions: International Soft Law, Finance, and Power* (2018); Brummer, *supra* note 76, ch. 4.

[117] Brummer, *supra* note 76, at 161–172.