I. INTRODUCTION

International financial regulation has developed as a response to the recognition that the financial system is truly global, and that actions
taken by a financial institution on one side of the world can have important ramifications for people living on the other. If this was not already self-evident prior to 2008, it became abundantly clear during the Financial Crisis, when the subprime mortgage crisis in the United States acted as a trigger for a global bank run. The post-Crisis international regulatory discourse has thus focused squarely on promoting the stability of the financial system, with the aim of avoiding or mitigating the global negative externalities that can result from the failure of financial institutions and markets. However, despite an overwhelming consensus around this goal, there is no clear agreement at the international level about what “financial stability” is.

In the post-Crisis era, it is probably true that there is some level of amorphous shared understanding of “what kind of thing financial stability is about,” but a detailed consensus on the meaning of “financial stability” is lacking. Some view financial instability as largely a “First World problem,” while others see it as a matter of global concern. Similarly, some view “financial stability” as synonymous with addressing “too big to fail” banks, whereas others argue for more imagination in anticipating the sources of future instability. Schisms in approaches to

3. See Brummer, supra note 1, at 265.
4. See infra Part II.
6. John Coffee, for example, states that “[t]he major financial nations—mainly the U.S. and Europe—did suffer from the 2008 crisis, while other nations with less developed financial infrastructures largely escaped damage.” John C. Coffee, Extraterritorial Financial Regulation: Why E.T. Can’t Come Home 14 (2014).
financial stability also result from cultural differences and divergent national interests.\textsuperscript{10} For example, European countries tend to view the failure of even one financial institution as unacceptable instability, while the United States is more tolerant of such failure.\textsuperscript{11} As such, international financial regulation should not proceed on the assumption that a consensus regarding the meaning of “financial stability” exists.

This Article argues that international financial regulation needs to be much more preoccupied with the content of the term “financial stability.” A lack of clarity regarding the goal of “financial stability” undermines efforts to harmonize financial stability regulation, and this will become increasingly apparent as international financial regulation embraces more goal-oriented, macroprudential tools.\textsuperscript{12} Determinations of functional equivalency, the operation of transnational supervisory colleges, and the conduct of Financial Sector Assessment Programs (FSAPs), are other practices that may be undermined by conflicting interpretations of “financial stability.”\textsuperscript{13} Therefore, in order to improve the efficacy of financial stability-related standards and practices, it is essential that the international financial regulatory community work towards developing a shared understanding of what “financial stability” is.\textsuperscript{14} To that end, this Article proposes the following definition of “financial stability,” which reflects both technical notions about the state of financial institutions and markets during periods of stability, and a value-based assessment of the function of the financial
system as a means to broader economic prosperity, rather than an end in itself:15

The term “financial stability” shall mean a state of affairs wherein (i) financial institutions and markets are able to facilitate capital intermediation, risk management, and payment services in a way that enables sustainable economic growth; (ii) there is no disruption to the ability of financial institutions or markets to carry out such functions that might cause harm to persons (wherever they may be resident) who are not customers or counterparties of those financial institutions, nor participants in those financial markets; and (iii) financial institutions and markets are able to withstand economic shocks (such as the failure of other markets and institutions, or a chain of significant loses at financial institutions) so that (x) there will be no disruption to the performance of the functions set forth in (i) and (y) no harm will be caused to the persons set forth in (ii).

Of course, this is not the only possible construction of “financial stability.” However, this Article aims to achieve two things in promulgating a plausible working definition. First, it seeks to focus attention on the technical and social aspects that should be considered in developing any definition of the term. Second, it intends to inspire a debate about the content of such definition. The expectation is that such debate will elicit people’s different conceptions of what is meant by “financial stability,” and thus shatter any implicit assumptions that there is consensus with regard to the goal of international financial stability.

The remainder of this Article proceeds as follows. Part II briefly explores the lacunae in international financial regulation with respect to the concept of “financial stability,” and Part III explains why these lacunae are problematic. Part IV then works through the issues that inform this Article’s definition of “financial stability” before exploring some of the implications of such an expansive definition for regulatory legitimacy and resource allocation. Part V concludes.

II. The Current Lack of Clarity

International financial regulation has been described as a series of standards, propounded by informal networks of technocrats from

15. See infra Part IV.
around the world. These networks include the Financial Stability Board (FSB), the Basel Committee on Banking Supervision (BCBS), the International Organization of Securities Commissioners (IOSCO), and the International Association of Insurance Supervisors (IAIS). Also participating in international financial regulation are the more formalized institutions of the International Monetary Fund (IMF) and the World Bank. When looking for the sources of international financial regulation, we look to the standards promulgated by these institutions, and to their foundational documents.

Unfortunately, the standards, charters, and mandates that have been published to date provide little clarity or context regarding the meaning of “financial stability.” For example, the Charter of the FSB—which emerged from the Financial Crisis as a body with oversight over the BCBS, IOSCO, and IAIS—states that “financial stability” is its core mission. Members of the FSB also commit to “pursue the maintenance of financial stability,” yet there is no attempt to define what is meant by “financial stability.” Similarly, the BCBS has a mandate “to strengthen the regulation, supervision and practices of banks worldwide with the purpose of enhancing financial stability,” but that mandate does not make clear what is meant by “financial stability.”

17. The FSB draws its membership from financial regulators and central banks in the G20 nations, as well as the IMF, the World Bank, the OECD, the Bank for International Settlements (BIS) and various international standard setters. Financial Stability Board, Charter of the Financial Stability Board, Annex A (Jun. 2012).
19. IOSCO is the network comprised of securities regulators from around the world. It is a larger and more inclusive body, comprising securities regulators from over 110 countries. International Organization of Securities Commissions, Fact Sheet, 2 (June 7, 2014, 10:36 AM), http://www.iosco.org/about/pdf/IOSCO-Fact-Sheet.pdf.
20. The membership of IAIS is also large: it is made up of insurance supervisors and regulators from nearly 140 nations. International Association of Insurance Supervisors, About the IAIS (June 7, 2014, 10:36 AM), http://www.iaisweb.org/About-the-IAIS-28.
22. Id. at 693.
23. “In collaboration with the international financial institutions, the FSB will address vulnerabilities affecting financial systems in the interest of global financial stability.” Financial Stability Board, supra note 17, at 2.
24. Id. at 3.
either. The Basel III standards promulgated by the BCBS do note that their objective is to “improve the banking sector’s ability to absorb shocks arising from financial and economic stress, whatever the source, thus reducing the risk of spillover from the financial sector to the real economy.”26 This language is somewhat helpful, but Basel III focuses narrowly on the banking sector and therefore does not give much guidance as to what is meant by stability for the financial system as a whole. And while Article IV of the IMF’s Articles of Agreement provides that “a principal objective is the continuing development of the orderly underlying conditions that are necessary for financial and economic stability,”27 it again gives no indication of what “financial stability” means. The key sources of international financial regulation, then, are lacking any clear statement about what is meant by “financial stability.”

This is not a situation where the domestic law of the key financial players offers much assistance, either. The Dodd-Frank Act, passed in the United States in the wake of the Financial Crisis, refers to “financial stability” no less than ninety-seven times without ever defining the term.28 Section 1A of the United Kingdom’s Bank of England Act of 1998 notes that protecting and enhancing the stability of the U.K. financial system is one of the objectives of the Bank of England without giving any color as to what is meant by such stability.29 At the European Union level, the regulation establishing the new European Systemic Risk Board does not define financial stability, but it does give some guidance in the form of a definition of “systemic risk” as “a risk of disruption in the financial system with the potential to have serious negative consequences for the internal market and the real economy.”30 Nonetheless, this regulation still assumes a shared understanding of


29. See Financial Services Act, 2012, 2 (Eng. Part 1, http://www.legislation.gov.uk/ukpga/2012/21/pdfs/ukpga_20120021_en.pdf). While amendments were made to this legislation late in 2012, none of these amendments sought to elaborate upon what is meant by the “stability of the financial system of the United Kingdom.”

what constitutes the “financial system” when there is no such understanding at present.

III. The Need For Consensus

The previous Part made it clear that international financial regulation does not proffer any formal definition of “financial stability.” This Part explores why the absence of consensus regarding the meaning of “financial stability” is, in fact, problematic.

At its most basic level, “a good definition is a prerequisite for good policy.”\(^{31}\) Given the prominence of financial stability as a policy goal, it is important that thought be given to its meaning so as to enable the formulation of cohesive policy solutions to achieve it.\(^{32}\) Furthermore, situations will arise where international financial stability regulation will require national regulators to sacrifice some national interest (often financial industry competitiveness),\(^{33}\) and such sacrifice is very difficult to justify in the absence of a fulsome explanation of what international financial stability is and why it is so important—the legitimacy of financial stability regulation as a goal of international financial regulation is dependent on people understanding and supporting it.\(^{34}\) At a more granular level, there are a number of context-specific arguments for a shared definition of “financial stability,” which this Part will explore.

A. Consensus as a Precondition for Harmonization

First and foremost is the need for a common definition to facilitate harmonization—the \textit{raison d’être} of international financial regulation. International financial regulation arose as a response to national concerns about the globalization of capital flows, which pose a host of difficulties for domestic financial regulation.\(^{35}\) National regulators are limited in their abilities to deal with the domestic activities of international financial conglomerates, and even the fates of purely domestic institutions can be inextricably linked with those of their foreign

\begin{itemize}
  \item \textsuperscript{31} Allen & Wood, \textit{supra} note 5, at 153.
  \item \textsuperscript{32} Id. at 153-54.
  \item \textsuperscript{33} D’Hulster, \textit{supra} note 10, at 11.
  \item \textsuperscript{34} This raises concerns about legitimacy that are additional to the legitimacy concerns usually voiced about international financial standards; namely, that they are formulated by technocrats with no democratic accountability, and often foisted upon nations that were not involved in the development of those standards. Brummer, \textit{supra} note 1, at 307-09.
  \item \textsuperscript{35} Id. at 265-67.
\end{itemize}
counterparties. To the extent that national regulators attempt to address these concerns with national rules, they need to be concerned with both the potential for regulatory arbitrage, and the fear that overly stringent national regulation will cause the national financial industry to decamp to laxer pastures. The international consensus is that the best way to address these concerns is to attempt to coordinate the rules that apply to international financial activity. As such, international financial regulation has developed as a compilation of harmonized international standards.

International financial regulation operates on the principle of subsidiarity, where “the power to apply and interpret the [standards vests] not in the networks...but in the agencies [i.e. national regulators] that belong to the networks.” With varied national actors applying and interpreting such standards, there is always the risk that any consistency generated by international agreement will be lost during implementation by different national regulators, especially when national interest and cultural differences affect that implementation. While these differences in national implementation will always persist to some extent, the harmonized implementation of financial stability-related standards is even less likely when those standards lack a clearly defined goal and rationale.

Admittedly, where international standards are technical and prescriptive, a shared understanding of the standards’ ultimate goals is perhaps less vital to their harmonized national implementation. Basel III’s risk-based capital standards (other than the countercyclical buffer discussed below) are a case in point. These standards require banks to fund a certain percentage of their risk-weighted assets with equity and

36. Coffee thus characterizes financial stability as a classic “tragedy of the commons.” Coffee, supra note 6, at 18-21.
37. Brummer, supra note 1, at 267-68.
38. Zaring, supra note 16, at 691.
39. Brummer, supra note 1, at 268-69 (discussing the calls from policymakers and scholars for greater coordination).
42. Riles, supra note 40, at 2.
equity-like instruments,\textsuperscript{44} and they are so detailed and prescriptive that consistent national implementation is possible, even in the absence of agreement as to their ultimate purpose. However, post-Financial Crisis, it is clear that microprudential regulations like the Basel III capital standards (again, excepting the countercyclical buffer), which are targeted at the safety and soundness of individual institutions, are insufficient to address many of the risks that are endogenous to the financial system as a whole.\textsuperscript{45} As such, financial regulation is starting to focus on the use of macroprudential regulatory tools,\textsuperscript{46} which, at least at present, are less prescriptive and rely more on an understanding of the end goal of financial stability. The more creative and unusual the macroprudential tool being employed, the more important it is to tie it to a specific regulatory outcome to ensure consistent implementation.

For example, the countercyclical capital buffer outlined in the Basel III standards will require national authorities to “monitor credit growth and other indicators that may signal a build up of system-wide risk and make assessments of whether credit growth is excessive and is leading to the build up of system-wide risk,”\textsuperscript{47} and if the circumstances warrant, require banks to fund their risk-weighted assets with up to 2.5\% more common equity than would otherwise be required.\textsuperscript{48} This type of assessment leaves a lot of discretion to national regulators, so consensus about financial stability—the desired end goal of the countercyclical capital buffer—will be a precondition to any consistent national implementation of the buffer. Furthermore, any decision to implement a countercyclical capital buffer is likely to be extremely unpopular.\textsuperscript{49} Although developing a shared understanding of “financial stability” will not dispose of political economy concerns about such a buffer, a

\textsuperscript{44} For a more detailed explanation of these standards, see Hilary J. Allen, \textit{Let’s Talk About Tax: Fixing Bank Incentives to Sabotage Stability}, 18 FORDHAM J. CORP. & FIN. L. 821, 830-31 (2013).


\textsuperscript{46} Id. at 3.

\textsuperscript{47} Basel Comm. on Banking Supervision, \textit{Basel III}, supra note 26, at 57. This requirement will not become fully effective until January 1, 2019. \textit{Id.} at 60.

\textsuperscript{48} Id. at 58.

clear financial stability mandate does provide some measure of legitimacy for the buffer.50

Basel III’s countercyclical buffer is not the only macroprudential tool being considered at the international level.51 In 2010, the leaders of the G20 nations specifically “called on the FSB, IMF, and BIS to do further work on macroprudential policy frameworks, including tools to mitigate the impact of excessive capital flows,”52 and so significant effort has been invested in developing macroprudential tools. Consensus regarding the goal of financial stability lends legitimacy to, and is a practical precondition for, international efforts to develop and harmonize the use of these tools.

B. Consensus Is Valuable Even for Harmonization Skeptics

The foregoing discussion has taken as a given that there is a broad international consensus around harmonization as the desiderata of international financial regulation, but this should not be read as implying that everyone concurs on the benefits of international regulatory harmonization. Roberta Romano, for example, has argued that the global harmonization of financial regulation “magnified the sever-
ity and global reach of the crisis” by incentivizing banks to hold assets with correlated risk exposures in a manner that proved destabilizing once those risks came to fruition.\footnote{Roberta Romano, For Diversity In The International Regulation of Financial Institutions: Critiquing and Recalibrating the Basel Architecture 5 (Yale Law & Economics Research Papers, Working Paper No. 452, 2013), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2127749.} Katharina Pistor has noted the potential for international financial regulation to hamstring sovereign nations who wish to intervene in crises that are unanticipated by international rules.\footnote{Katharina Pistor, A Legal Theory of Finance, 41 J. COMP. ECO. 315, 328 (2013).} Annelise Riles has focused on the reality that attempts to harmonize international rules often counterproductively create further opportunities for regulatory arbitrage because of differences in (and different paces of) national implementation.\footnote{Riles, supra note 40, at 2.} None of these critiques, however, rejects financial stability as an appropriate normative goal of international financial regulation. Riles describes financial stability as a “laudable goal”\footnote{Riles, supra note 40, at 2.} Pistor finds fundamental instability inherent in the financial system but nonetheless supports efforts to mitigate it;\footnote{See Pistor, supra note 54, at 323.} and Romano’s central position is that harmonization is problematic because it is not the best way to address systemic risk and engender financial stability.\footnote{Romano, supra note 53, at 5.} Similarly, while John Coffee argues that there are limitations on what soft law can achieve in promoting financial stability, he concurs that financial stability is the end goal that should be pursued.\footnote{Coffee, supra note 6, at 18.} As such, critics of regulatory harmonization tend to recognize the importance of financial stability as a goal; they just advocate a different way of achieving it. Just as for proponents of harmonization, these critiques would benefit from a concrete shared understanding of what is meant by “financial stability.”

C. Some Practical Consequences of Consensus Failure

This Subpart highlights a number of highly practical reasons for defining “financial stability” and emphasizes that this issue is not just of academic import. For example, regimes of substituted compliance (especially as they relate to derivatives regulation) are currently a hot
topic amongst U.S. and European regulators. In such regimes, national regulators defer to foreign regulation to the extent it is deemed “functionally equivalent” to the home state’s regulation. To the extent that substituted compliance regimes are targeted at the promotion of financial stability, an assessment of functional equivalency necessitates a shared understanding of what financial stability actually is. To give a concrete example, how can national regulators assess whether European rules requiring “ringfencing” (i.e. moving trading activity out of deposit-taking banks and into separately capitalized legal entities, albeit within the same corporate conglomerate as banks) are equivalent, in terms of protecting financial stability, to the U.S. Volcker Rule’s prohibition on banking entities engaging in proprietary trading, if they do not agree on what financial stability actually looks like?

Another practical reason for defining “financial stability” arises in the context of transnational supervisory colleges for multinational financial institutions. The FSB promotes the use of these colleges, which consist of both home country and host country supervisors, as the best way to monitor financial institutions with significant trans-border operations. These colleges have “the primary objective of exchanging information and establishing a dialogue in order to ensure that they are able to identify and address the main risks across a banking group.” However, differences in approaches to financial stability between home and host country supervisors can undermine effective cross-border supervision. That is not to say that the lack of a consistent financial stability mandate is the only obstacle in the way of supervisory colleges, but regulatory cooperation is certainly ham-

60. Id. at 20-22.
61. Id. at 12.
62. For a discussion of the functional equivalence of ring-fencing versus the Volcker Rule, see id. at 58-63.
63. Part of the FSB’s mandate is to “set guidelines for and support the establishment of supervisory colleges.” Financial Stability Board, MANDATE, available at http://www.financialstabilityboard.org/about/mandate.htm.
64. D’Hulster, supra note 10, at 1.
65. Id. at 12.
66. D’Hulster has also noted that supervisors within these colleges are subject to capture, can be overly nationally interested, and can have different tolerance for failure, confidentiality concerns, legal constraints, constraints on the capacity of supervisory agencies, doubts about the quality of supervision, the geographic risk profile of the banking group, the stage of supervision and lack of a common terminology, legal framework and prudential reporting systems. Id. at 28.
pered when regulators are not starting from the same baseline understanding of what they are trying to achieve.67

Consensus regarding stability is also important in the context of the IMF’s mandatory FSAP for countries with systemically important financial sectors.68 The FSAP comprises a stability assessment intended to “identify the main vulnerabilities that could trigger” a financial crisis,69 which evaluates “three components: (1) the source, probability, and potential impact of the main risks to macro-financial stability in the near-term; (2) the country’s financial stability policy framework; and (3) the authorities’ capacity to manage and resolve a financial crisis should the risks materialize.”70 The IMF then makes recommendations to national policymakers based on the results of the assessment.71 Given that the IMF retains responsibility for stability assessments and employs a consistent methodology in carrying them out, the absence of an internationally-agreed upon definition of “financial stability” might be perceived as less of a handicap on consistency here than in situations when different institutions are implementing rules on the basis of different assumptions about stability. However, the reality is that the FSAP process relies heavily on self-reporting by the nations being assessed.72 Without a concrete baseline for what constitutes “financial stability,” national self-reporting on the source, probability, and potential impact of risks to financial stability in each nation may vary widely from nation to nation. To the extent financial stability assessments are not based on comparable data, this will compromise the IMF’s ability to identify similar risks building up in similar nations, and thus the IMF may miss the development of transnational financial risks.

IV. WHAT DO WE MEAN BY “FINANCIAL STABILITY”?  
Given the concerns raised in Part III of this Article, it is somewhat surprising that academics and policymakers who have paid an enormous amount of attention to the goal of financial stability have invested

67. Id. at 12.
71. Id.
72. Brummer, supra note 1, at 291.
very little effort in refining the definition. At both the national and international level, most seem content to refer to “financial stability” without defining it. The Bank for International Settlements (BIS) pithily encapsulated this mentality when it noted that “the less-than-ideal definition of financial stability has not usually been regarded as a fundamental barrier to getting on with the job.”73 The previous Part makes clear the problems with this mentality. While people do share some level of common intuition regarding the contours of financial stability,74 this Part aims to flesh out that intuition into something more concrete that can be applied more consistently. The definition of “financial stability” proposed in the Introduction is directly informed by the discussion in this Part.

A. What Constitutes Stability?

Most of the limited literature available on defining “financial stability” actually predates the Financial Crisis,75 and much of this literature defines financial stability in relation to its inverse: financial stability is viewed as the absence of a financial crisis.76 This line of thought suggests that financial stability exists so long as there are no limits on capital availability resulting from the failure of the financial system, but this type of definition is not overly satisfying. It implies that we had financial stability immediately prior to the Financial Crisis, notwithstanding that the financial system was harboring all kinds of latent weaknesses and amplification mechanisms that only really become apparent upon the failure of Lehman Brothers. A prosperous bubble should not


74. “It is . . . clear what kind of thing financial stability is about. It is about institutions not suddenly collapsing and causing economic damage to people who could not reasonably have been expected to anticipate the collapse.” Allen & Wood, supra note 5, at 152-53.

75. For a survey of the literature, see Bank for International Settlements, supra note 73, at 31-33.

76. In 2004, British economist Charles Goodhart commented that when a group of experts was asked to define financial stability, “the most persuasive responses were that it was just the absence of financial instability.” Charles Goodhart, Per Jacobsson Lecture, in Zurich, Switzerland (June 27, 2004), available at http://www.bis.org/events/agm2004/sp040627.htm. In the same vein, former Federal Reserve Governor Susan Schmidt Bies noted in 2005 that “financial stability implies that key institutions in the financial system are operating without significant difficulty and markets are generally functioning well.” Susan Schmidt Bies, Governor of the Federal Reserve Board, Remarks at the Central Bank of the Republic of Turkey’s International Conference on Financial Stability and Implications of Basel II, (May 17, 2005), available at http://www.federalreserve.gov/boarddocs/speeches/2005/20050517/default.htm.
be characterized as stable; nor should instability simply be accepted as an inevitable, *deus ex machina*, downside of the business cycle.

For these reasons, others have sought to define financial stability by reference to the financial system’s smooth functioning and resistance to shocks. For example, Y. V. Reddy, former Governor of the Reserve Bank of India, described financial stability not as the “absence or avoidance of crisis, but presence of conditions conducive to efficient functioning without serious disruption.” Tomasso Padoa-Schioppa, former Executive Board Member of the European Central Bank, suggested defining financial stability as “a condition where the financial system is able to withstand shocks without giving way to cumulative processes which impair the allocation of savings to investment opportunities and the processing of payments in the economy.” However, there are potential dangers inherent in defining financial stability solely by reference to the system’s ability to absorb shocks without worsening; it is possible that the financial system could deteriorate to such an extent that future shocks would not make any difference to the equilibrium of systemic dysfunction. We certainly would not want to characterize such a base state as “financial stability.”

Instead, the definition of “financial stability” proposed in this Article follows William Allen and Geoffrey Wood’s lead in combining the two approaches, asserting that financial stability is not merely the absence of crisis, but also the ability to absorb (rather than amplify) shocks. Clearly, when we are in the midst of a crisis, financial stability is absent, but financial stability is also absent when the financial system appears to be working well, but is operating in such a way that a shock (an event

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78. In her ethnography of Wall Street, Karen Ho notes that “Wall Street investment bankers as well as academic and popular analysis of finance often resort to an abstraction they call ‘the market’ to explain these crises . . . [which are] understood to be the organic results of, market cycles (what goes up must come down) with a dash of greed and hubris as human nature thrown in.” Karen Ho, *Liquidated: An Ethnography of Wall Street* 10-11 (2009).


such as the failure of a large financial institution) can imperil its ability to function. This conception of stability raises a further fraught and fundamental definitional question, however: what exactly is this “financial system,” the stability of which regulation is designed to promote?

B. The Functional Dimensions of the Financial System

Allen and Wood have argued that “[i]n defining financial stability, it should be borne in mind that it is not only financial institutions whose collapse can cause economic damage . . . Thus emergency official support is occasionally provided not just for financially distressed financial institutions, but also for non-financial companies, and for sovereign nations.”82 This suggests a very broad conception of the financial system, encompassing as it does institutions outside of the financial services sector. Similarly, a definition of “financial system” promulgated by the IMF in the years before the Financial Crisis describes it as consisting of “institutional units and markets that interact, typically in a complex manner, for the purpose of mobilizing funds for investment and providing facilities, including payment systems, for the financing of commercial activity.”83 “Institutional units” are again conceived of broadly, to include households, corporations and government agencies,84 rather than just institutions that provide financing in the ordinary course of business.

If we accept the breadth of these definitions, it is difficult to see any dividing line between the financial system and the economy in general, and thus between financial stability and macroeconomic stability.85 This definitional approach is difficult to square with the entire concept of financial regulation (domestic or international), which is ultimately premised on (and justified by) the ability of financial institutions to cause negative externalities for consumers and taxpayers in a way that non-financial institutions generally do not.86 Rather, to keep financial stability regulation from swallowing up the entire economy, there

82. Id. at 154.
84. “An institutional unit is an entity, such as a household, corporation, or government agency, that is capable in its own right of owning assets, incurring liabilities, and engaging in economic activities and transactions with other entities.” Id. at 11 n. 1.
85. For the distinction between financial stability and macroeconomic stability, see Blinder, supra note 50, at 279-80.
86. Id. at 278-79.
needs to be some sort of demarcating line between the institutions that populate the financial system, and the broader economy. But where do we draw that line?

It can be tempting to limit our conception of the financial system to categories of financial institutions, like banks, that are known to cause externalities when they fail, and thus are currently subject to prudential regulation.87 However, this is a problematic definitional approach.88 Prior to the Financial Crisis, many asserted that commercial banks were “special” institutions, because they alone were vulnerable to the runs and panics that precipitate financial crises.89 However, runs in the money market mutual fund and repo markets during the Crisis illustrated that susceptibility to runs was not unique to commercial banks.90 In fact, any intermediary that is subject to maturity mismatch (i.e. uses short-term funding to acquire longer-term assets) can be subject to runs and panics.91 Post-Crisis, many now recognize that “shadow banking” institutions (including money market mutual funds and securities firms) can precipitate financial instability,92 but the larger lesson is that we should never be overconfident about the categories of institutions that pose risks to financial stability. As such, a functional approach to delineating the financial system is preferable, whereby the institutions and markets that populate the financial system are identified by reference to what they are intended to achieve, rather than how they are branded.93

Of course, a functional approach necessitates an elucidation of what the functions of the financial system actually are. As I have explored in previous work, the financial system exists primarily to intermediate capital, and also to manage risk and provide payment services.94 Accordingly, this Article’s proposed definition of “financial stability” focuses on the ability of institutions and markets “to facilitate capital

87. At the international level, the key prudential standards are set out in Basel III. See generally Basel Comm. on Banking Supervision, Basel III, supra note, 26. The Basel standards have never been applied to the shadow banking sector. Allen, supra note 44, at 882.
88. “The difficulty with using an institutional approach to identify the elements of the financial system is that it is unlikely to be adaptive when the system is experiencing change.” Anabtawi & Schwarcz, supra note 49, at 85.
90. Gorton & Metrick, supra note 9, at 267.
91. Id. at 298-99.
92. Id. at 261-62.
93. See Anabtawi & Schwarcz, supra note 49, at 85.
94. Allen, supra note 9, at 183.
intermediation, risk management, and payment services,” rather than on institutions (such as non-financial corporations and households) that do not provide these functions.

This does not mean, however, that there are no systemic links between financial institutions, non-financial corporations, and households.\textsuperscript{95} Institutions outside of the financial system can certainly cause, and suffer, negative externalities as a result of financial instability: non-financial markets (like real estate) can provide the shock that sets off a financial crisis, and households and non-financial corporations suffer from the restrictions on credit that tend to flow from financial instability.\textsuperscript{96} Indeed, these links between the financial system and the broader economy are the reason why financial stability is such an important policy goal.\textsuperscript{97} It is important, then, that the definition of “financial stability” reflect that a stable financial system is not an end in itself—we care about financial stability because of “the close linkages between financial stability and the health of the real economy,”\textsuperscript{98} and because of the social costs of economic contractions.\textsuperscript{99} If financial instability only affected the profitability and solvency of institutions and markets within the financial system, then there would be less need to target financial stability as a policy goal, and less need to intervene when financial institutions or markets fail.

Unfortunately, “a distinguishing feature of financial instability is that innocent bystanders get hurt.”\textsuperscript{100} Failures of capital intermediation

\textsuperscript{95} Anabtawi and Schwarcz identify a “system” as characterized by connected component parts that function together in a way that is distinct from the functioning of the individual parts. See Anabtawi & Schwarcz, supra note 49, at 78.

\textsuperscript{96} Allen & Wood, supra note 5, at 157.

\textsuperscript{97} Allen, supra note 9, at 183-84.

\textsuperscript{98} For a discussion of these linkages (particularly the provision of credit), see ANDREW CROCKETT, WHY IS FINANCIAL STABILITY A GOAL OF PUBLIC POLICY? 8 (1997).

\textsuperscript{99} Janet Yellen made it clear that these social costs go beyond statistics. Commenting on the unemployment that resulted from the financial crisis of 2007-2008, she noted that “[w]e know that long-term unemployment is devastating to workers and their families. Longer spells of unemployment raise the risk of homelessness and have been a factor contributing to the foreclosure crisis. When you’re unemployed for six months or a year, it is hard to qualify for a lease, so even the option of relocating to find a job is often off the table. The toll is simply terrible on the mental and physical health of workers, on their marriages, and on their children.” Janet L. Yellen, A Painfully Slow Recovery for America’s Workers: Causes, Implications, and the Federal Reserve’s Response, Address at the “A Trans-Atlantic Agenda for Shared Prosperity” conference sponsored by the AFL-CIO, Friedrich Ebert Stiftung, and the IMK Macroeconomic Policy Institute, Washington, D.C. (Feb. 11, 2013) (transcript available at http://www.federalreserve.gov/newsevents/speech/yellen20130211a.htm).

\textsuperscript{100} Allen & Wood, supra note 5, at 160.
functions in particular (such as the provision of credit) often result in recessions that translate into social distress (for example, unemployment) for people who had no direct connection to any failed financial institution or market.\footnote{Allen, \textit{supra} note 9, at 183.} By referring to “\textit{harm to persons . . . who are not customers or counterparties of those financial institutions, nor participants in those financial markets},” this Article’s definition makes it clear that financial stability is concerned with the externalities of financial system failure suffered by persons, not because of their relationships with financial institutions, but as a result of the broad economic contractions that flow from financial crises.

C. \textit{The Geographical Dimensions of the Financial System}

The working definition of “financial stability” proposed in Part I recognizes no geographical boundaries. The underlying assumption is that any financial institution or market involved in effecting capital intermediation, risk management, or payment services is part of the global financial system and has the potential to generate instability, no matter where the institution is located or where the transaction is carried out. However, some may be tempted to prefer a narrower definition of “financial stability” that constrains the boundaries of the “financial system” to those nations with developed financial sectors (and thus narrows the focus of international financial stability regulation to those nations). After all, financial institutions and markets in the United States and Europe are certainly the most visible and seem most likely to cause harm if disrupted,\footnote{See Coffee, \textit{supra} note 6, at 14.} and many practical benefits would flow from narrowly construing the ambit of international financial stability regulation. For example, international financial regulation is usually developed by way of consensus,\footnote{Brummer, \textit{supra} note 1, at 273.} so if the international financial stability project is seen to involve only nations with advanced economies, then other nations could legitimately be excluded from the debate on international financial stability standards. Consensus within such a smaller group is likely to be more feasible than in a group with broader participation.\footnote{Id. at 308.} International financial regulatory bodies also face serious resource constraints,\footnote{The standards setters “are lightly institutionalized, with tiny, barely-capable secretariats, unable to go through the process of regulation without the secondment of domestic bureaucrats} so trying to monitor the compli-
ance of all nations with the standards developed is a daunting prospect. If only nations with advanced economies are considered relevant to international financial stability, the task of monitoring becomes more manageable.

Despite these practical advantages to narrowly construing the scope of financial stability, such an approach is artificially under-inclusive. An analogy helps illuminate why this is the case: at present, financial regulation (both national and international) is focused on systemically important financial institutions (“SIFIs”), as their size and interconnectedness provide an obvious transmission belt for risks that can imperil financial stability. However, financial instability arises not only as a result of risks being transmitted from counterparty to counterparty, but also where institutions have correlated exposures to similar risks, such that each institution will (or the markets assume that each institution will) suffer the same losses following an economic shock. We are thus remiss if we focus solely on SIFIs: if there are enough similarly situated financial institutions with correlated risk exposures, then we need to be concerned, even if the individual institutions are themselves small. By the same logic, correlated risks building up in a sufficient number of countries could also imperil global financial system stability, and thus those countries’ non-compliance with financial stability-related standards should not be entirely ignored, even if they have less developed financial sectors.

Furthermore, not only does each nation have the potential to generate financial instability, but each nation also has the potential to suffer from financial instability. While it may be fair to say that the financial institutions of nations with advanced economies suffer more from global financial instability than do the financial institutions of other nations, all national economies have the potential to suffer. This Article has stressed that the financial system is only a means to an end, and focusing international financial stability regulation only on the nations that house the large financial institutions inappropriately

106. JOSEPH STIGLITZ, Regulation and Failure, in NEW PERSPECTIVES ON REGULATION 17 (David Moss & John Cisternino eds., 2009).
109. See Coffee, supra note 6, at 14.
110. See infra notes 112-13.
111. See supra text accompanying notes 98-99.
privileges such institutions as the end goal of international financial stability regulation. Instead, we should care about financial stability because of the negative externalities that financial collapse imposes on the broader economy, including the negative externalities that failure of the advanced nations’ financial institutions imposes (directly or indirectly) on the economies of all other nations. The economies of developing nations certainly did not escape the fallout from the Financial Crisis,\footnote{The negative externalities of the Crisis for non-core nations have been heterogeneous: some escaped largely unscathed while nations with large mining and garment sectors tended to suffer more. See Dirk Willem te Velde et al., \textit{The Global Financial Crisis and Developing Countries} \url{http://www.odi.org.uk/sites/odi.org.uk/files/odi-assets/publications-opinion-files/5856.pdf}.} even if harm was not always transmitted to them through the financial system itself. The BCBS notes that “the crisis also spread to a wider circle of countries around the globe. For these countries the transmission channels were less direct, resulting from a severe contraction in global liquidity, cross-border credit availability and demand for exports.”\footnote{Basel Comm. on Banking Supervision, \textit{Basel III}, supra note 26, at 2.} It is therefore important to take a realistically expansive geographical view of the financial system when defining “financial stability.” As such, the definition proposed in Part I refers to “harm to persons (wherever they may be resident).”

Such an approach concededly raises questions about the involvement of nations other than the advanced economies in the regulatory process (in terms of allowing them input in crafting financial stability standards, as well as subjecting them to the standards created), and also about how to allocate finite regulatory resources. The present structure of the international financial regulatory system evinces a preference for restricting full participation in the financial stability standard-setting process to the more developed nations. The FSB and the BCBS, being the standard setters presently most concerned with financial stability,\footnote{See text accompanying notes 23-26.} are reasonably exclusive clubs of developed nations. The FSB’s member nations are Argentina, Australia, Brazil, Canada, China, France, Germany, Hong Kong, India, Indonesia, Italy, Japan, Korea, Mexico, the Netherlands, Russia, Saudi Arabia, Singapore, South Africa, Spain, Switzerland, Turkey, the United Kingdom, and the United States (as well as the European Union).\footnote{As will be discussed further below, a number of international organizations are also members of the FSB.} The BCBS comprises representatives...
of these same nations, and also Sweden and Luxembourg116 (this Article will refer to any nation that is a member of the FSB or the BCBS as a “core nation,” and any nation that is not a member of either as a “non-core nation”). Because non-core nations suffer as a result of financial instability,117 they have a legitimate interest in being involved in the development of international financial stability regulatory standards. Non-core nations also have an interest in the development of such standards because they may be required to comply with them through the process of IMF and World Bank conditionality.118

Fortunately, non-core nations are not entirely excluded from the standard-setting process: they have an indirect voice with respect to financial stability issues through their membership in the IMF, World Bank, IOSCO, and IAIS (all of which are member institutions of the FSB).119 The FSB has also made further progress in outreach to non-core nations over the last few years, implementing in 2011 six regional consultative groups120 that meet regularly with the FSB and provide a structured mechanism for:

(a) interaction of FSB members with non-members regarding the various FSB initiatives underway and planned;
(b) promoting implementation within the region of international financial policy initiatives; and
(c) the regional group members to share amongst themselves and with the FSB their views on vulnerabilities affecting the

117. See text accompanying notes 112-13.
118. Brummer, supra note 1, at 289. Pistor’s legal theory of finance suggests that non-core nations will be afforded less flexibility, in terms of compliance with international financial stability standards, than core nations are, even though core nations had a hand in developing the standards and non-core nations did not. Under Pistor’s theory, the flexibility at the core of the financial system derives from a realpolitik perspective about both the threat core participants pose to the stability of the financial system and the ability of those core participants to backstop the system. Non-core nations have more limited involvement in the financial system, and thus are less central to its proper functioning; they accordingly have less flexibility. See Pistor, supra note 54, at 320-23.
119. See supra text accompanying note 115.
120. These include Regional Consultative Groups for the Americas, Asia, the Commonwealth of Independent States, Europe, the Middle East and North Africa, and Sub-Saharan Africa. See Charter of The Financial Stability Board, Annex B (June 2012).
financial system, on FSB initiatives and on other measures that could be taken to promote financial stability.\textsuperscript{121}

This Article does not purport to make a judgment as to whether this is the optimal process for crafting international financial stability standards. It does, however, assert that by including non-core nations in the conversation (even if their direct consensus on the wording of the standards is not required), the existing process reflects a realistically expansive view of the geographical ambit of international financial stability regulation. There is no practical need to artificially define financial stability as only concerning the core nations, as the existing process finds a way to give all countries affected by regulation of the financial system some level of voice.

Having considered the standard-setting process, we now turn to issues of monitoring compliance with those standards, and of regulatory resource allocation. Because the definition of “financial stability” proposed in Part I is not confined to financial institutions and markets located in a particular geographic area, it embraces the reality that activities conducted in non-core nations have the potential to generate or exacerbate financial instability. Ideally, then, there would be sufficient resources available to monitor compliance with international financial stability standards in both core and non-core nations. However, given the reality of limited resources, it is perhaps not surprising that stability assessments conducted as part of the IMF’s FSAP program are mandatory only for the following nations deemed to have systemically important financial sectors: Australia, Austria, Belgium, Brazil, Canada, China, France, Germany, Hong Kong SAR, Italy, Japan, India, Ireland, Luxembourg, Mexico, the Netherlands, Russia, Singapore, South Korea, Spain, Sweden, Switzerland, Turkey, the United Kingdom, and the United States.\textsuperscript{122} Some visibility, however, is given to systemic risks building in non-core nations by way of the regional consultative groups discussed above,\textsuperscript{123} which provide the FSB with information regarding developing vulnerabilities.\textsuperscript{124} Again, this Article

\textsuperscript{121.} \textit{Id.} art. 20.


\textsuperscript{123.} See supra text accompanying notes 120-21.

\textsuperscript{124.} A country can also make a request for a voluntary FSAP Assessment, which request will be prioritized by the IMF based on “(i) the systemic importance of the country; (ii) macroeconomic or financial vulnerabilities; (iii) major reform programs that might benefit from
does not purport to say that the resource allocation balance that has been struck here is the optimal one. However, the FSB’s regional consultative groups provide some level of ongoing surveillance of non-core nations, which indicates that there is no need for an artificially narrow vision of international financial stability regulation that dismisses such surveillance of non-core nations as entirely unachievable (or entirely unnecessary).

In sum, while international financial stability regulation is a vast and daunting undertaking, the international financial regulatory architecture already in place has achieved some measure of balance between core and non-core nations in terms of both allocation of resources and participation. It is therefore unnecessary to use a working definition of “financial stability” that is artificially narrow, in terms of its geographic scope, for purely practical reasons.

V. Conclusion

Because neither the financial system nor the social costs of financial system failure recognize national boundaries, financial stability regulation must, by necessity, be an international project. However, this Article has made it abundantly clear that there is not yet any detailed consensus at the international level regarding what “financial stability” means. Given that “much of the point [of international financial regulation] is to ensure that the same sort of work is done in the same sort of way,”125 international financial stability regulation will be undermined to the extent that it is implemented by nations with differing conceptions of financial stability as an end goal. This Article seeks to challenge any assumption that there is already a detailed consensus regarding the definition of “financial stability,” or that such detailed consensus is unimportant, and, in doing so, focus international attention on the important task of developing baseline definitional commonality. As a starting point in this endeavor, this Article articulates a plausible working definition of “financial stability” that draws attention to the true end goal of international financial stability regulation: protecting people, no matter where they live, from the broad economic contractions that flow from financial system failure.

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