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Breaking Up Is Hard to Do: The Interconnection Problem in Financial Markets and Financial Regulation, a European (Banking) Union Perspective

CAROLINE BRADLEY*

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INTRODUCTION

Financial stability and policies to ensure financial stability are, as a result of the global financial crisis, prominent as objectives of financial regulation and require rethinking regulation and its administration.[1] As policymakers and regulators who focus on financial markets develop responsibilities for financial stability, they are increasingly focusing on interconnectedness: how financial-market activity interconnects across territorial borders, across market sectors, and through transactional linkages.[2]

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1. *See, e.g.*, BANK OF ENG., FINANCIAL STABILITY REPORT 6–10 (June 2013) (reporting on the financial stability of the United Kingdom as required by law); Paul Tucker, *Competition, the Pressure for Returns, and Stability*, *in* STABILITY OF THE FINANCIAL SYSTEM: ILLUSION OR FEASIBLE CONCEPT? 200, 200 (Andreas Dombret & Otto Lucius eds., 2013) (discussing the overhaul of the banking system by international authorities); TOBIAS ADRIAN ET AL., FED. RESERVE BANK OF N.Y., FEDERAL RESERVE BANK OF NEW YORK STAFF REPORTS: FINANCIAL STABILITY MONITORING 2–3 (2013) (presenting a monitoring program to promote financial stability); *cf.* Stavros Gadinis, *The Financial Stability Board: The New Politics of International Financial Regulation*, 48 TEX. INT'L L.J. 157, 161 (2013) (arguing that new arrangements for coordinating transnational financial regulation through the G20 and FSB "constitute a stark departure from the paradigm of networks of independent regulators").

2. *See, e.g.*, Int'l Monetary Fund [IMF], *The IMF's Financial Surveillance Strategy*, at 4 (Aug. 28, 2012) [hereinafter IMF, *Surveillance Strategy*] (highlighting the interconnectedness of the modern financial

By emphasizing geographic, sectoral, and transactional interconnectedness (and by emphasizing that the different interconnections are themselves linked), supranational bodies legitimate supranational action and their claims to exercise controls over domestic actions.[3] Supranational bodies can claim the ability to address transnational issues in ways that would be difficult for domestic actors,[4] even when those domestic actors participate in transnational networks.[5] Ultimately, the legitimacy of those domestic actors may be called into question: Dirk Schoenmaker, for example, argues for recognition of a "financial trilemma" in which financial stability, financial integration, and national financial policies cannot coexist.[6] Supranational bodies—although subject to constraints in their founding documents—are free of the restrictions that national law may place on domestic regulators, restrictions that impede coordination between sectoral regulators domestically.[7]

But recognizing that increased interconnectedness in financial markets increases the risk of financial instability does not mean that supranational bodies will in fact be able to address issues effectively. Governance is multilevel and dispersed rather than centralized.[8] As a practical matter, networks of domestic regulators (such as the Basel Committee on Banking Supervision)—which focus on their own financial sectors—are important for the development of international standards of financial regulation,[9] and supranational bodies such as the International Monetary Fund

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world); *see also* Fin. Stability Bd. [FSB], *Shadow Banking: Strengthening Oversight and Regulation*, at 3–4 (Oct. 27, 2011) [hereinafter FSB, *Shadow Banking*] (discussing the importance of regulating shadow-banking entities and their impact on financial networks across borders); FIN. SERVICES AUTH., THE TURNER REVIEW: A REGULATORY RESPONSE TO THE GLOBAL BANKING CRISIS 36–37 (2009) [hereinafter THE TURNER REVIEW] (discussing the international character of the 2007 financial crisis and internationally focused solutions for avoiding such financial problems in the future).

3. *See, e.g.*, IMF, *Surveillance Strategy*, *supra* note 2, at 4 (noting how the "realization that the failure of one bank in one country can bring the global economy down" has changed the contours of thinking and policy making, and how the IMF is "uniquely placed to respond to new global financial challenges").

4. *E.g.*, *id.* at 13

> (Even though financial globalization is here to stay, the architecture for safeguarding financial stability remains predominantly national. This means that the capacity of country authorities to cope with global or multi-country shocks is severely constrained. The Fund, with its global membership, is uniquely placed to mobilize peer pressure and collective action.).

5. *See* Dirk Schoenmaker, *The Financial Trilemma*, 111 ECON. LETTERS 57, 57 (2011) (arguing that as international economic integration increases, individual nations' powers with respect to financial policy should decrease); C.A.E. Goodhart, *Myths About the Lender of Last Resort*, 2 INT'L FIN. 339, 352 (1999) (noting that increasing integration of the euro zone financial systems would highlight the disjunction between a centralized European Union (EU) monetary system and decentralized national fiscal policies).

6. Schoenmaker, *supra* note 5, at 57 ("The financial trilemma states that (1) financial stability, (2) financial integration and (3) national financial policies are incompatible. Any two of the three objectives can be combined but not all three; one has to give.").

7. *Cf.* Basel Comm. on Banking Supervision [BCBS], *Review of the Differentiated Nature and Scope of Financial Regulation: Key Issues and Recommendations*, at 3 (Jan. 2010) (acknowledging that sector-specific regulation can lead to regulatory gaps that cause "supervisory challenges and present[] opportunities for regulatory arbitrage").

8. Liesbet Hooghe & Gary Marks, *Unraveling the Central State, but How? Types of Multi-level Governance*, 97 AM. POL. SCI. REV. 233, 233 (2003) ("Modern governance is—and, according to many, should be—dispersed across multiple centers of authority."); Paul Cairney, '*Public Administration in an Age of Austerity*': *Positive Lessons from Policy Studies*, 27 PUB. POL'Y & ADMIN. 230, 235 (2012) ("In turn, 'multi-level governance' describes the dispersion of power from national central governments to other levels of government and non-governmental actors. It stresses the blurry boundaries between formal sources of authority and informal sources of influence when decisions are made in a rather messy policy making arena.").

9. *See, e.g.*, DUNCAN WOOD, GOVERNING GLOBAL BANKING: THE BASEL COMMITTEE AND THE

(IMF) and European Union (EU) must cooperate with these standard setters.[10] Supranational bodies are limited by the powers they derive from their founding treaties,[11] and incursions on domestic sovereignty are controversial.[12] The experience of the EU[13] suggests that harmonization of financial regulation is necessarily a slow and incremental endeavor even in an environment where states have made treaty commitments to harmonization[14]: each new measure builds on those that precede it.[15] In practice, therefore, transnational standards bodies rely on domestic regulators to implement the standards they promulgate.[16] And domestic regulators—rather than transnational regulators—attempt to achieve transnational financial regulation otherwise than through formal and binding harmonization.[17] Jurisdictions recognize the regulatory schemes of other jurisdictions,[18] and domestic regulators agree to

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POLITICS OF FINANCIAL GLOBALISATION 1 (John J. Kirton et al. eds., 2005) (arguing that the Basel Committee "has become one of the central organs of global economic governance" as it has "play[ed] an integral role in shaping the rules of the international financial system").

10. *See, e.g.*, *id.* at 160–61 (recognizing the importance of the Basel Committee to supranational groups and that groups such as the IMF and World Bank "have incorporated Basel standards into their reviews of member country financial systems").

11. *See, e.g.*, European Comm'n, *How the European Union Works: Your Guide to the EU Institutions*, at 3 (July 2007), http://bookshop.europa.eu/en/how-the-european-union-works-pbNA0113090/downloads/NA-01-13-090-EN-C/NA0113090ENC_002.pdf?FileName=NA0113090ENC_002.pdf&SKU=NA0113090ENC_PDF&CatalogueNumber=NA-01-13-090-EN-C ("The European Union is based on the rule of law. This means that every action taken by the EU is founded on treaties that have been approved voluntarily and democratically by all EU countries.")

12. *Cf.* EUROPEAN SCRUTINY COMMITTEE, ECONOMIC AND MONETARY UNION, 2012-13, H.C. 86-xxviii, at 6 (U.K.) (expressing concerns that national parliaments should be seen as having a role in ensuring democratic accountability with respect to the Economic and Monetary Union in the EU).

13. Harmonization is both easier within the EU than internationally and harder. It is easier because it takes place in the context of a binding treaty regime that spells out commitments to the creation of a single market. Consolidated Version of the Treaty on the Functioning of the European Union arts. 26–32, 45–66, Oct. 26, 2012, 2012 O.J. (C 326) 47, 59–60, 65–73. It is harder because legal harmonization in the EU (in contrast to standard setting by bodies like the Basel Committee) is a political as much as a technocratic activity. *See* CHRIS BRUMMER, SOFT LAW AND THE GLOBAL FINANCIAL SYSTEM 46 (2012) (noting that in the past national differences among the EU nations undermined efforts to "maintain a common position" at times but that now EU harmonization has increased and supervisory authorities have "the ability to draft technical standards with legal force when endorsed by the [European] Commission").

14. *See, e.g.*, HM GOV'T, REVIEW OF THE BALANCE OF COMPETENCES BETWEEN THE UNITED KINGDOM AND THE EUROPEAN UNION: THE SINGLE MARKET 13–16 (2013) [hereinafter HM GOV'T, BALANCE OF COMPETENCES] (noting that "[w]hat is now known as the Single Market was a concept at the heart of the original Treaty of Rome, which came into force in 1958" and discussing the evolution of the single-market system throughout the twentieth century).

15. *See id.* at 15 (discussing treaty changes and new legislation aimed at improving policies already in place).

16. *See* Duncan E. Alford, *Core Principles for Effective Banking Supervision: An Enforceable International Financial Standard?*, 28 B.C. INT'L & COMP. L. REV. 237, 286 (2005) ("[B]ecause the agreements [promulgated by international standards bodies] are not legally enforceable, nations can vary in their own interpretation and implementation of the standards."); *cf.* Maximillian L. Feldman, *The Domestic Implementation of International Regulations*, 88 N.Y.U. L. REV. 401, 407–08 (2013) ("Agencies that fail to implement regulations agreed upon internationally may lose credibility with their foreign counterparts, making future coordination more difficult.").

17. *See, e.g.*, Press Release, U.S. Sec. & Exch. Comm'n, SEC, European Regulators Establish Supervisory Cooperation Arrangements Related to the Asset Management Industry (July 19, 2013) (available at http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370539728294#.UkjHlBao1SU) (outlining supervisory agreements between domestic regulators in the United States with those in other countries).

18. *See, e.g.*, Commission Implementing Decision 2012/628, on the Recognition of the Legal and

cooperate in supervision and enforcement.[19] These transnational connections between domestic regulators have become more significant since the global financial crisis of 2007.[20]

Solving the financial trilemma by enhancing the power of supranational regulators would not necessarily solve the underlying problems of interconnectedness. Even if it were possible to centralize financial-standard setting and regulation, this new concentration of financial regulatory power would risk making the regulatory system more vulnerable.[21] The concentration of regulatory policymaking risks both over-reliance on poor regulatory strategies[22] and capture,[23] with serious implications for regulatory effectiveness and democratic legitimacy.

Policymakers can address interconnectedness in financial markets by breaking connections or by managing them. The transnational policy response to geographic interconnectedness has been to try to manage interconnectedness by focusing on financial stability as a global issue and to emphasize harmonization of standards, in particular the harmonization of the implementation of transnational standards.[24] But despite the efforts of networks of financial regulators,[25] the encouragement of financial market participants,[26] and the push by international standard setting bodies such as the Financial Stability Board (FSB) and the IMF for domestic regulators to implement transnational standards by means of peer reviews and implementation assessments,[27] these harmonization processes are slow, and implementation tends to be divergent rather than harmonious.[28]

Supervisory Framework of the United States of America, 2012 O.J. (L 274) 32, 33 (EU) (recognizing the U.S. legal and supervisory framework as equivalent to the requirements under EU law).

19. *See, e.g.*, U.S. Sec. & Exch. Comm'n, *supra* note 17 (announcing supervisory agreements between the United States and financial regulators of Member States of the EU).

20. *See, e.g.*, U.S. COMMODITY FUTURES TRADING COMM'N, THE FY 2014 PRESIDENT'S BUDGET AND PERFORMANCE PLAN 60 (2013) (explaining how and why the United States and other G20 nations came together after the 2007 financial crisis to regulate swaps exchanges).

21. *See* Pierre C. Boyer & Jorge Ponce, *Regulatory Capture and Banking Supervision Reform*, 8 J. FIN. STABILITY 206, 206 (2011) (arguing that concentrating supervisory power in the hands of a single supervisor may make the banking system "more prone to being captured by bankers").

22. *Cf.* THE TURNER REVIEW, *supra* note 2, at 39

> ([T]he crisis also raises important questions about the intellectual assumptions on which previous regulatory approaches have largely been built.... The predominant assumption behind financial market regulation—in the US, the UK and increasingly across the world—has been that financial markets are capable of being both efficient and rational and that a key goal of financial market regulation is to remove the impediments which might produce inefficient and illiquid markets.).

23. *See* Boyer & Ponce, *supra* note 21, at 206 ("[W]e argue that some of the current efforts to reform banking supervision systems by concentrating supervisory powers in the hands of a single supervisor could make them more prone to being captured by bankers.").

24. BRUMMER, *supra* note 13, at 210–65; Caroline Bradley, Coercive Peer Review in Transnational Financial Regulation: Comparative Regulatory Practice, Comparative Law, and Compliance 1 (Aug. 29, 2012) [hereinafter, Bradley, Coercive Peer Review] (unpublished manuscript) (on file with author).

25. Bradley, Coercive Peer Review, *supra* note 24, at 4–6.

26. *Id.* at 9–10.

27. *See, e.g.*, *id.* at 7–8 (explaining how the IMF and World Bank encouraged member nations to follow recommendations from peer reviews).

28. *See, e.g.*, BCBS, *Regulatory Consistency Assessment Programme (RCAP)—Analysis of Risk-Weighted Assets for Market Risk*, at 7 (Feb. 2013), *available at* http://www.bis.org/publ/bcbs240.pdf (concluding that significant variation between banks' market risk-weighted assets resulted partly from differing supervisory practices stemming from multiple private-sector studies).

It is difficult to imagine that strict separations between different national financial markets could be implemented across the board because many financial transactions and firms are transnational. However, transnational standard setters and domestic regulators do establish geographic separations: the Financial Action Task Force distinguishes between jurisdictions that implement its anti-money-laundering standards and those that do not, and it encourages compliant jurisdictions to avoid interacting with noncompliant jurisdictions.[29] U.S. regulators have proposed the ring-fencing[30] of bank capital of very large international banks carrying on business in the United States.[31] U.S. financial regulators define which entities are to be considered U.S. persons and which are not for the purpose of establishing a geographic perimeter for U.S. rules.[32] The United States, a member of the G20, has agreed to participate in the FSB's peer-review process,[33] and it has also acted more speedily in some respects than some other jurisdictions (including the EU) in developing post-crisis financial regulation.[34] Market participants expressed concern about possible divergence between U.S. and EU derivatives regulation, the extraterritoriality of U.S. rules, and uncertainties inherent in the U.S. Commodity Futures Trading Commission's proposed approach to defining U.S. persons.[35] In July 2013 the United States and the EU announced that they would be working together to harmonize their approaches to derivatives regulation and that harmonization would involve recognizing each other's rules as equivalent and issuing no-action letters.[36] This type of mutual recognition approach to coordinating regulation may be all that can be achieved at this time, but it reflects a compromise: The EU and the

29. Public Statement, Fin. Action Task Force [FATF], High-Risk and Non-Cooperative Jurisdictions (Oct. 19, 2012) (available at http://www.fatf-gafi.org/topics/high-riskandnon-cooperativejurisdictions/documents/fatfpublicstatement-19october2012.html).

30. Ring-fencing is the imposition of "different restrictions on intra-group cross-border transfers ... by the host/home country regulators." Eugenio Cerutti et al., *Bankers Without Borders? The Implications of Ring-Fencing for European Cross-Border Banks* 4 (Int'l Monetary Fund, Working Paper No. 10/247, 2010).

31. *See* Enhanced Prudential Standards and Early Remediation Requirements for Foreign Banking Organizations and Foreign Nonbank Financial Companies, 77 Fed. Reg. 76,628, 76,629 (Dec. 28, 2012) (to be codified at 12 C.F.R. pt. 252) (questioning the continued suitability of a regulatory approach that permits transnational banks to transfer capital and liquidity in the same way as before the 2007 financial crisis).

32. *See, e.g.*, Further Proposed Guidance Regarding Compliance with Certain Swap Regulations, 78 Fed. Reg. 909, 910 (Jan. 7, 2013) (noting that the Commission had received a number of comments with respect to its proposed definition of U.S. persons for the purposes of the application of regulations relating to swaps).

33. *See* G20, DECLARATION ON STRENGTHENING THE FINANCIAL SYSTEM 1 (2009), *available at* http://www.treasury.gov/resource-center/international/g7g20/Documents/London%20April%202009%20Fin_Deps_Fin_Reg_Annex_020409_-_1615_final.pdf (stating that members of the FSB "agree to undergo periodic peer reviews").

34. *See Laws for All: Lots of Rules, but Not All Good Ones*, ECONOMIST (Feb. 18, 2012), *available at* http://www.economist.com/node/21547835 (observing that the United States has acted decisively by enacting Dodd-Frank, while European regulators have proceeded in a "piecemeal" fashion).

35. *E.g.*, Letter from Sarah A. Miller, Chief Exec. Officer, Inst. of Int'l Bankers, to Melissa Jurgens, Sec'y, U.S. Commodity Futures Trading Comm'n (Feb. 6, 2013) (on file with editor).

36. Press Release, U.S. Commodity Futures Trading Comm'n [CFTC], The European Commission and the CFTC Reach a Common Path Forward on Derivatives (July 11, 2013) [hereinafter Derivatives Common Path] (available at http://www.cftc.gov/PressRoom/PressReleases/pr6640-13). The statement noted that "[w]e will not seek to apply our rules (unreasonably) in the other jurisdiction, but will rely on the application and enforcement of the rules by the other jurisdiction." *Id.*

United States are not achieving full harmonization, but they are also not implementing territorial separations.[37]

Just as transnational harmonization is incomplete, so is the effective management of sectoral and transactional interconnections in the financial markets. In February 2013 the FSB reported to the G20 on the progress of financial regulatory reform and noted slow progress in developing and implementing new rules relating to derivatives and shadow banking.[38] Shadow banking refers to activities carried out by "financial intermediaries that conduct maturity, credit, and liquidity transformation without explicit access to central bank liquidity or public sector credit guarantees."[39] Despite the lack of explicit guarantees, central banks intervened during the financial crisis to provide liquidity support to shadow banks.[40] Although market participants and trade associations argue that shadow banks make important contributions to the financial system,[41] policymakers have focused on developing appropriate regulation to address the risks posed to financial stability by shadow banks.[42] In contrast to the dominant approach to transnational issues, policymakers focusing on shadow banking have given serious consideration to policy proposals to break connections rather than manage their implications. In 2011 the FSB suggested a mixture of approaches: shadow-banking entities sponsored by banks should be consolidated in the banking group,[43] but banks should not be allowed to stand behind any unconsolidated entities.[44] Proposals to require banks that are protected by deposit-insurance schemes to abstain from proprietary trading are an example of breaking connections.[45] Suggestions to break up large banks as a solution to the too-big-to-fail (TBTF) problem are another.[46] Reconfiguring the market for derivatives

37. *See id.* ("We have both made significant progress in our regulatory reforms and, as a result of our joint collaborative effort in many places, our final rules are essentially identical. Nonetheless, our regulatory calendars are not always synchronized.").

38. Letter from Mark Carney, Chairman, FSB, to G20 Ministers and Central Bank Governors (Feb. 12, 2013) (available at http://www.financialstabilityboard.org/publications/r_130216.pdf).

39. Zoltan Pozsar et al., *Shadow Banking*, 19 FED. RES. BANK N.Y. ECON. POL'Y REV., Dec. 2013, at 1, 1.

40. *See, e.g.*, *id.* at 3 (discussing how liquidity facilities launched by the Federal Reserve responded to the liquidity and capital shortfalls of shadow banks).

41. *E.g.*, ASS'N FOR FIN. MKTS. IN EUR., SHADOW BANKING: AFME COMMENTS ON ECON DRAFT REPORT 1 (2012), *available at* http://www.afme.eu/WorkArea//DownloadAsset.aspx?id=6855 ("AFME believes that shadow banking contributes positively to the financial system by providing significant funding to capital markets and thus the economy, and by diversifying risk in the financial system.").

42. *See, e.g.*, FSB, *Shadow Banking*, *supra* note 2, at 1–5 (recognizing and responding to the G20 request that the FSB focus on shadow-banking).

43. *Id.* at 16.

44. *See id.* at 19–20 ("Recommendation 4: Restrict banks' ability to stand behind any entities that are not consolidated . . . .").

45. *See, e.g.*, Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds, 76 Fed. Reg. 68,846, 68,846 (Nov. 7, 2011) (to be codified at 12 C.F.R. pts. 44, 248, 351, 17 C.F.R. pt. 255) (proposing a rule that would restrict the ability of banks to engage in proprietary trading or have certain relationships with hedge funds or private equity funds); High-Level Expert Group on Reforming the Structure of the EU Banking Sector, *Final Report*, at iii (Oct. 2, 2012) [hereinafter *Liikanen Report*], *available at* http://ec.europa.eu/internal_market/bank/docs/high-level_expert_group/report_en.pdf (recommending the separation of banks' proprietary trading and other risky activities to tackle banks' complexity and interconnectedness).

46. *See, e.g.*, FED. RESERVE BANK OF DALL., FINANCIAL STABILITY: TRADITIONAL BANKS PAVE THE WAY 26–27 (2013), *available at* http://www.dallasfed.org/microsites/fed/annual/2012/1201e.pdf (discussing the merits of breaking up banks that are too big to fail); Richard W. Fisher, President, Fed. Reserve Bank of Dall., Ending 'Too Big to Fail': A Proposal for Reform Before It's Too Late (with

to move transactions onto organized markets is designed to enhance transparency and also to impede transmissions of risk by inserting clearinghouses between buyers and sellers of standardized derivatives.[47] Requiring banks to make their own assessments of creditworthiness rather than relying on credit-rating agencies is an attempt to reinforce divisions between different sectors of financial activity.[48] Some of these proposals to break connections have run into determined opposition.[49] Market participants and commentators argue that proposals to regulate to break connections between firms and functions will impose larger costs than the benefits new rules would generate.[50] Not paying serious attention to breaking connections where possible worsens the complexity problem in financial regulation.[51]

Making interconnectedness central to financial-regulation policy is a difficult goal to achieve.[52] Trying to address transnational and sectoral interconnections at the same time makes the task even more complex. The EU's experience of the global financial crisis and the sovereign-debt crisis provides a specific illustration of the multifaceted problem of financial interconnectedness.[53] And the EU's experience of

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Reference to Patrick Henry, Complexity and Reality), Remarks Before the Committee for the Republic (Jan. 16, 2013) (available at http://www.dallasfed.org/news/speeches/fisher/2013/fs130116.cfm) (recommending the restructuring of too-big-to-fail institutions into multiple business entities).

47. FSB, *Implementing OTC Derivatives Market Reforms*, at 9–10 (Oct. 25, 2010), *available at* http://www.financialstabilityboard.org/publications/r_101025.pdf. The Joint Forum identified settlement risk as a potential issue in the credit-default swaps market. BCBS, *Credit Risk Transfer: Developments from 2005 to 2007*, at 22–23 (July 2008), *available at* http://www.bis.org/publ/joint21.pdf.

48. *See, e.g.*, Guidance on Due Diligence Requirements in Determining Whether Securities Are Eligible for Investment 77 Fed. Reg. 35,259, 35,259 (June 13, 2012) (to be codified at 12 C.F.R. pts. 1, 160) (requiring agencies to establish, if feasible, uniform standards of creditworthiness); Alternatives to the Use of External Credit Ratings in the Regulations of the OCC, 77 Fed. Reg. 35,253, 35,253 (June 13, 2012) (to be codified at 12 C.F.R. pts. 1, 5, 16, 28, 160) (outlining regulatory expectations of banks to assess "creditworthiness of a security or money market instrument").

49. *See, e.g.*, ANJAN V. THAKOR, CTR. FOR CAPITAL MKTS. COMPETITIVENESS, THE ECONOMIC CONSEQUENCES OF THE VOLCKER RULE 6–7 (2012) (arguing that the Volcker Rule will adversely affect market risk).

50. *Cf.* Joséo Viñals et al., IMF, *Creating a Safer Financial System: Will the Volcker, Vickers, and Liikanen Structural Measures Help?*, at 18–21, IMF Staff Discussion Note SDN/13/4 (May 2013) (noting the potentially significant costs of structural reform of banking).

51. *See* Leonardo Gambacorta & Adrian van Rixtel, *Structural Bank Regulation Initiatives: Approaches and Implications* 2 (Bank for Int'l Settlements, Working Paper No. 412, 2013) (noting that structural separation "can reduce the complexity and possibly size of banking organisations, making them easier to manage, more transparent to outside stakeholders and easier to resolve; this in turn could improve risk management, contain moral hazard and strengthen market discipline"); *cf.* Philipp M. Hildebrand, *The Sub-Prime Crisis: A Central Banker's Perspective*, 4 J. FIN. STABILITY 313, 318 (2008) (questioning whether complex regulatory approaches are the best mode of financial-risk management).

52. The United Kingdom's Financial Services Authority was designed as a multifunction regulator in order to be able to regulate multifunction firms. *See* Eilis Feran, *Examining the United Kingdom's Experience in Adopting the Single Financial Regulator Model*, 28 BROOK. J. INT'L L. 257, 260–276 (2003) (describing the history behind and the reasons for the creation of the Financial Services Authority). After the financial crisis the U.K. government decided to separate regulatory responsibilities for microprudential regulation and financial conduct. *See, e.g.*, HM TREASURY, A NEW APPROACH TO FINANCIAL REGULATION: SECURING STABILITY, PROTECTING CONSUMERS, 2012, Cm. 8268, at 3 (listing the United Kingdom's core reforms as "establish[ing] a new 'macro-prudential' authority in the Bank of England" and "creat[ing] a powerful new conduct regulator to protect consumers and promote competition").

53. *See, e.g.*, Adrian Blundell-Wignall & Patrick Slovik, *A Market Perspective on the European Sovereign Debt and Banking Crisis*, OECD J. FIN. MKT. TRENDS, Feb. 2011, at 1, 21 (noting that one of the major issues confronting European markets is "[t]he banking crises in some of the periphery countries and in a number of German banks" and that "[g]iven the interconnectedness of banks, this is an issue for

trying to resolve the crises illustrates the difficulty of addressing interconnectedness.[54] Adopting a policy of managing interconnections and failing to implement that policy is risky—both to financial stability and to the institutional structures that manage (or fail to manage) interconnectedness. Adopting policies of breaking connections—where possible—could ultimately do more to promote financial stability than incompletely achieved policies of managing interconnection would. But attempts to break connections between financial firms run into opposition from those firms and their trade associations.[55] The EU's experience also illustrates another recurrent problem in financial regulation that the global financial crisis made very clear: Financial stability is linked to confidence in the financial markets, and market participants may have more or less confidence in the financial markets than the fundamentals justify.[56]

I. THE GLOBAL FINANCIAL CRISIS AND AN EU SOVEREIGN-DEBT CRISIS

The global financial crisis was initiated by a loss of confidence in some financial instruments that expanded to a loss of confidence in and an unwillingness to extend credit to financial firms.[57] The crisis created pressures for governments to step in to provide liquidity to[58]—and even rescue—troubled financial firms.[59] The crisis revealed the interconnectedness of financial firms and markets when stresses originating in the United States spread quickly around the world.[60] Uncertainty about the appropriate valuation of subprime-backed securities led to uncertainty about the valuation of other assets and to doubts about the viability of financial

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all of Europe").

54. *See generally* BCBS, *The Regulatory Framework: Balancing Risk Sensitivity, Simplicity and Comparability*, at 21 (July 2013) [hereinafter BCBS, *Balancing Risk Sensitivity*] (stating that "reducing global and domestic interconnectedness" is "beyond the direct remit of [even] the Basel Committee").

55. *See, e.g.*, THAKOR, *supra* note 49, at 6 (arguing that breaking interconnections will "impede [banks'] risk management, obstruct the ability to signal the quality of the loans they have securitized, reduce the value of financial services offered to customers, adversely impact the 'business model' of banking, and possibly hamper the economically-beneficial co-evolution of banks and financial markets"); Stephen Gandel, *Regulators Cave Quickly in First Volcker Rule Battle*, CNN MONEY (Jan. 6, 2014), http://finance.fortune.cnn.com/2014/01/06/regulators-fold-volcker/ (highlighting the stiff resistance of bankers against efforts to reduce interconnectedness).

56. *See, e.g.*, BCBS, *Balancing Risk Sensitivity*, *supra* note 54, at 9

> (Investor confidence in risk weights is also a crucial element of the regulatory infrastructure. When stakeholders believe that risk-based ratios provide reliable signals for the absolute and relative resilience of banks, the sensitivity of bank funding costs to changes in risk-taking is likely to increase, strengthening the effectiveness of market discipline in good times. And confidence in the risk-weighting regime should reduce uncertainty over counterparty solvency, reducing the risk of strains in bank funding markets in times of stress.).

57. Bank for Int'l Settlements [BIS], *78th Annual Report*, 2007–2008 BANK INT'L SETTLEMENTS ANN. REP. 5 (2008).

58. *See* C.A.E. Goodhart, *The Regulatory Response to the Financial Crisis*, 4 J. FIN. STABILITY 351, 354 (2008) (discussing liquidity support that central banks provided to banks).

59. *See, e.g.*, U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-11-616, FINANCIAL CRISIS: REVIEW OF FEDERAL RESERVE SYSTEM FINANCIAL ASSISTANCE TO AMERICAN INTERNATIONAL GROUP, INC. 7–9, 130 (2011), *available at* http://www.gao.gov/assets/590/585560.pdf (discussing the Federal Reserve System's rescue of American International Group, Inc.).

60. *See, e.g.*, Gert Wehinger, *The Turmoil and the Financial Industry: Developments and Policy Responses*, OECD J. FIN. MKT. TRENDS, July 2009, at 1, 2 ("The crisis has also reached countries and regions which earlier were believed to have been out of the range of contagion.").

firms.[61] The G20 countries attempted to limit the crisis by committing to: (1) a newly intensified harmonization of financial regulation;[62] (2) a new focus on financial stability as a focus of financial regulation;[63] and (3) a system of peer review to ensure state compliance with the new standards[64] and to remind states of the "international ramifications of their domestic actions."[65]

While the G20 acted collectively to enhance confidence in financial institutions, individual states provided financial support to their own financial firms.[66] But this national financial support strained public finances,[67] most visibly in certain EU Member States, and led to a European sovereign-debt crisis.[68] EU banks continued to hold the debt of European sovereigns, and the EU's capital-adequacy rules allowed these banks to do so without calculating the real risks associated with their investments.[69] Thus, a "vicious circle" was created between EU banks and sovereigns[70]: banks' troubles increased problems for sovereigns, and the sovereigns' fragilities undermined the banks.[71]

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61. *See* BRUMMER, *supra* note 13, at 211–13 (discussing speculation on subprime-backed securities as a catalyst for a larger mistrust of all banking holdings, which eventually resulted in financial institutions failing, receiving government bailouts, or being taken over by the government).

62. G20, *supra* note 33, at 1

> (We, the Leaders of the G20, have taken, and will continue to take, action to strengthen regulation and supervision in line with the commitments we made . . . to reform the regulation of the financial sector. Our principles are strengthening transparency and accountability, enhancing sound regulation, promoting integrity in financial markets and reinforcing international cooperation.).

63. *See, e.g.*, BIS, *82nd Annual Report*, 2011–2012 BANK INT'L SETTLEMENTS ANN. REP. 64 (2012)

> (The recent financial crisis has conveyed clear messages to market participants and to regulators entrusted with safeguarding financial stability . . . . The lessons learned from the crisis have influenced markets' and analysts' perception of banks and have led to new regulatory initiatives that will shape banks' post-crisis business models.).

64. G20, *supra* note 33, at 1, 4.

65. Mark Sobel, Deputy Assistant Sec'y for Int'l Monetary & Fin. Policy, U.S. Dep't of the Treasury, Remarks at the Woodrow Wilson Center on Mexico and the G-20 Leader's Summit (May 1, 2012) (available at http://www.treasury.gov/press-center/press-releases/Pages/tg1559.aspx).

66. *See, e.g.*, David M. Herszenhorn, *Bailout Plan Wins Approval; Democrats Vow Tighter Rules*, N.Y. TIMES (Oct. 3, 2008), http://www.nytimes.com/2008/10/04/business/economy/04bailout.html?pagewanted=1 (noting the U.S. government's approval of a $700-billion economic bailout package and warning that it "could become the most expensive government intervention in history").

67. *See, e.g.*, IMF, *Global Financial Stability Report: Meeting New Challenges to Stability and Building a Safer System*, at xi (Apr. 2010)

> (A key concern is that room for policy maneuvers in many advanced economies has either been exhausted or become much more limited. Moreover, sovereign risks in advanced economies could undermine financial stability gains and extend the crisis. The rapid increase in public debt and deterioration of fiscal balance sheets could be transmitted back to banking systems or across borders.).

68. *See, e.g.*, European Cent. Bank [ECB], *Financial Stability Review*, at 11 (Dec. 2010), *available at* http://www.ecb.int/pub/pdf/other/financialstabilityreview201012en.pdf (discussing the history and impact of the European sovereign-debt crisis).

69. *See* Hervé Hannoun, Deputy Gen. Manager, BIS, Sovereign Risk in Bank Regulation and Supervision: Where Do We Stand?, Remarks before the Fin. Stability Inst. High-Level Meeting 15 (Oct. 26, 2011), (available at http://www.bis.org/speeches/sp111026.pdf) (acknowledging that before the establishment of the European Banking Authority, the EU—along with governments in other advanced economies—did not regulate in such a way as to recognize the inherent "sovereign risk in banks' risk measurement and capital adequacy").

70. Press Release, Council of the European Union, Eurogroup Statement on the Follow-Up of the 29

The combined financial and sovereign-debt crises forced the EU to provide emergency financial support to EU banks and sovereigns. For example, the European Central Bank (ECB) gave support to banks under long-term refinancing operations[72] and established a Securities Markets Programme (SMP) to purchase sovereign debt.[73] The ECB explained that the purpose of the SMP was "to address the malfunctioning of securities markets and restore an appropriate monetary policy transmission mechanism."[74] The EU took other measures to manage the interconnections between public debt and the regulation of banks[75] and to take steps to limit speculation (by means of credit-default swaps) in the debt of EU Member States.[76] However, the combined crises had implications beyond Europe. Policymakers worried about the risk that the European problems could infect other parts of the world.[77] Lending to emerging-market economies fell as European banks suffered.[78]

These two linked crises illustrate the persistent tension in financial-market regulation between transnational markets and firms on the one hand and local regulation and politics on the other.[79] As Mervyn King observed, banks may be international in life, but they tend to be national in death.[80] And although the EU (a regional organization) and the IMF (a global organization) together provided

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June Euro Summit (July 9, 2012) (on file with editor).

71. *See* ECB, *Financial Integration in Europe: May 2011*, at 19 (May 2011) [hereinafter ECB, *Financial Integration in Europe*], *available at* http://www.ecb.europa.eu/pub/pdf/other/financial integrationineurope201105en.pdf

> ([T]he uncertainty in sovereign bond markets interacted, in certain cases, with the confidence in the balance sheets of banks, some of which were known or thought to be holding large volumes of government bonds. Unequal or partial information about actual holdings of various types of government bond by the banking sector may have exacerbated the problem.).

72. Press Release, ECB, ECB Announces Measures to Support Bank Lending and Money Market Activity (Dec. 8, 2011) (available at http://www.ecb.europa.eu/press/pr/date/2011/html/pr111208_1.en.html).

73. *See* Simone Manganelli, *The Impact of the Securities Markets Programme*, ECB RES. BULL., Winter 2012, at 2, 2 (stating that the Securities Markets Programme attempted to accomplish its goals by purchasing sovereign debt).

74. Decision of the European Central Bank 2010/05, Establishing a Securities Markets Programme, 2010 O.J. (L124) 8, 8 (EU).

75. *E.g.*, *Communication from the Commission: A Blueprint for a Deep and Genuine Economic and Monetary Union*, at 4–9, COM (2012) 777 final/2 (Nov. 30, 2012) [hereinafter *Blueprint*] (laying out the EU's steps to address the financial crisis, including budgetary and financial surveillance and the implementation of crisis resolution mechanisms).

76. Council Regulation 236/2012, 2012 O.J. (L 86) 1.

77. *See, e.g.*, Christine Lagarde, Managing Dir., IMF, Global Challenges in 2012, Speech in Berlin, Germany (Jan. 23, 2012) (available at http://www.imf.org/external/np/speeches/2012/012312.htm) ("It is not about saving any one country or region. It is about saving the world from a downward economic spiral. It is about avoiding a 1930s moment, in which inaction, insularity, and rigid ideology combine to cause a collapse in global demand.").

78. Stefan Avdjiev et al., *The Euro Area Crisis and Cross-Border Bank Lending to Emerging Markets*, BIS Q. REV., Dec. 2012, at 37, 37 ("Cross-border bank lending to emerging markets dropped sharply in the second half of 2011 as the euro area crisis intensified.").

79. *See* Hildebrand, *supra* note 51, at 314 ("Globalisation of the financial sector is presenting enormous challenges to authorities around the world. Put simply: Although many risks arise at a global level, the authorities are forced—to a large extent—to act locally.").

80. THE TURNER REVIEW, *supra* note 2, at 36; *see also* Goodhart, *supra* note 58, at 358 ("The problem of how to handle cross-border financial failures in a world of national fiscal and legal competences is understood, but not resolved.").

financial support for sovereign debtors in crisis, that support was conditioned on new austerity measures.[81] Austerity measures in turn provoked domestic opposition.[82]

Even within the EU, which has made significant efforts over a long period of time to establish a single market for financial services with harmonized rules of financial regulation,[83] there were significant gaps in the single market at the onset of the global financial crisis.[84] Although the EU had harmonized many of the rules of financial regulation, supervision of financial firms was a matter for the regulatory authorities of the individual member states.[85] The EU had an incompletely harmonized system of deposit insurance[86] and no harmonized rules for bank resolution.[87]

The EU's ability to act quickly to restore confidence in EU financial firms was limited by these harmonization gaps.[88] At times, the EU Member States acted

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81. *See, e.g.*, Press Release, IMF, Joint Statement on Greece by EU Commissioner Olli Rehn and IMF Managing Director Dominique Strauss-Kahn (May 2, 2010) (available at http://www.imf.org/external/np/sec/pr/2010/pr10177.htm) (announcing 110 billion euro aid from the EU and IMF after Greece adopted new economic policies); *cf.* Manos Matsaganis, *The Welfare State and the Crisis: The Case of Greece*, 21 J. EUR. SOC. POL'Y 501, 505–06 (2011) (describing Greek pension reform).

82. *E.g.*, Wolfgang Rüdig & Georgios Karyotis, *Who Protests in Greece? Mass Opposition to Austerity*, BRIT. J. POL. SCI., Oct. 2013, at 2 ("[A]nti-austerity protest appears to have been, at least thus far, much more intense in Greece than elsewhere, including in comparison to countries that have also had to resort to international financial rescues.").

83. *See, e.g.*, ECB, *Financial Integration in Europe: April 2012*, at 32–34 (2012), *available at* http://www.ecb.int/pub/pdf/other/financialintegrationineurope201204en.pdf (describing the creation of the EU and the single market).

84. *See, e.g.*, *id.* at 87 ("Broadly speaking, the pre-crisis financial stability arrangements in the EU were characterised by a dichotomy between the increasingly globalised nature of finance and the national nature of supervision and regulation, which remained a prerogative of Member States, with only a modest degree of supranational coordination.").

85. *See id.* at 32–35 (describing the early history of the EU, including attempts to harmonize regulation while leaving direct supervision of financial institutions to "home country control"); *cf.* *Communication from the Commission to the European Parliament and the Council: A Roadmap Towards a Banking Union*, at 3, COM (2012) 510 final (Sept. 12, 2012) [hereinafter *Roadmap*] ("Coordination between supervisors is vital but the crisis has shown that mere coordination is not enough, in particular in the context of a single currency and that there is a need for common decision-making.").

86. *See Report from the Commission to the European Parliament and to the Council: Review of Directive 94/19/EC on Deposit Guarantee Schemes*, at 2, COM (2010) 369 final (July 12, 2010) [hereinafter *Deposit Guarantee Schemes*]

> (The "minimum harmonisation" approach taken by Directive 94/19/EC resulted in significant differences between the [deposit insurance] coverage levels in Member States. When the financial crisis aggravated in autumn 2008, some EU depositors moved their deposits from banks in Member States with a lower coverage level to those with higher deposit protection.).

87. *Cf. Proposal for a Directive of the European Parliament and of the Council Establishing a Framework for the Recovery and Resolution of Credit Institutions and Investment Firms*, at 4, COM (2012) 280 final (June 6, 2012)

> ([A]n effective policy framework is needed to manage bank failures in an orderly way and to avoid contagion to other institutions. The aim of such a policy framework would be to equip the relevant authorities with common and effective tools and powers to address banking crises pre-emptively, safeguarding financial stability and minimising taxpayers' exposure to losses.).

88. *See, e.g.*, Niamh Moloney, *EU Financial Market Regulation After the Global Financial Crisis: "More Europe" or More Risks?*, 47 COMMON MKT. L. REV. 1317, 1324–25 (2010) (footnote omitted)

> (The crisis, by contrast, has not only slowed down the integration process .... The crisis underlined how home State deposit protection schemes could be exposed to failures in host States, and how home State resolution schemes and, ultimately, domestic tax-payers might carry

quickly in Summit Meetings rather than going through normal EU legislative procedures, but they incurred criticism as a result.[89] And the crises imposed costs on EU citizens in terms of rising levels of unemployment, increased taxation, and austerity measures.[90] EU action to increase financial regulatory harmonization required negotiation, the resolution of legal disputes, and even treaty amendments.[91] There may be a financial trilemma, but loosening the grip of states on financial regulation is not a simple matter.

A large part of the EU's difficulties in preventing and resolving the European sovereign-debt crisis related to defects in the institutional arrangements for the euro zone[92] and to the fact that some EU Member States are not members of the euro zone.[93] Incomplete harmonization—or at least incomplete management of risks associated with interconnections within the EU—was a source of financial instability in Europe, threatening to destabilize other regions of the world.[94] However, whereas the euro zone does not include all of the EU's Member States, the EU's single market in financial services does.[95] The EU has attempted to resolve the sovereign-debt crisis by intensifying cooperation between the euro-zone states and constraining those states' freedom of action.[96] However, in addition to focusing on the euro-zone

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the costs of failed cross-border institutions . . . .).

89. *See, e.g.*, Martin Schulz, President, European Parliament, Inaugural Speech Following His Election as President of the European Parliament (Jan. 17, 2012) (available at http://www.europarl.europa.eu/the-president/en/press/press_release_speeches/speeches/sp-2012/sp-2012-january/speeches-2012-january-1.html) ("The public are responding to this lack of parliamentary legitimacy by viewing political decisions taken by their leaders as nothing more than a series of diktats from Brussels.").

90. *See, e.g.*, JONATHAN CRIBB ET AL., INST. FOR FISCAL STUDIES, LIVING STANDARDS, POVERTY AND INEQUALITY IN THE UK: 2012 2 (2012), *available at* http://www.ifs.org.uk/comms/comm124.pdf (forecasting a continued decrease in British living standards due to a fall in employment and a tightened fiscal policy, including "net tax rises and cuts to benefits," because of the euro-zone financial problems).

91. Caroline Bradley, *From Global Financial Crisis to Sovereign Debt Crisis and Beyond: What Lies Ahead for the European Monetary Union?*, 22 TRANSNAT'L L. & CONTEMP. PROBS. 9, 12 (2013) [hereinafter, Bradley, *What Lies Ahead*].

92. *See, e.g.*, IMF, *World Economic Outlook: Growth Resuming, Dangers Remain*, at 23 (Apr. 2012) [hereinafter IMF, *World Economic Outlook*], *available at* https://www.imf.org/external/pubs/ft/weo/2012/01/pdf/text.pdf ("Over the medium term, many difficult decisions will be required to remedy [the EU's Economic and Monetary Union] design flaws that contributed to the crisis.").

93. *See, e.g.*, FOREIGN AND COMMONWEALTH AFFAIRS, REVIEW OF THE BALANCE OF COMPETENCES BETWEEN THE UNITED KINGDOM AND THE EUROPEAN UNION, 2012, Cm. 8415, at 4 (U.K.) (recognizing the need for "Eurozone countries to take steps towards closer fiscal and economic integration" while also maintaining that the United Kingdom should remain outside the euro zone). The euro zone comprises eighteen of the EU's twenty-eight Member States that have a common currency: the euro. *Euro Area Member States*, EUROZONE PORTAL, http://www.eurozone.europa.eu/euro-area/euro-area-member-states (last visited Apr. 5, 2014); *EU Member Countries*, EUROPEAN UNION, http://europa.eu/about-eu/countries/member-countries/index_en.htm (last visited Apr. 5, 2014). The members of the euro zone are Belgium, Germany, Estonia, Greece, Spain, France, Ireland, Italy, Cyprus, Luxembourg, Malta, the Netherlands, Austria, Portugal, Slovenia, Slovakia, Finland, and Latvia. *Euro Area Member States*, *supra* note 93. Latvia became a member of the euro zone in January 2014. Press Release, ECB, Latvia Joins the Euro Area (Jan. 1, 2014) (available at http://www.ecb.europa.eu/press/pr/date/2014/html/pr140101.en.html).

94. *See* IMF, *World Economic Outlook*, *supra* note 92, at 3, 69 (including mispriced risk and national supervision of integrated EU markets as causes of the crisis and recognizing that the financial instability in Europe could spill over to Iran and North Africa).

95. HM GOV'T, BALANCE OF COMPETENCES, *supra* note 14, at 20–21.

96. Council Regulation 473/2013, 2013 O.J. (L 140) 11, 11; *cf.* Maroš Šefčovič, Vice President, European Comm'n Responsible for Interinstitutional Relations and Admin., The Strength of the Community Method in Tackling the Crisis and the Role of the Lisbon Treaty, Speech at the Inst. of Int'l &

states' fiscal situations, the EU's solution to the defects in the euro zone involves addressing the interactions between banks and sovereigns by developing a system of euro-zone banking supervision,[97] and this risks undermining the single market in financial services.[98]

The EU was designed from the beginning to be a common market,[99] and legal harmonization was intended as a mechanism for achieving a common market.[100] The founding treaties prohibited the Member States from maintaining in force laws that functioned as barriers to the free movement of goods,[101] workers,[102] and capital[103] between Member States and also empowered the EU's institutions to adopt binding legal rules to harmonize certain laws within the EU.[104] But the EU's approach to achieving a single market has developed over time from an initial focus on achieving detailed harmonization, to mutual recognition based on minimum harmonization measures, to more recent attempts to achieve more complete and detailed harmonization through maximum harmonization measures[105] and even EU-level regulation.[106] Establishing separate rules in the euro zone and the wider EU would conflict with the idea of a single market. Separate systems of administration of common rules (with the risk of divergent interpretations of the common rules) also risk undermining the single market.[107]

European Affairs (Feb. 17, 2012) (transcript on file with editor)

> (I think it's fair to say that the fundamental lesson of the crisis is that of interdependence: now more than ever, we need greater integration to ensure that national economic and budgetary policies cannot again have such a devastating effect on the euro area and by extension the EU as a whole.).

97. *Blueprint*, *supra* note 75, at 7–8.

98. Although note that the crises also tended to undermine the single market, for example by encouraging banks to focus on domestic lending. *See* ECB, *Financial Integration in Europe, supra* note 71, at 31–34 (addressing that Member States chose to act unilaterally during the early stages of the financial crisis and encouraged banks to focus on domestic lending).

99. Treaty Establishing the European Economic Community, art. 2, Mar. 25, 1957, 298 U.N.T.S. 11 [hereinafter Treaty of Rome].

100. *See id.* arts. 100–02 (setting out means by which the European Economic Community could harmonize laws within individual Member States); *see also* HM GOV'T, BALANCE OF COMPETENCES, *supra* note 14, at 13 (discussing the creation of the common market).

101. Treaty of Rome arts. 9–37.

102. *Id.* arts. 48–51.

103. *Id.* arts. 67–73.

104. *Id.* arts. 100–02.

105. *See, e.g.*, HM GOV'T, BALANCE OF COMPETENCES, *supra* note 14, at 13–16 (explaining the evolution of the single market through treaties and legislation). The EU's prospectus rules are maximum harmonization measures: Member States are prohibited from imposing more demanding rules than those established in the Directive. Directive 2003/71, 2003 O.J. (L 345) 64, 66 (EC). The liability regimes in the Member States do vary, however. *See, e.g.*, European Sec. & Mkts. Auth. [ESMA], *Report: Comparison of Liability Regimes in Member States in Relation to the Prospectus Directive*, at 12-27, ESMA/2013/619 (May 30, 2013) (comparing liability regimes of Member States adopting measures to ensure stability during financial crisis).

106. *See* Council Regulation 513/2011, 2011 O.J. (L 145) 30, 30 (noting that the regulation intended to make ESMA "exclusively responsible for the registration and supervision of credit rating agencies in the Union"). For the original regulation, see Council Regulation 1060/2009, 2009 O.J. (L 302) 1.

107. *See* Moloney, *supra* note 88 at 1321 ("[P]ressure for greater homogeneity in, and centralization of, 'law in action' (supervision and enforcement) is increasing, countering the strong practical, political, legal, and Treaty forces which have retained supervision and enforcement at domestic levels.")

The EU reacted to the financial crisis by acknowledging the Member States' political imperatives to protect domestic financial institutions and liberalizing constraints on state aid.[108] But the EU also enacted centralizing measures, changing the institutional structures for financial regulation in the EU and creating EU-level authorities with new regulatory powers.[109] For example, the European Securities and Markets Authority authorizes and regulates credit-rating agencies within the EU.[110] The EU established a European Systemic Risk Board (ESRB) to address issues of financial stability within the EU and empowered the ESRB to implement international financial stability standards in the EU.[111] The ESRB has addressed issues of interconnection, stating, for example, that national authorities responsible for macroprudential policy should be "as a minimum operationally independent, in particular from political bodies and from the financial industry."[112] Similarly, the EU acted to control volatility by regulating short selling and credit-default swaps.[113] The EU institutions have considered proposals to harmonize rules relating to deposit insurance[114] and to rescuing financial institutions in distress.[115] In many ways the EU's

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108. Commission Communication, The Application of State Aid Rules to Measures Taken in Relation to Financial Institutions in the Context of the Current Global Financial Crisis, 2008 O.J. (C 270) 8, 8–9; *see also* Michael Reynolds et al., *EU Competition Policy in the Financial Crisis: Extraordinary Measures*, 33 FORDHAM INT'L L.J. 1670, 1689 (2010) ("The Commission has attempted to find a middle way between states clamoring for the power to rescue their most important financial institutions and legal purists decrying an apparent chasm between the existing state aid rules and the practice of the Commission.").

109. Council Regulation 1093/2010, Establishing a European Supervisory Authority (European Banking Authority), 2010 O.J. (L 331) 12, 13–14; Council Regulation 1095/2010, Establishing a European Supervisory Authority (European Securities and Markets Authority), 2010 O.J. (L 331) 84, 84–86; Council Regulation 1094/2010, Establishing a European Supervisory Authority (European Insurance and Occupational Pensions Authority), 2010 O.J. (L 331) 48, 48–58.

110. Council Regulation 513/2011, *supra* note 106, at 30–31.

111. Council Regulation 1092/2010, On European Union Macro-Prudential Oversight of the Financial System and Establishing a European Systematic Risk Board, 2010 O.J. (L 331) 1, 5–6.

112. *See, e.g.*, *Opinion of the European Systemic Risk Board on the Macro-Prudential Mandate of National Authorities*, 2012 O.J. (C 41) 1, 3.

113. Council Regulation 236/2012, *supra* note 76, at 1

> (At the height of the financial crisis in September 2008, competent authorities in several Member States . . . adopted emergency measures to restrict or ban short selling in some or all securities . . . . The measures adopted by Member States were divergent as the Union lacks a specific common regulatory framework for dealing with short selling issues.).

114. *E.g.*, *Proposal for a Directive of the European Parliament and of the Council Amending Directive 94/19/EC on Deposit Guarantee Schemes as Regards the Coverage Level and the Payout Delay*, at 4, COM (2008) 661 final (Oct. 15, 2008)

> (The current Directive allows an optional co-insurance of up to 10%, i.e. a certain percentage of losses that is borne by the depositor. This has proven counterproductive for the confidence of depositors and may have exacerbated the problems. The argument of moral hazard (depositors should be "punished" if they deposit their funds at a bank offering high interest rates but incurring high risks) is not tenable since retail depositors cannot, in general, judge the financial soundness of their bank. Consequently, this option should be discontinued.);

see also Council Directive 2009/14, 2009 O.J. (L68) 3, 3–4 (detailing the need for improvement of coverage for depositors); *Deposit Guarantee Schemes*, *supra* note 86 (discussing the appropriateness as well as the cost-benefit analysis of a deposit-guarantee scheme in the EU); *cf.* Sebastian Schich, *Financial Crisis: Deposit Insurance and Related Financial Safety Net Aspects*, OECD J. FIN. MKT. TRENDS, Dec. 2008, at 73, 93–101 (detailing issues, such as moral hazard and loss of credibility, that may arise if government deposit guarantees are perceived as limitless or do not have an exit strategy).

115. *See Commission Communication: An EU Framework for Cross-Border Crisis Management in the Banking Sector*, at 2, COM (2009) 561 final (Oct. 20, 2009) ("In autumn 2008, Member States agreed to

approach to new financial regulation in the wake of the financial crisis has followed international initiatives.[116] But market participants have sought to identify ways in which the EU's approach diverges from approaches in other jurisdictions and have at times urged the EU to wait until international standards are agreed upon before acting.[117]

With respect to the idea that some problems of interconnection might be dealt with by breaking rather than managing connections, the EU adopted a regulation in 2012, the European Market Infrastructure Regulation (EMIR) on "OTC derivatives, central counterparties and trade repositories."[118] EMIR provides for central clearing of certain classes of over-the-counter (OTC) derivatives; the application of risk mitigation techniques for noncentrally cleared OTC derivatives; reporting to trade repositories; the application of regulatory requirements to central counterparties with respect to organization, conduct of business, and prudential requirements; and requirements for trade repositories, including a duty to make certain data available to the public and relevant authorities.[119] EMIR recognizes that the EU needs to interact with other jurisdictions in the regulation of swaps. For example, recital number six to EMIR states that "[t]he Commission should cooperate with third-country authorities in order to explore mutually supportive solutions to ensure consistency between this Regulation and the requirements established by third countries and thus avoid any possible overlapping in this respect."[120] The broad design of the EU rules tracks international standards[121] and the U.S. approach to derivatives regulation.[122] However, market participants expressed concern that the details of the rules in the EU and in the United States would differ.[123] In July 2013 the EU and the United States announced that they would adopt a "Common Path" to regulating derivatives.[124]

Like the United States, the EU has been considering how to separate core banking functions from other functions in which financial institutions engage. The EU published a proposal to separate core banking from noncore banking in 2012

take the necessary action to recapitalise and guarantee banks, and this unprecedented action was coordinated at European level on an ad-hoc basis.").

116. *See* ECB, *The New EU Framework for Financial Crisis Management and Resolution*, MONTHLY BULL. (July 2011), at 85, 87–89, *available at* http://www.ecb.europa.eu/pub/pdf/other/art3_mb2011 07en_pp85-94en.pdf (detailing international and national initiatives and how the EU is taking global initiatives into account in the design of the European framework of financial regulation and crisis management).

117. *E.g.*, ASS'N FOR FIN. MKTS. IN EUR., *supra* note 41, at 3 ("A global approach to addressing issues is required. We believe EU policy makers should wait for the approach for shadow banking to be settled globally before proceeding with regulatory proposals.").

118. Commission Regulation 648/2012, 2012 O.J. (L 201) 1, 1.

119. *Id.* at 8–9, 14; *accord European Market Infrastructure Regulation (EMIR)*, ESMA, http://www.esma.europa.eu/page/European-Market-Infrastructure-Regulation-EMIR (last visited Apr. 5, 2014) (detailing the main obligations, scope, timing, and exemptions of EMIR).

120. Commission Regulation 648/2012, *supra* note 118, at 2.

121. *See* FSB, *Implementing OTC Derivatives Market Reforms*, *supra* note 47, at 3–7 (summarizing international standards recommended by the G20 for over-the-counter derivative-market reform).

122. For an analysis of the U.S. approach to derivative regulation embodied in the Dodd-Frank Act, see U.S. COMMODITY FUTURES TRADING COMM'N, STRATEGIC PLAN FY 2011–2015 18–26 (2011).

123. *E.g.*, Karel Lannoo, *The New Financial Regulatory Paradigm: A Transatlantic Perspective*, at 1, 5 (Ctr. for European Policy Studies, CEPS Policy Brief No. 287, 2013), *available at* http://www.ceps.be/book/new-financial-regulatory-paradigm-transatlantic-perspective.

124. Derivatives Common Path, *supra* note 36.

(the *Liikanen Report*) a year after the United States published its proposed Volcker Rule.[125] As of the fall of 2013 neither proposal has been adopted.[126] In May 2013 the EU Commission published a consultation document on structural reform of banking in the EU.[127] The Commission wrote that:

> Structural reforms of the banks that are too-big-to-fail would *directly* address intra-group complexity, intra-group subsidies, and excessive risk-taking incentives. Structural reforms may increase the credibility and effectiveness of the recovery and resolution process for large and complex banking groups, thereby lowering the ultimate taxpayer costs. Structural reforms also aim at a broader set of objectives, such as aligning the private incentives of banks with socially useful activities.[128]

The Commission suggested that EU rules were necessary to limit the possibilities for regulatory arbitrage and to reduce market fragmentation that might result from divergent rules in different Member States.[129] Within the EU, therefore, regulation of the structure of banks is linked to issues of geography. The International Swaps and Derivatives Association and the Association for Financial Markets in Europe argued that structural reform of banking in the EU could be harmful, reducing competition by increasing barriers to entry and preventing banks from responding to their clients' needs.[130] Structural separation of banking and nonbanking functions is intended to address risks that are not adequately addressed by regulatory measures such as capital requirements.[131] But, for a number of reasons, attempting to implement structural separation is costly.[132] In particular, defining the boundaries between permissible and impermissible activities for banks is complex.[133]

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125. *Liikanen Report*, *supra* note 45. For a discussion of the different proposals, see Viñals et al., *supra* note 50, at 14–16.

126. *See* Jesse Hamilton & Cheyenne Hopkins, *Volcker Rule Costs Tallied as U.S. Regulators Press Deadline*, BLOOMBERG (Sept. 29, 2013, 11:01 PM), http://www.bloomberg.com/news/2013-09-30/volcker-rule-costs-tallied-as-u-s-regulators-press-deadline.html (discussing current status of Volcker rule and reasons for the delay of its implementation); Howard Davies, *JP Morgan's Troubles Reignite the Debate on Banks Too Big to Fail*, GUARDIAN (Oct. 21, 2013, 8:23 PM), http://www.theguardian.com/business/economics-blog/2013/oct/21/jp-morgan-troubles-bank-too-big-fail (reporting reluctance to adopt the Liikanen proposal in Europe). The Final Volcker Rule was published in the Federal Register in January 2014. Prohibitions and Restrictions on Proprietary Trading and Certain Interests In, and Relationships with, Hedge Funds and Private Equity Funds, 79 Fed. Reg. 5536 (Jan. 31. 2014).

127. *Commission Consultation Paper on Reforming the Structure of the EU Banking Sector*, EUROPEAN COMMISSION, http://ec.europa.eu/internal_market/consultations/2013/banking-structural-reform/docs/consultation-document_en.pdf (last visited Apr. 5, 2014).

128. *Id.* at 2 (emphasis added).

129. *Id.* at 2–3.

130. Letter from Michael Lever, Managing Dir., Ass'n for Fin. Mkts. in Eur., & Richard Metcalfe, Deputy Reg'l Dir. & Senior Regulatory Advisor, Int'l Swaps & Derivatives Ass'n, to Alain Deckers, Head of Unit H2, Directorate Gen. Internal Mkt. & Servs., European Comm'n (July 11, 2013) (available at http://www2.isda.org/attachment/NTc0Mw==/http___assets.isda.org_media_d268a4bb_61a4360c.pdf)

> (In summary, structural separation of all of EU banks' trading activities is likely to lead to major changes in the structure of European capital markets. In effect, it would establish substantial barriers to entry for EU based banks, force the withdrawal of smaller and mid-sized service providers that depend on an overall relationship-based business model and restrict the ability of large banks to develop their business models to accommodate for changes in client and market requirements.).

131. *E.g.*, Viñals et al., *supra* note 50, at 9, box 1, 14–16.

132. *See, e.g.*, *id.* at 19 tbl.3 (breaking down potential costs of structural banking reform under the

The TBTF problem (for which structural separation represents a set of proposed solutions) is a global problem. But while the EU sought to address the global financial crisis by developing EU financial regulation in line with developing international standards (including international standards with respect to TBTF), the EU also had to address its own developing euro-zone sovereign-debt crisis that was prompted by strains on the budgets of some Member States caused by bailing out financial institutions in crisis and by poor fiscal management.[134] Addressing interconnections (especially between banks and sovereigns) within the euro zone was an urgent issue because of the sovereign-debt crisis. Concerns about the reliability of official data exacerbated the crisis.[135] The fiscal policies of the euro-zone Members were meant to be controlled by the EU's Stability and Growth Pact, but in practice this control was ineffective,[136] in part because of the single currency's importance as a tool of integration.[137] The EU and the IMF together provided financial support to euro-zone sovereigns in crisis on condition that those sovereigns implemented policies of austerity.[138]

The EU sovereign-debt crisis illustrates interconnections as a source of financial instability, both in terms of the vicious circle between banks and sovereigns[139] and in terms of the transmission of instability between members of the euro zone.[140] The EU example illustrates the risks of interconnectedness and the difficulties of achieving centralization of financial regulation and supervision. In particular, harmonization processes tend to be incremental and imperfect even within a strong system of harmonization like the EU's.[141] But as the euro zone's problems threatened to undermine the euro and even the EU as a whole, it was clear that EU policymakers were convinced that what mattered was not just the management of

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Volcker rule, the United Kingdom's ring-fence, and the Liikanen proposal).

133. *See, e.g.*, *id.* at 20 (pointing out that the high costs of implementing certain structural IMF reforms "relate to the challenge of distinguishing proscribed trading from permitted transactions and the resulting burden of compliance and reporting").

134. *E.g.*, Blundell-Wignall & Slovik, *supra* note 53, at 2.

135. *See, e.g.*, Org. for Econ. Co-operation & Dev. [OECD], *OECD Economic Surveys: Greece 2011*, at 4 (Aug. 2011) ("The dire economic situation was magnified by lost credibility as serious deficiencies in statistical monitoring of government accounts were exposed."); *cf.* Matsaganis, *supra* note 81, at 501 ("The revised figures stunned public opinion at home and shocked markets abroad.").

136. *See, e.g.*, Ludger Schuknecht et al., *The Stability and Growth Pact: Crisis and Reform*, at 1, 9 (European Cent. Bank, ECB Occasional Paper Series No. 129, 2011), *available at* http://www.ecb.int/pub/pdf/scpops/ecbocp129.pdf (noting that although the Member States agreed on a Stability and Growth Pact as a component of the institutional arrangements for the Euro, the "Pact's Achilles heel was its weak enforcement provisions"); *see also* IMF, *World Economic Outlook*, *supra* note 92, at 3 ("The Stability and Growth Pact was devised to bring about fiscal discipline but failed to forestall bad fiscal policies.").

137. *See, e.g.*, David Marsh, *Faltering Ambitions and Unrequited Hopes: The Battle for the Euro Intensifies*, 49 J. COMMON MKT. STUD. 45, 46 (2011) (discussing how the euro was created as part of an overall goal of greater political union).

138. *See, e.g.*, IMF, *Greece: Request for Stand-by Arrangement*, at 8, IMF Country Report No. 10/111 (May 2010), *available at* http://www.imf.org/external/pubs/ft/scr/2010/cr10111.pdf (noting that Greece would, among other measures, implement pension reform, health reform, and tax reform).

139. *Blueprint*, *supra* note 75, at 16 (internal quotation marks omitted).

140. *Id.* at 3 (stating that the inception of the European Monetary Union (EMU) "accelerated the transmission of shocks across national borders").

141. *See id.* at 33 ("Attaining a deep and genuine EMU involves incremental measures, building on what would have been achieved over the short and the medium-term and introducing further integration on a step-by-step, policy-by-policy basis.").

bank/state and state/state interconnections, but the management of market participants' perceptions of risks to financial stability.[142]

The EU now seeks to address both sets of interconnections by reinforcing fiscal controls and controls over banks. In addressing the interconnections, the EU has acted to develop stronger fiscal discipline[143] and to negotiate the establishment of a European Banking Union in which the ECB will be responsible for bank supervision within the euro zone.[144] Many of the documents referring to the European Banking Union state that its purpose is to end the vicious circle between banks and sovereigns.[145] Although the EU documents proposing the European Banking Union do not suggest that the European Banking Union is necessary to remedy defective national supervision of banks,[146] the financial crisis and events in Cyprus in 2012[147] did suggest that there were some weaknesses in EU banking supervision.[148]

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142. *See, e.g., id.* at 10 (acknowledging that because the crises led market participants to fear that the single currency may fail, there was less confidence in the EU's "model of a social market economy" and instead a "reinstating [of] the constraining power of national borders").

143. Treaty on Stability, Coordination and Governance in the Economic and Monetary Union, Mar. 2, 2012, T/SCG, *available at* http://www.european-council.europa.eu/media/579087/treaty.pdf; Treaty Establishing the European Stability Mechanism, Feb. 2, 2012, T/ESM 2012, *available at* http://www.european-council.europa.eu/media/582311/05-tesm2.en12.pdf.

144. *Roadmap, supra* note 85, at 7; *Proposal for a Council Regulation Conferring Specific Tasks on the European Central Bank Concerning Policies Relating to the Prudential Supervision of Credit Institutions*, at 2, COM (2012) 511 final (Sept. 12, 2012) [hereinafter *Proposal for Conferring Specific Tasks*]; *see also Proposal for a Regulation of the European Parliament and of the Council Amending Regulation (EU) No 1093/2010 Establishing a European Supervisory Authority (European Banking Authority) as Regards Its Interaction with Council Regulation (EU) No../... Conferring Specific Tasks on the European Central Bank Concerning Policies Relating to the Prudential Supervision of Credit Institutions*, COM (2012) 512 final, at 2–3 (Sept. 12, 2012) [hereinafter *Proposal for Amending Regulation Establishing EBA*] (discussing the ECB's supervisory role and the changes that should be made to the European Banking Authority so that its work will complement that of the ECB); *Blueprint, supra* note 75, at 11–13 (discussing the various short- and long-term steps that the EU should take in order to achieve a stable EMU, including creating a banking union and a single supervisory mechanism); *cf. President of the European Council, Towards a Genuine Economic and Monetary Union*, at 2 (Dec. 5, 2012), *available at* http://www.consilium.europa.eu/uedocs/cms_Data/docs/pressdata/en/ec/134069.pdf [hereinafter *Van Rompuy Report*] (discussing broadly the general steps that the EU could take in order to create a "genuine [EMU]"); *President of the European Council, Towards a Genuine Economic and Monetary Union*, at 4–7 (June 26, 2012), *available at* http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/131201.pdf (discussing the many challenges faced by the EMU and that a more detailed timetable needs to be worked out in order to create a "road map for the achievement of the genuine [EMU]").

145. *E.g., Blueprint, supra* note 75, at 16 (internal quotation marks omitted)

> (The euro area summit held on 29 June 2012 marked a turning point in the approach to the crisis. It recognized the imperative need to break the vicious circle between banks and sovereigns that is weakening the finances of euro area countries, to the point of threatening the very existence of the EMU.);

Presidency Conclusions, Brussels European Council, para. 10 (Dec. 14, 2012), *available at* http://www.consilium.europa.eu/uedocs/cms_Data/docs/pressdata/en/ec/134353.pdf#page=2 ("It is imperative to break the vicious circle between banks and sovereigns.").

146. *Cf.* FSB, *Peer Review of Italy*, at 5 (Jan. 27, 2011), *available at* http://www.financialstabilityboard.org/publications/r_110207b.pdf (stating that Italian resilience can be attributed to "the traditional, relationship-oriented business model and stable retail funding base of Italian banks" as well as the "regulatory and supervisory framework").

147. IMF, *Statement by Mr. Snel and Mr. Kanaris on Cyprus*, at 1 (May 10, 2013) *available at* http://www.stockwatch.com.cy/media/announce_pdf/May15_2013_IMF.pdf

> (Although Cyprus had weathered the beginnings of the European crisis relatively well, reluctance to correct long standing imbalances, the lax fiscal policies and the banking sector's

The 2012 proposal for a European Banking Union was published under Herman Van Rompuy's name[149] and was based on a system of integrated supervision of banks, a European deposit-insurance scheme, and a European resolution scheme.[150] If the euro zone is to develop a system for rescuing troubled banks, it makes sense for the euro zone to be involved in supervising those banks: The interconnections between bank supervision, deposit insurance, and bank resolution are evident. Although the euro zone has suffered from problems that have not affected the wider EU, the euro zone is part of the EU and thus of the single internal market in financial services.[151] The planned European Banking Union would operate alongside the EU's single market in financial services.[152] The Commission described the single market and the European Banking Union as "mutually reinforcing processes"[153] and has argued that the European Banking Union "would be able to end the disintegration of the EU's financial market and ensure reasonably equal financing conditions for households and business across the EU,"[154] but there is clear potential for collision. Although the Commission wrote in its *Roadmap* in September 2012 that a "single rulebook" for the single market within the EU was essential for the European Banking Union,[155] it soon became doubtful that the Commission's desired version of a single rulebook would be in place before the establishment of the Single Supervisory Mechanism (SSM).[156] In May 2013 Vítor Constâncio, Vice President of the ECB, stated that "[t]he more membership overlaps between the EU and the SSM, the more consistent will be the application of supervisory and regulatory practices."[157]

Like most of the European project, the process of working toward a European Banking Union is slow and incremental.[158] The EU institutions emphasized that they

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large exposure to Greece had started taking the toll on the country's ability to refinance its debt at rates compatible with long term fiscal sustainability.).

148. *See, e.g.*, IMF, *Cyprus: Request for Arrangement Under the Extended Fund Facility*, at 25, IMF Country Report No. 13/125 (May 2013), *available at* http://www.imf.org/external/pubs/ft/scr/2013/cr13125.pdf ("Lax supervisory practices have contributed to the buildup of vulnerabilities in the banking sector.").

149. Herman Van Rompuy is the first permanent President of the European Council, an EU institution that brings together the "Heads of State or Government of the Member States, together with its President and the President of the [European] Commission" to define the EU's direction and priorities. *The European Council - An Official Institution of the EU*, EUROPEAN COUNCIL, http://www.european-council.europa.eu/the-institution?lang=en (last visited Apr. 6, 2014).

150. *Van Rompuy Report*, *supra* note 144, at 4–5. For a proposal for an EU deposit-insurance scheme and resolution fund, see generally Dirk Schoenmaker & Daniel Gros, *A European Deposit Insurance and Resolution Fund* (Ctr. for European Policy Studies, CEPS Working Document No. 364, 2012).

151. *See supra* notes 93–99 and accompanying text.

152. *Roadmap*, *supra* note 85, at 4.

153. *Id.*

154. *Blueprint*, *supra* note 75, at 10.

155. *Roadmap*, *supra* note 85, at 4.

156. *See Blueprint*, *supra* note 75, at 17–18 (recognizing in October 2012 that although the SSM was to be implemented early in 2013, various proposals for a single rulebook were still under negotiation).

157. Vítor Constâncio, Vice President, ECB, Implications of the Single Supervisory Mechanism (SSM) on the European System of Financial Supervision (ESFS), Speech at a Public Hearing on Financial Supervision in the EU (May 24, 2013) (available at http://www.bis.org/review/r130527c.pdf).

158. *Blueprint*, *supra* note 75, at 33 ("Attaining a deep and genuine EMU involves incremental measures, building on what would have been achieved over the short and the medium-term and introducing further integration on a step-by-step, policy-by-policy basis.").

intended to proceed in a way that satisfied requirements of democratic accountability and legitimacy.[159] This is a recurrent issue within the EU: Discussions of the democratic deficit in Europe are longstanding,[160] and although the EU has made significant progress in increasing the role of the directly elected European Parliament in the legislative process[161] and in recognizing national parliaments in the EU's institutional structures,[162] the financial crises and the concomitant emergency and austerity measures have stressed European democratic processes and EU citizens' confidence in the EU's commitment to democracy.[163]

Van Rompuy's European Banking Union proposal encompassed common supervision and common arrangements for deposit insurance and resolution;[164] however, the EU began to work on common supervision before implementing a common-resolution regime[165] because common supervision was less controversial than common deposit insurance and resolution.[166] The European Banking Union plan envisaged the creation of a European Resolution Authority,[167] which the ECB said "should be established, or at least there should be clear deadlines for its establishment, when the ECB assumes its supervisory responsibility in full."[168] In July 2013 the Commission published a proposal for a single resolution mechanism and bank resolution fund for the euro area.[169] Although these new measures would create further distinctions between euro-zone banks and other EU banks, the Commission argued that banks outside the euro zone would benefit from enhanced bank supervision in the euro zone.[170]

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159. *See id.* at 11 ("The deeper integration of financial regulation, fiscal and economic policy and corresponding instruments must be accompanied by commensurate political integration, ensuring democratic legitimacy and accountability.").

160. *See generally* Andreas Follesdal & Simon Hix, *Why There Is a Democratic Deficit in the EU: A Response to Majone and Moravcsik*, 44 J. COMMON MKT. STUD. 533 (2006) (comparing different perspectives on the existence and extent of a democratic deficit in the EU).

161. *Id.* at 535.

162. *E.g.*, Consolidated Version of the Treaty on European Union art. 12, Oct. 26, 2012, 2012 O.J. (C 326) 13, 21 (describing the function of national parliaments within the greater EU structure).

163. Bradley, *What Lies Ahead*, *supra* note 91, at 16.

164. *See Blueprint*, *supra* note 75, at 17 ("The first, crucial step on this path will be the Single Supervisory Mechanism, which must subsequently be complemented by a Single Resolution Mechanism . . . .").

165. Presidency Conclusions, *supra* note 145, paras. 7–8.

166. *Cf.* EUROPEAN UNION COMMITTEE, EUROPEAN BANKING UNION: KEY ISSUES AND CHALLENGES, 2012-3, H.L. 88, at 11 (U.K.) ("[T]he proposals for a European resolution scheme and, in particular, a European deposit insurance scheme, have proved politically contentious for net contributor Member States, notably Germany.").

167. *See Blueprint*, *supra* note 75, at 18–19 (discussing a Single Resolution Mechanism).

168. *Opinion of the European Central Bank on a Proposal for a Council Regulation Conferring Specific Tasks on the European Central Bank Concerning Policies Relating to the Prudential Supervision of Credit Institutions and a Proposal for a Regulation of the European Parliament and of the Council Amending Regulation (EU) No 1093/2010 Establishing a European Supervisory Authority (European Banking Authority)*, 2013 O.J. (C 30) 6, 7 [hereinafter *Opinion of the ECB*].

169. *Proposal for a Regulation of the European Parliament and of the Council Establishing Uniform Rules and a Uniform Procedure for the Resolution of Credit Institutions and Certain Investment Firms in the Framework of a Single Resolution Mechanism and a Single Bank Resolution Fund and Amending Regulation (EU) No 1093/2010 of the European Parliament and of the Council*, at 3–4, COM (2013) 520 final (July 10, 2013).

170. *Id.* at 2–3.

The core of the SSM is the transfer of supervisory responsibilities for euro-zone banks to the ECB.[171] Non-euro-zone Members of the EU will be able to opt into the SSM.[172] The ECB does not have experience in bank supervision and will need additional resources to carry out supervisory functions with respect to 6000 banks.[173] In practice, the ECB will supervise larger banks, and national regulators will continue to supervise smaller banks.[174] The SSM is designed as a limited centralization of supervisory authority.[175] But centralization of supervision, or at least of the oversight of supervision, in the ECB is meant to ensure that banks within the SSM are subject to more uniform supervision than they would be in a decentralized supervisory regime.[176] This advantage of the SSM might encourage national regulators outside the SSM to conform their supervision to the ECB's approach.[177]

Commentators have expressed a number of concerns about the European Banking Union: from worries that the ECB's responsibilities for monetary policy will conflict with its role as a bank supervisor;[178] to concerns about the interactions among the European Banking Union, SSM, and the single market;[179] to whether the

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171. *See Blueprint*, *supra* note 75, at 17 ("The [SSM] as proposed by the Commission is based on the transfer to the European level of specific, key supervisory tasks for banks established in the euro area Member States . . . .").

172. *Id.*; *cf.* IMF, *Euro Area Policies: 2012 Article IV Consultation—Selected Issues Paper*, at 15, IMF Country Report No. 12/182 (July 2012), *available at* http://www.imf.org/external/pubs/ft/scr/2012/cr12182.pdf (stating that the "framework of the Banking Union should allow other EU countries to opt-in").

173. *See* Vítor Constâncio, Vice President, ECB, Establishing the Single Supervisory Mechanism, Speech at the BAFT-IFSA 2013 Europe Bank-to-Bank Forum (Jan. 29, 2013) (available at http://www.ecb.int/press/key/date/2013/html/sp130129_1.en.html) (acknowledging that it is "neither realistic nor desirable" to have the ECB supervise more than 6000 credit institutions and that no agency can have the resources to be perfect in its supervisory duties).

174. *See, e.g.*, *id.* (discussing how the legislation proposed to leave "'less significant' credit institutions" to the regulation of the Member States).

175. *Id.* ("[T]he ECB would be directly responsible for the supervision of a limited number of institutions which covers nevertheless more than 80% of the euro area banking system in terms of assets. The methodology also ensures that the majority of the financial system of SSM countries is covered.").

176. *Id.* States, rather than banks, have the ability to opt into the SSM. *See Blueprint*, *supra* note 75, at 33, 39 (arguing that non-euro-zone Member States could be allowed to opt in "if [they] wished" but that any opt-in should be "irrevocable").

177. *Cf.* Gadinis, *supra* note 1, at 173–74 (stating the implementation of global standards may vary by region and noting that "peer pressure among jurisdictions to comply" with these global requirements may increase compliance even among nations that do not participate in the FSB).

178. *See, e.g.*, Constâncio, *supra* note 173 (discussing the various problems the ECB will face and arguing that failures of financial supervision would harm the ECB's reputation in the context of its management of monetary policy).

179. *See, e.g.*, EUROPEAN UNION COMMITTEE, EUROPEAN BANKING UNION: KEY ISSUES AND CHALLENGES, 2012-3, H.L. 88, at 12 (U.K.) ("Membership of the banking union and the single market will not correspond. The strain on the single market will be compounded by the potential impact of the proposals on the relative powers and influence of the ECB . . . ."); *cf.* Presidency Conclusions, *supra* note 145, para. 4

> (The process of completing EMU will build on the EU's institutional and legal framework. It will be open and transparent towards Member States not using the single currency. Throughout the process the integrity of the Single Market will be fully respected, including in the different legislative proposals which will be made. It is also important to ensure a level playing field between Member States which take part in the SSM and those which do not.).

ECB has the capability to act as a banking supervisor.[180] The ECB has sought to quell these concerns:

> From the ECB's perspective, the proposed SSM regulation should comply with the following main principles. First, the ECB, within the SSM, should be able to carry out the tasks assigned to it effectively and rigorously without any risk to its reputation. Second, the ECB should remain independent in carrying out all its tasks. Third, there should be a strict separation between the ECB's new tasks concerning supervision and its monetary policy tasks assigned by the Treaty. Fourth, the ECB should be able to have full recourse to the knowledge, expertise and operational resources of national supervisory authorities. Fifth, the SSM should operate in a manner fully consistent with the principles underpinning the single market in financial services and in full adherence to the single rulebook for financial services. In this regard, the ECB also welcomes the possibility to involve non-euro area Member States in the SSM to ensure greater harmonisation of supervisory practices within the European Union, thus strengthening the internal market. Sixth, the ECB is ready to comply with the highest standards of accountability for the supervisory tasks.[181]

The United Kingdom, where a large part of EU financial activity has been located, which sees financial services as a significant contributor to its economy and takes pride in its system of financial regulation and participation in global standard setting,[182] will not join the SSM[183] (and it is even possible that the United Kingdom will leave the EU).[184] If the distinction between the euro zone and the broader EU persists,[185] the EU's sectoral authorities and the ECB will need to collaborate on evolution of the EU's system of financial regulation.[186] The original European Banking Union proposals contain arrangements for coordination of the roles of the ECB and European Banking Authority (EBA).[187] For example, the proposal for

180. *Cf.* Constâncio, *supra* note 173 (acknowledging that allowing the ECB full supervision of all banks "is neither realistic nor desirable . . . considering both the wealth of expertise at national level and the advantages stemming from proximity in supervision").

181. *Opinion of the ECB*, *supra* note 168, at 7.

182. *Cf.* Caroline Bradley, *Financial Trade Associations and Multilevel Regulation*, *in* MULTILEVEL REGULATION AND THE EU: THE INTERPLAY BETWEEN GLOBAL, EUROPEAN AND NATIONAL NORMATIVE PROCESSES 73, 81–82 (Andreas Follesdal et al. eds., 2008) [hereinafter Bradley, *Financial Trade Associations and Multilevel Regulation*] (discussing the development of the United Kingdom as a world leader in financial services, in part as a result of its regulatory policies).

183. FOREIGN AFFAIRS COMMITTEE, THE FUTURE OF THE EUROPEAN UNION: UK GOVERNMENT POLICY, 2013-4, H.C. 87-I, para. 82.

184. *See* David Cameron, Prime Minister, United Kingdom, EU Speech at Bloomberg (Jan. 23, 2013) (available at http://www.number10.gov.uk/news/eu-speech-at-bloomberg/) (promising to offer British citizens a referendum if the Conservative Party wins the next election on whether the United Kingdom should retain its EU membership).

185. The House of Lords EU Committee noted that the European Banking Union proposals would have different implications for states that planned to remain outside the euro zone and for states that contemplated joining the euro zone in future. EUROPEAN UNION COMMITTEE, EUROPEAN BANKING UNION: KEY ISSUES AND CHALLENGES, 2012-3, H.L. 88, at 12 (U.K.).

186. *See Proposal for Conferring Specific Tasks*, *supra* note 144, at 3–4 (proposing that the ECB will closely cooperate with the three European supervisory authorities).

187. *See, e.g.*, *Roadmap*, *supra* note 85, at 5–6 (addressing the roles of the ECB and the EBA as well as the importance to the ECB of the EBA in performing its functions competently). *But cf.* EUROPEAN UNION COMMITTEE, EUROPEAN BANKING UNION: KEY ISSUES AND CHALLENGES, 2012-3, H.L. 88, at 27

amendments to the EBA regulation adjusts the rules for decision making "to ensure that the integrity of the internal market remains preserved while avoiding at the same time the risk of paralysing the EBA decision making."[188]

For the time being, the EU is working on transferring the supervision of euro-zone banks (and not other financial institutions) to the ECB.[189] From the perspective of financial stability and interconnectedness, this solution is only a partial solution. The ECB would be supervising banks but not shadow banks.[190] On the other hand, if the ECB were to gain supervisory powers over nonbanks, this would exacerbate the euro-zone/EU single-market tensions.[191]

The recent evolution of EU financial regulation has combined moving forward with the G20 agenda for the reform of financial regulation with taking action to address the eurozone's particular crisis.[192] In addressing revisions to financial regulation from these two quite different perspectives, it is clear that the EU has, at times, needed to address immediate threats to financial stability (even financial instabilities) rather than address the longer-term issues. And the distinction between the euro-zone and non-euro-zone EU is set to become greater in the future: The *Blueprint* even imagined a new, "more active role" for the euro zone in "multilateral institutions and fora as well as in bilateral dialogues with strategic partners,"[193] a euro-zone fiscal capacity,[194] and the issuance of eurobills.[195] Potential fragmentation with respect to regulation in the EU raises issues of how effectively the EU can address issues of interconnectedness in the financial markets.[196]

(U.K.) (footnote omitted)

> (As an EU-wide institution, one of the EBA's fundamental objectives is to ensure the effective functioning of the single market. The issues of how such a relatively small and newly-established body will interact with such an immensely powerful institution as the ECB, and the potential consequences for the integrity of the single market . . . will become vital ones to address.).

188. *Proposal for Amending Regulation Establishing EBA*, *supra* note 144, at 4.

189. *See Proposal for Conferring Specific Tasks*, *supra* note 144, at 4 ("The ECB will be exclusively competent for key supervisory tasks which are indispensable to detect risks for banks' viability and require them to take the necessary action.").

190. *Cf.* ASS'N FOR FIN. MKTS. IN EUR., *supra* note 41, at 2–3 ("[O]ur views echo those of the ECB . . . that any shadow bank regulation needs to be thoroughly analysed in terms of costs and benefits and focus only on systemically important institutions and activities.").

191. *See* Bradley, *What Lies Ahead*, *supra* note 91, at 34-35 (noting that the creation of a regulatory scheme that would not apply to banks would draw new distinctions between the euro zone and EU and would interfere with the single market).

192. *See id.* at 21–22

> (The EU is part of the G20, and as the G20's work on financial stability . . . evolves, the EU is becoming more of a layer within a more complex multilevel system of financial regulation. While the G20 has reacted to the global financial crisis by emphasizing the need for increased harmonization of standards for financial regulation at the international level, EU institutions have reacted to the crises by increasing EU level regulation of financial firms, financial markets, and the economic policies of the Member States.).

193. *Blueprint*, *supra* note 75, at 25.

194. *Id.* at 27.

195. *Id.* at 29–30.

196. *See Liikanen Report*, *supra* note 45, at 30–31 (discussing the risk of "retrenchment of banks behind national borders" as a result of efforts to regulate the financial market).

CONCLUSIONS

Within the EU and at the international level, policymakers focusing on financial regulation are trying to protect financial stability by addressing issues of interconnectedness across territorial borders, across market sectors, and through transactional linkages. The policies they are developing involve recognizing and managing interconnectedness or preventing it by enforcing separation. The entire EU project is one of moving toward an ever-closer union, even if incrementally.[197] The Commission tends to assume that more geographic integration is desirable.[198] The Member States do not always agree.[199] But whereas geographic integration is the objective of the EU, there is no preordained EU view as to whether it is better to address interconnectedness between different sectors of financial regulation by managing the interconnectedness or by enforcing separations (although the EU does have separate sectoral authorities for banking, securities, and insurance and occupational pensions). Thus, the *Liikanen Report*, the result of a post-financial-crisis review of EU financial regulation, advocated EU measures to separate core banking activities from proprietary trading in securities and derivatives, which are viewed as excessively risky.[200] The idea of separation is very similar to the U.S. proposals in the Volcker rule. And market participants have reacted to this proposal, much as they have to the proposed Volcker rule, by arguing that there was insufficient evidence to support the proposal.[201] In addition, market participants have argued that it would be problematic for the EU to adopt separation requirements that differed from those in other jurisdictions,[202] and in particular, that this would

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197. Subsidiarity should provide opportunities to argue against integration and harmonization in all cases.

198. *See, e.g.*, *Blueprint*, *supra* note 75, at 1 (lauding the achievements of the euro in integrating Europe without acknowledging any concerns as to its desirability).

199. *See, e.g.*, FOREIGN AFFAIRS COMMITTEE, THE FUTURE OF THE EUROPEAN UNION: UK GOVERNMENT POLICY, 2013-4, H.C. 87-I, paras. 88–92 (explaining that the EU's attempts to increase integration have caused the U.K. government concern that its interests are not being best served by the EU); *cf.* Cameron, *supra* note 184 (addressing "public disillusionment" that the EU is moving toward "political integration" and not just economic integration).

200. *Liikanen Report*, *supra* note 45, at iii

> ([P]roprietary trading and other significant trading activities should be assigned to a separate legal entity if the activities to be separated amount to a significant share of a bank's business. This would ensure that trading activities beyond the threshold are carried out on a stand-alone basis and separate from the deposit bank. As a consequence, deposits, and the explicit and implicit guarantee they carry, would no longer directly support risky trading activities. The long-standing universal banking model in Europe would remain, however, untouched, since the separated activities would be carried out in the same banking group. Hence, banks' ability to provide a wide range of financial services to their customers would be maintained.).

201. *E.g.*, Directorate Gen. Internal Mkt. & Servs. *Summary of the Replies to the Consultation of the Internal Market and Services Directorate General on the Recommendations of the High-Level Expert Group on Reforming the Structure of the EU Banking Sector*, at 2 (Dec. 2012), *available at* http://ec.europa.eu/internal_market/consultations/2012/hleg-banking/replies-summary_en.pdf [hereinafter *Summary of the Replies*] ("In general, banks welcomed the Group's analysis, but argued that a compelling case for mandatory separation of trading activities has not been made. They felt that the proposal was not backed by the required evidence, and that there was a need for a thorough impact assessment.").

202. *Id.* at 3 ("Banks are concerned about inconsistency between structural reforms at EU level and what has already been proposed in the USA and the UK."); *cf.* Simon Johnson, *Last-Ditch Attempt to Derail Volcker Rule*, N.Y. TIMES ECONOMIX BLOG (Dec. 20, 2012, 5:00 AM), http://economix.blogs.nytimes.com/2012/12/20/last-ditch-attempt-to-derail-volcker-rule/ (noting arguments that the Volcker rule violates the United States' trade obligations).

harm the competitiveness of EU-based firms.[203] This example illustrates that in an interconnected world, market participants can easily challenge regulatory proposals that differ from existing rules or proposals in other jurisdictions. Differences in rules affect the competitiveness of financial firms and deprive consumers of the choices competition would bring. Geographic interconnectedness may thus impede consideration of structural separations that would be conducive to financial stability.[204] Dealing with geographic and sectoral interconnectedness together is a long and complex project.

Yet even without the sectoral issues, managing geographic interconnectedness is not simple. Complete centralization of financial regulation would create a single point of failure. Networks are messier and involve coordination problems, but at least they do not have a single point of failure, they are harder to capture, and they may generate new and useful ideas that could be squelched in a centralized regime. Complete centralization at the global level is unlikely, and the EU example shows that, even in a context where some level of commitment to geographic integration is a given, centralization is difficult to achieve. The EU's sovereign-debt crisis was a result of a failure to manage interconnections effectively, and, whereas the EU's attempts to control its recent crises emphasize greater coordination among a subset of EU Member States, those attempts also risk undermining the EU's achievements in moving toward networked integration among the full EU membership.

203. *See Summary of the Replies*, *supra* note 201, at 3 (acknowledging that it has been argued that structural reform may harm the competitiveness of EU banks).

204. *See* Bradley, *Financial Trade Associations and Multilevel Regulation*, *supra* note 182, at 97–99 (arguing that attempts at harmonization may affect financial firms' abilities to compete globally due to divergent implementation of standards in different countries).