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

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I. Introduction

Financial stability, and polices to ensure financial stability, are at the cutting edge of financial regulation, requiring rethinking of regulation and its administration. As policy-makers and regulators who focus on financial markets develop responsibilities for financial stability they are increasingly focusing on how financial market activity interconnects across territorial borders and across market sectors.[1]

By emphasizing geographic and sectoral interconnectedness supranational bodies legitimate supranational action and their claims to exercise controls over domestic actions. Supranational bodies can claim the ability to address transnational issues in ways that would be difficult for domestic actors,[2] even when those domestic actors participate in transnational

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[1] *See, e.g.*, Financial Stability Board, Shadow Banking: Strengthening Oversight and Regulation, (Oct. 27, 2011) at http://www.financialstabilityboard.org/publications/r_111027a.pdf; IMF, The IMF's Financial Surveillance Strategy (Aug. 28, 2012) at http://www.imf.org/external/np/pp/eng/2012/082812.pdf ("Systemic risk has become ever more complex, with shocks propagating rapidly through highly interconnected financial systems and across economies."

[2] *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.") And see also, e.g., *id.* at 4 ("The Fund's nearly universal membership allows it to build on a wide range of country experiences and discussions with national policy makers and other stakeholders. The Fund's independence provides an impartial, credible, and effective platform for promoting the global good. In addition, the Fund's singular role in crisis management, assisting countries that are hard hit by the global financial crisis, is a critical input to surveillance. Finally, the Fund's diverse staff provides it with the range of perspectives, skills, and policy-relevant experience necessary to meet the emerging needs of its membership.")

networks. 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 co-exist.[3] Plus, supranational bodies are free of the restrictions which national law may place on domestic regulators, restrictions which impede co-ordination between sectoral regulators domestically.

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 the issues effectively. Governance is in fact multi-level and dispersed, rather than centralized.[4] 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, and supranational bodies such as the IMF and EU institutions must co-operate with these standard-setters. Supranational bodies such as the IMF and the institutions of the EU are limited by the powers they derive from their founding

[3] Dirk Schoenmaker, *The Financial Trilemma*, 111 ECONOMICS LETTERS 57, 57 (2011) ("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.") *Cf.* CAE Goodhart, *Myths about the Lender of Last Resort*, 2 INT'L FIN. 339, 352 (1999)("For the time being the considerable (and even surprising) extent of segmentation in national financial systems within Europe will enable the present system of crisis resolution being centred on national institutions to continue (with the ECB playing a consultative, overseeing and advisory role). Once the European financial system becomes more integrated, the disjunction between a centralized, federal monetary system and decentralized national fiscal powers will become more difficult to reconcile. It will be interesting to observe how this disjunction will be resolved in future.")

[4] *See, e.g.*, Paul Cairney, *'Public Administration in an Age of Austerity': Positive Lessons from Policy Studies,* 27 PUB. POLICY AND ADMIN. 230, 235 (2012) ("'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."); Liesbet Hooghe & Gary Marks, *Unraveling the Central State, But How? Types of Multi-Level Governance*, 97 AM. POL. SCI. REV. 233 (2003).

treaties, and incursions on domestic sovereignty are controversial.[5] The experience of the EU[6] suggests that harmonization of financial regulation is necessarily a slow and incremental endeavour: each new measure builds on those which precede it.

Nor would solving the financial trilemma by enhancing the power of supranational regulators necessarily solve the underlying problems: 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 to capture,[7] with serious implications for regulatory effectiveness and democratic legitimacy.

Policy-makers 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, and, in particular harmonization of the implementation of transnational standards.[8] But despite the efforts of

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[5] Cf. House of Commons European Scrutiny Committee, Economic and Monetary Union, Twenty-eighth Report of Session 2012–13, HC 86-xxviii (Jan. 21, 2013) (expressing concerns that national parliaments should be seen as having a role in ensuring democratic accountability with respect to Economic and Monetary Union in the EU).

[6] Harmonization is both easier within the EU than internationally and harder. Easier because it takes place in the context of a binding Treaty regime which spells out commitments to the creation of a single market. 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.

[7] *See, e.g.*, Pierre C. Boyer & Jorge Ponce, *Regulatory Capture and Banking Supervision Reform*, 8 J. FIN. STABILITY 206, 206 (2012) ("we 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. Certain features of banking supervision—e.g. the very specialized skills and the vast amount of data that are necessary to conduct banking supervision, and the maintenance of confidentiality—may facilitate the capture of supervisors by bankers.")

[8] *See, e.g.*, Chris Brummer, SOFT LAW AND THE GLOBAL FINANCIAL SYSTEM (2012); Caroline Bradley, *Coercive Peer Review in Transnational Financial Regulation: Comparative Regulatory Practice, Comparative Law, and Compliance* (unpublished manuscript, August 2012 draft available at http://blenderlaw.umlaw.net/wp-content/uploads/2007/07/peerreview.004.pdf).

networks of financial regulators and the encouragement of financial market participants these harmonization processes are slow, and implementation tends to be divergent rather than harmonious.[9] Implementing strict separation between different national financial markets across the board is inconceivable, although it is possible to identify some attempts at geographic separation.[10]

Just as transnational harmonization is incomplete, so is the effective management of sectoral and other similar types of interconnections[11] in the financial markets to reduce risks to financial stability.[12] In contrast to the dominant approach to transnational issues, policy-makers focusing on sectoral interconnections have given serious consideration to policy proposals to break connections rather than manage their implications. In addressing shadow banking, for example, the Financial Stability Board suggested a mixture of approaches: shadow banking entities sponsored by banks should be consolidated in the banking group,[13] but banks should not

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[9] Basel Committee on Banking Supervision, Regulatory Consistency Assessment Programme (RCAP) – Analysis of Risk-weighted Assets for Market Risk (Jan 2013) at http://www.bis.org/publ/bcbs240.pdf.

[10] *See, e.g.*, FATF, Public Statement: High-risk and Non-cooperative Jurisdictions (Oct. 19, 2012).

[11] In the paper I refer to sectoral interconnections, which invokes traditional separations in some jurisdictions between banking, securities and insurance business. In some jurisdictions "universal" banks were not subject to the sort of restrictions which applied to banks in the US. The Volcker rule, and other similar proposals seek to draw a line between traditional banking business and non-banking business. In the paper I would like to consider other examples of interconnections in which risks in one area of activity may infect a different type of activity. Weaknesses in the credit rating process, for example, may affect securities businesses, or the ability of sovereigns to raise funds at appropriate rates. The word "sectoral" does not properly capture the full range of possible problematic interconnections, but I use it in this draft nonetheless.

[12] Although *cf.* e.g., AFME, Shadow Banking: AFME Comments on ECON Draft Report (Sep. 14, 2012) at http://www.afme.eu/WorkArea//DownloadAsset.aspx?id=6855 (Arguing 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.")

[13] FSB, Shadow Banking, *supra* note 1, at 16.

be allowed to stand behind any unconsolidated entities.[14] Proposals to require banks which are protected by deposit insurance schemes to abstain from proprietary trading are an example of breaking connections.[15] So too are suggestions that the solution to the "too big to fail" problem is to break up large banks.[16] Similarly, 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.[17] Some of these proposals to break connections have run into determined opposition.[18] But not paying serious attention to breaking connections where possible worsens the complexity problem in financial regulation.[19]

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[14] *Id.* at 19-20.

[15] *See, e.g.*, Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Securities and Exchange Commission, Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds, 76 Fed. Reg. 68846 (Nov. 7, 2011) (Volcker Rule); Report of the High-level Expert Group on Reforming the Structure of the EU Banking Sector (Oct. 2, 2012) (Liikanen Report).

[16] *See, e.g.*, Financial Stability: Traditional Banks Pave the Way, Federal Reserve Bank of Dallas Special Report, (Jan. 2013) at http://www.dallasfed.org/microsites/fed/annual/2012/1201e.pdf ; Richard W. Fisher, Ending 'Too Big to Fail': A Proposal for Reform Before It's Too Late (With Reference to Patrick Henry, Complexity and Reality), Remarks before the Committee for the Republic, Washington, D.C. (Jan.16, 2013) at http://www.dallasfed.org/news/speeches/fisher/2013/fs130116.cfm.

[17] *See, e.g.*, Office of the Comptroller of the Currency, Alternatives to the Use of External Credit Ratings in the Regulations of the OCC, 77 Fed. Reg. 35253 (June 13, 2012); Office of the Comptroller of the Currency, Guidance on Due Diligence Requirements in Determining Whether Securities Are Eligible for Investment 77 Fed. Reg. 35259 (June 13, 2012).

[18] *See, e.g.*, *supra* note 15.

[19] Philipp M. Hildebrand, *The Sub-prime Crisis: a Central Banker's Perspective*, 4 J. FIN. STABILITY 313, 318 (2008) ("What is more, the current crisis has mercilessly laid bare the limitations of complex regulations and models. We must live with the fact that risk measurement will always be incomplete, despite a wide range of planned and widely discussed improvements. Even the most complex models will never be infallible. It is therefore questionable, whether the current regulatory approach in and of itself, with its increasingly complex provisions that intervene at an ever deeper level in the daily business of banks, is the right one.")

Making interconnectedness central to financial regulation policy is a difficult goal to achieve.[20] Trying to address transnational and sectoral interconnections at the same time makes the task even more complex. This paper uses the example of Europe's experience of the global financial crisis and the sovereign debt crisis to illustrate the effects of interconnectedness. It uses the EU's experience of trying to resolve the crises as an illustration of the difficulty of addressing interconnectedness. Adopting a policy of managing interconnections and failing in implementing that policy is risky — both to financial stability and to the institutional structures which manage (or fail to manage) interconnectedness. The paper argues that adopting, where possible, policies of breaking connections could ultimately do more to promote financial stability than incompletely achieved policies of managing interconnection.

II. The Global Financial Crisis

The global financial crisis was a crisis initiated by a loss of confidence in some financial instruments which expanded to a loss of confidence in and an unwillingness to extend credit to financial firms.[21] The crisis created pressures for governments to step in to provide liquidity to,[22] and even rescue, troubled financial firms.[23] The crisis revealed the interconnectedness of financial firms and markets when stresses originating in the US spread quickly around the world. The G20 countries attempted to limit the crisis by committing to a newly intensified harmonization of financial regulation, to a new focus on financial stability as a focus of financial

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[20] The UK's FSA was designed as a multi-function regulator in order to be able to regulate multi-function firms. After the financial crisis the UK government decided to separate regulatory responsibilities for micro-prudential regulation and financial conduct. HM Treasury, A New Approach to Financial Regulation, Cm. 8268 (Jan. 2012).

[21] *See, e.g.*, BIS, 78TH ANNUAL REPORT: 1 APRIL 2007-31 MARCH 2008 (2008).

[22] *See, e.g.*, C.A.E. Goodhart, *The Regulatory Response to the Financial Crisis*, 4 J. FIN. STABILITY 351, 354-356 (2008) (discussing liquidity support).

[23] *See, e.g.*, GAO, *Review of Federal Reserve System Financial Assistance to American International Group, Inc.*, GAO-11-616 (Sep. 2011) at http://www.gao.gov/assets/590/585560.pdf.

regulation,[24] and to a system of peer review to ensure states' compliance with the new standards[25] and to remind them of the "international ramifications of domestic actions."[26]

While the G20 acted collectively to enhance confidence in financial institutions, individual states provided financial support to their own financial firms. But this national financial support strained public finances,[27] most visibly in certain EU member states, and the financial crisis led to a European sovereign debt crisis.[28] EU banks continued to hold the debt of European sovereigns, and the EU's capital adequacy rules allowed them to do so without calculating the real risks associated with their investment.[29] Thus a "vicious circle" was created

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[24] *See, e.g.*, BIS, 82ND ANNUAL REPORT: 1 APRIL 2011– 31 MARCH 2012, at 64 (Jun. 24, 2012) ("The recent financial crisis has conveyed clear messages to market participants and to regulators entrusted with safeguarding financial stability. One is that banks had mismanaged their liquidity positions, both domestically and internationally, and failed to secure stable and diversified sources of income and to contain costs. Another is that opaque balance sheets significantly impaired analyses of risk, thus preventing a timely awareness of the weakness of banks' capital buffers. And the troubles that beset the banks imposed material losses on their stakeholders, brought financial intermediation to a halt and plunged the global economy into recession. 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.")

[25] *See, e.g.*, G20, *Declaration on Strengthening the Financial System*, (Apr. 2, 2009).

[26] Remarks by Deputy Assistant Secretary Mark Sobel at the Woodrow Wilson Center on Mexico and the G-20 Leader's Summit (May.1, 2012) at http://www.treasury.gov/press-center/press-releases/Pages/tg1559.aspx.

[27] *See, e.g.*, International Monetary Fund, Global Financial Stability Report: Meeting New Challenges to Stability and Building a Safer System, 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.")

[28] *See, e.g.*, European Central Bank, Financial Stability Review, (Dec. 2010) at http://www.ecb.int/pub/pdf/other/financialstabilityreview201012en.pdf.

[29] *See, e.g.*, Hervé Hannoun, Deputy General Manager Bank for International Settlements, *Sovereign Risk in Bank Regulation and Supervision: Where Do We Stand?*, Speech at the

between EU banks and sovereigns:[30] banks' troubles increased problems for sovereigns and the sovereigns' fragilities undermined the banks.

The combined financial and sovereign debt crises forced the EU to provide emergency financial support to EU banks and sovereigns. For example the ECB gave support to banks under long term refinancing operations (LTRO),[31] and established a Securities Market Programme (SMP) to purchase sovereign debt.[32] 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."[33] The EU took other measures to manage the interconnections between public debt and the regulation of banks,[34] and to take steps to limit speculation (by means of credit default swaps) in the debt of EU Member States.[35] However, the combined crises had implications beyond Europe. Policy-makers worried about the risks that the European

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Financial Stability Institute High-Level Meeting, Abu Dhabi, UAE (Oct. 26, 2011) at http://www.bis.org/speeches/sp111026.pdf.

[30] Eurogroup Statement on the Follow-up of the 29 June Euro Summit (Jul. 9, 2012) at http://eurozone.europa.eu/media/773180/eg_statement_9_july_2012_final.pdf. *Cf.* ECB, FINANCIAL INTEGRATION IN EUROPE MAY 2011, at 19 ("the 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.")

[31] *See, e.g.*, ECB Press Release, ECB Announces Measures to Support Bank Lending and Money Market Activity (Dec. 8, 2011).

[32] *See, e.g.*, Simone Manganelli, *The Impact of the Securities Markets Programme*, ECB Research Bulletin No. 17, at 2-5 (WINTER 2012).

[33] European Central Bank, Decision of 14 May 2010 Establishing a Securities Markets Programme (ECB/2010/5) at Recital No. 3.

[34] *See, e.g.*, EU Commission, A Blueprint for a Deep and Genuine Economic and Monetary Union: Launching a European Debate, COM(2012) 777 final/2 (Nov. 30, 2012) (Blueprint).

[35] Council Regulation 236/2012, 2012 O.J. (L 86/1) (Short Selling Regulation).

problems could infect other parts of the world.[36] Lending to emerging market economies fell as European banks suffered.[37]

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.[38] As Mervyn King observed, banks may be international in life, but they tend to be national in death.[39] And although the EU (a regional organization) and the IMF (an international organization) together provided financial support for sovereign debtors in crisis, that support was conditioned on new austerity measures.[40] The austerity measures have in turn provoked domestic opposition.

Even within the EU, which has made significant efforts over a long period of time to

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[36] *See, e.g.*, Christine Lagarde, Managing Director, International Monetary Fund, Global Challenges in 2012, Speech in Berlin (Jan. 23, 2012) at http://www.imf.org/external/np/speeches/2012/012312.htm ("But what we must all understand is that this is a defining moment. 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. The longer we wait, the worse it will get. The only solution is to move forward together. Our collective economic future depends on it."

[37] *See, e.g.*, Stefan Avdjiev, Zsolt Kuti & Elõd Takáts, *The Euro Area Crisis and Cross-border Bank Lending To Emerging Markets*, BIS Quarterly Review (December 2012) p. 37.

[38] *See, e.g.*, Hildebrand, supra note 19, 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.")

[39] *Cf.* Goodhart, *supra* note 22, 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.") (NB Mervyn King cite).

[40] *See, e.g.*, Joint Statement on Greece by EU Commissioner Olli Rehn and IMF Managing Director Dominique Strauss-Kahn, IMF Press Release No.10/177 (May 2, 2010) at http://www.imf.org/external/np/sec/pr/2010/pr10177.htm; Manos Matsaganis, *The Welfare State and the Crisis: the Case of Greece*, 21 J. EUR. SOC. POL. 501, 505-6 (2011) (describing Greek pension reform).

establish a single market for financial services with harmonized rules of financial regulation,[41] there were significant gaps in the single market at the onset of the global financial crisis. 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. The EU had an incompletely harmonized system of deposit insurance, and no harmonized rules for bank resolution.

The EU's ability to act quickly to restore confidence in EU financial firms was limited by these harmonization gaps.[42] At times the EU Member States acted quickly in Summit Meetings rather than going through normal EU legislative procedures, but they incurred criticism as a result.[43] And the crises imposed costs on EU citizens in terms of rising levels of unemployment, increased taxation, and austerity measures.[44] EU action to increase financial regulatory harmonization required negotiation, the resolution of legal disputes, and even Treaty amendments.[45] 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

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[41] *See, e.g.*, ECB, Financial Integration in Europe April 2012 (2012) at http://www.ecb.int/pub/pdf/other/financialintegrationineurope201204en.pdf at Chapter II.

[42] *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 (2010).

[43] *See, e.g.*, Martin Schulz, President of the Eur. Parliament, Inaugural Speech Following His Election as President of the European Parliament (Jan. 17, 2012) at http://www.europarl.europa.eu/the-president/en/press/press_release_speeches/speeches/sp-2012/sp-2012-january/speeches-2012-january-1.html.

[44] *See, e.g.*, Jonathan Cribb, Robert Joyce & David Phillip, Institute for Fiscal Studies, LIVING STANDARDS, POVERTY AND INEQUALITY IN THE UK: 2012 (2012), available at http://www.ifs.org.uk/comms/comm124.pdf

[45] *See, e.g.*, Caroline Bradley, *From Global Financial Crisis to Sovereign Debt Crisis and Beyond: What Lies Ahead for the European Monetary Union?*, forthcoming 22 TRANSNAT'L L & CONTEMP. PROBS. (2012).

debt crisis related to defects in the institutional arrangements for the eurozone,[46] and from the fact that some EU Member States are not members of the eurozone.[47] 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. The EU's current attempt to resolve the sovereign debt crisis involves intensifying co-operation between the eurozone states[48] and constraining those states' freedom of action. However, in fixing the defects in the eurozone the EU risks undermining the single market in financial services.[49]

The EU's approach to achieving the single market has developed over time from an initial

[46] See, e.g., IMF, World Economic Outlook April 2012: Growth Resuming, Dangers Remain, at 23 (Apr. 2012) , available at http://www.imf.org/external/pubs/ft/weo/2012/01/pdf/text.pdf ("Over the medium term, many difficult decisions will be required to remedy EMU design flaws that contributed to the crisis . . . . A strong mechanism that delivers responsible fiscal policies is urgently needed.") The eurozone comprises seventeen of the EU's twenty-seven Member States which have a common currency, the euro. The members of the eurozone are Belgium, Germany, Estonia, Greece, Spain, France, Ireland, Italy, Cyprus, Luxembourg, Malta, the Netherlands, Austria, Portugal, Slovenia, Slovakia and Finland.

[47] *See, e.g.*, REVIEW OF THE BALANCE OF COMPETENCES BETWEEN THE UNITED KINGDOM AND THE EUROPEAN UNION, 5, 2012, Cm. 8415, http://www.fco.gov.uk/resources/en/pdf/publications/eu-balance-of-competences-review.pdf ("The crisis in the Eurozone has intensified the debate in every country on the future of Europe and there is no exception here. Now is the right time to take a critical and constructive look at exactly which competences lie with the EU, which lie with the UK, and whether it works in our national interest.")

[48] Cf. Maroš Šefčovič, Vice-President, Eur. Comm'n Responsible for Interinstitutional Relations and Admin., Speech at the Inst. of Int'l and Eur. Affairs: The Strength of the Community Method in Tackling the Crisis and the Role of the Lisbon Treaty (Feb. 17, 2012) ("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.").

[49] Although note that the crises also tended to undermine the single market, for example by encouraging banks to focus on domestic lending. *See, e.g.*, ECB, FINANCIAL INTEGRATION 2011, *supra* note 30, at 31-34.

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 (such as those which apply to prospectuses) and even EU-level regulation. Establishing separate rules in the eurozone and the wider EU would conflict with the idea of a single market. Separate systems of administration of common rules also risk undermining the single market.

The EU's response to the crises involved a number of different actions, from liberalizing constraints on state aids[50] to changing the institutional structures for financial regulation in the EU, creating EU-level authorities with new regulatory powers.[51] For example, the European Securities Markets Authority authorizes and regulates credit rating agencies within the EU.[52] The EU established a European Systemic Risk Board (ESRB),[53] to address issues of financial stability within the EU, and empowered the ESRB to implement international financial stability standards in the EU. The ESRB has addressed issues of interconnection, stating, for example, that national

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[50] *See, e.g.*, European Commission Communication, 2008 O.J. C 270/2 (Application of State Aid Rules to Measures Taken in Relation to Financial Institutions in the Context of the Current Global Financial Crisis); Michael Reynolds, Sarah Macrory & Michelle Chowdhury, *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.")

[51] *See* Regulation No 1093/2010 establishing a European Supervisory Authority (European Banking Authority), O.J. L 331/12 (Dec. 15, 2010); Regulation No 1095/2010 Establishing a European Supervisory Authority (European Securities and Markets Authority), O.J. L 331/84 (Dec. 15, 2010); Regulation No 1094/2010 establishing a European Supervisory Authority (European Insurance and Occupational Pensions Authority) O.J. L 331/48 (Dec. 15, 2010).

[52] *See* Council Regulation 513/2011, 2011 O.J. (L 145/30) Recital no. 6 (noting that the Regulation makes 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).

[53] Council Regulation 1092/2010, 2010 O.J. (L 331/1) 1 [hereinafter ESRB Regulation]; see also Eur. Systematic Risk Bd. [ESRB], http://www.esrb.europa.eu/home/html/index.en.html

authorities responsible for macro-prudential policy should be "as a minimum operationally independent, in particular from political bodies and from the financial industry."[54] Similarly, the EU has acted to control volatility by regulating short selling and credit default swaps.[55] And the EU institutions have considered proposals to harmonize rules relating to deposit insurance,[56] and to rescuing financial institutions in distress,[57] In many ways the EU's approach to new financial regulation in the wake of the financial crisis has followed international initiatives. Market participants have sought to identify ways in which the EU's approach diverges from approaches

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[54] ESRB, Recommendation on the Macro-Prudential Mandate of National Authorities, 2012 O.J. (C 41).

[55] Short Selling Regulation, *supra* note ?, at Recital no. 1 ("At the height of the financial crisis in September 2008, competent authorities in several Member States and supervisory authorities in third countries such as the United States of America and Japan adopted emergency measures to restrict or ban short selling in some or all securities. They acted due to concerns that at a time of considerable financial instability, short selling could aggravate the downward spiral in the prices of shares, notably in financial institutions, in a way which could ultimately threaten their viability and create systemic risks. The measures adopted by Member States were divergent as the Union lacks a specific common regulatory framework for dealing with short selling issues.")

[56] *See, e.g.*, Proposal for a Directive Amending Directive 94/19/EC on Deposit Guarantee Schemes as Regards the Coverage Level and the Payout Delay, COM(2008) 661 (Oct. 15, 2008) at ¶ 5.2 ("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.") *Cf.* Sebastian Schich, *Financial Crisis: Deposit Insurance and Related Financial Safety Net Aspects*, 95 FIN. MKT. TRENDS (OECD 2008/2).

[57] *See, e.g.*, European Commission Communication, COM (2009)561 (Oct. 20, 2009) (An EU Framework for Cross-Border Crisis Management in the Financial Sector) at p 2 ("The recent crisis has exposed the EU's lack of an effective crisis management for cross-border financial institutions. In autumn 2008, Member States agreed to take the necessary action to recapitalise and guarantee banks, and this unprecedented action was coordinated at European level on an ad-hoc basis. The measures were necessary in the exceptional conditions that afflicted the financial system.")

in other jurisdictions and have urged the EU to wait to act until international standards are agreed.[58]

III The EU Sovereign Debt Crisis

Recent events in the EU illustrate 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. In practice financial regulation has to be accomplished in a networked environment. Although the EU has been very much involved in transnational efforts to address issues of financial stability, the sovereign debt crisis diverted the EU from working on the G20/IMF global financial stability agenda to focus on fixing problems in the eurozone, because the eurozone's problems threatened to undermine the euro and even the EU as a whole.[59]

In addressing the sovereign-debt/bank interconnections the EU has acted to develop stronger fiscal discipline,[60] and to negotiate the establishment of a European Banking Union in which the ECB will be responsible for bank supervision within the eurozone.[61] Many of the

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[58] *See, e.g.*, AFME shadow banking comments, *supra* note 12 ("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.")

[59] *See, e.g.*, Blueprint, *supra* note 34, at 10 ("Ultimately, the negative feedback loop between sovereigns and banks and the associated refragmentation of the EU's financial markets led to the emergence of a re-denomination risk, the bet by financial market participants that this development would eventually threaten the existence of the single currency. Anachronistically, more than 50 years after the foundation of the European Union the crisis of confidence appears to be reinstating the constraining power of national borders, questioning the Single Market and threatening the achievements and as yet unfulfilled aspirations of Economic and Monetary Union. This is also a threat to the European Union's model of a social market economy.")

[60] Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (Jan. 31, 2012); Treaty Establishing the European Stability Mechanism, (Feb. 2, 2012).

[61] Herman Van Rompuy, Towards a Genuine Economic and Monetary Union (Jun. 26, 2012); Herman Van Rompuy, José Manuel Barroso, Jean-Claude Juncker & Mario Draghi, Towards a Genuine Economic and Monetary Union (Dec. 5, 2012); EU Commission, A Roadmap Towards a Banking Union COM (2012) 510 final (Sept. 12, 2012) (Roadmap);

documents referring to the European Banking Union state that its purpose is to end the "vicious circle" between banks and sovereigns.[62] The documents do not suggest that the European Banking Union is necessary to remedy defective national supervision of banks.[63]

Van Rompuy's[64] proposal for a European Banking Union was based on a system of integrated supervision of banks, a European deposit insurance scheme, and a European resolution scheme.[65] If the eurozone is to develop a system for rescuing troubled banks, it makes sense for the eurozone to be involved in supervising those banks: the interconnections between bank supervision, deposit insurance, and bank resolution are evident. But, although the eurozone has

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Proposal for a Regulation 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 (Sept. 12, 2012) (Proposed amendment to EBA Regulation); Proposal for a Council Regulation Conferring Specific Tasks on the European Central Bank Concerning Policies Relating to the Prudential Supervision of Credit Institutions, COM (2012) 511 final (Sept. 12, 2012); Blueprint, *supra* note 34.

[62] *See, e.g.*, Blueprint, *supra* note 34; European Council, Roadmap for the Completion of EMU, European Council Conclusions (Dec 13-14 2012) at ¶ 10.

[63] *Cf.* FSB, Peer Review of Italy (Jan. 27, 2011) at http://www.financialstabilityboard.org/publications/r_110207b.pdf at p 5 ("The Italian financial system showed much resilience to the recent global financial crisis, although it was affected by the knock-on effects on the economy.. This resilience can be attributed to the traditional, relationship-oriented business model and stable retail funding base of Italian banks, as well as to the prudent regulatory and supervisory framework that promoted conservative mortgage lending practices and discouraged banks from participating in complex securitization activities and sponsoring structured investment vehicles.")

[64] Herman Van Rompuy is the first permanent President of the European Council, an EU institution which brings together the Heads of State or Government of the Member States and the President of the Commission to define the EU's direction and priorities.

[65] Herman Van Rompuy, Towards a Genuine Economic and Monetary Union, *supra* note 61, at 4-5. For a proposal for an EU deposit insurance scheme and resolution fund, see, e.g., Dirk Schoenmaker & Daniel Gros, A European Deposit Insurance and Resolution Fund, CEPS Working Document WD 364 (May 2012).

suffered from problems which have not affected the wider EU, the eurozone is part of the EU, and thus of the single internal market in financial services.[66] The planned European Banking Union is to operate alongside the EU's single market in financial services. The Commission has described the single market and the European Banking Union as "mutually reinforcing processes,"[67] 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,"[68] 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,[69] 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).[70]

Like most of the European project, the process of working towards a European Banking Union will be slow and incremental. The EU institutions have emphasized that they intend to proceed in a way that satisfies requirements of democratic accountability and legitimacy.[71] This is

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[66] Although the EU has been moving towards achieving a single internal market a number of barriers remain. The crises have increased fragmentation of the financial markets in the EU.

[67] Roadmap, *supra* note 61, at 4.

[68] Blueprint, *supra* note 34, at 10.

[69] Roadmap, *supra* note 61, at 4 ("The creation of the banking union must not compromise the unity and integrity of the single market which remains one of the greatest achievements of European integration. Indeed, the banking union rests on the completion of the programme of substantive regulatory reform underway for the single market (the "single rulebook")")

[70] See Blueprint, *supra* note 34, at ("An integrated financial framework including a single supervision and subsequently a single resolution mechanism must be based on a single rulebook. Therefore, it is essential to conclude as a matter of urgency the negotiations on the Commission proposals establishing new regulatory frameworks in the areas of banking prudential rules, deposit guarantees, and bank recovery and resolution.")

[71] *See, e.g.*, *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.").

a recurrent issue within the EU: discussions of the democratic deficit in Europe are longstanding and although the EU has made significant progress in increasing the role of the directly elected European Parliament in the legislative process and in recognizing national parliaments in the EU's institutional structures, 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.

Van Rompuy's proposal encompassed common supervision and common arrangements for deposit insurance and resolution, but in practice the EU is working on common supervision before implementing a common resolution regime.[72] The plan envisages the setting up of a European Resolution Authority,[73] which the ECB has said should be "established, or at least there should be clear deadlines for its establishment, when the ECB assumes its supervisory responsibility in full."[74] The Blueprint imagined a new, more active, role for the eurozone in "multilateral institutions and fora as well as in bilateral dialogues with strategic partners,"[75] a eurozone fiscal capacity,[76] and the issuance of eurobills.[77]

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[72] Blueprint, *supra* note34, 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."); European Council Roadmap, supra note 62, at ¶ 7. *Cf.* House of Lords European Union Committee, European Banking Union: Key Issues and Challenges, 7th Report of Session 2012–13, HL Paper 88 (Dec. 12, 2012) at 11 (noting that "the 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.")

[73] Blueprint, *supra* note34, at 18.

[74] 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 Amending Regulation No 1093/2010 Establishing a European Supervisory Authority (European Banking Authority), O.J. No. C 30/6 (Feb. 1, 2013) at ¶ 1.3.

[75] Blueprint, *supra* note 34, at 25.

[76] Blueprint, *supra* note34, at 27.

[77] Blueprint, *supra* note34, at 29-30.

The core of the SSM is the transfer of supervisory responsibilities for eurozone banks to the ECB. Non-eurozone members of the EU will be able to opt into the SSM.[78] The ECB does not have experience in bank supervision, and will need additional resources to carry out supervisory functions with respect to 6000 banks. In practice the ECB will supervise larger banks and national regulators will continue to supervise smaller banks.[79] The SSM is designed as a limited centralization of supervisory authority. 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.[80] This advantage of the SSM might encourage national regulators outside the SSM to conform their supervision to the ECB's approach.

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,[81] to concerns about the interactions between the European Banking Union and

[78] Blueprint, *supra* note34, at 14 ("the progress towards a banking union needs to start through the adoption and implementation of the proposals made on financial regulation and supervision, notably the proposal for a Single Supervisory Mechanism (SSM) for the euro area and for non-euro area states wishing to join.") *Cf.* IMF, Euro Area Policies: 2012 Article IV Consultation - Selected Issues Paper, at 15, IMF Country Report No. 12/182 (July 2012) (stating that the "framework of the Banking Union should allow other countries to opt-in.")

[79] *See, e.g.*, Vítor Constâncio, Vice-President of the ECB, Establishing the Single Supervisory Mechanism, Speech at the BAFT-IFSA 2013 Europe Bank-to-Bank Forum (Jan. 29, 2013) at http://www.ecb.int/press/key/date/2013/html/sp130129_1.en.html .

[80] *See, e.g.*, *id.* States, rather than banks, have the ability to opt into the SSM.

[81] *Cf.* Constâncio, *supra* note 79 ("The "true" risk is the issue of reputation risk of the central bank. The monetary policy function of the central bank requires that it maintains a high level of credibility and reputation, since it is essential to keep expectations of rising inflation at bay. However, if the central bank is responsible for both price stability and bank supervision, any negative event in the second task could damage the central bank's reputation as a monetary authority. The risk is real because as we all know, supervision is an area that can never be perfect as it lacks the resources to see everything, meaning that accidents are always possible. What I would call "false" risks include the argument that conflicts of interest might arise between the different central bank functions... The ECB will have clear separate and hierarchical mandates that places price stability separate from other concerns. The ECB also has the advantage of

SSM and the single market,[82] to whether the ECB has the capability to act as a banking supervisor. 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.[83]

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having a very clear, transparent and measurable goal of price stability...Internal procedures can be, and will be, designed in a way that the separation between monetary policy and banking supervision is efficiently implemented.")

[82] *See, e.g.*,. House of Lords EU Committee Report, *supra* note 72. *Cf.* European Council, Roadmap for the completion of EMU, European Council Conclusions (Dec 13-14 2012) at http://www.consilium.europa.eu/uedocs/cms_Data/docs/pressdata/en/ec/134353.pdf#page=2 ¶ 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."

[83] ECB Opinion, *supra* note 74, at ¶1.4.

The UK, where a large part of EU financial activity has been located, which sees financial services as a significant contributor to its economy, and which takes pride in its system of financial regulation and participation in global standard-setting, will not join the SSM (and it is even possible that the UK will leave the EU[84]). If the distinction between the eurozone and the EU persists,[85] the EU's sectoral authorities and the ECB will need to collaborate on evolution of the EU's system of financial regulation. The original European Banking Union proposals contain arrangements for co-ordination of the roles of the ECB and EBA.[86] For example, the proposal for 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."[87] For the time being, the EU is planning to transfer bank supervision to the ECB, and not the supervision of all financial activity which might have implications for financial stability in the eurozone. If the ECB's role develops to include supervisory powers over non-banks this will exacerbate rthe eurozone/EU single market tensions.

IV Conclusions

This paper has looked at interconnectedness (whether geographic or sectoral/functional connectedness) as a target of policies to ensure financial stability, and suggests that policies towards interconnectedness involve either recognizing and managing interconnectedness or

[84] David Cameron, EU Speech at Bloomberg (Jan 23, 2013) at http://www.number10.gov.uk/news/eu-speech-at-bloomberg/ .

[85] The House of Lords EU Committee noted that the European Banking Union proposals would have different implications for states which planned to remain outside the eurozone and for states which contemplated joining the eurozone in future. House of Lords EU Committee Report, *supra* note 72, at 12-13.

[86] Although *cf. e.g.*, House of Lords EU Committee Report, *supra* note 72, at 27 ("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.")

[87] Proposed amendment to EBA Regulation, *supra* note 61, at 4.

preventing it by enforcing separation. The entire EU project is one of moving towards an ever closer union — incrementally.[88] The Commission tends to assume that more geographic integration is desirable. The Member States do not always agree. But whereas geographic integration is the objective of the EU, there is no pre-ordained 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 conceived of as excessively risky.[89] The idea of separation is very similar to the US 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.[90] In addition market participants have argued that it would be problematic for the EU to adopt separation requirements which differed from those in other

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[88] Subsidiarity should provide opportunities to argue against integration and harmonization in all cases.

[89] Liikanen Report, *supra* note 15, at iii ("proprietary 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.")

[90] EU Commission, 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 (Dec. 2012) http://ec.europa.eu/internal_market/consultations/2012/hleg-banking/replies-summary_en.pdf at 2 (" 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.")

jurisdictions,[91] and, in particular that this would harm the competitiveness of EU based firms.[92] This example illustrates that in an interconnected world, market participants can easily challenge regulatory proposals which 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 which would be conducive to financial stability.[93] Dealing with geographic and sectoral interconnectedness together is a long and complex project.

Managing geographic interconnectedness is not simple, even without the sectoral issues. Complete centralization of financial regulation would create a single point of failure. Networks are messier, and involve co-ordination 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 which 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 the result of a failure to manage interconnections effectively. The EU's attempts to control its recent crises emphasize greater co-ordination among a sub-set of EU Member States. In so doing, the EU risks undermining its achievements in moving towards networked integration among the full EU membership.

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[91] *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 (Dec. 20, 2012) at http://economix.blogs.nytimes.com/2012/12/20/last-ditch-attempt-to-derail-volcker-rule/ (Noting arguments that the Volcker rule violates the US' trade obligations).

[92] *Id.* ("Structural reform is argued to harm competitiveness of the EU banking sector.")

[93] *Cf.* Caroline Bradley, *Financial Trade Associations and Multilevel Regulation*, in Ramses Wessel, Andreas Follesdal & Jan Wouters eds., MULTILEVEL REGULATION AND THE EU: THE INTERPLAY BETWEEN GLOBAL, EUROPEAN AND NATIONAL NORMATIVE PROCESSES (2008).