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, as a result of the global financial crisis, prominent as objectives of financial regulation, requiring rethinking of regulation and its administration.[1] As policy-makers 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]

By emphasizing geographic and 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. Supranational bodies can claim the ability to address transnational issues in ways that would be

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[1] *See, e.g.*, Bank of England, Financial Stability Report (Jun. 2013); Andreas Dombret & Otto Lucius (eds.) STABILITY OF THE FINANCIAL SYSTEM, ILLUSION OR FEASIBLE CONCEPT (2013); Tobias Adrian, Daniel Covitz, & Nellie Liang, Financial Stability Monitoring, Federal Reserve Bank of New York Staff Reports, no. 601 (Feb. 2013). *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 co-ordinating transnational financial regulation through the G20 and Financial Stability Board "constitute a stark departure from the paradigm of networks of independent regulators.")

[2] *See, e.g.*, Financial Services Authority, THE TURNER REVIEW: A REGULATORY RESPONSE TO THE GLOBAL BANKING CRISIS, 36 (Mar. 2009) ("The crisis revealed fault lines in the global regulation and supervision of some of these cross-border firms, which raise fundamental issues about the appropriate future approach. The essence of the problem – as the Governor of the Bank of England, Mervyn King has put it – is that global banking institutions are global in life, but national in death."); Financial Stability Board, Shadow Banking: Strengthening Oversight and Regulation, (Oct. 27, 2011); IMF, The IMF's Financial Surveillance Strategy, 1 (Aug. 28, 2012) ("Systemic risk has become ever more complex, with shocks propagating rapidly through highly interconnected financial systems and across economies.")

difficult for domestic actors,[3] even when those domestic actors participate in transnational 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.[4] Supranational bodies — although subject to constraints in their founding documents— are free of the restrictions which national law may place on domestic regulators, restrictions which impede co-ordination between sectoral regulators domestically.[5]

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[3] *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.")

[4] 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.")

[5] Although *cf.* Joint Forum, Review of the Differentiated Nature and Scope of Financial Regulation - Key Issues and Recommendations, 3 (Jan. 2010) (noting that "International financial regulation is sector specific as evidenced by the independent development of core principles or standards in each financial sector. A sector-specific approach to supervision comes with the potential for increasing regulatory gaps, which causes supervisory challenges and presents opportunities for regulatory arbitrage. Differences exist in the nature of financial regulation among the banking, insurance, and securities sectors.")

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 multi-level and dispersed, rather than centralized.[6] 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,[7] 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 treaties, and incursions on domestic sovereignty are controversial.[8] The experience of the EU[9] 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[10]: each new measure builds on those which precede it. In practice, therefore,

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[6] *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).

[7] *See, e.g.*, Duncan Wood, GOVERNING GLOBAL BANKING: THE BASEL COMMITTEE AND THE POLITICS OF FINANCIAL GLOBALISATION (2005).

[8] *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).

[9] 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.

[10] See, e.g., HM Government, Review of the Balance of Competences between the United Kingdom and the European Union: The Single Market, 13 (Jul. 22, 2013) ("What is now known

transnational standards bodies rely on domestic regulators to implement the standards they promulgate. And domestic regulators — rather than transnational regulators — attempt to achieve transnational financial regulation otherwise than through formal and binding harmonization. Jurisdictions recognize the regulatory schemes of other jurisdictions,[11] and domestic regulators agree to co-operate in supervision and enforcement.[12] These transnational connections between domestic regulators are more significant since the financial crisis.[13]

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. Concentration of regulatory policy-making risks over-reliance on poor regulatory strategies[14] and capture,[15] with serious

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as the Single Market was a concept at the heart of the original Treaty of Rome, which came into force in 1958. That Treaty aimed at creating a "common market", later "internal market", covering the whole territory of the then six members of the then EEC.")

[11] *See, e.g.*, Commission Implementing Decision on the Recognition of the Legal and Supervisory Framework of the United States of America as Equivalent to the Requirements of Regulation (Ec) No 1060/2009 of the European Parliament and of the Council on Credit Rating Agencies, O.J,. L 274/32 (Oct. 9, 2012).

[12] *See, e.g.*, Sec. & Exch. Comm'n, SEC, European Regulators Establish Supervisory Cooperation Arrangements Related to the Asset Management Industry, (Jul. 19, 2013).

[13] *See, e.g.*, Commodity Futures Trading Commission, FY 2014 President's Budget and Performance Plan, 60 (Apr. 2013) ("Because the swaps market is conducted on a global basis, it is possible for swaps executed offshore by U.S. financial institutions to transmit the risk of those transactions back to the United States. Recognizing this risk, the United States joined with other G20 leaders in 2009 to require that all major market jurisdictions bring swaps under regulation. Since that date, the Commission has been engaged in an unprecedented outreach to major market jurisdictions and expanded involvement in numerous international working groups to encourage the adoption of robust swaps regulation.")

[14] *Cf.* The Turner Review, *supra* note 2, at 39 (noting that "the 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

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.[16] But despite the efforts of 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, [17] although the international standard setting bodies, the Financial Stability Board and the IMF are encouraging domestic regulators to implement transnational standards by means of peer reviews and assessments of implementation.

It is difficult to imagine that strict separations between different national financial markets across the board could be implemented 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 which implement its anti-moneylaundering standards and those which do not, and encourages

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impediments which might produce inefficient and illiquid markets.")

[15] *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.")

[16] *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, copy on file with author).

[17] *See, e.g.*, 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.

compliant jurisdictions not to interact with non-compliant jurisdictions.[18] US regulators have proposed ring-fencing of bank capital of very large international banks carrying on business in the US.[19] US financial regulators define which entities are to be considered to be US persons and which are not for the purposes of establishing a geographic perimeter for US rules.[20] The US is a member of the G20 and has agreed to participate in the Financial Stability Board's peer review process, but has also acted more speedily in some respects than some other jurisdictions (including the EU) in developing post-crisis financial regulation. Market participants expressed concern about possible divergence between US and EU derivatives regulation, and about extraterritoriality of US rules and uncertainties inherent in the CFTC's proposed approach to defining US persons.[21] In July 2013 the US and the EU announced that they would be working together to harmonize their approaches to derivatives regulation, and that harmonization would involve recognizing rules as equivalent and issuing no-action letters.[22] This type of mutual

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

[19] *See* Federal Reserve System, Enhanced Prudential Standards and Early Remediation Requirements for Foreign Banking Organizations and Foreign Nonbank Financial Companies, 77. Fed. Reg. 76628, 76629 (Dec. 28, 2012) ("The structural diversity and consolidated management of capital and liquidity permitted under the current approach has facilitated cross-border banking and increased global flows of capital and liquidity. However, the increase in concentration, complexity, and interconnectedness of the U.S. operations of foreign banking organizations and the financial stability lessons learned during the crisis have raised questions about the continued suitability of this approach.")

[20] *See, e.g.*, Commodity Futures Trading Commission, 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 "US persons" for the purposes of the application of regulations relating to swaps.)

[21] *See, e.g.*, Comments of Sarah A. Miller for the Institute of International Bankers on Proposed Rule 78 FR 909 (Feb. 6, 2013).

[22] *See, e.g.*, Commodity Futures Trading Commission, Press Release: The European Commission and the CFTC reach a Common Path Forward on Derivatives (Jul. 11, 2013)(Derivatives Common Path). The statement noted that "We will not seek to apply our rules (unreasonably) in the other jurisdiction, but will rely on the application and enforcement of the

recognition approach to co-ordinating regulation may be all that can be achieved at this point, but it reflects a compromise: the EU and the US are not achieving full harmonization, nor are they implementing territorial separations.

Just as transnational harmonization is incomplete, so is the effective management of sectoral and transactional interconnections in the financial markets. In February 2013 the Financial Stability Board 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.[23] 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." [24] Despite the lack of explicit guarantees, central banks intervened during the financial crisis to provide liquidity support to shadow banks.[25] Although market participants and trade associations have argued that shadow banks make important contributions to the financial system,[26] policy-makers have focused on developing appropriate regulation to address the risks posed to financial stability by shadow banks. In contrast to the dominant approach to transnational issues, policy-makers focusing on shadow banking have given serious consideration to policy proposals to break connections rather than manage their implications. In 2011 the Financial Stability Board suggested a mixture of approaches: shadow banking entities sponsored by banks should be consolidated in the banking

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rules by the other jurisdiction." *Id.*

[23] Financial Stability Board, Progress of Financial Regulatory Reforms (Feb. 12, 2013).

[24] Zoltan Pozsar, Tobias Adrian, Adam Ashcraft & Hayley Boesky, *Shadow Banking*, FRBNY Economic Policy Review / Forthcoming, http://www.newyorkfed.org/research/epr/2013/0713adri.pdf at p. 1.

[25] *See, e.g.*, *id.* at 3.

[26] *See, 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.")

group,[27] but banks should not be allowed to stand behind any unconsolidated entities.[28] Proposals to require banks which are protected by deposit insurance schemes to abstain from proprietary trading are an example of breaking connections.[29] So too are suggestions that the solution to the "too big to fail" problem is to break up large banks.[30] Reconfiguring the market for derivatives to move transactions onto organized markets is designed to enhance transparency, but also to impede transmissions of risk by inserting clearinghouses between buyers and sellers of standardized derivatives.[31] 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.[32] Some of these proposals to break connections have run into

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[27] FSB, Shadow Banking, *supra* note 2, at 16.

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

[29] *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).

[30] *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.

[31] *See, e.g.*, Financial Stability Board, Report on Implementing OTC Derivative Market Reforms (Oct. 2010). The Joint Forum identified settlement risk as a potential issue in the credit default swaps market. The Joint Forum, Credit Risk Transfer: Developments from 2005 to 2007, 22-23 (Jul. 2008) available at http://www.bis.org/publ/joint21.pdf .

[32] *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).

determined opposition.[33] 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.[34] Not paying serious attention to breaking connections where possible worsens the complexity problem in financial regulation.[35]

Making interconnectedness central to financial regulation policy is a difficult goal to achieve.[36] 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. And the EU's experience of trying to resolve the crises illustrate 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

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[33] *See, e.g.*, Anjan V. Thakor, THE ECONOMIC CONSEQUENCES OF THE VOLCKER RULE, Center for Capital Markets Competitiveness (Summer 2012).

[34] *See, e.g.*, José Viñals, Ceyla Pazarbasioglu, Jay Surti, Aditya Narain, Michaela Erbenova & Julian Chow, Creating a Safer Financial System: Will the Volcker, Vickers, and Liikanen Structural Measures Help?, IMF Staff Discussion Note SDN/13/4, 21 (May 2013) (noting potential costs of structural reform of banking).

[35] *See, e.g.*, Leonardo Gambacorta & Adrian van Rixtel, *Structural Bank Regulation Initiatives: Approaches and Implications*, BIS Working Papers No 412, 2 (Apr. 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) ("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.")

[36] The UK's Financial Services Authority 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. *See, e.g.*, HM Treasury, A New Approach to Financial Regulation, Cm. 8268 (Jan. 2012).

structures which 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. But attempts to break connections between financial firms run into opposition from those firms and their trade associations. 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.[37]

II. The Global Financial Crisis and an EU Sovereign Debt 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.[38] The crisis created pressures for governments to step in to provide liquidity to,[39] and even rescue, troubled financial firms.[40] The crisis revealed the interconnectedness of

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[37] *Cf.* Basel Committee on Banking Supervision, the Regulatory Framework: Balancing Risk Sensitivity, Simplicity and Comparability, 9 (Jul. 2013) ("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. Conversely, a lack of comparability, driven by complexity in the risk-weighting process, may erode market confidence in risk-based capital ratios as a measure of financial soundness, adding an uncertainty premium to bank liabilities. In recent years, bank equity analysts have frequently remarked on the difficulty of understanding differences in risk-weighted assets both across firms and through time.")

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

[39] *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).

[40] *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.

financial firms and markets when stresses originating in the US spread quickly around the world.[41] Uncertainty about the appropriate valuation of sub-prime-backed securities led to uncertainty about the valuation of other assets and to doubts about the viability of financial firms. 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 regulation,[42] and to a system of peer review to ensure states' compliance with the new standards[43] and to remind them of the "international ramifications of domestic actions."[44]

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,[45] most visibly in certain EU member states, and the

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[41] *See, e.g.*, Gert Wehinger, *The Turmoil and the Financial Industry: Developments and Policy Responses*, OECD 96 Financial Market Trends 1, 2 (2009) (" The crisis has also reached countries and regions which earlier were believed to have been out of the range of contagion.")

[42] *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.")

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

[44] 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.

[45] *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

financial crisis led to a European sovereign debt crisis.[46] 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.[47] Thus a "vicious circle" was created between EU banks and sovereigns:[48] 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),[49] and established a Securities Market Programme (SMP) to purchase sovereign debt.[50] 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."[51] The EU took other measures to manage the interconnections

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balance sheets could be transmitted back to banking systems or across borders.")

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

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

[48] Eurogroup Statement on the Follow-up of the 29 June Euro Summit (Jul. 9, 2012). *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.")

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

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

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

between public debt and the regulation of banks,[52] and to take steps to limit speculation (by means of credit default swaps) in the debt of EU Member States.[53] However, the combined crises had implications beyond Europe. Policy-makers worried about the risks that the European problems could infect other parts of the world.[54] Lending to emerging market economies fell as European banks suffered.[55]

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.[56] As Mervyn King observed, banks may be international in life, but they tend to be national in death.[57] 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

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[52] *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).

[53] Council Regulation 236/2012, O.J. No. L 86/1 (Mar 24, 2012) (Short Selling Regulation).

[54] *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."

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

[56] *See, e.g.*, Hildebrand, supra note 35, 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.")

[57] *See, e.g.*, Turner Review, supra note 2. *Cf.* Goodhart, *supra* note 39, 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.")

conditioned on new austerity measures.[58] Austerity measures in turn provoked domestic opposition.[59]

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,[60] 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.[61] The EU had an incompletely harmonized system of deposit insurance,[62] and no harmonized rules for bank resolution.[63]

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[58] *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).

[59] *See, e.g.*, Wolfgang Rüdig & Georgios Karyotis, *Who Protests in Greece? Mass Opposition to Austerity*, forthcoming British Journal of Political Science (2013) available on CJO2013. doi:10.1017/S0007123413000112. At p. 2 (noting that "anti-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.")

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

[61] *See, e.g.*, EU Commission, A Roadmap Towards a Banking Union COM (2012) 510 final at 3 (Sept. 12, 2012) (Roadmap) ("Ccordination 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.")

[62] *See, e.g.*, EU Commission, Review of Directive 94/19/EC on Deposit Guarantee Schemes COM (2010) 369 final (Jul. 12, 2010) at 2 ("The 'minimum harmonisation' approach taken by Directive 94/19/EC resulted in significant differences between the 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.")

[63] *See, e.g.*, EU Commission, Proposal for a Directive Establishing a Framework for the Recovery and Resolution of Credit Institutions and Investment Firms, COM (2012) 280 final

The EU's ability to act quickly to restore confidence in EU financial firms was limited by these harmonization gaps.[64] 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.[65] And the crises imposed costs on EU citizens in terms of rising levels of unemployment, increased taxation, and austerity measures.[66] EU action to increase financial regulatory harmonization required negotiation, the resolution of legal disputes, and even Treaty amendments.[67] 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 eurozone,[68] and from the

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(Jun. 6, 2012) at 4 ("an 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.")

[64] *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).

[65] *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.

[66] *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

[67] *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).

[68] See, e.g., IMF, World Economic Outlook April 2012: Growth Resuming, Dangers Remain, 23 (Apr. 2012) ("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-eight Member States which have a common currency: the euro. The members of the

fact that some EU Member States are not members of the eurozone.[69] 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. However, whereas the eurozone does not include all of the EU's Member States, the EU's single market in financial services does. The EU has attempted to resolve the sovereign debt crisis by intensifying co-operation between the eurozone states[70] and constraining those states' freedom of action.[71] However, in addition to focusing on the eurozone states' fiscal situations, the EU's solution to the defects in the eurozone involves addressing the interactions between banks and sovereigns by developing a system of eurozone banking supervision,[72] and this risks

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eurozone are Belgium, Germany, Estonia, Greece, Spain, France, Ireland, Italy, Cyprus, Luxembourg, Malta, the Netherlands, Austria, Portugal, Slovenia, Slovakia and Finland. Latvia will become a member of the eurozone in January 2014. *See* Council of the EU Press Release, Euro Area Countries Recommend Latvia Euro Accession (Jun. 21, 2013).

[69] *See, e.g.*, REVIEW OF THE BALANCE OF COMPETENCES BETWEEN THE UNITED KINGDOM AND THE EUROPEAN UNION, 5 Cm. 8415 (2012) ("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.")

[70] *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.").

[71] *See, e.g.*, Regulation 473/2013 on Common Provisions for Monitoring and Assessing Draft Budgetary Plans and Ensuring the Correction of Excessive Deficit of the Member States in the Euro Area O.J. No. L 140/11 (May 27, 2013); Regulation 472/2013 on the Strengthening of Economic and Budgetary Surveillance of Member States in the Euro Area Experiencing or Threatened with Serious Difficulties with Respect to Their Financial Stability O.J. No. L 140/1 (May 27, 2013).

[72] *See, e.g.*, Blueprint, *supra* note 52.

undermining the single market in financial services.[73]

The EU was designed from the beginning to be a common market, and legal harmonization was intended as a mechanism for achieving a common market. The founding Treaties (as interpreted by the judiciary) prohibited the Member States from maintaining in force laws which functioned as barriers to the free movement of goods, workers and capital between Member States, and empowered the EU's institutions to adopt binding legal rules to harmonize certain laws within the EU. But the EU's approach to achieving a single market has developed over time[74] 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[75] and even EU-level regulation.[76] 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 (with the risk of divergent interpretations of the common rules) also risk undermining the single market.

The EU reacted to the financial crisis by acknowledging the Member States' political imperatives to protect domestic financial institutions, and liberalizing constraints on state aids.[77]

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[73] 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 48, at 31-34.

[74] *See, e.g.*, Balance of Competences, supra note 10.

[75] 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/EC on the Prospectus to Be Published When Securities Are Offered to the Public or Admitted to Trading, O.J. No. L 345/64 (Dec. 31, 2003). The liability regimes in the Member States do vary, however. *See, e.g.*, ESMA, Report: Comparison of Liability Regimes in Member States in Relation to the Prospectus Directive (May 30, 2013).

[76] *See* Council Regulation 513/2011, O.J. No. L 145/30 (May 31, 2011) 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, O.J. No. L 302/1 (Nov. 17, 2009)

[77] *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

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.[78] For example, the European Securities Markets Authority authorizes and regulates credit rating agencies within the EU.[79] The EU established a European Systemic Risk Board (ESRB),[80] 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 authorities responsible for macro-prudential policy should be "as a minimum operationally independent, in particular from political bodies and from the financial industry."[81] Similarly, the EU acted to control volatility by regulating short selling and credit default swaps.[82] The EU institutions have considered proposals to harmonize

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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.")

[78] *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).

[79] *See supra* note 76.

[80] Council Regulation 1092/2010, O.J. L 331/1 (Dec. 15, 2010) [hereinafter ESRB Regulation].

[81] ESRB, Recommendation on the Macro-Prudential Mandate of National Authorities, Recommendation ESRB/2011/3,) O.J. C 41/1 (Feb. 14, 2012.).

[82] Short Selling Regulation, *supra* note 53, 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

rules relating to deposit insurance,[83] and to rescuing financial institutions in distress,[84] In many ways the EU's approach to new financial regulation in the wake of the financial crisis has followed international initiatives. 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 to act until international standards are agreed.[85]

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 on OTC Derivatives Central Counterparties and Trade Repositories (European Market Infrastructure Regulation

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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.")

[83] *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."); Directive 2009/14/EC on Deposit-guarantee Schemes as Regards the Coverage Level and the Payout Delay, O.J. No. L68/3 (Mar. 13, 2009); EU Commission, Review of Directive 94/19/EC on Deposit Guarantee Schemes, COM (2010) 369 final (Jul. 12, 2010). *Cf.* Sebastian Schich, *Financial Crisis: Deposit Insurance and Related Financial Safety Net Aspects*, 95 FIN. MKT. TRENDS (OECD 2008/2).

[84] *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.")

[85] *See, e.g.*, AFME shadow banking comments, *supra* note 26 ("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.")

(EMIR)) in 2012.[86] EMIR provides for central clearing of certain classes of OTC derivatives; the application of risk mitigation techniques for non-centrally cleared OTC derivatives; reporting to trade repositories; the application of regulatory requirements to central counterparties (CCPs) 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. EMIR recognizes that the EU needs to interact with other jurisdictions in the regulation of swaps. For example recital number 6 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."[87] The broad design of the EU rules tracks international standards[88] and the US approach to derivatives regulation.[89] However market participants expr4essed concern that the details of the rules in the EU and the US would differ. In July 2013 the US and EU announced that they would adopt a "Common Path" to regulating derivatives.[90]

Like the US, 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 non-core banking in 2012 (the Liikanen proposal) a year after the US published its proposed Volcker Rule.[91] As of the summer of 2013 neither proposal has been adopted. In May 2013 the EU Commission published a consultation document on structural

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[86] Regulation No 648/2012 on OTC Derivatives, Central Counterparties (CCPs) and Trade Repositories, O.J. No. L 201/1 (Jul. 27, 2012).

[87] *Id.* at recital no. 6.

[88] *See, e.g.*, Financial Stability Board, REPORT ON IMPLEMENTING OTC DERIVATIVE MARKET REFORMS (Oct. 25, 2010).

[89] *See, e.g.*, Commodity Futures Trading Commission, Strategic Plan FY 2011-2015 (Mar. 2011).

[90] Derivatives Common Path, *supra* note 22.

[91] *See* supra note 29. For a discussion of the different proposals see José Viñals et al, supra note 34.

reform of banking in the EU.[92] 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.[93]

The Commission suggested that EU rules were necessary to limit the possibilities for regulatory arbitrage and to reduce market fragmentation which might result from divergent rules in different Member States.[94] Within the EU, therefore, regulation of the structure of banks is linked to issues of geography. ISDA and AFME 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.[95] Structural separation of banking and non-banking functions is intended to address risks that are not adequately addressed by regulatory measures such as capital requirements,[96] but, for a number of reasons attempting to implement structural separation is

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[92] EU Commission, Reforming the Structure of the EU Banking Sector: Consultation Paper (May 2013).

[93] *Id.* at 2.

[94] *Id.* at 3.

[95] Response Submission from AFME and ISDA to the Consultation by the Commission on the Structural Reform of the Banking Sector (Jul. 11, 2013) 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.")

[96] *See, e.g.*, José Viñals et al, supra note 34, at 5 ("Financial institutions that are considered too important to fail (TITF) pose a risk to the financial system as a whole. There are

costly. In particular, defining the boundaries between permitted and impermissible activities for banks is complex.[97]

The Too Big To Fail 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 Too Big To Fail) the EU also had to address its own developing eurozone sovereign debt crisis which was prompted by strains on the budgets of some Member States caused by bailing out financial institutions in crisis and poor fiscal management.[98] Interconnections within the eurozone were more complex and urgent than the broader intyernational interconnections. And concerns about the reliability of official data exacerbated the crisis.[99] The fiscal policies of the eurozone Members were meant to be controlled by the EU's

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two broad approaches to reducing this negative externality: (1) price-based regulations accompanied by enhanced supervision and effective resolution; and (2) structural limits on the size and scope of the activities of these institutions.")

[97] *See, e.g.*, *id*. at 20 ("Implementation costs relate to the challenge of distinguishing proscribed trading from permitted transactions and the resulting burden of compliance and reporting... Distinguishing proprietary from permitted trading will be difficult..This challenge is particularly relevant for the Volcker rule and the French and German ring-fencing proposals. For example, it will be difficult to differentiate risk exposures of banks due to hedging or market making versus risk from proprietary trading .. It is for this reason that the Liikanen group recommended that market making be placed outside the ring-fence alongside proprietary trading.")

[98] *See, e.g.*, Adrian Blundell-Wignall & Patrick Slovik, *A Market Perspective on the European Sovereign Debt and Banking Crisis*, 2010:2 OECD Journal Financial Market Trends 1, 2.

[99] *See, e.g.*, OECD, OECD Economic Surveys: Greece 2011, 11 (2011) ("The dire economic situation was magnified by lost credibility as serious deficiencies in statistical monitoring of government accounts were exposed."); Manos Matsaganis, *The Welfare State and the Crisis: The Case of Greece*, 21 J. EUR. SOC. POL. 501, 501 (2011) ("The revised figures stunned public opinion at home and shocked markets abroad.")

Stability and Growth Pact, but in practice this control was ineffective,[100] in part because of the single currency's importance as a tool of integration.[101] The EU and the IMF together provided financial support to eurozone sovereigns in crisis on condition that those sovereigns implemented policies of austerity.[102]

The EU sovereign debt crisis illustrates interconnection as a source of financial instability, both in terms of the "vicious circle" between banks and sovereigns,[103] and in terms of the transmission of instability between members of the eurozone. The EU's 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. But as the eurozone'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 bank/state and state/state interconnections, but the management of market participants' perceptions of risks to financial stability.[104]

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[100] *See, e.g.*, Ludger Schuknecht et al., *The Stability and Growth Pact: Crisis and Reform*, 9, European Central Bank Occasional Paper Series No 129 (Sep. 2011) 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".); International Monetary Fund, Growth Resuming, Dangers Remain, 3, World Economic Outlook (Apr. 2012) at http://www.imf.org/external/pubs/ft/weo/2012/01/pdf/text.pdf ("The Stability and Growth Pact was devised to bring about fiscal discipline but failed to forestall bad fiscal policies.")

[101] *See, e.g.*, David Marsh, *Faltering Ambitions and Unrequited Hopes: The Battle for the Euro Intensifies?* 49 J. COMMON MKT. STUD. 45, 46 (2011).

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

[103] *See supra* text at note 48.

[104] *See, e.g.*, Blueprint, *supra* note 52, at 10 ("Ultimately, the negative feedback loop between sovereigns and banks and the associated refragmentation of the EU's financial markets

The EU now seeks to address both sets of interconnection by reinforcing fiscal controls and controls over banks. In addressing the interconnections the EU has acted to develop stronger fiscal discipline,[105] and to negotiate the establishment of a European Banking Union in which the ECB will be responsible for bank supervision within the eurozone.[106] Many of the documents referring to the European Banking Union state that its purpose is to end the "vicious circle" between banks and sovereigns.[107] 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,[108] although the financial crisis, and events in Cyprus in 2012[109] did suggest

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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.")

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

[106] 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);Roadmap, *supra* note 61; 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 52.

[107] *See, e.g.*, Blueprint, *supra* note 52; European Council, Roadmap for the Completion of EMU, European Council Conclusions (Dec 13-14 2012) at ¶ 10.

[108] *Cf.* FSB, Peer Review of Italy, 5 (Jan. 27, 2011) ("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

that there were some weaknesses in EU banking supervision.

The 2012 proposal for a European Banking Union was published under Herman Van Rompuy's name,[110] and was based on a system of integrated supervision of banks, a European deposit insurance scheme, and a European resolution scheme.[111] 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 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. The planned European Banking Union is to operate alongside the EU's single market in financial services. The Commission described the single market and the European Banking Union as "mutually reinforcing processes,"[112] 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,"[113] 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

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and discouraged banks from participating in complex securitization activities and sponsoring structured investment vehicles.")

[109] *See, e.g.*, International Monetary Fund, Cyprus: Request for Arrangement under the Extended Fund Facility, IMF Country Report No. 13/125 (May 2013).

[110] 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.

[111] Herman Van Rompuy, Towards a Genuine Economic and Monetary Union, *supra* note 106, 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).

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

[113] Blueprint, *supra* note 52, at 10.

Union,[114] 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).[115] In May 2013, Vítor Constâncio, Vice-President of the European Central Bank, 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."[116]

Like most of the European project, the process of working towards a European Banking Union is slow and incremental. The EU institutions emphasized that they intended to proceed in a way that satisfied requirements of democratic accountability and legitimacy.[117] This is a recurrent issue within the EU: discussions of the democratic deficit in Europe are longstanding[118] 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

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[114] 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")")

[115] See Blueprint, *supra* note 52, 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.")

[116] Vítor Constâncio: 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, Brussels (May 24, 2013).

[117] *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.").

[118] *See, e.g.*, 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)

commitment to democracy.

Van Rompuy's European Banking Union proposal encompassed common supervision and common arrangements for deposit insurance and resolution, however the EU began to work on common supervision before implementing a common resolution regime because common supervision was less controversial than common deposit insurance and resolution.[119] The European Banking Union plan envisaged the setting up of a European Resolution Authority,[120] 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."[121] In July 2013 the Commission published proposals for a single resolution mechanism and bank resolution fund for the euro area.[122] Although these new measures would create further distinctions between eurozone banks and other EU banks, the Commission argued that banks outside the eurozone would benefit from enhanced bank supervision in the eurozone.[123]

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[119] Blueprint, *supra* note52, 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 107, 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.")

[120] Blueprint, *supra* note52, at 18.

[121] 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.

[122] EU Commission, Proposal for a Regulation 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, COM(2013) 520 final (Jul. 10, 2013).

[123] *Id.* at 3 ("The enhanced financial stability generated by the Banking Union will also boost confidence and the prospects for growth across the internal market. Central and uniform application of prudential and resolution rules in the Member States participating in the Banking

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.[124] 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.[125] 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.[126] 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,[127] to concerns about the interactions between the European Banking Union and

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Union will benefit all Member States. By overcoming the financial fragmentation currently hampering economic activity, it will help ensure fair competition for and remove obstacles to the free exercise of fundamental freedoms not only in the participating Member States but in the whole of the internal market.")

[124] Blueprint, *supra* note52, 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.")

[125] *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 .

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

[127] *Cf.* Constâncio, *supra* note 125 ("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

SSM and the single market,[128] 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

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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 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.")

[128] *See, e.g.*,. House of Lords EU Committee Report, *supra* note 119. *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."

accountability for the supervisory tasks.[129]

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).[130] If the distinction between the eurozone and the broader EU persists,[131] 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.[132] 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."[133]

For the time being, the EU is working on transferring the supervision of eurozone banks (and not other financial institutions) to the ECB. 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. On the other and, if the ECB were to gain supervisory powers over non-banks this would exacerbate the eurozone/EU single market tensions.

The recent evolution of EU financial regulation has combined moving forward with the

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[129] ECB Opinion, *supra* note 121, at ¶1.4.

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

[131] 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 119, at 12-13.

[132] Although *cf. e.g.*, House of Lords EU Committee Report, *supra* note 119, 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.")

[133] Proposed amendment to EBA Regulation, *supra* note 106, at 4.

G20 agenda for the reform of financial regulation with taking action to address the eurozone's particular crisis. 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 addressing the longer term issues. And the distinction between the eurozone and non-eurozone EU is set to become greater in the future: the Blueprint even imagined a new, more active, role for the eurozone in "multilateral institutions and fora as well as in bilateral dialogues with strategic partners,"[134] a eurozone fiscal capacity,[135] and the issuance of eurobills.[136] 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.

III Conclusions

Within the EU and at the international level, policy-makers 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 towards an ever closer union — incrementally.[137] 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

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[134] Blueprint, *supra* note 52, at 25.

[135] Blueprint, *supra* note52, at 27.

[136] Blueprint, *supra* note52, at 29-30.

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

banking activities from proprietary trading in securities and derivatives, which are conceived of as excessively risky.[138] 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.[139] In addition market participants have argued that it would be problematic for the EU to adopt separation requirements which differed from those in other jurisdictions,[140] and, in particular that this would harm the competitiveness of EU based firms.[141] 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

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[138] Liikanen Report, *supra* note 29, 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.")

[139] 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.")

[140] *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).

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

stability.[142] 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, and whereas the EU's attempts to control its recent crises emphasize greater co-ordination among a sub-set of EU Member States those attempts also risk undermining the EU's achievements in moving towards networked integration among the full EU membership.

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[142] *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).