European Integration and Cross-Border Financial Governance in the Aftermath of the Global Financial Crisis

Challenges and Prospects of Post-Crisis Policy Responses to Systemic Risk in the European Union

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ABSTRACT

With the ripple effects of the global financial crisis of 2008 exhibiting enduring rifts in the global economy to date, an assessment of the crisis as being rooted in both market and regulatory failure sheds light on the significance and the severity of the challenges cross-border financial capitalism presents nation states with in the wake of globalization. As externalities increase, the threats the unprecedented interdependence and instability of the modern financial system pose are unlikely to recede; on the contrary, they are bound to become more pressing. This is of considerable significance for financial governance, implying that sovereign nation states – formally legitimized to conduct regulatory functions – must construct robust cross-border structures to cope with the challenges of governing an inherently crisis-prone system. In an attempt to address the underlying shortcomings exposed by the crisis – among them that the regulatory and supervisory architecture was not commensurate with the complexity and sophistication of financial markets – the European Union embarked on an ambitious reform path. The potential capacity of European integration in this regard, though central in the academic debate, has yet to be analyzed systematically with respect to systemic risk in terms of both its systemic qualities and political embeddedness. Drawing on a refined definition thereof set out by Willke et al. (2013), this research aims to shed light on how these themes resonate in the European context to inform the critical analysis of conducted reforms. Based on the assumption that cross-border finance requires integrated governance schemes to ensure its integrity and efficacy, the central goals are to (i) assess both systemic-risk related reform measures and the challenges they are confronted with, and (ii) illuminate the significance of reform, while underpinning the case for enhanced integration.

Drawing on a broad theoretical framework combining insights from various EU integration theories to trace the rationale and assess the potential and significance of supranational integration, and constructing an analytical framework within which to assess the order-, legitimacy- and expertise-related challenges current structures are confronted with, i.e. factors inhibiting governance capacity, the research concludes that though substantive reforms have largely failed to address the core systemic issues exposed by the crisis, there has indeed been substantial progress in terms of the reform of the institutional governance architecture at the European level. While monumental challenges remain, it would be premature to discredit the response in its entirety. The analysis highlights the European Union’s remarkable capacity to adjust, with institutional responses essentially at the boundaries of legal and political feasibility. Given what is at stake, however, it contends that – with a view to future challenges – supranational governance regimes remain short of optimal scope and must be strengthened to forestall the gradual erosion of governance capacity vis-à-vis an increasingly interdependent and fragile financial system.
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<thead>
<tr>
<th>Abbreviation</th>
<th>Full Form</th>
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<tbody>
<tr>
<td>ABS</td>
<td>Asset-Backed Securities</td>
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<tr>
<td>ASC</td>
<td>Advisory Scientific Committee of the European Systemic Risk Board</td>
</tr>
<tr>
<td>ATC</td>
<td>Advisory Technical Committee of the European Systemic Risk Board</td>
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<tr>
<td>BCBS</td>
<td>Basel Committee on Banking Supervision</td>
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<tr>
<td>BIS</td>
<td>Bank for International Settlements</td>
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<tr>
<td>BoS</td>
<td>Board of Supervisors</td>
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<td>BRRD</td>
<td>Bank Recovery and Resolution Directive</td>
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<td>BU</td>
<td>Banking Union</td>
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<tr>
<td>CDO</td>
<td>Collateralized Debt Obligation</td>
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<td>CDS</td>
<td>Credit Default Swap</td>
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<td>CEBS</td>
<td>Committee of European Bank Supervisors</td>
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<td>CEIOPS</td>
<td>Committee of European Insurance and Occupational Pensions Supervisors</td>
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<td>CESR</td>
<td>Committee of European Securities Regulators</td>
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<tr>
<td>CJEU</td>
<td>Court of Justice of the European Union</td>
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<td>CRD</td>
<td>Capital Requirements Directive</td>
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<td>CRR</td>
<td>Capital Requirements Regulation</td>
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<tr>
<td>DFA</td>
<td>Dodd-Frank-Act</td>
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<tr>
<td>DGS</td>
<td>Deposit Guarantee Scheme</td>
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<td>EBA</td>
<td>European Banking Authority</td>
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<tr>
<td>ECB</td>
<td>European Central Bank</td>
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<td>EFSF</td>
<td>European Financial Stability Facility</td>
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<tr>
<td>EFSM</td>
<td>European Financial Stabilization Mechanism</td>
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<tr>
<td>EIOPA</td>
<td>European Insurance and Occupational Pension Authority</td>
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<tr>
<td>EMIR</td>
<td>European Market Infrastructure Regulation</td>
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<tr>
<td>EMU</td>
<td>Economic and Monetary Union</td>
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<tr>
<td>ESA</td>
<td>European Supervisory Authority</td>
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<td>ESCB</td>
<td>European System of Central Banks</td>
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<td>ESFS</td>
<td>European System of Financial Supervision</td>
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<td>ESM</td>
<td>European Stability Mechanism</td>
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<td>ESMA</td>
<td>European Securities and Markets Authority</td>
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<td>European Systemic Risk Board</td>
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<td>EU</td>
<td>European Union</td>
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<td>EMU</td>
<td>Economic and Monetary Union</td>
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FED Federal Reserve System (US)
FPC Financial Policy Committee (UK)
FSA Financial Services Authority (UK)
FSAP Financial Services Action Plans
FSB Financial Stability Board
FSOC Financial Stability Oversight Council (US)
G-SIB Global Systemically Important Bank
G20 Group of Twenty Finance Ministers and Central Bank Governors
IAIS International Association of Insurance Supervisors
IASB International Accounting Standards Board
IFRS International Financial Reporting Standard
IMF International Monetary Fund
IOSCO International Organisation of Securities Commissions
ISD Investment Services Directive
LCFI Large Complex Financial Institution
MAD Market Abuse Directive
MaRS Macroprudential Research Network
MiFID Markets in Financial Instruments Directive
MiFIR Markets in Financial Instruments Regulation
MoU Memorandum of Understanding
NCA National Competent Authority
NCB National Central Bank
OFR Office of Financial Research (US)
OTC Over-the-Counter (Derivatives)
QMV Qualified Majority Voting
RWA Risk Weighted Assets
SEA Single European Act
SIFI Systemically Important Financial Institution
SRB Single Resolution Board
SRM Single Resolution Mechanism
SSM Single Supervisory Mechanism
TBTF Too Big to Fail
TFEU Treaty on the Functioning of the European Union
1. PART I: INTRODUCTION

Never before in the history of the modern nation state has public authority been confronted with so many complex challenges and existential threats. The developments transpiring within the global system throughout the past decades – the evolution of which with respect to finance culminated in the crash of 2008 – attest to the validity of this claim and serve as clear evidence that sustainable cross-border governance is indispensable in an era of increasing economic interdependence. In this context, the global financial crisis of the late 2000s highlighted two crucial features of the international system arising from the way in which the latter evolved over the past decades: While (i) autarky is no longer a viable form of governance, (ii) the interdependence resulting from and transmission mechanisms inherent in cross-border financial capitalism have made all nations susceptible to the fallacies of other actors as well as the externalities of the system’s properties and fundamentals in general. The crisis – unprecedented in its magnitude, reach and systemic quality – exhibited the destructive capacity of systemic risk, i.e. the negative externalities of a globalized financial system, like never before, demonstrating that even minor disruptions can wreck havoc and pervade entire socio-political systems. With faith in the self-regulatory capacity of the market seriously compromised and national territorial authority – the traditional form of governance – increasingly unable to attain and secure its regulatory objectives on its own, cooperative and integrated cross-border governance becomes imperative to ensure the stability, equity and efficiency of finance, inter alia in order to secure the benefits of integration and open markets. The issue at stake is, therefore, not whether globalization will be governed, but rather how it should be governed (Keohane and Nye 2000, 2009).

This issue is all the more consequential in the financial domain, seeing as in the post-Bretton Woods era global finance has evolved into one of the “most complex, innovative, dynamic and expertise-based” (Willke et al. 2013: 76) systems that exist at present. Unparalleled interdependence coupled with the complexity and instability of an inherently crisis-prone modern financial system invariably challenges sovereign nation states. Compounding these structural developments is the fact that financial institutions are international in life, yet national in death as the former Governor of the Bank of England, Sir Mervyn King, rightly stated (FSA 2009: 36). This has crucial implications, among them that while transactions are conducted on a cross-border basis, central bank liquidity and government support is generally provided at the national level, and systemic risk, induced inter alia by time-inconsistency and distortions in national governance, inevitably has cross-border repercussions, rendering transnational regulation a necessity.

To a degree, the financial crisis that preceded the so-called Great Recession can be regarded as the epitome of a troubled relationship between public authority and the private sector or nation states and their

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1 For the sake of simplicity, when referring to the financial crisis throughout, the term is employed to denote the financial turmoil that ensued after the collapse of Lehman Brothers in the fall of 2008, “even if the strength of the causal links between the subprime, banking and sovereign debt crises” (Mügge 2013: 467) is still debatable.

2 To illustrate the sheer scale of the crisis and its consequences, it is instructive to refer to the immediate ramifications and knock-on effects of the Lehman Brothers collapse in 2008 after which 13 million jobs were lost and a sharp decline in global trade,
financial institutions, calling the very foundations of the state-market divide into question. Yet while it may well be a mistake to assume the world is indeed “moving beyond market fundamentalism” (Stiglitz 2009a: 345), what is striking is the fact that though economists remain divided on the issue of market self-sufficiency, they appear increasingly willing to accept the flaws inherent in the conventional wisdom of pre-crisis paradigms – for instance, the fact that the nexus between deregulation, efficiency and system stability at large has proven inconclusive. Where assumptions of perfect markets and competition do not hold, implications for reconciling the multiple trade-offs between social equity, growth and stability arise.

Ultimately, two pivotal and interdependent imperatives can be deduced from the latter in the supranational context: (i) the need for effective financial governance (public authority vis-à-vis the financial sector), comprising institutional and substantive elements in the realm of financial regulation and supervision on the one hand, and (ii) the need for enhanced cross-border governance (cooperation among member states) on the other. Bridging this divide and reconciling both imperatives is particularly significant in the case of systemic risk as, in essence, systemic risk – which is the threat of a systemic breakdown and is essentially unpredictable – arises from the structural foundations and dynamics of the financial system as well as from the political economy context within which the system as such is embedded. An illustration of the latter is the phenomenon of too big to fail or systemically significant financial institutions which poses a threat to the global economy and results inter alia from incentive-incompatibilities (e.g. time inconsistent policy interventions) and distortions (e.g. bailout expectations) between the public and private sector, which in turn result from the uncertainty engrained in an inherently fragile and crisis-prone financial system, and are aggravated by the cross-border nature of financial activity, adding an additional layer of complexity to financial governance.

Rooted in both market and regulatory failure, it is conclusive to conceptualize the crisis of 2008 – widely regarded as the systemic crisis (Becker 2016; French et al. 2010; Levitin 2014; Willke et al. 2013) – as a crisis of governance. It therefore comes as no surprise that given the fundamental issues exposed in its wake the crisis prompted an ambitious overhaul of the regulatory architecture in the EU, essentially presenting the latter’s attempt to remedy the flaws of governance configurations that were considered unfit for purpose (De Larosière 2009; FSA 2009). With the majority of post-crisis reforms in terms of both financial market regulation and institutional structures now in place at the European level, an assessment of their merits is warranted in order to assess whether alterations are commensurate with the underlying issues and challenges highlighted by the crisis. This research offers an in-depth analysis of reform and ensuing cross-

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3 An example to illustrate division in this regard is the Nobel Prize of 2013 with which Eugene Fama (a rational expectations theorist) and Robert Shiller (a behavioral finance theorist) were honored for their respective contributions. Worth noting in this context is that despite the disparity between their approaches, both neglect Knightian uncertainty, i.e. the inevitability of unforeseeable developments to which no probabilities can be assigned (Knight 1965). This insight is a crucial component of the argument in favor of the build-up of reactive cross-border governance capacity (see section 4.3.3).

4 The implication thereof is that public authority must inevitably frame the parameters of financial markets to ensure system stability and resilience at large, irrespective of the prevailing degree of liberalization and market integration.
border governance capacity in the post-crisis era – conducted against the backdrop of a refined and novel definition of systemic risk set out by Willke et al. (2013) which integrates political and systemic elements and draws attention to the political economy and system-related factors that engender systemic risk.

When assessing the significance of the European response to the crisis, two key issues are at stake: (i) the extent to which the financial system’s institutional components and dynamics are actually governable, and (ii) which institutional structures present viable schemes for coping with the instability, complexity, and interdependence inherent in modern finance, while mitigating the political economy distortions that inevitably arise. In essence, systemic crises are facilitated by the underlying fundamentals and dynamic qualities of a system that is inherently unstable and has become increasingly complex and tightly coupled, essentially making them unpredictable, while giving rise to contagion, which ultimately renders their immediate, yet contextual handling an outright necessity given their externalities and knock-on effects. In view of the latter, the issue of governance capacity is crucial, which in the context of this research denotes the build-up of reactive cross-border capacity in supranational or intergovernmental terms and must inevitably integrate prevention and crisis management, both of which are essential with respect to systemic risk mitigation.

The potential supranational contribution in this respect is central to the argument throughout, particularly to the call for more integrated solutions and the need to rethink the legal bases of such approaches given the imperatives of financial globalization. Yet, ultimately, as will be laid out, systemic risk may be indicative of a fundamental dilemma in modern nation state-centric capitalism, i.e. the inability of the latter to cope with an increasingly knowledge-intensive, unstable, tightly coupled and dynamic cross-border system and the corresponding risks it gives rise to (Goldin and Vogel 2010; Willke et al. 2013).

This research examines how these themes resonate in the European context, analyzing both advances in integration in terms of financial governance and the challenges confronting them. Based on the assumption that pre-crisis constellations in Europe were deficient and that cross-border finance requires consolidated and integrated governance schemes to mitigate and manage systemic risk given the high comparative degree of integration in the EU the objective is essentially threefold. The first chapters of the thesis review and critically assess rationales and dynamics of transnational cooperation and supranational integration against the backdrop of the theoretical premises upon which they build and discuss both the crisis and the phenomenon of systemic risk as well as the respective governance imperatives they give rise to in order to illustrate why cooperation in this regard is indispensable, laying the basis for analyzing the governance advances that have transpired and theorizing the challenges confronting them, thereby constraining governance capacity at the supranational level. Against the backdrop of the above, the research thereafter assesses the post-crisis response in institutional and substantive terms, whereby the aim throughout is to examine the state of systemic-risk related reform and delineate the extent to which the governance structures put in place are viable in view of the shortcomings revealed by the crisis. The goal is ultimately an appraisal of progress in terms of governance innovation, and in turn an attempt to assess the
inevitable limitations structures exhibit with a view to the factors that inhibit meaningful integration and the extension of governance capacity at the supranational level. Theorizing impediments militating against the latter by integrating elements of governance theory, i.e. expertise-, order- and legitimacy-related constraints into an analytical framework, it aims to contextualize the challenges of governing a system that is as inherently unstable, complex and knowledge-intensive as finance. Finally, drawing conclusions from the conducted analysis, it is argued that though substantial institutional progress and innovation has been attained, considerable substantive shortcomings remain, while the case for extending regulatory integration even further in order to augment supranational governance capacity persists. It is further contended that, in order to cope with interdependence and the challenge of governing an ever-evolving financial system, the potential of delegation in various senses ought to be explored in light of the crisis lessons and in view of the dynamic system properties of finance – a system that by definition requires robust and reactive cross-border capacities. The research is an analysis of the implications of reform in terms of governance capacity. As such, it is not geared toward explaining change as a process, but rather assessing and contextualizing the outcome of reform and by consequence the EU’s evolutionary capacity in terms of financial governance integration and European integration more generally.

Precisely this capacity is embodied in the institutional innovation and experimentation that has taken place to date from which transformative change that combines both incrementalism and great leaps has transpired despite remaining challenges. On the one hand, while fostering the move toward a comprehensive and genuine single rulebook for the common market, complemented by further regulatory measures pertaining to crisis management, bank recovery, bank resolution and deposit insurance, the pan-European System of Financial Supervision (ESFS) prompted an upward transfer of authority to the European level and thereby contributes to regulatory and supervisory centralization, fostering coordination and reducing governance uncertainty in the process. On the other, the banking union – instituted for the eurozone in the wake of the sovereign debt crisis with the potential to include non-euro member states in future – introduces supranational supervisory and resolution regimes in an attempt to mitigate moral hazard, decouple financial institutions from their governments and enhance common regulatory and supervisory governance capacities. Both institutional innovations are aimed at fostering system stability by institutionalizing regulatory and supervisory governance structures within which the tasks of crisis prevention and crisis management can be tackled. Given the pervasive negative externalities of systemic crises, or even simply the adverse effects of instability and uncertainty on the economic and political system in general, it is important to draw attention to the fact that financial stability – in short, a vital public good – benefits and is in the interest of all actors and jurisdictions regardless of their status within the EU.

This notwithstanding, many scholars are critical of the potential of instituted reforms (see e.g. Howarth and Quaglia 2015; Jones et al. 2016), for instance as to whether they are sufficiently comprehensive or with regard to their practical implementation. And indeed, while there has been progress, challenges
remain and thwart efforts at constructing a robust post-crisis financial governance architecture. Obstacles facing regulators and policymakers result from the confluence of interlocking structural and knowledge-related factors and highlight the challenges of governing a complex and fragile system such as finance. It stands to reason to suspect that these impediments have structural roots and are symptomatic of the trade-offs involved in transnational governance. Institutional, i.e. order-related weaknesses, for instance, pertain to issues of design and soft law, which are in large part due to the reluctance to transfer authority to the supranational level, while legitimacy-related challenges are deeply entrenched in the incompatibility of governance imperatives and national sensitivities. These then are exacerbated by constraints rooted in the characteristics and system properties of finance as such, defined as expertise-related challenges. The latter include knowledge asymmetries vis-à-vis the regulated industry which bear the potential for various types of capture and political economy distortions as well as systemic challenges such as non-knowledge and knowledge deficiencies on the part of all actors due to bounded rationality and the prevailing degree of complexity in finance which give rise to the imminent threat of unintended consequences resulting from regulatory action or industry innovation (see e.g. Becker 2016; Willke et al. 2013).

The EU, as is the case in global schemes, is in a state of crisis – a crisis in which integration and fragmentation can be witnessed simultaneously. Nonetheless, all predictions to the contrary, European financial governance schemes have evolved in both scope and reach. The analysis throughout ultimately highlights the EU’s remarkable capacity to evolve and adjust, with institutional responses essentially being at the boundaries of both legal and political feasibility (see e.g. Ferran 2014c). As financial systems and the risks they give rise to evolve, defying territorial borders and regulatory capacities in the process, static regulatory properties and governance structures are counterproductive, while adaptive structures and reactive governance capacity as well as reflexivity in both territorial and regulatory terms becomes increasingly important. Showcasing the EU’s advantages in terms of its adaptive potential is, for instance, the flexibility demonstrated in terms of differentiation in European integration – in the context of which pan-European and eurozone structures have been reconciled (see e.g. Ferran 2014b; Leuffen et al. 2013; see also section 5.6). Against this backdrop, it is argued that in addition to its strength in terms of adaptability, EU governance solutions are well placed to tackle the challenges exposed by the crisis in terms of neutrality, coherence and incentives – with the latter being so central in the context of systemic risk. The crucial issue thereby, however, is that governance structures must be credible in order to achieve the desired goals.

The ambiguity in what has been advanced above due to the complexity of the issue at stake can be summarized as follows. Precisely as fundamental substantive reform remains minimal and inevitable shortcomings regarding systemic risk prevention persist, integration should be enhanced. To date, despite substantial institutional evolution and integration, enacted reforms have largely failed to address the core systemic issues exposed by the crisis, falling short of delivering a fundamental overhaul of the substantive

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5 It is worth noting that despite all its alleged flaws, the EU is an instance of transnational integration with no historical equivalent and benefits greatly from its comparative homogeneity and collective values vis-à-vis other regional schemes (Parsons 2002).
regulation of finance (Admati and Hellwig 2013; El-Erian 2017b; Wolf 2014b). Of significance in this regard is the fact that while it is commonplace in governance theory to assume that functional institutional foundations provide the basis for resilient governance, and while institutional developments may without doubt be interpreted as progress, policymakers have failed to bridge the divide between institutional regulatory governance and substantive progress (see e.g. Mügge and Perry 2014 on the international dimension). What this means is essentially that there have been limited attempts to alter the underlying fundamentals of the system, including the structural characteristics of financial institutions and markets (see also Wolf 2014b on the corresponding macro-economic dimension). Neither in terms of structural features, for instance via bank break-ups, stringent size caps or full-fledged functional separation, nor in terms of behavioral and activity-based restrictions such as large-scale trading curbs or substantially higher prudential capital requirements that adequately account for individual institutional risk profiles, or indeed in more fundamental terms such as a rethinking of the credit provision function as such has structural or even behavioral reform been radically implemented or even seriously considered.

The ambiguity in what has been advanced above due to the complexity of the issue at stake can be summarized as follows. Precisely as fundamental substantive reform remains minimal and inevitable shortcomings regarding systemic risk prevention persist, integration should be enhanced. To date, despite substantial institutional evolution and integration, enacted reforms have largely failed to address the core systemic issues exposed by the crisis, falling short of delivering a fundamental overhaul of the substantive regulation of finance and the financial system as such (Admati and Hellwig 2013; El-Erian 2017b; Wolf 2014b). Of significance in this regard is the fact that while it is commonplace in governance theory to assume that functional institutional foundations provide the basis for resilient governance, and while institutional developments may without doubt be interpreted as progress, policymakers have failed to bridge the divide between institutional regulatory governance and substantive progress (see e.g. Mügge and Perry 2014 on the international dimension). What this means is essentially that there have been limited attempts to alter the underlying fundamentals of the system, including the structural characteristics of financial institutions and markets (see also Wolf 2014b). Neither (i) in terms of structural regulation, for instance via bank break-ups, functional separation or stringent size caps, nor (ii) in terms of behavioral and activity-based restrictions, such as large-scale trading curbs or substantially higher prudential capital requirements that adequately account for individual institutional risk profiles (Weber 2012), has structural or even behavioral reform been implemented radically. In essence, this implies that the system remains as complex, fragile and crisis-prone as ever (El-Erian 2017b; Wolf 2014b), while reactive governance capacities as well as crisis prevention and crisis management frameworks become all the more important. Unfortunately, the structural features of the pre-crisis era, i.e. the characteristics that these solutions aim to resolve, such as too big to fail or too complex to manage and price, therefore largely remain intact (Bair 2014; Bott and Jenkins 2017), and with them the underlying system properties complexity, instability and
uncertainty as key sources of systemic risk. Serving to highlight the insufficiently fundamental and robust policy response in terms of what is defined as substantive reform, essentially referring to the substance or content of regulation, is the following: (i) there has been limited substantive behavioral reform in terms of, for instance, prudential regulation and resolution regimes, with the latter being well below par given the contextual nature and contingency of their application, including the fact that they are largely untested and will have to be implemented in an increasingly complex, differentiated and fragmented environment, and (ii) there has been limited substantive structural reform as referred to above, implying that an overall reduction of complexity and instability is unlikely. As such, given the fault lines in substantive reform, it is doubtful as to whether instituted measures are commensurate with the features of complex modern markets and sufficiently robust to tackle the root causes exposed by the crisis, while one of the most imminent dangers may well be that substantive fault lines undermine and jeopardize the integrity of the institutional advances made to date. It is therefore argued that though valuable progress has been attained, the overarching adequacy of the response remains questionable, as the structural characteristics of the pre-crisis era have by and large remained in place, albeit with some important qualifications.

This notwithstanding, while considerable shortcomings persist in terms of the adequacy of substantive reform, it is precisely on these grounds that the case for more integration is made, pertaining in essence to the need to adjust legal boundaries in supranational financial market governance in order to further augment governance capacities and reactive capabilities in order to come to terms with an inherently crisis-prone transnational system, rendering crises more manageable by creating a modus operandi for dealing with systemic risk, which insufficiently stringent prudential regulation, preventive system oversight schemes and untested resolution mechanisms are unlikely to ensure – at least on their own. This is essentially where the issue of double standards comes into play in an appraisal of European and international versus national alternatives to financial governance, as the latter are not only futile in preventing, containing and managing systemic crises, but may – in instances where they distort incentives or add to complexity and uncertainty – prove counterproductive, highlighting the shortcomings of the nation state in coming to terms with systemic risk in the financial system. In consequence, potential solutions to the threat of systemic risk, as will be discussed throughout, should be approached by thinking about a revision or extension of legal authority in the sphere of financial governance in a two-dimensional sense, including the vertical transfer of authority to the supranational level on the one hand, and the horizontal conferral of competencies to independent regulatory and supervisory institutions on the other, so as to foster capacity in terms of both crisis prevention and crisis management, while removing regulatory governance from distortionary political forces to the greatest extent possible, thereby mitigating moral hazard and devising structures within which crisis management can be conducted on a cross-border basis as crises are in effect inevitable.

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6 See chapter four on the newly devised resolution procedures and the potential limitations of their application (see also Alexander 2017; Bair 2014). Also relevant is the fact that unintended consequences are bound to arise and frustrate attempts to limit contagion, while activities and risks may migrate to institutions and sectors to which these procedures cannot be applied.
1.1 Introduction to the Research Context

As the financialization of large swathes of the developed world advanced and financial markets matured, the ramifications of financial globalization became increasingly apparent (Sheng 2013). In finance, the effects of globalization have been both more acute and pronounced than in most other functional spheres due to the latter’s centrality in terms of fostering economic activity (Mügge 2013) as well as its systemic qualities, i.e. its inherent instability, complexity and cross-border nature (Willke et al. 2013). When the US investment bank Lehman Brothers collapsed in the fall of 2008, it sent shock waves through the global economy and set a chain of events in motion that had previously seemed impossible. With the onset of the most acute phase of the crisis in which contagion contributed to widespread distress within and beyond the financial sector, national governments were suddenly confronted with the reality that the requisite regimes for dealing with a crisis of global dimensions were lacking and that transnational arrangements, and national constellations for that matter, had proven incapable of keeping pace with the evolution of the global financial system. While risks and financial markets had become increasingly global, their magnitude and scale as well as their externalities had become less containable.7

Originating in the US subprime mortgage market and rapidly spreading throughout the global system, the meltdown – in which risks were transmitted via markets for mortgage-backed securities and collateralized debt obligations, resulting in a full-fledged crisis of confidence – was ultimately precipitated by the failure of Lehman Brothers. Lehman’s collapse set a crisis of liquidity in motion which in turn impacted capital levels and consequently solvency, exacerbated by the market infrastructure in place (e.g. mark-to-market accounting methods) as well as inadequate corporate governance and risk management (e.g. the use of flawed internal risk models coupled with increasing leverage and exposures to off-balance sheet entities), ultimately shedding light on the fallacies of the pre-crisis microprudential regulatory focus which had neglected the importance of system perspectives and the dangers of panic and contagion in financial markets.

With a view to the nature as well as the severity of the disruption, the crisis of 2008 can be framed as the consequence of a crisis of financial globalization, interdependence and interstate cooperation, a crisis of deficient regulatory expertise and the supervisory governance architecture (De Larosière 2009), or even interpreted as the inevitable result of regulatory capture (e.g. Johnson and Kwak 2011; Mügge 2011a, 2011b) in which a deregulatory neo-liberal paradigm was implemented to serve the industry, progressively increasing market complexity, financial innovation, market activity and consequently industry profits,

7 Not only was the infrastructure to tackle the crisis inadequate, but the ability to fathom what was transpiring and react accordingly was seriously limited. The element of surprise, therefore, compromised the extent to which policy responses and instances of crisis management could be timely and indeed effective. Though some academics and market participants such as, for instance, Warren Buffett (2003: 13e) had long warned that derivatives were ticking time bombs and risks in general were building up (see e.g. Partnoy and Skeel 2006; Rajan 2005; Shiller 2005), most observers had not predicted the Second Great Contraction (Reinhart and Rogoff 2009). Serving to illustrate the degree to which policymakers were oblivious to the disastrous potential of systemic risk are statements by the former US Treasury Secretary Henry Paulson and former Federal Reserve Chairman Ben Bernanke, who prior to the Lehman collapse had been convinced that the impact of the subprime mortgage problems “on the broader economy and financial markets” (quoted in Sorkin 2010: 5; see also Paulson 2011) had been contained.
while governments profited from regulatory arbitrage, augmented competitiveness and growth. Alternatively, the system properties of finance which constrain its governance, or indeed any combination of the above, may serve as decisive explanatory elements. Inevitably, the crisis and its multifaceted causes is a matter of perspective, implying it is not a one-dimensional phenomenon, but rather a construct that gives rise to multiple diverging narratives that are advanced within and beyond the entrenched consensus (Mayntz 2012). Yet irrespective of the interpretation chosen, the crisis shed light on a multitude of flaws with respect to both the functioning and governance of financial markets and exposed fault lines on multiple fronts, among them systemic, structural, behavioral and technical issues as well as the interdependencies between them. As is to be expected, the deficiencies highlighted by the crisis are multifaceted and span structural issues such as the size and complexity of both financial institutions and the system at large, procedural-institutional elements such as inadequate supervisory models and the lack of integrated resolution regimes, regulatory issues such as a misguided focus on individual institutions, and governance dilemmas such as inefficient burden-sharing or linkages between policy areas.

In terms of the ensuing post-crisis policy response, substantial reform has in theory been witnessed with the ultimate question being whether this will translate into equitable change in the long run. A host of substantive regulatory issues are on the reform agenda and have been tackled at the national, European and global level to varying degrees, ranging from the newly instituted or overhauled regulation of credit rating agencies and alternative investment funds to the regulation of financial practices, business models and products.8 In an attempt to categorize the reform effort in the European context with particular emphasis on elements of significance for systemic risk governance, in addition to substantive and institutional change alluded to above, the analysis distinguishes the functional dimensions of crisis prevention and crisis management.9 Though interdependent, their separation is of analytical value. With regard to the former, while institutions and mechanisms for system oversight, systemic risk analysis and the coordination of subsequent micro- and macroprudential regulatory action have been established at the EU level within the context of the European Systemic Risk Board (ESRB), European research initiatives (ESCB 2013) have also been introduced to aid the latter in data collection, data aggregation and the build-up of expertise. The latter are central to the new macroprudential paradigm, the significance of which is laid out below. In a nutshell, the new paradigm is the attempt to construct a comprehensive and holistic macroprudential regulatory framework that integrates system perspectives. These, then, are complemented by new micro-prudential constellations, i.e. by institutions for supervisory and regulatory coherence and convergence to facilitate cooperation and augment reactive capacity in the form of the pan-European System of Financial Supervision (ESFS), which comprises the ESRB and the three newly established European Supervisory Agencies (ESAs), which mirror traditional financial market segments: the European Banking Authority

8 See chapters four and five for a classification and elaboration of regulatory measures.
9 A central component of the policy response, a substantive element integral to both micro- and macroprudential policy which is at the heart of the new macroprudential regulatory paradigm pertains to the revised prudential policy regime which regulates capital and leverage ratios as well as liquidity and integrates various policy measures with implications for prevention and crisis management.
The latter are, to varying extents, integrally involved in preventive regulatory and supervisory schemes and stabilization mechanisms, ensuring the integrity, stability and safety of financial institutions, applying overhauled prudential requirements, conducting stress tests and orchestrating resolution planning in the form of living wills, in addition to participating in crisis management, for instance in resolution procedures, applying macro- and microprudential instruments and so on. Micro- and macroprudential policy for preventive purposes both in turn feed into explicit crisis management measures, most notably the newly instituted resolution authorities and mechanisms on both the national and European level, with the latter being the Single Resolution Mechanism (SRM) for the eurozone – which in combination with the SSM constitutes a central component of the banking union – and the Bank Recovery and Resolution Directive (BRRD) as the pan-European dimension, which essentially serves as a comprehensive framework for convergence, harmonization and collaboration in crisis management at the supranational level.

The goal of the analysis is ultimately to gauge the degree to which structures and institutions have been Europeanized and what this implies in terms of the capacity to govern finance and mitigate systemic risk, thereafter proposing further integration in order to enhance its potential. The overarching argument is that given the lessons of the crisis – most prominently, the need for system perspectives, the ramifications of pervasive financial instability and complexity as well as the political economy issues at stake in engendering systemic risk – mechanisms and solutions at the European-level in terms of prevention and crisis management – of which supervision and resolution are the central components – are at the heart of dealing with systemic risk which is cross-border by definition. In terms of what EU-level solutions can contribute in this respect, the research argues in favor of the rationale for the ESFS and the banking union. In addition to neutrality in supervision, a European as opposed to national sphere of authority for bank resolution is a step toward credible cross-border crisis management. It institutionalizes a degree of neutral supranational authority, which, though potentially politically divisive, may contribute to mitigating systemic risk as moral hazard is held at bay and capacity regarding contingencies is augmented, which is needed to induce an element of predictability into governance schemes so as to mitigate distortions and political economy pressures. It is indeed significant that these schemes have emerged at the European level, though EU schemes are surely no panacea, i.e. are also susceptible to shortcomings, particularly with respect to resolution. A global scheme has yet to emerge and uncertainty remains, while the question as to whether resolution regimes as such are sufficient alternatives for addressing the issue of too big to fail is contested and remains a matter of debate as these schemes have yet to be tested on systemically significant institutions in full-blown crisis scenarios. They are, nonetheless, a step in the right direction.

10 The issue is particularly acute in an integrated financial market in which incoherence, uncertainty and fragmentation are particularly harmful. See Schoenmaker (2013d) for a survey of and statistics on immediate post-crisis levels of fragmentation and retrenchment. See also ECB (2017a, 2017b) for official assessments, indicators and data on integration in the post-crisis era.
Moving beyond governance issues, the core features of the financial system – among them, most notably, its complexity and inherently instability as well as the prevalence of large and complex cross-border institutions at its core – largely remain intact in spite of post-crisis reform efforts, while the multiple root causes that precipitated the crisis and extend beyond finance remain unaddressed. With regard to structural macroeconomic issues, for instance, excessive global imbalances facilitated by loose monetary policy persist (El-Erian 2016; Turner 2013a), while unsustainably high debt levels (Das 2016) and imprudent tendencies of advanced welfare states rooted in debt-driven consumption and unfunded social programs endanger system stability. In addition, sector-specific characteristics such as unrestrained financial sector growth, including financial activity that served no obvious purpose for the real economy, particularly in the decade preceding the crisis – at least partially – remain intact. The latter manifested itself in large trading volumes and a wide array of instruments, products and procedures that in hindsight were considered of limited marginal utility, meaning that they were unjustified in terms of their contribution to the real economy (Turner 2009). Ultimately, disproportionate financial activity remains consistently above what is required to enable “the trading of real goods and services [as] trading in financial claims over real economic activity” (Das 2014) yields greater profits. Moreover, in the post-crisis era, developed economies’ banking sectors have “not decreased materially” (ibid.), while the system appears more consolidated than ever, comprising larger as well as increasingly fragile and complex financial institutions (Admati and Hellwig 2013; Bott and Jenkins 2017 Haldane 2014). Resolving these underlying structural issues requires decisive and unequivocal political action and will which appears to be lacking at present. Yet in addition to these – turning to the central issues that complicate financial governance – there are two particularly significant overarching challenges that must be explicitly acknowledged and addressed. These are essentially of systemic and regulatory nature, and lead us to the central lessons of the crisis.

For the purpose of this analysis, two core lessons from the crisis can be singled out when analyzing the events of 2008 and beyond, assessing European responses, and consequently arguing for further regulatory integration. These pertain to the financial system’s underlying fundamentals and system properties, that is its limited governability (the systemic element) on the one hand, and its structural characteristics as well as finance’s embeddeness and centrality in the politico-economic system (its political embeddedness) on the other. Distinguishing these dimensions and employing both elements when analyzing implications for systemic risk and financial governance facilitates a nuanced, yet holistic perspective on post-crisis policy responses as well as their prospects and the need for integration, while mirroring the political economy approach employed throughout, which integrates both dimensions and, most importantly, acknowledges their interdependence. The crux is essentially that they serve two purposes:

11 Das (2014) also lists excessive liquidity and low central bank interest rates which incentivize risk-taking and exacerbate instability as the Bank for International Settlements, in contrast to the IMF, warns tirelessly. The degree of interconnectedness which facilitates contagion via complex links within the financial system and between sovereigns and their financial institutions – which generally increase in the aftermath of crises if government intervention is part of the response – as well as complex capital and liquidity regimes persist, implying underlying issues remain unresolved (see also Sheng 2013).
They are explanatory devices that serve to illustrate how systemic risk is engendered and in turn also serve to underpin the hypothesis that enhanced supranational and regulatory capacity is required to tackle systemic risk. As such, they are both components of the framework set out in depth in chapter four against the backdrop of which policy responses are assessed, the analysis of governance capacity is conducted, and the case for further integration, including competence transferal to the supranational level, is made.

The first element revolves around the nature of the financial system as such and the challenges its system properties, including inherent instability, complexity and tight coupling give rise to owing to the system’s underlying characteristics (composition, size and complexity of financial institutions and market infrastructures) on the one hand, and its system dynamics (contagion, herding behavior and so on) on the other. In tandem the latter compromise and undermine the ability to govern finance given the widespread expertise and capacity shortfalls which arise from uncertainty, the system’s complexity and knowledge asymmetries. This became increasingly apparent in the wake of the crisis, shedding light on both the fundamental flaws in the prevailing regulatory approach and the inherent challenges of an unstable, complex and interdependent financial system.

Among the flawed pre-crisis notions exposed by the crisis were (i) the viability of microprudential paradigms, i.e. the assumption that a regulatory focus on individual institutions was adequate, while system-wide perspectives, system interdependence and the potential adverse and unintended consequences thereof were largely neglected (see Borio 2003; Brunnermeier et al. 2009; see also chapter four),12 as well as (ii) the potential for and prospects of crisis prevention and the provision of stability, which are illusory given the inherent instability and crisis-prone nature of finance (see e.g. Turner 2010a). These, then, feed into a third flawed and particularly critical notion pertaining to the validity of the assumption of governability or rather the ability to steer and control the system at large (Willke and Willke 2012; Willke et al. 2013). Indeed, both the non-knowledge resulting from uncertainty and the bounded rationality of human actors implies there are limits to the extent to which complex systems can be governed (Forrester 1971; Kahneman 2011; Palmer and Maher 2010; Willke et al. 2013). This means preventive action is only part of the equation, while the build-up of expertise and the implementation of stringent regulation is insufficient (see chapter four). In this context, central to the definition employed throughout the analysis is the concept of Knightian uncertainty, which is essentially the inevitability of unforeseeable change to which no probabilities may be assigned, a fact many economists neglect and, more importantly, most political scholars do not explicitly spell out with regard to its political implications. This insight, however, is central to the rationale and argument for a build-up of reactive cross-border governance capacity.13

Before addressing the second element, it is important to illustrate its interdependence with the above. Most important in this respect is the phenomenon of too big to fail (TBTF) which is at the heart of systemic

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12 It should, however, be noted that some scholars and practitioners had indeed addressed the flaws inherent in microprudential paradigms prior to the crisis (see, for instance, Borio 2003; De Bandt and Hartmann 2000).

13 See Willke et al. (2013) on the distinction between risk and uncertainty. See also Knight (1965) for the respective theoretical underpinnings.
risk and is both induced by while having implications for political dynamics and must therefore be analyzed in both its political economy and systemic context. Ultimately, the fact that large and complex cross-border financial institutions at the system’s core are inherently unstable – due to, among other factors, their size, complexity, the scale of their business operations, their market share or interconnectedness – and thereby, as a result, may destabilize the entire economic system, is pivotal. The degree of their complexity, opacity and interconnectedness, for instance, exacerbates the extent to which institutional failures and their consequences can be predicted and adequately handled as unintended consequences are inherent in both finance and regulation, while precisely this fact exacerbates moral hazard as the probability of public support for the industry in the event of distress rises in tandem with uncertainty and the spectre of potential catastrophes – the knock-on effects of which have been painfully evidenced throughout the past decade.\(^{14}\) It is important to note in this context that the degree of system fragility and complexity as well as the effect it has on the objective and subjective cost-benefit analyses of policymakers is by and large unique to finance and produces particularly acute political dilemmas (Wolf 2010).

This, then, is a crucial insight for the second fundamental issue exposed by the crisis: The degree to which finance is embedded in the political system and the challenges this gives rise to. What is meant by political embeddedness is, in brief, finance’s significance for the economy and society at large (see Mügge 2013 for an extensive analysis), its intricate connections to politics, and the complex multifaceted challenges that ensue from this constellation (Coffee 2012; Johnson and Kwak 2011; Weder di Mauro and Klüh 2010). As alluded to, a central issue in this context is the distortion caused by the phenomenon of too big to fail which is at the heart of the public-private sector nexus.\(^{15}\) The latter essentially denotes the systemic risk potential emanating from financial institutions that due to an array of multifaceted and at times interdependent factors, including among others size, function, interconnectedness or proximity to the political system, are considered systematically relevant, would most likely precipitate a systemic crisis if they failed,\(^{16}\) and therefore cannot be allowed to fail.\(^{17}\) Though too big to fail had been an issue prior to the crisis as well (see Feldman and Stern 2004; Geithner 2004; Mayer 1975), the sheer scale of the post-Lehman disaster catapulted it to the

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\(^{14}\) Aggravating the issue of institutional fragility and complexity is the fact that the failure of a large or otherwise systematically important firm is not the only potential trigger of a systemic crisis. As set out in chapter four, unforeseen events, including anything from wars to natural disasters could just as well produce systemic shocks.

\(^{15}\) Note that in addition to individual financial institutions being too big to fail, market infrastructures and entire markets such as clearing houses or the money market fund industry can be systematically significant. Also, notwithstanding the paramount importance of the regulatory and analytic emphasis on eliminating TBTF, the overly dominant focus on the stringent regulation of systematically significant institutions (SIFIs) bears the potential of losing sight of the system as such, as systemic failures may just as well arise in a system with many small and interconnected institutions in which none are systematically relevant, yet all institutions are exposed to correlated risks and exhibit correlated behavior (Stiglitz 2009; Wolf 2014c).

\(^{16}\) Due to the unforeseeable nature of systemic risk given Knightian uncertainty, which in contrast to risk implies no probabilities may be assigned to potential outcomes, the crucial issue at stake is that it is unclear which dynamics might play out in the event of failure. This implies that there is no genuinely objective way to assess a financial institution’s systemic significance ex ante.

\(^{17}\) This is essentially a reference to the collapse of Lehman Brothers as TBTF does not imply that institutions cannot fail. Rather, in short, whether they are allowed to go down is ultimately a political issue. In hindsight, Lehman Brothers was systematically significant and allowing it to fail essentially established a precedent. Though the decision was ultimately meant to curb bailout expectations and undoubtedly also attenuate political and social tensions, it may have served to reinforce them (see e.g. Becker 2016). This, for instance, might be deduced from the fact that in the post-crisis era, institutions have not necessarily become smaller, but rather have increased in size (see Bott and Jenkins 2017; see also chapter four for an in-depth analysis).
forefront of the political agenda. As noted, contrary to market expectations, Lehman was not rescued. Paradoxically, the crisis, and particularly the catastrophe following Lehman’s collapse, have therefore served to extend the prospect of public assistance from deposit-taking institutions to investment banks (Stiglitz 2009a: 5). This holds true to date despite the ongoing reform of global capital regimes and the institution of resolution mechanisms with potentially catastrophic consequences (see e.g. Alexander 2017; Bair 2014; Bott and Jenkins 2017; Wolf 2014c; see also section 4.5).

To illustrate the trade-offs at stake in this context, it is instructive to briefly contextualize the economic implications of failure in financial markets from which the political rationale for bailouts may be deduced. During crises, when institutions are on the verge of collapse and political intervention is required, central banks engage in liquidity provision, while governments often intervene by recapitalizing, restructuring or otherwise backing institutions and market segments (Quaglia et al. 2009). In some instances, governments assist in stabilizing measures, including deal-making activities by orchestrating mergers and acquisitions, while at times even taking on part of the financial burden to ensure the functionality of the system and avoid costly disruptions to economic activity. Due to the potential costs and adverse economic and social consequences, failure is generally viewed as the most costly option, while conventional bankruptcy procedures are not generally viewed as viable mechanisms for resolving financial institutions due to their structures and ongoing business operations.18

Ultimately, in the context of the above, the issue of costs and benefits that accrue to both the public and private sector is highly complex. In a nutshell, the ex ante assessment of the public burden in case of bailouts, other public sector solutions, or indeed a disorderly failure is not possible.19 Apart from institutions that profit from market deterioration, market participants generally benefit from bailouts and rescue programs, either evading costs arising from indirect and direct contagion as counterparties and thus benefiting from stability, or from takeovers with beneficial conditions. With regard to the public sector, the financial effects, and thereby also the ultimate taxpayer costs, are in turn dependent on the conditions of the bailout schemes and terms employed (Stiglitz 2009a).20 In some instances, governments may even profit in financial terms (Grossman and Woll 2012). This, however, does not necessarily hold true from a political perspective. Potential non-quantifiable political ramifications – most prominently, negative externalities such as moral hazard, perverse incentives and ensuing social tensions – must be borne in mind and are at the heart of systemic risk (Levitin 2011; Mayer 1975; Willke et al. 2013). This notwithstanding, the rationale for bailouts influencing political decision-making in crises is rooted in the

18 Resolution mechanisms were largely absent in the crisis and though they have now been constructed, they essentially remain untested, while their utility in a systemic crisis remains questionable (Alexander 2017; Goldstein and Véron 2011; Wolf 2014b; see also section 4.4.1).

19 Even in hindsight, limited clarity as to what would have happened were an institution not to have been rescued remains, precisely as there is no way to assess ex post whether an institution was indeed systemically significant (Stiglitz 2009a).

20 See also Grossman and Woll (2012) on diverse constellations and the markedly different financial consequences of bailout schemes in selected European member states. In Denmark, for instance, a substantial amount of public funds were pledged, though ultimately only a fraction was spent (ibid.).
implications of disorderly failure that may potentially result in systemic crises. Though the financial costs of bailouts are high, full-blown systemic crises are generally far more costly in the near-term (Mayer 1975). Macroeconomic consequences include crisis-induced recessions and subsequent anemic growth, increases in public debt and lost economic output as well as declining productivity (Wolf 2014a).

The issue at stake regarding systemic crises is ultimately the difficulty of understanding their dynamics and evaluating their implications. The uncertainty resulting from the complex trade-offs involved in crisis management substantially complicates decision-making, while the resulting bailout expectations and implicit government subsidies for systemically significant financial institutions give rise to and reinforce moral hazard, thereby distorting incentives between the public sector and the private sector (Kane 2014; Weder di Mauro and Klüh 2010). In this light, despite the severity of the crisis, the degree of economic damage it entailed, and the extent of regulatory reform that ensued, the crisis that resulted from Lehman Brother’s collapse has had conflicting implications for bailout prospects. Whether TBTF has been solved, therefore, remains a highly contentious and divisive theme in both politics and academia – with the elephant in the room essentially being the uncertainty that this implies (Bott and Jenkins 2017).21

Worth noting in this respect is also that the EU did not experience a single disorderly bankruptcy. Given the degree of havoc wreaked by the failure of the comparatively small investment bank Lehman Brothers, however, it stands to reason to suspect that EU governments would not want to let their national champions go under.22 In addition, were the instituted yet untested resolution procedures and mechanisms, which will be discussed in depth in chapters four and five to fall short of expectations in the future as many analysts including the markets suspect, public intervention and support is highly likely and potentially unavoidable, and with it a key incentive for firms to be systemically significant, inter alia fostering imprudent industry conduct and risk management. As will become clear throughout, it is uncertain whether reform at the national, European or international level are sufficient in this regard.

This notwithstanding, in view of the systemic qualities and political embeddedness of finance as integral components of systemic risk described above, further capacity expansion in terms of European governance is absolutely essential to keep the political economy forces and pressures giving rise to too big to fail in check, mitigate moral hazard, and strengthen the reactive capacity of European authorities and schemes in the event of crisis, bearing in mind that regulators and hence crisis prevention are inevitably fallible due to non-knowledge and uncertainty, implying therefore that requisite crisis management tools and European

21 See Johnson (2013a; 2013b) and Calomiris (2013) on diverging perspectives regarding the prospects of eliminating TBTF and the subsidies that accrue to SIFIs. TBTF is ultimately determined by the market’s verdict and expectations of public intervention have risen. As the analysis throughout illustrates, it is doubtful whether measures in any jurisdictions sufficiently address the issue of too big to fail, and it indeed, it is widely acknowledged that TBTF remains a threat (see e.g. Bair 2014; Vickers 2016).

22 See, for instance, Goldstein and Véron (2011) on the historical roots of the European aversion to bankruptcies. The rationale is ultimately grounded in national, political and economic interests and legacies. Note also that European banks were more leveraged and appear to have suffered more from the subprime crisis (Haldane 2013), while banks in general are of much greater significance to the financial system in Europe than in the United States as the former is bank-based, while the latter has deeper and more sophisticated capital markets.
schemes are required in order to augment the capacity of institutions to react in a timely fashion and cooperative manner when signs of crisis begin to emerge. As will be elaborated throughout, supranational governance solutions can contribute to these objectives. Credibility and neutrality are enhanced by the transferal of governance mechanisms to the European level. Correcting incentives, eliminating distortions, and forestalling forbearance, are potential consequences of this form of integration. As a result and in this light, EU initiatives ultimately present potential progress, though the status quo still falls short of what is needed in order to present a comprehensive and credible response to the phenomenon of systemic risk.

In conclusion, of significance for the analysis is the fact that finance is a functionally differentiated, highly complex, tightly coupled, interdependent and knowledge-intensive policy field. The degree of its sophistication as well as the sophistication of the policy framework required to govern it surpasses many comparable policy arenas. Given the centrality of finance in modern capitalist societies as well as its interdependence with macroeconomic and fiscal policy – which is at the heart of nations’ well-being and competitiveness – the importance of the challenges its centrality gives rise to including distortions, capture, the knock-on effects of financial instability throughout economies and the like (its political embeddedness) cannot be overstated (Whyte 2009). On the one hand, its inherent instability and complexity as well as its innovative and adaptive capacity (its systemic qualities) imply that governability is limited, though capacities to address and attenuate these qualities must be devised nonetheless. On the other hand, the system properties of modern finance present states with fundamentally new challenges, encroaching on their economic sovereignty and regulatory self-sufficiency, while undermining their capacity to come to terms with developments that challenge the nationally-determined boundaries of law, taxing both public comprehension and engagement and severely limiting the ability of national jurisdictions in terms of policy formulation and corresponding financial governance.23 The regulatory imperative that flows from this is ultimately that the build-up of cross-border governance capacity and the construction of supranational regimes must be given priority, the potential for and the capacity of which the research sets out to examine throughout.

1.2 Research Interest and Objectives

In an era of globalization and European financial market integration, and in view of the issues that came to light during the crisis – most prominently, the nature of the system that had emerged throughout the past decades and the threats posed by systemic risk given the prevalence of increasingly interdependent global markets – integrated financial governance has become a necessity. As a consequence, scholarly interest in the phenomenon of systemic risk and governments’ or rather public authority’s role in regulating finance has increased exponentially in the wake of the crisis and its aftermath, while the

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23 With regard to substantive regulatory reform, cosmetic modifications have largely been witnessed, rather than structural change (see section 4.5). Normal accidents will persist therefore persist if no game changers redefine and fundamentally alter the system (Willke et al. 2013).
potential of European economic integration in general and the ensuing capacity it gives rise to – in terms of the ability of nation states to integrate and the respective implications and potential thereof – is a perennial theme in the academic debate, including, for instance, in political science, economics, European studies and comparative regionalism. Yet though systemic risk features prominently in the academic debate in finance and economics (see, for instance, Anabtawi and Schwarz 2011; Gai 2013; Gai et al. 2011; Schwarz 2008, 2014), its multifaceted implications for European governance remain vague and have received limited explicit scholarly attention in the context of European political governance, especially with a view to more refined and multipronged definitions of systemic risk such as the one drawn upon throughout (Willke et al. 2013; see also chapter four). Indeed, the specific challenges as well as the potential and prospects of increased and strengthened supranational governance have yet to be analyzed systematically with respect to systemic risk in the European sphere. In this context, it is important to draw attention to the fact that many scholars of European integration neglect issues at stake regarding the substance of what is being regulated, while in turn economists and legal scholars do not take the specifics of the European Union and its nature as well as its unique features into account. It is this context within which the current research is placed and this divide that it attempts to reconcile.

The goal throughout is essentially twofold. The research sets out to analyze (i) developments in and elements of post-crisis financial market regulation and systemic risk governance in the European context, largely limiting the analysis to the reform of the regulatory and supervisory architecture directed at systemic risk in a broad sense, i.e. measures aimed at financial stability, and (ii) the evolution of European schemes as well as European integration’s potential and capacity in this regard with a view to the potential of European financial integration more broadly. Thereby, based on both theoretical and empirical insights, the contribution focuses on the build-up of cross-border capacity in financial governance via European integration against the backdrop of a framework to assess both the challenges confronting integration as well as its prospects. The attention afforded to the discussion of integration, governance and corresponding theory reflects this focus. Ultimately, the intent of the analysis at hand is to enhance the understanding of what is required in governance terms in the aftermath of a crisis of such proportions by embedding systemic risk into its political and economic context, and analyzing it with a view to both its systemic qualities and political embeddedness. While the dominant discourse portrays systemic risk as an economic phenomenon, this research explicitly draws on a political economy approach (Willke et al. 2013) to demonstrate how risks are generated and exacerbated as a consequence of both the financial system’s embeddedness and its

24 Mügge and Perry (2014), for instance, as proponents of this critique, maintain that analyses of cross-border governance architectures are all too often divorced from what is being governed, i.e. the substance of the policy sphere at stake, while overlooking the significance of substantive economic debates. This essentially implies that there is a divide between the analysis of the structures and processes of governance on the one hand, and the substance or content of the issue area at stake on the other, i.e. that they are all too often analyzed in isolation.

25 The definition and significance of reactive governance capacity as the overarching imperative resulting from the lessons of the crisis in view of the nature of systemic risk is discussed in depth in chapter four.
properties, specifically examining how these themes resonate in the European context in order to analyze the viability of reforms instituted at the supranational level.

In this context, the following is of particular relevance. The financial crisis of 2008 exposed the fault lines of the conventional wisdom that was deeply engrained in the paradigms of the pre-crisis era with regard to both finance and its regulation. Fallacies include the assumptions (i) that markets are superior as self-regulating systems, (ii) the regulatory and supervisory institutional structures in place were sufficient, and (iii) that sovereign nation states, formally positioned and thus legitimized to organize and conduct regulatory functions, were capable of doing so in a sustainable fashion, while mirroring the cross-border nature of the underlying policy sphere. This analysis of European policy responses to the crisis is based on a rejection of all three, hypothesizing that the system’s instability and complexity has implications for the extent to which (i) it can be regulated both by the market and its actors as well as by regulatory institutions due to bounded rationality and knowledge deficiencies on the part of all actors, and (ii) how it should be regulated, arguing that crisis mitigation and management in the sense of fostering governance capacity must be conducted on a cross-border basis given finance’s propensity to shift risks across borders.

Given what is at stake in the context of systemic risk, the crisis marks an opportunity to mediate a transition to a more balanced system that incorporates a nuanced perspective on the limitations that both markets (with regard to their self-organizing capacity) and regulatory institutions (with regard to their governance capacity) exhibit, and thereby attempt to redefine the balance between markets and the political systems and governance schemes in which they are embedded in order to render the system more sustainable and resilient. In doing so, however, its cross-border nature must be heeded, bringing us to the third fault line, which is inextricably linked to the former: The need for sufficiently robust transnational governance regimes capable of shouldering the burden of sustainable regulation. The capacity of reformed European schemes as well as the challenges confronting them is the focus of the thesis.

At stake is ultimately the degree and quality of integration that transpired in the aftermath of the crisis in order to evaluate the governance capacity resulting from instituted reforms, with the argument throughout essentially being that systemic risk results both from the system properties that characterize modern finance (e.g. its inherent instability, complexity and crisis-prone nature) and from the degree to which finance is embedded in the political system (i.e. from its significance within the political-economy nexus), which in the case of the former limits public authorities’ capacity to preclude crises altogether and in the case of the latter gives rise to perverse incentives, for instance, encouraging financial actors to become systemically significant and reap the according benefits. Both factors effectively lend weight to the claim that there is a rationale for supranational governance capacity in the context of financial regulation which is discussed in depth throughout chapter four. Not only is collective reactive capacity in the form of EU-level regulatory schemes and cross-border crisis management regimes required in view of the single market and as crises will inevitably transpire in future, it can also, in theory and if instituted in a sustainable and credible
fashion, counteract the destructive tendencies that result from constellations at the national level – by, for instance, curbing moral hazard and bailout expectations by way of transferring authority in terms of crisis management tools to the supranational level. Both aims can be achieved if reforms reduce uncertainty, project credibility and strengthen market discipline by reinforcing cross-border governance regimes in order to enable swift and effective intervention in the event of crisis and mitigate delayed intervention and regulatory forbearance.26

1.2.1 The Research Argument in Brief

Against the backdrop of the crisis and its aftermath as well as with a view to the nature of finance in an increasingly integrated and borderless environment, it is argued throughout that supranational integration is indispensable and EU institutions are imperative to mitigate systemic risk. Indeed, in the pre-crisis era, both the fragmented governance architecture in place and the substantive regulatory state of affairs was no longer fit for purpose (see e.g. De Larosière 2009; FSA 2009), while the incongruence of governance schemes coupled with lacking crisis management mechanisms, preventive policy schemes and venues for cooperation at both the European and national levels gave rise to considerable shortfalls of capacity during the crisis, contributing substantially to lacking regulatory resolve, uncertainty and cross-border contagion. It is these shortcomings that post-crisis reforms attempt to overcome and remedy.

Ultimately, with regard to the evolution of post-crisis transnational financial governance, the question arises as to whether the EU has eschewed precedents, defying its critics in light of the landmark reforms enacted. In this context, Véron (2014a: 3), for instance, argues that the ambition underpinning “European integration should not be underestimated”, and indeed, the empirical and theoretical analysis conducted throughout highlights that the crisis was transformational for both financial market regulation and European integration more generally, prompting both institutional innovation and experimentation with respect to financial governance at a time when the regulatory environment was highly politicized, essentially showcasing the Union’s adaptive evolutionary potential in times of crisis. Though significant political and institutional barriers as well as structural and substantive challenges persist – particularly the fact that most of the system properties that enabled the crisis remain unresolved – the reform outcome is potentially significant in terms of both its potential to increase capacity at the supranational level and the ensuing prospects for further integration and institutional consolidation as institutions have essentially pushed the boundaries of legal authority in the pan-European sphere (Ferran 2012), and path dependencies as well as functional pressures are likely to create momentum for further integration in the future – with potential benefits and

26 Moreover, collective capacity is key to ensuring the stability and functionality of the single market. Indeed, transferring capacity to supranational institutions has multiple benefits, including, among them, to reduce the propensity for capture and reduce dynamics that effectively generate distortions due to the inclination of national authorities to disregard imperatives of timely intervention, implying that they either intervene too early on the grounds of political expediency, or too late resulting in potentially harmful regulatory forbearance (Beck et al. 2012; Weder di Mauro and Klüh 2010).
synergies for the credibility and functionality of cross-border governance regimes and mechanisms. Indeed, in terms of post-crisis governance reforms, the new macroprudential paradigm as well as the elements of the revised regulatory and supervisory framework by and large present a step-by-step transfer of governance functions to the pan-European level, including key breakthroughs and, most importantly, an “upward shift of de facto regulatory power” (Mayntz 2013: 2).

In essence, in terms of the integration of regulatory and supervisory governance schemes and structures at the supranational level, incremental yet substantial integration has taken place throughout the past two decades, particularly in the post-crisis era. Though not sufficient as of yet, developments bode well for the future. It must, however, be borne in mind that while regarding European integration schemes trial and error is the only viable mode of progress at present, regarding the financial system and its substantive regulation as such, reform in the vein of muddling through is no longer sufficient to credibly forestall systemic crises. Further integration of institutional governance structures and fundamental reform of the system and its properties as such is therefore inevitable and imperative.

1.3 Structure of the Study

Combining theoretical perspectives and empirical analysis, the present research sets out to assess and contextualize the potential of conducted post-crisis reforms directed at mitigating systemic risk as well as deconstruct and theorize developments in European integration in the sphere of financial governance. The dependent variable at stake is ultimately the governance architecture resulting from reform – comprising the institutional schemes and policies adopted to govern systemic risk – and constructed to tackle the substantive challenges exposed by the financial crisis and mitigate highlighted shortfalls in terms of cross-border capacity. Thereby, the research is conducted against the backdrop of an assessment of challenges deduced from the analysis of instituted reforms with a view to their implications in terms of governance capacity, and includes a discussion of advances in and prospects of further integration in this policy domain. The following sets out in detail how the research is structured.

At the outset, the theoretical foundation is laid out and theoretical perspectives are presented. In broad terms, in order to engage in the analysis of governance schemes and thereby evaluate integration as well as challenges and prospects in this regard, central theoretical insights are introduced in the context of which the global system is contextualized and the need for cross-border cooperation in light of existing governance challenges and the limits of autonomous governance is addressed. Rationales for cross-border

27 It attempts to do so by offering nuanced governance-oriented perspectives on the issues at stake in order to contribute to the study of the potential of supranational financial integration with respect to the mitigation of systemic risk. The attention afforded to the discussion of integration and corresponding theory reflects this focus.

28 Capacity in this context is assessed against the challenges set out in chapter six and defined as the constructed governance architecture’s degree of integration which should, in theory, strengthen the functionality and efficacy of the EU’s governance regime.
cooperation and transnational economic integration which can be deduced from the former are conceptualized thereafter, before constructing the theoretical framework within which to embed the conducted analysis and evaluate post-crisis developments as well as emerging schemes in depth. More specifically, functioning as a basis for the theoretical framework, chapter two begins by operationalizing central concepts employed in the contribution, putting their various dimensions into perspective and embedding them theoretically, thereby offering a conceptual take on the governance issues at stake. Thereafter, it addresses the need for integration and cooperation among nation states. In this context, it examines the shortcomings of autarky in terms of incongruence, complexity and the challenges an integrated cross-border system poses as well as the corresponding rationales for cross-border governance, both essentially being what drives cooperation in general and European integration in particular – examined from an overarching theoretical perspective and tailored to the specifics of financial regulation, i.e. applied to finance and systemic risk in the European context thereafter in chapters three and four.

Chapter two then goes on to break down the strategies nation states choose to generate and harness the benefits open societies and economies offer and the schemes they develop as attempts to cope with the common challenges that inevitably arise. It does so by conceptualizing regional integration and offering perspectives on its conceptual tenets, while specifying issues of relevance in this specific jurisdictional and sectoral context, that is with particular emphasis on issues unique to the process of European integration – in this context addressing and highlighting its increasing scope and complexity as well as its unique nature and significance, but also its challenges. As such, it essentially serves as a foundation for the theoretical framework and its application to the analysis that follows. Thereafter, as the second broad component of chapter two, the thesis presents the theoretical discourse on integration and constructs the theoretical framework, which includes an elaboration of theoretical approaches employed in this research. These are European integration theories, which shed light on why and how member states integrate, and thereby offer approaches to theorize rationales and dynamics as well as limitations and challenges of European integration. This section ultimately serves as a backdrop for the analysis and a framework for the assessment of reforms and their significance throughout chapters five to seven and encompasses a critical analysis of employed theories’ conceptual premises, applicability and explanatory potential in this specific context as well as limitations inherent in the theoretical approaches themselves.

While in chapter two issues pertaining to European integration, cooperation and cross-border governance are presented and embedded theoretically, chapters three and four contextualize the latter in empirical terms, i.e. with respect to their rationales, dynamics, developments and challenges, and apply the analysis of integration to the specifics of the sphere of European financial market and regulatory integration to establish insights of relevance for the subsequent analysis. To complement the theoretical framework set out in chapter two and construct the foundation for the analysis, chapter three aims to shed light on rationales for integration as well as pre-crisis developments and the status quo of integration in the realm
of finance, that is, more specifically, the integration of financial markets and regulatory regimes at the height of the crisis from which the reforms at stake essentially advanced. The goal thereby – together with chapter four – is to systematize the institutional setting and environment in European finance as well as set out issues and challenges against the backdrop of which to assess the reform outcome. These include processes and dynamics of financial liberalization and the emergence of corresponding supranational governance. The rationale for including the analysis of the pre-crisis regulatory and supervisory landscape and market reality is straightforward. As the aim is ultimately to gauge the current degree and significance of integrated governance in the post-crisis era as well as its potential and prospects, it serves to contextualize the theoretical foundation by elaborating the specifics of financial integration, as well as being the basis for assessing the significance of as well as the progress that has taken place with respect to European financial regulatory integration in terms of post-crisis reforms. To conclude, an assessment of the prevailing pre-crisis regulatory paradigms is presented.

In order to complement chapters two and three, chapter four elaborates the conceptual foundation by addressing issues central to both the analysis and evaluation. It thereby constitutes the second element in the overarching theoretical and conceptual framework presented throughout chapters two to four against which the analysis is essentially conducted. As such chapters two to four serve as the theoretical and conceptual context for chapters five to seven. The rationale for the extensive theoretical and conceptual framework presented throughout is predicated on the nature and complexity of the research interest. Issues at stake in the conceptual foundation include reviewing, contextualizing, and theorizing systemic risk and the financial crisis as well as the multifaceted regulatory implications of the latter, i.e. the challenges it exposed in terms of pre-crisis financial system and regulatory deficiencies and the responses it triggered in a broad sense, inter alia giving rise to new or revised paradigms. In this context, the chapter conducts an in-depth analysis of the financial crisis, analyzing potential contributing causes and systematizing its revelations, while shedding light on the highlighted challenges facing transnational cooperation in the European context with regard to policy failures and coordination deficiencies from which challenges and priorities for European reform can be deduced and theorized. Moreover, with regard to the former, it includes a discussion of narratives shaping the multitude of explanatory approaches advanced and their ramifications for governing finance and mitigating systemic risk.

Subsequently, against the backdrop of the above, the chapter approaches the topic of systemic risk, whereby its discussion and an assessment of its respective regulatory implications is essential for the analysis of post-crisis reforms and central to the arguments put forward regarding the imperatives, challenges and potential of financial governance integration. In this context, it revisits and frames the systemic risk debate that ensued in the aftermath of the crisis by reviewing definitions of systemic risk and juxtaposing and contrasting two approaches to theorizing it that have been put forward in the literature. Thereafter, it presents a novel approach – more precisely, it establishes a refined definition of systemic
risk based on Willke et al. (2013) in order to conceptualize and theorize the precise regulatory implications of systemic risk exemplified by the crisis and, importantly, adapt it to the context of cross-border governance. To do so, it constructs a two-pronged approach, essentially combining political and economic aspects and perspectives, defining systemic risk from a systemic or systems theory perspective on the one hand, drawing on the concepts of risk and uncertainty to showcase the systemic nature of the financial system as well as the ramifications for its governance, and shedding light on the political embeddedness of finance, i.e. the impact and effects political structures and the politico-economic ecosystem in which financial markets are embedded have in terms of engendering and exacerbating systemic risk on the other.

With regard to the former, a pivotal insight in the post-crisis era with respect to systemic risk and financial regulation more broadly has been that while policymakers and regulators are indeed relatively proficient in understanding the microprudential aspects of finance, that is the constituent parts of the system such as individual institutions’ risk profiles or the riskiness of individual financial products, they lacked the ability to comprehend the dynamics of the system in its entirety, i.e. the interplay of the system’s components and their potential to create systemic distress, as did all other actors involved, including financial institutions. The chapter therefore goes on to contextualize the implications of the resulting uncertainty, which stemming from the system’s properties – and coupled with political embeddedness, the second element of the definition – became so apparent and was so detrimental and destabilizing throughout the crisis – for regulatory governance imperatives. In short, it sheds light on the dilemmas and challenges the system’s features present, resulting in the inability of regulatory institutions and market participants to sufficiently mitigate financial instability and crises, while adding the dimension of the financial system’s political embeddedness, which contributes to systemic risk in order to deduce corresponding regulatory imperatives, i.e. the rationale for a build-up in cross-border governance capacity resulting from this conundrum.

Thereafter, the following sections go on to add more depth to the conceptual framework in order to illustrate systemic risk’s underlying foundations and underscore both its regulatory implications as well as its ramifications for implemented post-crisis reforms’ potential. They do so by setting out the foundations of modern finance that developed throughout the past decades – defined as structures, characteristics and dynamics – including their significance and the challenges they pose as the market dimensions of relevance for systemic risk and the ensuing analysis. The goal when analyzing system developments is to pin down elements fostering systemic risk that are grounded in the financial system’s structures, characteristics and dynamics, and thereby to theorize them so as to employ them as analytical elements in the analysis. In this context, the section starts out by addressing the foundations of finance defined more specifically as (i) system properties – which are, in essence, inherent qualities arising from structural foundations – such as, for

29 This distress then has the potential to give rise to widespread contagion and eventually a breakdown of parts of the system.
30 This is essentially why the macroprudential perspective has now become a key component of the post-crisis regulatory agenda, though the question remains as to whether this new paradigm is sufficient to stabilize the system via regulatory means and whether the features of systemness and what is actually systemic in systemic risk is indeed being considered and taken seriously by all parties involved.
instance, inherent system fragility generated by the very nature of finance and fostered above all by the prevailing degree of financial market complexity and uncertainty,\(^3\) (ii) characteristics of the financial system,\(^2\) including financial institutions, market structures and the like, the phenomena of too big to fail and too-complex-to-manage as well as the challenges they pose, and finally (iii) system-level dynamics such as, for instance, contagion which is an adverse dynamic that results from system characteristics and structural features such as interconnectedness and is facilitated by excessive leverage in the financial sector and eventually produces liquidity shortages which often precipitate systemic crises.\(^3\) Thereafter, in order to set the stage for the following, the elements and their interplay are reviewed with a view to their regulatory implications as the backdrop against which reforms and their challenges can be assessed.

Of crucial importance in this context is the significance of what is defined throughout as reactive cross-border governance capacity, i.e. the build-up of capacity via institutions and mechanisms at the supranational level – an assumption deduced from the preceding analysis and a central issue throughout with regard to the regimes at stake. Thereby, the central premise upon which the analysis throughout rests is that integrated governance capacities, i.e. European integration and centralization are the optimal solution, and therefore the end goal, for increasing governance capacity in view of integrated markets. The prospect of attaining consistency and coherence as well as signaling and projecting predictability, credibility and neutrality vis-à-vis financial market actors that may flow from the build-up of common governance structures and capacities for crisis prevention and management at the European level are central aspects in this respect and constitute central elements of curbing moral hazard. The analysis is therefore conducted on the premise that integration and centralization are, in theory, and if conducted diligently, desirable. Against this backdrop, the analysis sets out to assess the degree of integration that has transpired with the premise being the following: Capacity is ultimately dictated by the degree of integration resulting from reform. In order to attain the goal of reactive governance capacity two dimensions are crucial: Substantive policy and the institutional elements of the governance architecture. The latter implements the former and is essential for the emergence and build-up of governance capacity and credibility, which is required to inhibit systemic risk and moral hazard and deal with effects of unexpected crises that will inevitably arise. Though this research is essentially a governance analysis and focuses primarily on the institutional governance architecture constructed in the aftermath of the crisis, it wraps up chapter four by contextualizing substantive policy elements of regulatory reform that are of relevance in terms of systemic risk, including, among others, prudential requirements and capital regimes as well as newly instituted resolution regimes, which actors in the governance institutions then implement. The latter are integral

\(^3\) With this feature in particular constituting a pivotal insight for the analysis, with regard to for instance assumptions regarding the system’s limited governability. In addition, the entire foundation set out serves – in technical terms – as the analytic core of assumptions upon which the analysis rests, i.e. on which they are based throughout and as such present the basis for the analysis.

\(^2\) With these essentially being components that constitute the structures.

\(^3\) Note the interdependence between structures, system characteristics and dynamics: Leverage, for instance, is a system characteristic which facilitates adverse dynamics and influences system properties like instability.
components of the governance reforms at stake in this research and central in terms of both crisis prevention and crisis management. Of significance throughout is that given the inevitable shortcomings of structural and substantive policy reforms such as, for instance, the fact that the underlying flaws of Basel II remain largely intact in the context of the reform of capital regimes and have “not changed the overall approach” (Admati and Hellwig 2013: 83), or the fact that the viability and feasibility of the new bail-in rules and resolution regimes for failing financial institutions in the event of crisis is by no means guaranteed given the latter’s contingent nature (Wolf 2014b; Véron 2013a; Véron and Goldstein 2011).34 Cross-border integration and robust cooperation schemes become all the more important in order to enable regulators and policymakers to react to all eventualities.

On the basis of the theoretical and conceptual framework, the research thereafter turns to the analysis and assessment of governance reforms from chapter five onward. The focus thereby is on the reform of the regulatory and supervisory architecture as the context in which regulatory actors implement established regulatory mechanisms and policy tools, and is followed by an assessment of the challenges they face with particular regard to the definition of systemic risk set employed the regulatory imperatives deduced throughout.35 The empirical analysis in chapter five presents an overview of the regulatory aftermath of the crisis, including an elaboration of the policymaking context and pre-crisis regulatory deficiencies in order to set the stage for the discussion of post-crisis regulatory reforms with the latter essentially being a review of the outcome of the post-crisis reform process which includes (i) taking stock of systemic risk-related governance reforms and contextualizing their characteristics and nature as such, and (ii) assessing the resulting degree of integration that has transpired and the overall significance of the evolution that has resulted from reform.

At stake in the former, which is essentially a contextual and descriptive analysis from an empirical-analytical perspective, are the nature and scope of the newly instituted or revised institutions’ rationales and mandates as well as their legal foundations, institutional settings and competencies, while the objective throughout is to assess the degree of integration that has transpired and the overall significance of the evolution, i.e. the progress that has taken place in terms of EU governance – ultimately assessing what developments, i.e. the reform outcome imply for the status quo of European financial integration in general and convergence, harmonization and centralization in particular, thereafter evaluating the capacity and potential implications of constructed institutional structures and instituted policies, regimes and mechanisms in systemic risk-related terms. Both of the above essentially synthesize and contextualize the overarching post-crisis policy and polity developments and serve as a basis for the assessment of challenges in chapter six and their implications in chapter seven.

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34 Their contingent nature ultimately implies that as crises are usually unpredictable, as are their scale and the ensuing dynamics, the ability to implement resolution mechanisms and bail-in tools is always dependent upon the nature of the crisis.
35 These imperatives are deduced throughout chapter four with a view to the systemic risk definition employed, both to highlight (i) the challenges systemic risk presents, and also (ii) how to approach and potentially remedy these.
The goal of the analysis in part five is ultimately to assess post-crisis reform elements – comprising the new institutions and governing bodies which implement the measures set out in chapter four and which, taken together, constitute the new governance architecture – thereby attempting to mirror the breadth and scope of reforms, while bringing coherence to the complexity of the European response to the crisis. In this context, it emphasizes themes of relevance for both pan-European reforms and the regime for centralized supervision and resolution in the eurozone – with mitigating fragmentation and instability being their principle aims – and seeks to clarify key issues of significance when assessing the design of regulatory and supervisory structures and their implications in terms of regulatory governance capacity by including a discussion of analytical concepts with implications for the analysis of European governance schemes as well as the challenges they face. These issues include overarching themes affecting cross-border governance on the one hand and more specific technical issues regarding the design of established institutional schemes and regulatory regimes on the other, with both being of significance for the analysis of reform elements’ overall significance, capacity and challenges in the subsequent sections. In essence, they comprise issues against which the reform outcome is analyzed, revolving around the design of institutional structures that impact capacity and are directly related to challenges such as, for instance, (i) the centralization of structures and processes of regulation on the one hand (centralization and complexity versus proximity and simplicity and the risks and opportunities of supervisory centralization), and regulatory conduct and policy implementation on the other,36 (ii) the discussion of the themes of soft law versus hard law, with both being of significance regarding capacity, and (iii) the issue of regulatory and supervisory design and the inevitable trade-offs inherent therein vis-à-vis ideal-types, particularly at the supranational level.37

As the analytic core of the thesis, chapter six goes on to evaluate and contextualize reforms from a governance perspective in the sense that it assesses the extrapolated challenges they face and their impact on governance capacity in terms of their potential regarding crisis prevention and crisis management at the European level. As an analysis of constraints that inhibit effective cross-border financial governance – conducted on the basis of the assessment of the reform outcome with reference to the issues set out in chapter four, more specifically, with respect to the definition of systemic risk employed and respective governance imperatives resulting from the crisis – the research objective is ultimately to specify and assess macro-level governance factors impacting effective integration and European governance in the aftermath of the crisis. It does so by constructing a framework within which to systematize and critically assess inherently interdependent challenges identified in and derived from the analysis in the preceding chapters and deliver insight into their repercussions for integration and integrated governance. Categories of the analytical framework include order-, legitimacy- and expertise-related challenges, which might also be

36 Developments are assessed against the backdrop of the limited consensus that exists as regards the adequacy of constellations in vertical (national and supranational) and horizontal (as regards scale and scope of authority) terms at the national and European level respectively.
37 The rationale behind discussing issues of trade-offs in elements of regulatory governance design which inevitably impact regulatory capacity is to underline both (i) the significance of the outcome, i.e. of compromise, and (ii) the fact that there is no one optimal design in these spheres. Therefore, trial and error appears to be inevitable.
defined as institutional, political and knowledge-related dimensions of governance, and present governance determinants employed as analytical tools with respect to which reforms can be assessed, resulting capacity can be defined and the extent to which stringent and sustainable integration has been attained can be analyzed.

Thereafter, in chapter seven the research sets out to theorize post-crisis developments in overarching terms, applying the theoretical insights established in chapter two to the reform outcome and evaluating the significance and prospects of both reforms and integration against the backdrop of the insights presented in chapter four and the challenges assessed in chapter six, exploring the ramifications for EU-level financial governance capacity in particular and European integration more broadly. As the analytic core of the research endeavor, chapters six and seven conclude on the basis of the assessment throughout that substantial progress, institutional innovation and capacity expansion has indeed been witnessed, though substantial obstacles as well as interdependent and highly complex challenges persist, constraining cross-border governance and limiting capacity in the process.

To conclude, the research presents and summarizes the main findings, putting conclusions into perspective, exploring the reforms’ ramifications and prospects for the mitigation of systemic risk as well as the extension of governance capacity in the European Union and offering an outlook on future potential with respect to European integration.

1.4 Significance and Limitations of the Study

The financial crisis of 2008 serves as an illustration of the flaws and limitations of unrestrained market capitalism and the degree to which financial markets can be left to their own devices given the inclination of the system – if left unchecked and afforded too much leeway – to generate dynamics that give rise to inefficiencies, inequities and instability, and thereby increase the potential for and likelihood of crises as well as the severity of the respective economic and social knock-on effects and negative externalities that generally ensue (see e.g. Véron 2012). In this context, it also sheds light on the dilemmas governments and supranational institutions alike, but particularly national jurisdictions, face in coming to terms with the challenges that result from the latter and inevitably require solutions beyond the nation state. Given the centrality of finance in terms of its pivotal role in supporting the functioning of modern capitalist economies as well as its susceptibility to crises (see e.g. Mügge 2013), the significance of financial stability and financial system integrity and resilience – to be attained via political governance and intervention – is beyond dispute. As a consequence, due to the considerable threat instability poses to the functionality and legitimacy of modern societies, promoting viable and equitable governance regimes and structures in the form of both policy and polity, equipped with the requisite tools and mechanisms required to govern
effectively in cross-border terms, implies institutions, or rather the design of the governance architecture, does indeed matter, rendering this issue pivotal.\textsuperscript{38}

The significance of systemic risk, the governance implications of cross-border finance, and the related significance of the phenomenon of European integration and its potential in this regard have emerged as issues of relevance in their own right on both the policy and academic agendas in the post-crisis era, presenting the rationale for this research, which is ultimately a comprehensive contextualization of post-crisis systemic risk-related developments, with the focus essentially being a macro-level analysis of the capacity resulting from architectural reforms against the backdrop of a refined definition of systemic risk based on Willke et al. (2013). As an interdisciplinary governance analysis, it assesses the significance of developments in the European jurisdiction by embedding them into European integration theory, arguing that – on the whole and in terms of the build up of capacity and advances in integration – they represent progress in systemic risk-related terms. In this context, the research presents a nuanced contribution to the discourses on European governance and integration as well as regulatory and supervisory reform and the respective challenges that arise in a highly complex policy field. It thereby combines an analysis of the instituted governance architecture with insights pertaining to the substance of what is essentially being regulated – a dimension that is all too often neglected when analyzing governance structures (see e.g. Mügge and Perry 2014).

This notwithstanding, as is the case with any analysis, defining the parameters of a research endeavor inevitably entails omitting certain dimensions and adjacent issue areas of the research object at stake. In effect, limitations are of relevance in multiple respects in the context of this contribution and can be divided into several categories, with the latter essentially being substantive, methodological and thematic in nature. The following is an analytical attempt to delineate the research object and issues at stake by alluding to what goes beyond the scope of this contribution in order to illustrate the complexity and multifaceted nature of the policy sphere in question as well as the intricacies involved in its analysis.

Ultimately, the focus of this research is laid on the systemic risk-related reform outcome and presents a macro-analysis of challenges facing the newly devised and reformed regulatory governance architecture at the supranational level. It is important to note in this context that as a governance analysis, i.e. an assessment of supranational governance structures, the assessment of the substantive content of regulatory reform is potentially limited. Indeed, the analysis of substantive regulatory reform, i.e. the content of policy change and the overarching reform endeavor in all its facets, including its multifaceted behavioral and structural elements, is necessarily limited due to space constraints, implying there are limits to the analysis’ comprehensiveness.\textsuperscript{39} Thereby, only substantive elements of immediate relevance in terms of the provision of financial stability, i.e. for systemic risk mitigation and governance purposes, are

\textsuperscript{38} Indeed, if it is assumed that legitimacy, essential in both national and supranational contexts, is dependent on robust institutional structures that ensure capacity, reform’s effects thereon are of central importance.

\textsuperscript{39} See chapters 4.4 and 4.5 on distinctions in this regard.
included. For instance, as an example, while prudential regulatory measures such as capital requirements – as policy instruments implemented within the new or revised institutional governance regimes – are taken into account and discussed in depth, the regulation of market infrastructures and incentive regimes such as the regulation of compensation and the like are not included in the analysis.40

In addition, in terms of inevitable methodological research limitations, the following is of relevance. To trace the development of multiple institutional structures and substantive issue areas since 2008 over time and simultaneously, inevitably raises the issue of feasibility and limitations regarding the scope and depth of the analysis. The nature of the research context – a multifaceted and multilevel reform effort and process – does not enable, for instance, an in-depth reconstruction of negotiation processes.41 Moreover, overarching reform dynamics and policy initiatives will not be discussed as that would go beyond the scope of this research, nor will the research conduct a the systematic comparison of national, European and international reforms, though cross-references will be made when relevant.42

In terms of thematic limitations, multiple adjacent issues are relevant and require brief clarification. To start off, it is imperative to delineate this clearly: The focus lies on financial regulation in the aftermath of the global financial crisis, which was primarily a banking crisis. The sovereign debt crisis, which lingers on to this day, is a crisis ensuing from the knock-on effects of the banking crisis that laid the structural and macroeconomic imbalances and unsustainable fundamentals within EMU bare, and though it has many overlapping and coinciding triggers, causes and dynamics, it is imperfectly correlated with the banking crisis which takes precedence in this contribution (see e.g. Grossman and Woll 2012 and Mügge 2012 for a similar interpretation). It does, however, serve to illustrate the centrality of the financial system in advanced economies’ ecosystems and its underlying importance for socio-economic stability and prosperity and will be drawn upon when relevant – as for instance with regard to the rationale for banking union, which ultimately also aims to mitigate externalities between banking and sovereign debt crises.

By the same token, the efficacy, evolution and significance of monetary, macroeconomic, and fiscal policy convergence is not considered, though there are linkages. For instance, monetary policy is an integral component of the new framework, especially with respect to macroprudential policy implementation and financial stability more broadly. In addition, though largely considered a failure by most economists, monetary union’s rationale is essentially to facilitate intraregional commerce in trade and services, while the free flow of capital is envisioned to strengthen economies with tangible benefits. Unfortunately, divergence persists and thwarts benefits. In EMU, convergence criteria, including budget and deficit rules,
dictate harsh austerity measures, which are difficult to reconcile with interests of both creditor and debtor countries. The tension this brings with it is an acute risk for the EU as a whole and must be borne in mind, though it is not considered in depth.

Last, yet certainly not least, the importance of the global dimension is acknowledged, as finance is a globally integrated functional system. Though interdependencies of the European and international context and their governance are explored, it is important to note that the latter is a distinct issue area given the degree of financial integration in the European single market, which warrants a distinct analysis, though international coordination undoubtedly remains indispensable.

1.5 The Research Design: Theoretical and Methodological Considerations

Again, the goal throughout the study is ultimately to evaluate and contextualize the reform outcome, i.e. the institutional evolution and corresponding content of crucial post-crisis regulatory and supervisory governance reforms, and their significance in terms of integrated cross-border systemic risk governance and European integration in the financial sphere. Having framed the research interest and the research argument previously, the following section sets out to (i) reflect on the overarching research approach adopted to this end, which includes a discussion of the rationale for drawing on a qualitative research design in the form of a case study, and (ii) present the research methods employed, and thereby, with regard to both the approach and design, outline and contextualize additional theoretical and methodological considerations that have informed this research.

1.5.1 The Overarching Research Approach

In essence, the overarching research approach is qualitative in nature. A qualitative approach facilitates the search for nuanced and contextual explanations by generating meaning from the data gathered and sources assessed and enables drawing nuanced conclusions from the conducted analysis, thereby capturing subtle complexities that might not be possible or significantly more difficult to attain in the context of quantitative research. In effect, a qualitative approach is best suited for a complex multifaceted subject matter such as the one at hand as qualitative approaches essentially facilitate the provision of context and texture, enabling, for instance, the research to employ a mix of theoretical approaches and frames required to capture the full complexity of the research interest and the issue area at stake (Hayek 1945, 1974).43

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43 Nuanced and contextual analyses ultimately present the principal objective of qualitative and interpretative research approaches. Inevitable limitations of qualitative research approaches in this context, however, include the limited representative nature and external validity of the conclusions drawn, though analytical generalizations can indeed be made (Yin 2009).
The overarching research design is based on a case study of the comprehensive overhaul and reform of the European financial regulatory and supervisory architecture for the governance of systemic risk and its externalities in which institutional and substantive policy reform initiatives in both the pan-European and eurozone context serve as embedded units. If the EU and its governance architecture is regarded as sui generis, as is the case in this research and as will be discussed with reference to relevant literature in the theoretical framework, there are no comparable cases as such to date. As to the question whether this research qualifies as a case study, it is important to note that in social science, a case study, such as the one at hand – which essentially presents a critical case (Flyvbjerg 2006) – can be framed as an in-depth empirical inquiry into “a contemporary phenomenon […] especially when the boundaries between phenomenon and context are not clearly evident” (Yin 2009: 18; see also Ragin 1992 on the foundations of social inquiry and case study research). As a consequence, the research need not be comparative as such.

1.5.2 The Research Design: Employed Methods

As this is a governance analysis, the primary focus is on institutional structures and the capacity generated by instituted polity and policy measures, more specifically, the regulatory and supervisory ramifications of institutional innovations at the supranational level in response to substantive structural dilemmas and governance challenges, while to a lesser extent focusing on the idiosyncrasies of the political negotiation and reform process, though the implications of political dynamics will be analyzed with regard to the effects structures may have on agency in the post-crisis reform environment, i.e. in terms of crisis management and future integration prospects.

Combining theoretical perspectives and empirical analysis, the present research sets out to assess the potential of conducted post-crisis reforms directed at mitigating systemic risk as well as theorize developments in European integration in the sphere of financial governance. In order to trace the rationale and potential of supranational integration, while assessing the significance of post-crisis developments in the European context against challenges that influence the build-up of capacity, the research draws on a broad theoretical framework combining insights from legal theory and economics as well EU integration theory, reflecting the complexity and nature of the interdisciplinary research endeavor. Thereby, the analysis of legislation as well as primary and secondary literature is complemented by a selection of in-depth expert interviews conducted to corroborate the data employed and inform the empirical analysis, drawn predominantly from policy documents and specialized media.

44 As discussed in the preceding section, the focus thereby is explicitly on systemic risk-related reform elements related to the single market in financial services and financial integration; not, however, on fiscal, economic and monetary integration. With respect to the scope of the research endeavor and the respective units of analysis, the components of governance reforms constitute the dependent variables at stake, while independent variables include institutional, political, structural and knowledge-related challenges from which reforms’ significance can be deduced with a view to the resulting governance capacity they entail.

45 Therefore, with respect to theory, comparative politics is not employed, though similar developments in other jurisdictions are taken into account to assess the significance of institutional developments.
More specifically and in more detail, the conducted research draws on: (i) primary and secondary academic literature, (ii) the extensive study of legislative documents and founding legislative acts, (iii) a review of central post-crisis reports, official publications and central policy documents from European sources, international standard-setting bodies and national authorities, which includes press releases, speeches and conference contributions from actors of relevance, and is finally complemented by (iv) media coverage due to its contemporary nature. In addition, eight interviews were conducted, whereby interview partners were selected in accordance with their practical insights and in some cases direct experience with respect to the institutions at stake in this contribution, for instance as members of the ESFS’s constitutive committees or as leading officials at national central banks.

1.6 The Academic Debates: A Brief Overview

This section seeks to present a brief overview of the literature informing the research and drawn upon throughout as part of the research approach. Given the breadth of the issues at stake this is a challenging exercise. Nonetheless, it is an attempt to present a recapitulation of the literature and issues at stake, which are elaborated and developed further in the respective sections when they are of relevance. For the sake of simplicity and in view of the interdisciplinary research interest, it is useful to distinguish between the discussion of European integration and the concept of cross-border governance in general on the one hand, and systemic risk research and financial governance in particular on the other. The goal throughout is to balance the discussion between the two in order to enable an inclusive perspective that informs the analysis of the challenges of post-crisis financial governance in the European context. As is to be expected, the literature on both is abundant and ever increasing.

With respect to the issue of regional and European integration in economic spheres, the scholarly debate advances contrasting theses as to both the potential of integrated governance schemes and the ability to attain sustainable and effective integration, including the transferal of authority to the supranational level and the extent to which integration can advance beyond the lowest common denominator. This essentially means that they differ as regards their views on the extent to which governance schemes can progress beyond what would in theory be expected, i.e. beyond the original intent of negotiating partners, and as a result the degree of common capacity that can be attained at the European level. Perspectives also diverge as regards the desirability of both market and governance integration, though the view largely prevails that a supranational approach is required to ensure a resilient, stable and equitable financial system given the degree of integration that prevails to date (De Larosière 2009; FSA 2009). These perspectives on the

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46 The contemporary nature of this research – the object being a moving target – is in part dictated by the framework within which it was conducted: a research project funded by the German Research Foundation on policy responses to the financial crisis.

47 For instance, an overview of the theoretical discourse and stances on theoretical approaches employed throughout on the rationales and challenges, i.e. forces driving and inhibiting European integration, are discussed within the respective sections on EU integration in chapter two and its application in chapter seven.
causes, processes and outcomes of integration are discussed throughout chapters two when constructing the theoretical foundation as well as throughout the application of the latter in chapter seven in order to assess the reform outcome as well as the challenges systemic risk governance and instituted schemes face. In brief, the theoretical framework draws on the seminal contributions of prominent scholars of the study of European integration, such as Ernst Haas (1958, 1964, 1975) and Andrew Moravcsik (1993, 1998), in addition to newer contributions of relevance that are discussed throughout in the respective chapters.\footnote{Chapters two and three revolve around European financial integration in theoretical and practical terms. In this context, chapter three explicitly focuses on pre-crisis developments in European financial market and governance integration, including issues such as the rationale, evolution and challenges of EU cooperation and integration (drawing, among others, on Haar 2014; Mügge 2011a; Quaglia 2012; Schoenmaker 2011; Story and Walter 1997), and is rounded off by a discussion of the evolution of regulatory paradigms and crisis narratives in both their pre- and post-crisis contexts as a basis for the discussion of the crisis and the ensuing reform initiatives. Also, while European integration theory is discussed in depth in chapter two and applied in chapter seven, systems theory is drawn on in chapter four to showcase and theorize the dilemmas inherent in the financial system and financial governance.} 

The second element is that of financial market and regulatory integration as well as financial governance in light of the crisis, with the link being the question as to how financial globalization, market integration and the revelations of the crisis have affected the mitigation and management of crises at the supranational level. It is ultimately the technical discussion of the reform outcome and its prospects in terms of cross-border crisis prevention and management. In this context, while chapter three presents the pre-crisis regulatory status quo as a backdrop for the analysis, chapter four revolves around the concept of systemic risk, whereby it revisits the crisis and focuses on its revelations with respect to the threats inherent in the financial system as the foundation for the emergence of systemic risk.

Contrary to widespread perception, systemic risk has been an issue of concern in academia as well as in policy circles for some time, though in the pre-crisis era systemic risk research was largely confined to economics (see, for instance, Allen and Herring 2001; Davis 1995; Freixas et al. 2000; Hellwig 1998; Kaufman 1996), while research at international organizations (see, for instance, Borio 2003; De Bandt and Hartmann 2000) on related themes such as the dangers arising from large institutions (Mayer 1975; Mishkin 2006; Stern and Feldman 2004) were not paid much attention, implying the impact on theory and practice was minimal. Both its academic relevance and its policy influence have evolved, however, in line with the increasing recognition of its significance with respect to the provision of financial stability. On the one hand, the crisis intensified interest in the threats systemic risk poses, with the latter's rise to prominence resulting in it finding its way onto the policy agenda in the form of the new macroprudential policy paradigm. On the other hand, in the aftermath of the crisis, systemic risk received widespread interest from multiple disciplinary angles in academia as an evolving field of research under intense scrutiny. In this context, though the vast majority of publications on systemic risk has been produced by economists (see e.g. Gai 2013; Hansen 2013; see also Engle et al. 2012 for an explicit European focus), insightful interdisciplinary analyses have also been contributed by legal scholars (see e.g. Anabtawi and
Schwarcz 2011; Levitin 2011, 2014; Schwarcz 2008) as well as governance scholars, political economists and sociologists (see e.g. Lounsbury and Hirsch 2010).

Yet though the post-crisis wave of research contributed significantly to the wealth of perspectives that exist today, it did not necessarily deliver clarity as to defining systemic risk. Indeed, there has been limited consensus as to its exact definition, nature and the respective implications. It is into this context that the contribution in this research is placed and the debate to which it contributes. In a nutshell, it contributes to scholarly debates on both systemic risk in an interdisciplinary sense and cross-border financial governance within political science and political economy, focusing on the potential of governance and the build-up of capacity in the European context in the aftermath of the crisis, and most importantly, the rationale and need for it given both the political embeddedness and systemic nature of systemic risk. In addition, it contributes to the discourse on European integration more generally. Finally, it should be noted that the risk of disciplinary shortcomings is, evidently, ever present in an interdisciplinary analysis.

When conceptualizing systemic risk and its implications for regulatory governance in the European context, the research draws extensively on insights advanced by Willke et al. (2013), synthesizing system theoretical and political-economy elements, which include political and economic interpretations of systemic risk to contextualize the intricacies involved in its cross-border governance, and in turn draw on Levitin (2011, 2014), Anabtawi and Schwarcz (2011) and Schwarcz (2008, 2014) for political and economic interpretations of systemic risk. Moreover, to facilitate theorizing the latter, a section on the evolution of the financial system in the pre-crisis era – a period in which the latter evolved into an increasingly tightly coupled and interdependent system (Palmer and Maher 2010; Tucker 2014; Willke et al. 2013) – complements chapter four, serving as an analysis of the system properties and structural characteristics that gave rise to the vulnerabilities that produced systemic risk. System properties, which constitute the key underlying qualities or foundations of modern finance, thwarting regulatory governance capacity and presenting factors conducive to systemic risk, include, most importantly, uncertainty, system instability and complexity which has been on the rise on all fronts – in institutional, regulatory and system-related terms. In this context, among others, Gai (2013), Gai et al. (2011) and Haldane and Madouros (2012) as well as Kapoor (2013), Kindleberger (1978), Minsky (1986, 2008) and Turner (2013a, 2015) are drawn on. Finally, system theory is employed, drawing on contributions and insights from, among others,Helbing (2010), Palmer and Maher (2010), Perrow (1981, 1984) and Willke et al. (2013). What sets the analysis apart in this context is essentially its inclusion of the often-neglected underlying system fundamentals that are so central to the emergence of systemic risk in finance (see Willke et al. 2013) and have crucial implications for both the ability of public authorities to deal with systemic risk and with respect to governance capacity in transnational spheres.

49 This is in line with, for instance, Helleiner and Pagliari (2011), Mügge and Perry (2014) or Pinto et al. (2011).
50 In-depth scrutiny of the substantive nature of contemporary finance and its integration in institutional and governance analyses bears tremendous potential for political governance issues more generally.
Chapter five on the newly devised or reformed governance schemes that emerged in the aftermath of the crisis in turn draws heavily on the contributions and intricate legal analyses delivered by Ferran (2011b, 2014b, 2014c), Ferran and Babis (2013), Ferran and Kern (2011) and Haar (2014) on the foundations and innovative significance of both the banking union and the ESFS, and many others, including, for instance, on Chang (2015), Quaglia and Howarth (2015) and Wymeersch (2012a, 2014) for critical perspectives on institutional reforms and innovations. These, then, are complemented by empirical research, including (i) extensive legislative analyses, i.e. in-depth assessments of the constituting legislation, (ii) the analysis of official EU documents of relevance, including post-crisis reports, press releases and speeches, (iii) accompanying media coverage, and finally (iv) semi-structured expert interviews conducted by the author, serving as qualitative case-based evidence. It is important to note that the European regulatory reforms discussed throughout chapters four and five remain to a degree – even to date – moving targets, implying they have yet to be fully implemented (e.g. in the case of the Basel Accords’ capital regimes), have yet to be fully established (as in the case of the SRM’s resolution fund) or have yet to be tested in the event of a genuinely systemic crisis (e.g. in the case of resolution mechanisms and bail-in rules).

Chapter six goes on to discuss the governance challenges deduced from the analysis and is complemented by an overarching assessment of the reform outcome in both practical and theoretical terms in chapter seven with a view to (i) substantive regulatory issues and governance imperatives relating to the nature of systemic risk as such based on the definition delivered and insights advanced by Willke et al. (2013) with regard to its systemic and political dimensions, as well as with respect to (ii) the implications of the reform outcome in terms of European integration in which, for instance, the insightful analyses of Chang (2015) and Schimmelfennig (2017a, 2017b) are drawn upon to assess integration and reform developments against the backdrop of the theoretical framework set out in chapter two.
2. PART II: THEORETICAL FOUNDATION AND PERSPECTIVES

Among the many flaws the crisis exposed with respect to the functioning of financial markets, their regulation, and the provision of financial stability at large, issues of cross-border governance rose to prominence in both policy-making circles and academia in the post-crisis era as it had become evident that the governance schemes in place did not match the cross-border nature of the underlying policy sphere, particularly in the European context. To lay the basis for the discussion of the repercussions of this development with respect to the ensuing reforms instituted in the European sphere, the following chapter addresses what drives states to cooperate and integrate, whereafter the schemes they choose and approaches toward theorizing these phenomena and processes are presented. As the theoretical foundation of the research, it essentially constitutes the basis for (i) the construction of the conceptual framework in chapters three and four, which shed light on developments in European financial and regulatory integration as well as the issues exposed by the financial crisis in terms of the implications of systemic risk with respect to the governance of cross-border finance, and (ii) the analysis of policy reforms instituted at the European level in the aftermath of the crisis. Given the nature and complexity of the research interest, the theoretical context is presented at the outset, conceptualizing the general governance issues and challenges at stake as the backdrop against which the research is conducted. To do so, the concept is briefly revisited and operationalized from a theoretical perspective. Given its breadth and contested nature, its definition and contextualization are required to ensure its utility.51

2.1 Defining Central Insights: Theoretical Premises and Governance Issues

The study of transnational order and governance in its various manifestations has advanced substantially throughout the past decades as the evolution of and developments in the global system and its functional sub-systems as well as globalization in general have progressed ever more rapidly. Theorizing governance requires analyzing the dynamics of global, or rather transnational order. For this purpose, i.e. to conceptualize the nature and processes of the global system, the phenomenon and process of globalization is employed as the dominant trend and overarching external backdrop – despite setbacks in the current era – against which the research is conducted. To do so, the concept is briefly revisited and operationalized from a theoretical perspective. Given its breadth and contested nature, its definition and contextualization are required to ensure its utility.51

In essence, globalization, linked to other developments such as technological progress, is essentially a multifaceted, uneven and incomplete process of increasing cross-border interdependence in diverse

51 Keohane and Nye (2000), for instance, maintain it is obsolete and of no analytical value.
spheres and to differing degrees (Donahue and Nye 2000; Keohane 2003; Keohane and Nye 2000; 2009). In economic terms, it is a process that increasingly connects and integrates markets for goods, services and capital. As linkages evolve and intensify, they broaden and deepen the degree to which it prevails (Zürn 1998). Thereby, though it has contributed substantially to global efficiency and prosperity, it does not necessarily foster homogenous and equitable outcomes, implying it is neither unequivocally beneficial nor detrimental. Indeed, given the speed with and extent to which it has developed – for instance in the financial sphere – it poses a critical challenge for all actors in the global system.

In the wake of advancing globalization, multiple trends are relevant with regard to financial regulation and economic governance more broadly. These include structural macro-level factors and developments such as changes in terms of compositions of order, including the evolution of sub-national and transnational regional forces that demand authority under the guise of subsidiarity (ibid.), and structural meta-level factors such as system complexity, opacity and knowledge-intensity. Both dimensions exacerbate pressures on and increase the need for integrated, functional and cross-border governance. In addition, in economic terms and with regard to the dynamics of global capitalism, globalization drives interdependence by way of increasing the linkages between markets for goods, services and capital as well as with regard to factor markets. Externalities caused by linkages are then transmitted via the markets that produce them given the interdependence of issue areas and the highly complex nature of market connections. The consequence of these developments is ultimately that globalization encroaches on national sovereignty and the autonomy of national economic governance, giving rise to the need for effective cross-border cooperation and integrated governance beyond territorial boundaries (Sassen 1999, 2000).

Against this backdrop, globalization also gives rise to opportunities and challenges, prompting debates on the ensuing consequences in terms of both costs and benefits – in particular as it may precipitate social disintegration or aggravate developmental asymmetries between and within nations (Rodrik 2000). In this light, and as a consequence of the above, governance integration is an increasingly pressing issue; indeed, it is a necessity in order to address negative externalities that arise from the nature and characteristics of cross-border finance inter alia as instability and crises are so devastating for all market participants and government actors – above all in the EU given the prevailing degree of market integration (ECB 2017a, 2017b). With a view to these issues, the financial crisis ultimately undermined confidence in self-regulating markets, proving laissez-faire and limited intervention are no longer viable options. In the same vein, it highlighted the scale of interdependencies connecting nation states, especially within the EU, and the degree of damage the negative externalities of disruptions in one sphere can imply for another, both in sectoral and jurisdictional terms. As a consequence, autonomous governance and unilateralism as well as exclusively state-centric approaches to economic governance, regulation and law are essentially untenable.

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52 In the current context, though it has come under increasing strain across the developed world (Deaton 2017), the latter has essentially advanced beyond complex interdependence (Keohane and Nye 2000) and now exhibits highly complex globalism which comprises “a range of networks of interdependence” (ibid).
in a globalized world. The issue at stake is therefore not whether globalization, and by default also finance, ought to be governed on a cross-border basis – as the effectiveness of autonomous governance increasingly declines – but rather how this is to be done (Keohane and Nye 2000: 1).

This research therefore scrutinizes the complex regional integration schemes and arrangements established and designed to adapt financial regulation and governance to the new post-2008 realities, critically examining and assessing the systemic, structural and institutional challenges frustrating attempts directed at constructing a viable European governance architecture. Throughout, the analysis is thereby based on the premise that it is unlikely that – particularly in the sphere of finance and in the European jurisdiction – disruptions of sufficient magnitude will derail the evolution toward increasing cross-border integration and, importantly, the increasing complexity and knowledge-intensity of the global system, and with it the case for integrated governance remains and indeed becomes increasingly strong (Beck 2013a, 2013b; De Grauwe 2017). Therefore, the argument that effective cross-border governance in this sphere is vital and increasingly important ultimately remains valid.

This notwithstanding, and despite the challenges a complex globalized world presents, the nation state’s primacy is undisputed and is indeed experiencing a resurgence of sorts, therefore, to a degree, complicating cross-border governance in the process, and thereby also thwarting the establishment of viable governance structures. The challenges and tensions this gives rise to as well as the issues at stake in this context are discussed in the following.

2.2 Conceptualizing Rationales for Cooperation: The Limits of Autonomous Governance

In overarching theoretical terms, this part focuses on prevailing constellations of authority and the need for cooperative governance in light of existing governance challenges, while addressing the precise rationales and incentives for transnational integration in general terms thereafter.

Nation States and the Limits of Autarky

In the modern era – though scope and intensity of developments and waves of integration in global spheres have varied, implying that they have fluctuated, at times even exhibiting simultaneous centralization and fragmentation as well as differing degrees of global homogeneity and heterogeneity – the international system that has emerged may be characterized as exhibiting greater order than disorder. The EU is a prime example of this development, though the nation state evidently remains the most significant actor in the prevailing global governance architecture. Having asserted itself vis-à-vis other alternatives and forms of governance, its primacy in governance in general – including transnational financial governance – is undisputed (Gilpin 1983; Luhmann 1998). Indeed, it has proven to be the most
efficient form of political, social and economic organization to date as it has – inter alia as a source of
formal institutions on which advanced economies depend – been able to reduce the transaction costs
inherent in the process of governing, while providing for stability and certainty, for instance laying out
frameworks for reliable economic transactions, reconciling internal and external pressures and exigencies
as well as dealing with the broader risks societies face.53 In addition, and importantly, the nation state can
rely on significant and distinctive resources such as the ability to mediate institutionalized discourses and
can thereby capitalize on notions of collective identity.

Despite the fact that private-sector actors, including transnational corporations, industry and public
interest groups, are increasingly active in and central to cross-border activities and governance,54 the view
which largely prevails in international relations theory is that nation states continue to dominate and will
likely retain their traditional governance prerogatives in future (see e.g. Keohane and Nye 2000, 2009).
This even holds true in a globalized world, owing to (i) their superior capacity to perform governing
functions such as devising, legitimizing, structuring, implementing and monitoring the governance of large
swathes of societal activity and providing the legal structures within which regulation and enforcement is
conducted, and (ii) their ability to accommodate and adjust to forces attempting to subvert or undermine
their authority. Governance is, therefore, on the whole, mostly conducted through or with government
rather than without (Najam et al. 2006). Overall, the resilience the nation state has exhibited is remarkable
and is ultimately due to its flexibility, attesting to its capacity to evolve and adapt its structures (see e.g.
North 1981). It must, therefore, be assumed that it will persist despite its flaws.

This notwithstanding, and despite its primacy and resilience, its exclusive authority is increasingly being
undermined (Willke 2009). One aspect is that the coexistence of multiple sources of authority has become
increasingly manifest (Avant et al. 2010; Rosenau 2000), as authority is also situated in and mediated via
other forms of national and transnational as well as public and private sector formations and networks,
while in the European context European institutions have amassed considerable influence and importance
in multiple regards.55 Another is that though the state essentially provides fundamental collective goods
from, among others, “social stability under conditions of high market uncertainty, to popular support for
the market economy itself – that are undersupplied by markets and valued by actors who are interested in
productivity” (Garrett 1998: 823; see also Whyte 2009), this does not go to show that autonomous
governance per se is viable. Indeed, as the crisis illustrated, the governance of capitalism, and above all the

53 The fact that informal institutions such as, for instance, norms and reputations are also essential in this regard is indisputable.
On the significance of formal and informal institutions, see North (1990).
54 Indeed, to varying degrees, autonomous private governance is on the rise – for instance in the form of voluntary and/or self-egulation – and may increase further in light of the increasing complexity of multiple issue areas. Yet, though becoming more
fluid and multifaceted, private and non-governmental actors, while increasingly significant as ‘initiators of change’ – technology
giants being prime examples in this regard – system change and overarching developments are still largely determined and guided
by the formal structures of nation states which thereby retain their overarching legitimizing functions (Wendt 1999).
55 With regard to financial governance in the European context, the jurisdiction and remit of European institutions includes rule-
making and standard-setting, i.e. regulation and the enactment of legislation as well as implementation and supervisory activities,
i.e. the application and conduct of regulation and governance, mostly in tandem with national authorities. The European
Commission’s right of initiative is particularly important in this regard.
regulation of finance, is imperative. Thereby, market forces and government intervention must be balanced and reconciled. Overly stringent intervention can result in destructive protectionism or disastrous unintended consequences, while limited intervention can foster instability, inequitable outcomes and the like. Both, in turn, can result in declining efficiency, functionality and prosperity. Approaches to financial governance must therefore not be interpreted as “a dichotomous choice between the primacy of the market and […] the state” (Willke 2009: 12).

Yet while this implies that the state is indeed needed to a degree given its primacy in internal governance and transnational interest mediation, it is insufficient on its own as finance in a globalized economy arguably defies territorial borders and thereby inevitably induces tension between different levels of governance, evading the exclusive sphere of influence of individual nation states – while inter alia given its inherent complexity and fragility – generating uncertainty as well as complicating governance in the form of guidance and control (Sassen 1999, 2000; Zürn 1998). This has become particularly apparent in the post-crisis era. The consequence is therefore that as autonomous governance is impeded, integrated cooperative governance is needed. Yet unfortunately, a core dilemma of financial governance is the incongruence of levels of formal authority. In this context, issues of capacity and legitimacy regarding governance and regulation complicate and blur established lines regarding the classical notion of sovereignty in multi-level and multidimensional policy-making architectures.

Subsuming the issues of challenges of autonomous governance in general and public intervention in particular, two insights are of particular significance and present underlying working assumptions throughout: (i) political systems and governance schemes are increasingly significant with respect to capacity-building, monitoring and regulating externalities, as finance cannot be left to its own devices, yet complete governmental control is not feasible, and (ii) cooperation and integration are imperative as exclusively nationally-denominated and state-centric regulatory approaches are manifestly untenable in this issue area. The resulting challenge in the process of constructing integrated regimes – as will be addressed throughout – is therefore to avoid reducing governance to a dichotomy between national and global spheres and between public authority and market forces, while the reconciliation and intricate combinations of elements “of national sovereignty, transnational coordination, and forms of public and private authority” (Willke et al. 2013: 183) are of utmost importance. Ultimately, with respect to the preceding discussion of limits of autonomous governance, it is conclusive to assume that cross-border financial governance and European integration in this sphere is imperative. In this context, systemic risk is a test case for transnational governance as its pervasive, dynamic, global and unpredictable nature, as illustrated by the crisis, render it, by definition, a cross-border governance dilemma and also, by necessity, a challenge for cross-border governance – a challenge integrated schemes must attempt to remedy.

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56 The multilevel policy-making environment that has emerged essentially “confuses the idea of state sovereignty” (Willke 2009) and demands it. See also Grande and Pauly (2005) on the concept of complex sovereignty and reconstituting political authority as well as Porter and Ronit (2006) on the private sector dimensions of and participation in regulatory rule-making.
History points to both the increasing need for and capacity of cross-border governance. Ultimately, the scope of integrated governance has increased in both supranational and international terms and with regard to the former has progressed toward deep, i.e. positive integration which increasingly impacts domestic regulation and thereby reduces national autonomy. Indeed, despite reluctance to transfer authority in general, there has been an extraordinary rise and extension of scope in terms of the issue areas subject to integrated cross-border European governance throughout the past decades (Scharpf 2001). This is manifestly due to the declining capacity and effectiveness of autonomous governance which is likely to increase in future as globalization and/or fragmentation advances and negative externalities arise, yet it is also an indication that substantial gains drive these efforts at integrated governance – underscored, for instance, by the pull effect the EU still exhibits despite all its current crises (Cameron 2010; Stubb 2017).

Indeed, when analyzing the capacity of cooperative transnational governance, it is important to note that in economic terms globalization drives interdependence by way of increasing linkages between actors, markets and jurisdictions, while giving rise to the potential for contagion and externalities in various respects. Thereby, it is beyond doubt that with interdependencies on the rise, the capacity and effectiveness of autonomous territorially-denominated action is limited – even increasingly declining. This interpretation largely prevails as the dominant view in the academic debate despite current developments (see, among others, Abdelal and Meunier 2010; Avgouleas 2012, 2013; Habermas 1998; Rosenau 2000; Zürn 1998), and should serve to prevent idealizing the nation state’s qualities and capacity with respect to governance (Werner and Wilde 2001; Zahrnt 2004). Against this backdrop, cross-border cooperation and integration yields both material benefits and serves to offset the adverse consequences of forces beyond the control of single entities. Both qualities essentially attest to the relative capacity of governance at the European – and indeed even international level – vis-à-vis autarky.

But what explains this state of affairs, i.e. the declining capacity of autonomous national governance? One of the principle drivers of international cooperation and integration has been the evolution of the global capitalist system in the modern era, which has given rise to complex interdependence (Keohane and Nye 2000). Globalist scholars thereby draw attention to nation states’ narrow problem-solving capacities in view of the increasingly overbearing processes and repercussions of globalization. Indeed, throughout the past century the emergent globalized knowledge society has evolved from a unitary and linear order into a complex order, comprising elements of both order and disorder (Willke 2009: 99). The latter is characterized by functional differentiation which transcends national boundaries, implying the subsystems of national social and economic structures and processes are permeated and at times overpowered, or even replaced by international opportunities and constraints. By default, the consequence of globalized

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57 In advanced economies, markets and relative prices largely determine economic transactions, while externalities such as contagion and the like are thereby largely removed from individual jurisdictions’ immediate control.

58 On the consequences of modernity, see Giddens (1990).
markets is therefore that authority is no longer the exclusive preserve of nation states and the logical consequence is ultimately that national policies are inherently limited. As set out above, globalization compromises the autonomy of national economic governance and thereby encroaches on national sovereignty – both directly and indirectly (Kurtulus 2004). Given that it is testing their boundaries, state-centric approaches must inevitably be subject to scrutiny, while – in order to adapt and preserve their governance capacity, and with it their sovereignty and territorial integrity – the nation state must find ways to evolve (see, for instance, Milward 1992 and Moravcsik 1998 on integration as a potential solution).

The resulting rationale for integrated governance schemes is thus grounded in the fact that they are essential for coping with the challenges globalized finance poses, i.e. required in order to coordinate transnational functional cooperation on all governance levels, particularly in the functional sphere of finance, while in addition being integral to reconciling the multifaceted tensions between public intervention, market forces, substantive cross-border interdependencies and individual national goals. There are, however, also tangible incentives fostering integration schemes’ proliferation. These pertain to the positive, i.e. material welfare benefits integrated markets may yield if one accepts that there are indeed benefits to market integration, yet also focus on integrated schemes’ contributions to facilitating the efficiency and efficacy of the governance process and its outcomes as such. As exhibited by the crisis, financial markets’ social and political legitimacy as well as their economic efficiency, functionality and integrity ultimately depends on coherent, predictable and institutionalized governance. Integrated schemes can contribute to attempts to stabilize a dynamic, complex and inherently fragile functional system such as finance (see section 4.3) by giving rise to collective intervention capacity. Ultimately, objectives of governing institutions range from fostering compliance and predictability to transparency regarding behavior and lowering transaction costs in the context of conducting governance activities.

Yet why do states enter into such alliances and thereby cede sovereignty? They generally integrate when perceived gains outweigh associated costs (Gilpin 1983), and as their interests are often interdependent – as is often the case in the financial sphere, for instance regarding the attainment of public goods such as financial stability and prosperity – states are generally inclined to subject themselves to these regimes if they are considered to be positive sum games (Strange 1996, 1999). The challenge thereby is ultimately to reconcile the welfare benefits that accrue to the integrating states and their respective industries and national constituents as well as the increasing efficacy and efficiency of governance, i.e. the capacity to act and govern, with the costs involved, thereby compensating for the loss of competence and authority a transfer of sovereignty inevitably entails while essentially framing it as – and potentially transforming it into – a win-win situation.59

The above has analyzed rationales for economic integration in overarching terms. The following

59 The goal is ultimately to think of this situation in the following terms: By affording actors capacity through integration, sovereignty-sharing may actually be perceived as a mechanism of regaining the sovereignty states lost prior to integration (Moravcsik 1998; see also Milward 1992).
conceptualizes schemes states chose to advance integration, with particular emphasis on issues unique to European integration, thereafter constructing the theoretical framework to analyze the latter.

2.3 Defining Regionalism: Perspectives on Regional and European Integration

Having addressed what drives states to integrate above, this section presents perspectives on regionalism and regional integration as well as the schemes adopted in this context, and applies the discussion to the specifics, i.e. the unique nature and attributes of European integration. To this end, it briefly revisits the phenomenon and process of regional integration, i.e. the formation of integrated regions, by defining its conceptual features, which include its foundations, dimensions, institutional characteristics and processes, and thereafter contextualizes the study of regionalism in this geographical context.

A region may be defined as an entity composed of states that are linked in geographical terms and exhibit a certain, i.e. sufficient degree of mutual interdependence (Nye 1971), while regional integration – defined in the regional studies literature as policy and project (see e.g. Söderbaum 2008) – is the process of cooperation and coordination by means of constructing frameworks and schemes within which to interact and coordinate strategy in a manner that is mutually beneficial for all actors, usually via institution-building to structure and sustain these interactions. In this context, regional schemes – which, to varying degrees, incorporate institutional features and governance mechanisms which once pertained to the national sphere or, alternatively, add layers to complement national arrangements – are constructed on the supranational or macro-regional level, that is between the national and global governance levels and may be applied to all policy spheres or delimited areas of public sector governance activity.

In the immediate post-war era, regional integration was generally rather protectionist in nature. This notwithstanding, from the outset, the EU model has, by and large, been an example of open regionalism, particularly in economic spheres. Its approach is based on the premise that integration stimulates economic activity and competitiveness and “suggests a symbiotic process where responses to globalization can promote globalization” (Breslin et al. 2002: 8), with the response in this case being regional schemes, which in turn promote globalization. Indeed, the parallel evolution of liberalization and regulatory integration in economic spheres, is not contradictory, but rather complementary (ibid.), with the imperative being to ensure they are compatible, and in the case of regulatory cooperation, mutually enhancing so as to safeguard financial stability and also ensure comprehensiveness in terms of the regulatory coverage of the system in order to mitigate negative externalities, regulatory arbitrage, moral hazard and other factors that might foster perverse incentives and hence instability.

60 In this context, regionalization may be defined as the process of cooperation and integration which takes place on multiple levels and in various spheres and gives rise to multifaceted regional networks, actors and organizations. See Fawcett and Hurrell (2005) and Söderbaum (2008) for an elaboration of the respective definitions.

61 See, for instance, Jacoby and Meunier (2010) on the EU’s approach being the advocacy of the paradigm of managed globalization, its goal being to forestall ad hoc deregulation and economic protectionism.
Indeed, in terms of the handling of globalized capitalism, market integration and globalization as such present unique opportunities, while in turn giving rise to persistent as well as constantly evolving challenges arising from liberalization and deregulation as well as the dynamism and inherent instability of the system as such. Against the backdrop of these challenges, and the increasing complexity, significance and thus stake of this sector, market integration has gone hand in hand with increasingly complex schemes of transnational governance in order to harness the benefits of integration and offset the negative externalities of interdependence, including the ensuing loss of governance capacity at the national level. Ultimately, one might – to a degree – conceptualize regional integration as a recursive and self-reinforcing process. Initially driven by the attempt to reap the multifaceted benefits of integration, it may be interpreted as a response to challenges of market integration, but it also gives rise to challenges of coordination, thus requiring ongoing review and optimization to ensure it is fit for purpose in practice, and must simultaneously also be subject to continual scrutiny in theoretical terms. The following therefore looks into the study of regional integration before applying it more specifically to the European context.

The literature on regional integration, including its rationales, characteristics, dimensions and issue areas is vast, as is scholarship on European integration, with the academic discourse having evolved in tandem with regional integration and integrated governance schemes’ advances. Given both the diversity and complexity witnessed in regional integration – that is the diversity of its dynamics and developments throughout the past decades – the phenomenon and the theoretical approach selected to analyze it require demarcation for conceptual clarity, which calls for delineating the research context and the specific research focus adopted in terms of the precise dimensions of regional integration at stake in this contribution in order to proceed (Breslin et al. 2002). The research focus, in short, is formal state-led European integration – defined in literature as policy and project – thereby limiting the analysis of regional integration in this instance to formal features and developments, with these being, more specifically, polity and policy elements of the new European governance framework, i.e. instituted institutional and substantive policy responses.62 This ultimately implies that some facets of integration are not considered. Excluded dimensions include, for instance, the multifaceted, multi-actor and multi-level processes of regionalization, i.e. of cooperation that take place outside of formal structures, i.e. official regulatory frameworks in the corporate private sector, in civil society and beyond.63

With regard to the latter, the present research on European financial regulatory reform, more specifically, the analysis of European integration in the financial sphere, its evolution and the progress reforms signify in this regard, is idiographic as opposed to nomothetic in comparative interregional terms.64 This is – as

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62 With these in turn representing the dependent variables, while endogenous and exogenous variables such as structural constraints facing them – as determinants influencing their capacity – serve as independent variables.

63 Regionalization as defined to above results in the emergence of regional actors and networks (Breslin et al. 2002), yet is a largely unstudied and highly complex phenomenon.

64 This implies that the analysis relates to the study of particular scientific facts in this specific region rather than attempting to devise or apply general laws applicable in comparative interregional terms. It is, however, only idiographic to a degree, meaning
will become clear below – due to the fact that genuinely coherent, comprehensive and meaningful comparative empirical and theoretical research is limited, while constructive tools and frames have yet to emerge (De Lombaerde et al. 2009) – even to date, which ultimately presents the central dilemma in and drawback to comparative research. Indeed, though scholars initially attempted to formulate overarching, comprehensive and universally applicable theoretical approaches – for instance, by trying to pin down which variables and dimensions are most significant – given the degree of interregional diversity and divergence across regions in multiple dimensions, e.g. regarding facets of interdependence and their corresponding effects on the degrees and nature of integration (Söderbaum 2008), which resulted in a multitude of theoretical and methodological difficulties and shortcomings, attempts have generally been considered unconvincing and findings regarded as inconclusive. As a consequence, the complexity and diversity of regional integration encourages us to adopt a narrower focus and single out significant variables and explain their interaction (Breslin et al. 2002: 11), which in this case means conducting ideographic research and is therefore ultimately also the rationale for an EU-focused perspective and the justification for employing EU-centered integration theories at the intersection of political science and international relations. This is elaborated and contextualized further in the following.

2.3.1 Establishing the Uniqueness of and Making the Case for European Integration

This section is intended to serve two interdependent yet also distinct purposes simultaneously. On the one hand, the objective is to establish that – and expound in what way – the EU as an instance of regional integration, meaning the phenomenon of European integration as such, is unique in terms of its characteristics, its nature and with respect to its – no doubt notable – achievements, that is specifically the degree and significance of integration that has been achieved to date, and thereafter argue that this is of significance for the research interest, i.e. regarding integrated governance in this specific issue area. This assumption upon which the conclusions are based is relevant in multiple respects, including with regard to the stance adopted, which is essentially the take on European integration and its rationales and potential in terms of benefits, and which is elaborated in the following, aimed at making the case for integration. Potential in this context is defined in terms of tangible economic and political benefits as opposed to the potential for further future capacity extension – thereby referring to the degree and depth of integration.

the analysis is only conducted with regard to this region (see the subsequent discussion of European integration’s unique nature for the rationale), yet is also nomothetic in the sense that it draws on and employs multiple EU integration theories to analyze and deduce general laws with regard to European integration, that is within the discipline as such.

65 Due to the extreme diversity and disparities in regional integration efforts they may perhaps even be counterproductive.

66 In essence, this subchapter is a foundation for the theoretical framework and presents a justification for the approach adopted.

67 We argue that – despite the multiple existential threats facing the European Union – the argument put forward here regarding the significance of the EU’s achievements in terms of integration remains the case to date, i.e. that the arguments supporting and underpinning this view hold true. This issue will be borne in mind and addressed throughout.

68 The assumption of uniqueness serves as a basis for conclusions regarding the significance of the respective achievements of regional integration in the European context and with regard to its present and future potential.

69 Potential in this context is defined in terms of tangible economic and political benefits as opposed to the potential for further future capacity extension – thereby referring to the degree and depth of integration.
consequential for the arguments and conclusions in chapter seven on both the potential of integration and also the need for an extension of cross-border governance capacity. Moreover, particularly when the phenomenon as such is analyzed in comparative terms – which showcases the significance of developments in European integration in a persuasive manner, even in spite of contemporary developments and in light of current turmoil – it, i.e. the assumption of the European Union being 

\textit{sui generis}, presents a central insight for the analysis and assessment of the reformed architecture and newly instituted regulatory and supervisory regimes and their respective significance and potential.\textsuperscript{70} On the other hand, drawing on the arguments made in the former, an additional aim is to illustrate and justify why European integration theory is drawn upon. As such, it essentially serves as a foundation for or prelude to constructing the theoretical framework.\textsuperscript{71} In short, the first part therefore makes the case for the European Union’s 

\textit{sui generis} nature, or more specifically European integration’s uniqueness and significance, while the second discusses the phenomenon’s significance in relation to theory, with the 

\textit{sui generis} nature being the justification for and rationale upon which our theory selection is based.

Whether European integration as an instance of regional integration is indeed unique and sets itself apart from other jurisdictions and contexts has been subject to debate for quite some time pitting proponents and advocates (see, for instance, Caporaso and Choi 2002; Kahler 2000; Sbraiga 2002) against skeptics (see, for instance, the various contributors in Caporaso et al. 1998) in the study of European integration. The dominant interpretation in the academic literature can, however, be summarized as follows: most scholars of comparative regionalism concur that caution is advised when attempting to draw conclusions on regional integration from the European Union and indeed employ it as a model which can be copied entirely, emulated in delimited issue areas or even just drawn upon to inform assumptions on potential prospects in other jurisdictions and regional contexts (see e.g. Cameron 2010; De Lombaerde et al. 2009). This is largely due to the nature and characteristics of the Union today and the preconditions that the EU, i.e. the region as such and in terms of its composition of advanced economies fulfills and indeed fulfilled at the time it was constructed. In short, and of relevance for European integration theory, the preconditions for effective integration are given in the European context, particularly when viewed in comparative terms. This is largely due to the high degree of development and interdependence advanced European economies exhibit. These preconditions include, for instance, structural features such as meaningful levels of economic development, for the most part balanced and diversified economic systems and largely sustainable growth dynamics and patterns as well as the prevalence of socio-economic and political stability, which is positive and self-reinforcing in the sense that it fosters political, social and economic confidence, and predictability, which in turn is derived via democratic governance, legitimate governments, the prevalence of the rule of law and the like. These are all features advanced European

\textsuperscript{70} These schemes are presented in chapter five and thereafter analyzed and contextualized in chapters six and seven respectively.

\textsuperscript{71} In this vein, it also aids the application of the theoretical framework and underscores the arguments made and conclusions drawn.
economies generally exhibit and they facilitate cooperation and integration in the face of interdependence. Not only do these features facilitate integration and enable synergies and reaping the benefits of cooperation, they also present the driver of integration as such.

Indeed, it is indisputable that the EU was and indeed remains “the most complex, densely institutionalized and authoritative supranational regime in the world” (Caporaso et al. 1997) and – constituting an unusual regime – is unique in multiple respects. Setting it apart, include advantages the region exhibits such as the favorable circumstances that were present at the time the union was constructed or its characteristics that are conducive to integration vis-à-vis other regions, such as for instance similar types of economies and economic structures, levels and degrees of economic development as mentioned above, plural yet in many respects also homogeneous liberal societies, in addition to having similar power structures, autonomy constellations regarding industry elites, interest groups and governmental elites and the like (Zahrnt 2004). More specifically to summarize, with the following also being of relevance with regard to why European integration theories are fitting and warrant being drawn upon in this context, unique regional tenets that facilitate integration in contrast to other regions include (i) high economic interdependence with a competitive business environment which drives innovation etc. while mutual policies, cooperation and integration is in turn more lucrative and important and the benefits more significant if economies are complementary, while (ii) in terms of political structures as opposed to other regions, particularly Africa, South America and South-East Asia, in addition to historical bonds, similarities and stability in political structures increase predictability and trust while lowering transaction and adjustment costs, avoiding tension within the region which in others would severely limit bargaining stability, the efficiency and efficacy of cooperation as essential prerequisites for effective regional integration.

As regards the second objective of this subchapter, i.e. to underscore the phenomenon’s significance in view of the notable achievements and the degree of integration attained in the European context and address the respective theoretical ramifications of the latter, the following is of relevance. Early foundational contributions to the theory of regional integration were of a “distinctly comparative and historical” (Caporaso et al. 1997) nature as the contributions of pioneers on state and community formations in the post-war period and earlier illustrate. In essence, they acknowledged “important contextual differences among regional units, yet did not clamor for “sui generis theory” (ibid.). However, as EU integration progressed and the EU evolved, becoming ever more complex, while extending and deepening the scope of its overall remit, institutional base and policy competences, it was increasingly analyzed in isolation. The reasoning behind this being, so it is argued (ibid.), that the integration process in the European context in both political and economic terms is unique in the sense that it is qualitatively different, with it being “so novel that it truly represents a Hegelian moment, a novelty that, however prescient in terms of future developments, has no current analogies” (ibid.).

72 Prominent scholars include Ernst Haas (1958, 1961) on integration in Europe and beyond and Karl Deutsch (1964, 1968) on the concept of political community.
As to the question whether the EU is indeed a unique case – in other words *sui generis* – and what the respective implications are in theoretical terms, it is argued the discussion should be cast in a balanced light. While cross-references are made throughout, no comparative theory is employed and no comparative connections are made in theoretical terms. Though European integration theories are drawn upon, which are essentially based on the premise that the EU is indeed *sui generis*, other theoretical strands and lenses are also regarded as useful.

Finally, to conclude and underline the rationale of the approach employed, it is important to emphasize one point yet again. As a consequence of European integration’s unique nature, though the analysis is conducted on the basis of a multi-pronged theoretical approach, it nonetheless places particular emphasis on European integration theory and its utility in this context. This is inter alia informed by the following, which essentially presents a reason for the study being idiosyncratic. With a view to the rationale against employing comparative perspectives, the research attempts to mitigate both cultural relativism and ethnocentric bias against which scholars of regionalism warn (see e.g. Hettne and Söderbaum 2000: 461)\textsuperscript{73} and to which particularly political scientists are susceptible, such as, for instance those employing deductive-nomological comparative perspectives (see Caporaso et al. 1997) and, therefore, conducts a contextual and multipronged interdisciplinary analysis with explicit emphasis on the unique nature and features of the EU when aiming to explain the reallocation and diffusion of authority within the European context and the ramifications of shifts of authoritative competencies from member states to the supranational level.

### 2.3.2 Working Assumptions and the Theoretical Stance on European Financial Integration

Before proceeding with the theoretical framework, the following briefly discusses the stance taken in terms of the perspective on cross-border European financial integration and regulatory cooperation and lays out general working assumptions guiding the analysis, thereby making the case and arguing the need for cross-border cooperation and integration in the wake of market integration, i.e. a single market in financial services and capital, and cross-border finance despite the tradeoffs involved. This discussion lays the foundation for the discussion of the rationales of economic integration as well as the evaluation of reform efforts throughout chapters five, six and seven which is conducted against the backdrop of the insights deduced in regulatory terms from the financial crisis analyzed in chapter four.

To shed light on the limited viability of autarky, it is important to note that history has proven time and time again that retreating from open societies generally has disastrous consequences (see Winham 2005).

\textsuperscript{73} This is particularly a potential threat in the discipline of regional studies. Luckily, however, there is a wealth of EU-centered perspectives that can be drawn upon with respect to the research interest.
This applies to most socio-economic issues and spheres (see, for instance, Deaton 2017) — ultimately implying that cross-border activity has the potential to be a positive sum game for all participants involved if conducted equitably and taking account of safeguarding global public goods — though the case for financial integration and financial globalization is somewhat less strong and not as unequivocal as for instance the case for trade and economic integration given the many trade-offs involved and the regulatory complications finance gives rise to owing to the adverse consequences and costs of the financial system’s inherent instability and political embeddedness which are discussed further in chapter four.

In general, however, the assumption in this research is that — in line with the interpretations and stances that largely prevail in the literature (see discussion below) — market integration can be beneficial and a positive sum game, or, in the European context, that the single market is indeed a worthy objective and, in principle, has the potential to create synergies and promote growth and prosperity if regulated adequately and diligently to mitigate adverse consequence. Indeed, as will be put into context and discussed more extensively throughout, liberal and integrated capital markets, a single market in financial services and the mobility of capital in general yield substantial advantages in terms of diversification and efficiency benefits (Allen et al. 2011), presenting key facilitators of economic activity, growth and prosperity if channeled productively (Turner 2009, 2015). This notwithstanding, as stated above, caveats apply. In short, there are substantial challenges financial integration brings with it, the most significant of which is ultimately financial instability due to the so-called financial trilemma — the inability to sufficiently reconcile cross-border financial intermediation, national policies and the provision of financial stability (Schoenmaker 2011; 2013c) mirroring the impossible trinity of monetary policy and the globalization trilemma (Rodrik 2007). Therefore, it is argued in line with Mügge (2011a) — as is discussed in chapter three on regulatory developments and pre-crisis paradigms — that there are limits to liberalization, deregulation and regulatory liberalism if implemented in a dogmatic sense. The interpretation of the value of market integration and the need for corresponding regulation is therefore ultimately a matter of degree.

Progressing beyond the issue of a normative evaluation, however, whether the benefits outweigh the costs of financial integration is not the issue at stake. Rather, as one must ultimately assume that despite partial retrenchment and fragmentation cross-border financial intermediation is here to stay (Begg 2009), increasing the potential for systemic risk and contagion in the process, the underlying issue at stake is not whether, but rather how cross-border finance is to be governed and regulated. Therefore, the research is informed by the assumption that in order to mitigate externalities, regulatory and supervisory integration and cross-border governance, i.e. the supranationalization of financial governance, is imperative to

74 On the roots of the current critique directed at globalization and its many dimensions and ramifications, the Nobel laureate discusses why issues are being trivialized and globalization is being wrongfully blamed for the many of the ailments of modern Western economies and welfare states, which are essentially grappling with the effects of increasing automation and economic transformation in the age of artificial intelligence and fundamental technological change.

75 Though there are indeed scholars and economists that argue against the need for both integration and corresponding regulatory homogeneity, this is inevitably a matter of degree with regard to which there is no definitive academic consensus.
provide for stability, particularly given (i) the prevalent degree of cross-border financial market integration that exists to date,76 and (ii) the nature and tenets of the financial system as such.77

By definition, if financial liberalization and integration in wholesale and retail financial markets is the reality,78 regulatory integration and cross-border governance are a necessity to ensure stability and equity, mitigate and address market failures and counterbalance the ramifications of imperfect competition as comparative advantages are relative and not necessarily absolute. In this context, the foundations of the governance structures put in place as pre-requisites of cooperation play a key role in ensuring the viability of the regulatory system – it is these that are at stake throughout.

Before proceeding, it is useful to draw attention to one more issue of relevance in this context. When assessing the rationales of regulatory convergence, cooperation and integration in finance, opinions in the academic realm diverge as regards different degrees of convergence and divergence and their necessity (see table 1 for a typology of possible dimensions). As alluded to above, there are scholars and economists that argue against the need for regulatory homogeneity and cooperative governance (see e.g. Eichengreen 2009; Kapoor 2013; Rodrik 2009; Stiglitz 2010; Warwick Commission 2009).79 In general, one can distinguish between two diametrically opposed stances with regard to cross-border financial governance in this context, advocating either regulatory homogeneity or regulatory heterogeneity. Proponents of the former, i.e. the homogeneity argument, advocate and argue in favor of global or rather cross-border financial governance as the only viable strategy for national regulators to exert control over financial markets and tackle the threat of systemic risk as long as these remain as complex and integrated as they are at present.80 This is the argument adopted throughout.

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76 For a technical definition of EU financial market integration, i.e. the cross-border integration of retail and wholesale financial markets and relevant indicators see European Commission (2007c, 2014a) and their annual European Financial Stability and Integration Reports.

77 Indeed, due to the very nature of finance the regulatory rationale is given, be it national, supranational or global. In the pre-crisis context, both the degree of market interconnectedness and the absence of adequate cross-border crisis management mechanisms exacerbated the adverse consequences of instability and contagion.

78 It should be noted, however, that wholesale finance is substantially more advanced than integration in retail markets (Grossman and Leblond 2011).

79 The Warwick Commission (2009), for instance, claims with respect to regulation that “one size does not fit all” and an unlevel playing field could potentially increase stability rather than jeopardize it. In this vein, uniformity in both the industry and with respect to regulation is regarded as increasing the risk of herding behavior and contagion (Kapoor 2013: 9) of which a pertinent example is the adaptive behavior that resulted from Basel II and decreased the financial sector’s overall resilience to shocks. The underlying hope is ultimately that an unlevel playing field would potentially imply more frequent yet also smaller crises that do not become systemic in nature, though the implications of divergence and cooperative decentralization remain inadequately studied (Helleiner and Pagliari 2011) even today. Surely, weakening standards allowing for more national diversity would not necessarily imply that no cooperation at all takes place on adverse spillovers. It is, however, doubtful whether this would suffice. In this light, Stiglitz’ (2010) argument is somewhat more nuanced as he argues unilateral regulatory strengthening and stringency is the “second best” option, implying it is the preferred option only if no meaningful and comprehensive cross-border regime is attainable (see Helleiner and Pagliari 2011 for a discussion of the main proponents in this debate).

80 See chapter four on the properties of complex and tightly coupled systems such as finance and the corresponding rationale for devising collective and reactive strategies and frameworks for crisis prevention and crisis management given the inability to steer and govern the system comprehensively.
Table 1: Overview and Typology of Regulatory Governance Options

<table>
<thead>
<tr>
<th>Homogeneity and Regulatory Convergence</th>
<th>Heterogeneity and Regulatory Divergence</th>
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<tbody>
<tr>
<td>Cross-border Cooperation</td>
<td>Globally Applicable Standards</td>
</tr>
<tr>
<td>Absence of Cooperation</td>
<td>Informal Convergence</td>
</tr>
<tr>
<td></td>
<td>Cooperative Decentralization</td>
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<tr>
<td></td>
<td>Fragmentation</td>
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</tbody>
</table>

Source: Own Construction

In essence, the underlying question is whether a level playing field is a necessity and desirable, or whether selective harmonization and cooperation might suffice to govern finance, provide for stability and mitigate contagion. This notwithstanding, for the most part this debate revolves around the issue of the harmonization of regulatory standards at the international level and not so much around issues pertaining to regulatory regimes, mechanisms and supervisory structures, i.e. cross-border governance capacity, in integrated markets which this research focuses on, implying this debate is of less relevance in the European sphere. Indeed, the issue at stake in this context is ultimately why regulatory integration and integrated governance at the European level, i.e. integrated solutions and collective capacity are required in view of the level of market integration in the EU with the answer, in a nutshell, being precisely the prevailing degree of market integration and the nature of finance as such. Why this is particularly relevant with regard to systemic risk will be discussed in chapter four.

Though the immediate post-crisis political environment was dominated by domestic concerns and political pressures, which inevitably gave rise to preference heterogeneity and declining political and regulatory capacity to commit to cooperation, incentives to cooperate continued to prevail due to enduring financial interdependence, which intensifies cross-border competitive pressures and increases the potential for negative externalities, among them protectionism and spillovers from regulatory arbitrage and instability (Helleiner and Pagliari 2011: 194), particularly in the European context. Tax policy and tax evasion are additional spheres where fragmentation or cooperative decentralization is not an option if they are to be effective. The financial crisis was the wake up call in this respect, attesting to the need to regulate cross-border finance cooperatively at both the European and international level.

In more general terms, embedding the analysis into the current context in view of turmoil at the global level in terms of the dismantling of the liberal world order, it is assumed in line with Deaton (2017) that the real issue at the heart of debates on and forces of disintegration and fragmentation in the Western world ultimately revolves around the flaws of market capitalism rather than globalization as such which will likely persist, while most tensions in the European Union throughout the past decade have revolved

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81 As will be shown in chapter three, integration can ultimately be interpreted as a self-reinforcing process. Negative market integration, i.e. the reduction of barriers in order to foster a common market, ultimately gives rise to the rationale for regulatory integration and cross-border governance which in turn facilitates economic activity and integration within a given jurisdiction.
around immigration as well as monetary and economic (i.e. fiscal) policy. A central working assumption throughout is, therefore, that the rationale for and commitment to economic integration in terms of the internal market for goods, services and capital remains and will most likely remain in tact in future despite Brexit and multiple lingering political crises. Indeed, the single market will likely retain its traction, and with it the need for cooperation in terms of the regulation and supervision of cross-border finance will remain. Though European integration in its entirety is by no means irreversible, it is the political project which is at stake and the narrative of political integration and political union which has been jeopardized by recent developments, while in light of external pressures and sheer economic necessity, the common market is likely to remain a pull-mechanism of sorts. There may even be a significant revision of the European project and a great leap in terms of integration in the long-term future as the latter have often resulted from crises that either shed light on economic necessity or have been induced by external threats and pressures (Sandbu 2017b; Thornhill 2015). In sum, it would likely be a mistake to underestimate the ambition underpinning European integration as will become clear throughout (Véron 2014a: 3).

Finally, having established why countries integrate in overarching terms with a view to the multifaceted incentives and trade-offs involved in their complex considerations, including the research’s stance with regard to the economic rationale for integrated and cooperative governance, before proceeding, and in order to round off the preceding subchapters on general theoretical perspectives, the following sets out the theoretical framework drawn upon, in the context of which the analysis is embedded. The theoretical framework encompasses the approaches employed given their utility in terms of analyzing the nature and process of integration as well as conceptualizing the outcome of reform, the degree of integration that has transpired and the implications thereof with regard to the issues at stake. More specifically, they offer insight into the rationales of integration as well as the processes that take place within the schemes devised to govern and administer cooperation, thereby contributing to analyzing the – at times surprising – reform developments and theorizing the reform outcome in terms of the respective implications of instituted governance structures with regard to the resulting governance capacity they give rise to. In this context, drawing on the insights established above as regards the unique nature of the European Union, i.e. with reference to the issue of its significance, which serves as the justification for the approaches selected, European integration theories are drawn upon as they shed light on why and how member states cooperate, and thereby offer insights which can be drawn on to theorize the trajectory as well as the challenges of cross-border financial regulation and integrated systemic risk governance in order to assess

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82 With respect to the outlook for disintegration at the European level the argument can be made that in spite of the multiple challenges the Union is facing at present, the likes of Brexit, increasing international trade tensions and looming external geopolitical threats may paradoxically facilitate further integration (Stubb 2017). There is even hope for more integration in the eurozone (Sandbu 2017b). An important fact in this respect is that opposition toward European integration is primarily directed at political union, i.e. issues that touch on acute sovereign concerns or matters of high politics such as foreign policy and immigration, implying they do not necessarily pertain to the traditional economic issues of European integration. On the contrary, economic integration and therefore also power in terms of external influence is consequential for most member states, especially the smaller ones, even more so in a multipolar and rapidly changing world. Finally, putting the risks associated with Brexit and the fragmentation or even breakdown of the Western liberal world order into context, some current developments may even be positive in the sense that they are conducive to European integration and the build up of common capacity.
post-crisis developments and their potential against the backdrop of the obstacles discussed. Throughout the remainder of the chapter, which presents employed theories’ main conceptual tenets as well as a critical assessment of their respective applicability and explanatory potential in order to enable an adequate evaluation of the reform outcome, the objective is ultimately to lay the theoretical foundation, which in combination with the conceptual framework set out in chapters three and four, constitutes the analytical frame within which the empirical analysis of the reform outcome and resulting regulatory capacity in the European context is conducted. Thereby, the lenses set out serve as the backdrop for the evaluation of post-crisis developments and their significance in chapters five to seven and as a basis for the analytical framework in chapter six in which challenges facing the instituted governance arrangements are theorized.

2.4 The Theoretical Discourse on European Integration: An Introduction

The 2008 financial crisis, arguably “the worst crisis since the Great Depression” (Financial Crisis Inquiry Commission 2011; see also Levitin 2014), highlighted just how destructive financial instability can be and the havoc systemic crises can wreak, with the implicit costs of the crisis – in which risks were essentially socialized, illustrating that the financial system is by far the most subsidized industry in the world (Wolf 2010) – including “tens of trillions […] in lost output” (Haldane quoted in Wolf 2010) and the knock-effects of a multi-year recession, the effects of which are still being felt today. However, in addition to highlighting the necessity of government intervention on the one hand (as the financial markets can evidently no longer be left entirely to their own devices), and cross-border cooperation on the other (owing to the fact that markets shift risks across borders and therefore inevitably require comprehensive cross-border oversight), the crisis also exposed the fact that crucial preventive and crisis management tools were lacking at both the national and supranational level (Claessens et al. 2010; Turner 2009; Véron 2012). Thus, in an attempt to remedy these shortcomings, the EU embarked on an ambitious reform path to overhaul its regulatory architecture in the post-crisis era.

When examining the events that took place and developments that unfolded in the immediate wake of the global financial crisis (2007-2009) and its aftermath (2010-2014), which extended into the sovereign debt crisis, the advances that were made in terms of European integration and governance reform, and indeed the compromises that were reached in an era of acute and perhaps even existential crisis – in which both the economy and financial system ultimately survived “a near death experience” (Wolf 2010) in the form of a complete collapse – are striking, begging the question as to how this is to be explained and what the potential implications are. Notwithstanding the turmoil and multifaceted domestic political pressures that prevailed at the time – both catalyzing reform given the degree of public outrage, yet also complicating it given the degree of scrutiny to which policymakers and regulators were subject – the advances in general, for instance vis-à-vis other jurisdictions, and in terms of integration and cross-border financial governance
in particular, have been quite far-reaching in the European sphere, especially in terms of institutional innovation. This is, for instance, the case with respect to eurozone integration, i.e. with regard to the banking union, which has been described as one of the most significant integrative steps forward and the most ambitious European project since the introduction of the euro and the construction of Economic and Monetary Union (EMU) in the early 1990s (see, for instance, Chang 2015; Howarth and Quaglia 2013a). It has also, to a degree, been the case in pan-European terms, in which there has been a step-by-step transfer of governance functions to the supranational level, including key breakthroughs and, most importantly, an accumulation and “upward shift of de facto regulatory power” (Mayntz 2013).

Ultimately, prompting institutional innovation and experimentation in financial governance, the crisis appears to have been transformational for the evolution of European financial market regulation and European integration more generally. Despite all its flaws, the post-crisis response – encompassing inter alia the European System of Financial Supervision (ESFS), the banking union and a revised regulatory and supervisory framework that integrates macroprudential policy elements – on the whole appears to have increased the prevailing degree of integration in the European jurisdiction, and therefore potentially also the degree of collective cross-border governance capacity at the supranational level. The paradox at stake is essentially that – amid economic turmoil and at a time when popular approval for deeper integration was waning – significant leaps forward did indeed transpire in an issue area in which politics and economics clearly clash, with the outcome being common supervision and resolution in the eurozone and further regulatory and supervisory centralization in the Union as a whole. Yet how was this feasible and what are the implications of the reform outcome in terms of the resulting degree of governance integration in the supranational context and the ensuing governance capacity it gives rise to? These are issues European integration theories can help explain as they offer insights with which the degree, quality and nature of integration attained, essentially the issues analyzed in due course, can be assessed.

Before exploring the theoretical discourse on European integration and political theories of relevance in this context, however, one particular issue is of importance. European integration has always – or perhaps more accurately most often – advanced in the aftermath of crises as both an immediate response to crises as such and as a matter of functional necessity which the crisis at stake ultimately exposes, i.e. with regard

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83 It is important to note in this context that though banking union was originally a response to the sovereign debt crisis, it is essential for the mitigation and management of banking crises as well as for the provision of system stability and as such is also a response to systemic risks in their various forms – both those that emanate from banking crises and those that result from sovereign debt turmoil as well as the interdependencies between the two.

84 The potential for European centralization may, in effect, have been systematically underestimated. With respect to the evolution of transnational financial governance and European integration in the aftermath of the crisis, the question ultimately arises as to what extent the EU has eschewed precedent and defied its critics in light of the landmark reforms enacted. Véron (2014a: 3), for instance, argues the ambition underpinning “European integration should not be underestimated” as for many states it constitutes “a core component of [their] national identity” (ibid.), while the crisis has highlighted some of the Union’s strengths such as, for instance, its innovative potential (discussed below). Notwithstanding the progress that has been made, however, the question as to whether reforms in both substantive and institutional terms are sufficient to mitigate systemic risk and moral hazard is yet another question and will be addressed throughout the analysis.
to the underlying issues and deficiencies it lays bare. The same is true for financial regulation and the organization of financial governance, as – given the fact that law and regulatory policy are inherently incomplete, while policymakers and regulators are manifestly unable to devise rules and regulations that anticipate all contingencies due to the non-knowledge they inevitably face (Hart 1961; Luhmann 2008) – continuous adjustment, modification and innovation is unavoidable. The history of regulatory reform is therefore essentially a history of financial crises (Begg 2009; Hennessey 2011). With regard to financial integration and regulatory governance integration in the European context, the story is, however, slightly different. Though the crisis no doubt presented a catalyst for reform in this context – showcasing the functional necessity of the changes instituted in multiple respects – previous episodes of integration in financial governance in the European context were not as such responses to crises, but rather responses to functional spillover from other sectors, influenced by functional necessity or ultimately presenting a symptom, i.e. being a reflection of the overarching mood and paradigm that prevailed throughout the Western world in terms of integration and liberalization (see, for instance, Mügge 2011a). This is analytically consequential in terms of the application of EU integration theory and has implications for theorizing the potential and nature of European integration as will be become clear throughout.

Again, having demonstrated why states integrate in overarching terms as well as presenting this research’s stance with regard to economic integration and cooperative governance, the following now turns to the theoretical perspectives drawn on to conceptualize the reform developments that transpired in the aftermath of the crisis, i.e. approaches designed to theorize the reform outcome in terms of both the structure and functioning of new or revised cross-border governance arrangements.

Drawing on the insights established in the preceding chapter as regards the unique nature and tenets of the European Union in its current form and the stance regarding European integration, the following subchapter sets out the theoretical framework which essentially comprises primarily political schools of thought and political science perspectives on integration, i.e. those of relevance in terms of analyzing the nature and process of integration and cross-border financial governance and which include perspectives on rationales of economic integration. It does so by laying out their main tenets, premises and

85 In the context of the current crisis, for instance, shortcomings that were laid bare include those pertaining to (i) the regulatory paradigm as such, i.e. the microprudential focus of regulatory and supervisory policy (see, for instance, Borio 2011; Brunnermeier et al. 2009), (ii) the organization of the European governance architecture, i.e. insufficient regard for potential externalities of cross-border financial intermediation and cross-border dimensions of regulation and supervision in a single European market and beyond (see, for instance, Begg 2009; Turner 2009; Véron 2012) or, (iii) the lack of robust, credible and integrated crisis management and resolution tools and frameworks.

86 Luhmann (2008: 145) showcases the dilemma regulators and policymakers face in this context with regard to the illusion of control and non-knowledge and captures the essence of the issue at stake: “The impossibility for the political system effectively to control other systems with an adequate grasp of consequences and limited risk is inversely proportional to the facility with which […] decisions can [be] put into force and, however sporadically, actually implemented. The astonishing expansion of competence in the welfare state begets a gigantic and uncontrollable machinery for increasing risk.” The implication is ultimately that regulators can never entirely preclude and mitigate risks and the regulatory system’s fallibility must be born in mind at all times.

87 This is ultimately an argument in favor of neofunctionalism and to a lesser extent liberal intergovernmentalism, not necessarily a theory that requires an external trigger to explain fundamental change such as, for instance, historical institutionalism. Rather, in the former, integration can be interpreted as a process set in motion by internal, i.e. endogenous forces (Lefkofridi and Schmitter 2015: 10) and as such may be of significance for the potential and significance of integration outcomes.
assumptions and examining their utility and explanatory significance in this specific context in order to lay the theoretical foundation for the analysis of the outcome of the regulatory reform process in all its facets, the degree of integration that has transpired in the European context and the respective implications thereof with regard to the research endeavor, including the challenges and limitations witnessed in this regard. In this context, it must again be noted that theories’ main tenets and assumptions as well as their utility, explanatory potential and significance in this regard are set out and discussed in the present chapter and thereafter elaborated further – with theoretical insights applied in detail to the reform outcome – throughout chapters six and seven.\textsuperscript{88}

Approaches drawn upon include those which integrate insights on rationales of integration as well as the processes and dynamics that take place within the schemes devised to govern cooperation and thereby essentially contribute to analyzing and theorizing the outcome of instituted governance reforms and their implications in terms of cooperative governance capacity, i.e. in terms of their structure and functioning. Thereby, the theories and lenses set out ultimately serve as the backdrop for the assessment and evaluation of post-crisis developments and their significance throughout chapters five to seven and as a basis for the analytical framework in chapter six in which the challenges facing the instituted governance arrangements are theorized and contextualize, while the following also encompasses a critical analysis of employed theories’ conceptual tenets and premises, their applicability and explanatory potential in this specific context as well as limitations inherent in the theoretical approaches themselves.

The aim of the subchapter in overarching terms is to construct a broad theoretical framework, which is based on the theoretical foundation presented throughout sections 2.1 to 2.3 and which in combination with the conceptual framework set out in chapters three and four, constitutes and serves as the analytical frame within and against the backdrop of which the empirical analysis and assessment of the reform outcome and resulting regulatory capacity in the European context can be conducted. In this context, it draws on largely actor-centered approaches and theoretical frames of relevance for our research interest to theorize the developments, challenges and significance of post-crisis systemic risk regulation in the supranational jurisdiction.\textsuperscript{89} European integration theories are drawn upon as they shed light on why and how member states cooperate and integrate, and thereby offer insights and approaches which can be drawn on thereafter to analyze and theorize the rationales, trajectories and dynamics as well as the challenges and limitations regional integration – in the present case in terms cross-border financial regulation and systemic risk governance in the European context – is confronted with in order to assess

\textsuperscript{88} In this context we draw extensively on analyses and research conducted by Chang (2015) for the banking union and Ferran (2011b) and Ferran and Kern (2011) for the institutions of the ESFS.

\textsuperscript{89} This is ultimately justified by the governance theme at stake in this analysis. The goal is an innovative research design in which we integrate system-oriented and actor-centered approaches as well as constructivist and rationalist perspectives and attempt to bridge the divide between them despite diverging epistemological and ontological bases. System-oriented approaches, for instance, include system theory drawn upon in chapter four to discuss and contextualize systemic risk which is valuable due to its ability to explain financial sector and system-specific dynamics, when actor-based perspectives fall short – and essentially serves as an additional perspective to highlight the difficulties confronting the governance of modern finance.
the post-crisis developments and their ramifications, i.e. in terms of their potential against the backdrop of the obstacles and trade-offs the new governance architecture exhibits.\textsuperscript{90} Thereby, European integration theories drawn upon throughout with implications for the research interest at stake – selected on the basis of their utility for the analysis of European integration and developments in cooperative governance – include neo-functionalism, liberal intergovernmentalism, and elements of constructivist strands of European integration theory, or, more precisely, approaches which include ideational and institutionalist elements such as supranational institutionalism.

The section establishing the theoretical framework is structured as follows. Discussed in depth throughout are (i) the underlying foundations of conventional theoretical perspectives on integration and the structure and functioning of cooperative governance employed throughout, with section 2.4.1 at the outset essentially functioning as pre-theory, (ii) theoretical approaches to theorize the drivers and rationales of integration as well as conceptualizing the potential for and of integrated governance arrangements, (iii) a recapitulation of their explanatory potential in this context, including a discussion of their limitations, while finally (iv) arguing in favor of a synthesis of approaches before proceeding with an analysis of finance-specific issues to set the stage for the conceptual framework thereafter. In sum, the analysis of the approaches drawn upon throughout\textsuperscript{91} is complemented by a recapitulation of the latter in terms of their explanatory potential, significance and viability, that is their comprehensiveness, reach and the like in the context at stake in this contribution, which inevitably includes critique in the form of a discussion of their respective limitations and, as a consequence, an argument in favor of combining and synthesizing theoretical approaches in order to offer a comprehensive theoretical framework for the discussion and theoretical evaluation of developments and reform outcomes in terms of what they imply for the degree of integration attained, the shortcomings and challenges they exhibit, and their future perspectives.\textsuperscript{92}

It is important to note, again, that while European integration theory is suitable for theorizing integration in its various dimensions and facets and the policy choices and outcomes attained at the European level, additional theoretical approaches and elements are drawn upon when relevant in the respective chapters – such as, for instance, systems theory in chapter four on the crisis and systemic risk, while elements of governance theory are employed in chapter six in order to contextualize the challenges post-crisis reforms are confronted with and put them into perspective.

\textsuperscript{90} In this context it is important to note again – with reference to the EU’s unique nature discussed previously – that the issue of significance feeds into the theory selection at stake in the following section and ultimately serves as the justification for the selection of the European integration theories which are employed throughout.

\textsuperscript{91} Only traditional European integration theories are discussed in this chapter, while additional lenses and concepts are alluded to throughout when of relevance in the respective chapters. For instance, system theory is employed in chapter four on the crisis and systemic risk, while elements of governance theory are employed in chapter six in order to contextualize the challenges post-crisis reforms are confronted with and put them into perspective.

\textsuperscript{92} Though attention will be given to not being too eclectic and simplistic – and despite partially diverging theoretical traditions – this presents a novel approach and, as a consequence, also a novel contribution.
Finally, given the complexity of both the reform process and the phenomenon of integration at stake in this contribution, the theoretical foundation is followed up by an empirical, sectoral and jurisdictional contextualization of integration dynamics and regulatory paradigms in the European Union in chapter three which – coupled with chapter four on market dimensions at stake in the analysis including the revelations and regulatory implications of systemic risk and resulting reform challenges of the financial crisis as well as the significance of reactive governance capacity given the foundations of modern finance including system characteristics and developments – seeks to set the stage and lay the foundation for the analysis and assessment of the emerging post-crisis policy regime conducted throughout.

2.4.1 Underlying Foundations of Conventional Theoretical Perspectives on Integration

The following presents the underlying theoretical foundations of perspectives that are employed throughout, that is those that are relevant for European integration theory. As the introductory subsection to the theoretical framework, it sets out and discusses the overarching theoretical underpinnings of theories and the disciplinary concerns of their respective traditions drawn upon in this research. It thereby elaborates the theoretical foundations of approaches and perspectives employed in order to thereafter apply the theoretical framework to the conclusions of the empirical analysis conducted in chapter five regarding the outcome of reforms, i.e. employing it as a basis for examining structural, institutional, political and expertise-related determinants and challenges of European financial governance and the prospects for integrated and cooperative governance in chapters six and seven.

It is important to note at the outset that while the research borrows and integrates elements from international relations theory, i.e. alluding to parallels in theoretical traditions and divides, it does not explicitly employ and apply them. Rather, the conceptual elements deduced from overarching theoretical traditions and paradigms are primarily applied to European integration theories which do, however, reflect the divides and concepts drawn on in – i.e. are at the core of and present essential elements of – theories of international relations revolving around interstate and cross-border cooperation and integration.

When addressing what generates cooperation and drives political entities to integrate on various levels of governance as well as theorizing dynamics of cooperation and integration as efforts directed at constructing common governance structures and mechanisms, theories generally draw on perspectives and concepts rooted in either of two traditions, with these being utilitarianism, which comprises rationalist, realist and liberalist elements on the one hand, and social constructivism on the other. The divide between these two is important in theoretical terms as they are largely considered to be

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93 In this context, chapter three serves as an application of the discussion of regional economic integration to the European context and to financial market integration and governance and constructs a complementary conceptual framework by revisiting pre-crisis and EU-specific integration dynamics in the realm of finance.

94 In their extreme forms, they can be regarded as belonging to and employed in the Machiavellian tradition.
contradictory due to the fact that they rest upon or are regarded as being based – to a degree – on diverging premises, assumptions and propositions.95

The theoretical approach employed in this research and the theoretical framework constructed – which serves as the foundation for contextualizing the conducted analysis of the reform outcome, i.e. the assessment of structural and institutional challenges facing constructed financial governance frameworks, structures and policy regimes – combines rationalist and social constructivist perspectives and insights, integrating both ideational elements and factors as well as conceptual foundations and arguments of utilitarian theory when addressing and theorizing what drives and motivates actors to interact, integrate and govern cooperatively, that is share power and authority, thereby in de jure terms curbing their own sovereignty in the process – though the argument made throughout is ultimately that in de facto terms integration affords nation states more sovereignty by increasing their collective governance capacity.

These perspectives also serve to conceptualize what drives integration and influences the way integration is conducted as well as the ensuing result, essentially meaning the outcome of integration and integrative processes – and thus, to an extent and depending on the variables at stake, the resulting capacity, in addition to presenting a framework within which challenges and shortcomings can be examined and the potential of mutual governance and further integration can be deduced in order to explain, make sense of and theorize the reform outcome and its implications and as a consequence generate hypotheses, for instance regarding future potential – both in terms of overarching European integration and as regards concrete policy and governance integration, i.e. in terms of the specific policy sphere at stake.96

Yet though both theoretical traditions are drawn upon throughout, it is nonetheless important to note that in traditional international relations theory – i.e. throughout the discipline’s early years, that is in its infancy and particularly in the immediate post-war era (Ruggie 1998)97 – neoutilitarian approaches generally dominated in terms of theorizing what generates interstate interaction and cooperation and conceptualizing cross-border governance, having also found their way into European integration theory.

Indeed, it is noteworthy that in the academic debate of the immediate post-war era – which is also incidentally the time of the EU’s inception – an historically imposed resistance or reluctance to endorse idealism gave rise to the discounting of and therefore consequently poor grasp on ideational and even for the most part liberalist theoretical approaches and explanatory elements and factors including identities, norms, or, more generally, overarching “ideas about cause-effect relations” (Ruggie 1998: 855), the role of

95 The fact that they are incompatible ultimately presents a central dilemma in theoretical debates, though we argue throughout that they can still be combined and reconciled if done diligently and with caution, implying that they are not necessarily mutually exclusive. The rationale upon which drawing on both traditions is based is discussed throughout and is in line with the argument of a synthesis of partially diverging theoretical approaches.
96 Note again that these issues are discussed in terms of political theory, while economic elements, issues and perspectives are added later on in order to examine developments further, explain them and put conclusions into perspective.
97 See Ruggie (1998) for an in-depth discussion of the “aversion to idealism” in this period’s discourse. Also of significance is the fact that it is not inconceivable that these theories will experience a revival in the current political climate. On the contrary, it is in fact even quite probable. Blyth, for instance, questions the centrality of dominant interest-based explanations and examines the “turn to ideas” (Blyth 2003; see also Garrett and Weingast 1993).
which was dismissed or largely disregarded in international relations theorizing of international politics and integration throughout the 20th century (Ruggie 1998; Wendt 1992, 1999). The result was ultimately the widespread dominance of realist and rationalist theories and approaches, incorporating assumptions based on ontological neo-utilitarianism throughout the post-war period and well into the 1980s, especially in terms of the study of international politics and relations. In European politics and integration theory, the trend in theorizing, i.e. the turn away from narrowly focused dogmatic neorealism and exclusively rationalist approaches, occurred somewhat earlier, however, with the so-called relaunch of European integration, which denotes efforts to foster and advance the latter throughout the 1980s, and developments leading up to the Single European Act in 1986, which introduced a change in the emphasis of theoretical strands as to the drivers and nature of interactions at both international and regional levels and in the European context.

Yet, it is important to draw attention to the fact, however, that despite their considerable – and at times perhaps even superior – analytic rigor and explanatory potential, they, i.e. theories that fit into the broad rationalist theoretical tradition, do exhibit limitations and shortcomings regarding their explanatory value and comprehensiveness in terms of contributing to systemic understanding and may often result in the inability to explain developments that do not coincide with their models and assumptions, omitting potentially significant variables and disregarding elements of relevance. As a consequence, in the theoretical framework of international relations, constructivism, which corresponds with ideational perspectives in political science and European integration theory, emerged and aims to tackle resulting flaws and explanatory gaps. Numerous scholars have drawn attention to the issue of shortcomings of exclusively rationalist theories and questioned their benefits vis-à-vis ideational theory (see, for instance, Abdelal et al. 2010; Blyth 1997, 2002, 2003; Lieberman 2002; Quaglia 2012; Wendt 1992, 1999). Frequently noted critique includes the fact that dogmatic rationalist theory is often too deterministic and disregards the potential for dynamics and developments (in our case pertaining to the potential for regulatory cooperation and governance integration) that, in short, their models cannot predict. As we will see throughout, this is indeed the case to a degree in the context of post-crisis supranational reforms.

Constructivist and ideational perspectives focus inter alia on the “intersubjective dimension of human action” (Ruggie 1998: 856) and agents’ ability to lend the world “significance” (ibid.) and have been regarded as promising ways of conceptualizing the interplay between actors’ respective identities, material

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98 If drawn on at all in the context of mainstream theorizing, they are generally downgraded to tools employed in instrumental terms as mere instruments to attain benefits and pursue explicit preferences, material benefits and foster efficiency (Ruggie 1998).

99 With the historical backdrop for a shift in the emphasis of dominant approaches being the end of the cold war and increasingly homogenous assumptions and views regarding the potential for the end of history and the inevitability of the resilience of the liberal world order or Western liberal democracy as the ultimate form of human government (Fukuyama 1989).

100 Indeed, mirroring developments in international relations which witnessed an ideological turn (Blyth 1997, 2002, 2003), supranational institutionalism and ideological perspectives emerged in the 1990s and early 2000s.


102 See also Weber (1956, 1968).
interests and aggregated preferences in combination with shared and intersubjective knowledge as well as common norms and values as ideational forces embedded in institutional structures. Thereby, and in this vein, it is regarded as facilitating understanding and theorizing forms and dynamics of interaction, cooperation and integration as an additional lens or alternative perspective thereto by those scholars that advocate it (see, for instance, Fawcett and Hurrell 1995 who claim that it presents crucial progress and an evolution in the realm of international relations theory).\textsuperscript{103} Employing constructivism to understand interaction and explain it, i.e. as a conceptual toolkit for actors’ rationales, actions and interactions, Wendt (1992) emphasizes the significance of concepts and notions of shared knowledge, ideational forces such as shared norms and values, and institutional structures and their impact on cooperation as well as their contribution to comprehending and theorizing it.

Yet notwithstanding their potential contributions and significance in terms of theorizing interaction and governance integration, constructivism and ideational theoretical perspectives in general cannot necessarily be characterized as genuinely coherent and comprehensive theoretical approaches, paradigms or bodies of theory. As a consequence, they might rather, and perhaps more accurately, be framed as complementary, i.e. additional theoretically informed perspectives on empirical developments, and ultimately also regarded as an insightful and critical reflection on the limitations of – therefore also serving as a compelling addition to – utilitarian and rationalist theory as well as presenting a counterbalancing force and correcting lens vis-à-vis the flaws or rather limitations thereof. This view is also shared and advocated by authors that question the exclusive leverage and explanatory potential of rational theories in this respect. Ruggie, for instance, supports and argues in favor of critical stances in this regard with reference and by pointing to the prevalent critique of methodological individualism and its fundamentals – which can ultimately be interpreted as the core assumption of utilitarianism. This critique revolves around the notion that allegedly rational, myopic and interest-driven agents’ actions, behavior and strategies may diverge from – thereby essentially acting contrary to – rationalist and individualist assumptions, i.e. may defy the prescriptions, predictions and premises inherent in utilitarianism and its corresponding theories and models, ultimately advancing beyond and diverging from the behavior expected in specific contexts (see, for instance, Douglas 1991 on Durkheim’s critique of and challenge to methodological individualism; see also Ruggie 1998). It is these instances that we must set out to examine and explain. It is also these instances that present the context within which these perspectives prove most useful. In a nutshell, social constructivism ultimately revolves around the role and effects of human consciousness in international interaction and cooperation arguing that both the interests and identities of participating actors are socially constructed and as such are integral to interactions and outcomes in terms of decision-making and mutual governance. While it does not dispute “the fact that human behavior at all levels of social aggregation is constrained

\textsuperscript{103} See also Hurrell (1995) on regional perspectives and the debate in regional theory, Hettne and Söderbaum (2000) and Wendt (1992, 1999). The latter is a principle proponent, i.e. at the forefront of this tradition in international relations, having essentially spearheaded it.
[nor that] modal responses may exist to some types of structural constraints or situational exigencies” (Ruggie 1998: 856), it argues that these very constraints should not unduly dominate the scientific study of the forces determining international cooperation and integration.104 Notwithstanding the fact that our analysis and arguments are primarily based on the former, implying that the theoretical framework largely incorporates rationalist perspectives and corresponding EU integration theories in this tradition, we are aware of and appreciate the potential and additional value of social constructivist and ideational approaches and therefore also – to a degree – draw on and integrate elements throughout. Ultimately, though they are not generally considered suitable for combining as such – with some scholars going as far as maintaining that this is due to widely presumed limits to their paradigmatic reconcilability, i.e. despite their alleged irreconcilability – we combine them arguing in favor of an eclectic use of theories in order to assess developments, reform outcomes and integration processes through multiple theoretical lenses and in a more holistic and comprehensive manner – as do, for instance, Heipertz and Verdun (2010) in the context of European integration and Chang (2015) with regard to the banking union – and concur with the view that they are in fact both valuable in the sense that they facilitate defining, contextualizing and offsetting or rather counterbalancing the other approaches’ respective limitations (see, for instance, Blyth 1997, 2002; Chang 2015; Heipertz and Verdun 2010; Leuffen et al. 2013; Ruggie 1998; Schimmelfennig 2017a for a variety of publications that are in line with this approach). Integrating both ultimately implies counteracting tendencies toward insularity (see Blyth 1997, 2002, 2003)105 and, in this vein, also facilitates gaining a comprehensive and holistic understanding of actors’ intentions and interactions as well as their effects in terms of governance and reform outcomes and dynamics and therefore potentially also gaining insights on resulting capacity as well as future potential and trajectories, in other words gaining a holistic understanding of (the research interest at stake, i.e.) the structure and functioning of the supranational polity, interstate interaction and integrated governance. In terms of theoretical considerations, for instance in integration theory, Breslin et al. (2002: 12) also claim that limiting the analysis of regionalism to research in distinct disciplinary silos and domains produces divides and “unhelpful barrier[s]” that ultimately jeopardize “innovative theoretical developments”.106 This issue is also of central importance for the argument set out in section 2.6 which argues in favor of synthesizing diverse theoretical lenses to assess the reform outcome.

104 This is a notion adhered to throughout in the construction of the theoretical framework and is, in addition, born in mind when it is being applied to the analysis in due course.

105 In line with Blyth’s (1997) discussion of and conclusions regarding the ideational turn of comparative political economy, for instance, Ruggie (1998) maintains with regard to the so-called social constructivist challenge to neoutilitarianism in international relations theory – thereby concisely summing up the debate regarding the divide at stake – that “neo-utilitarians should strive to expand their analytical foundations, and constructivists should strive for greater analytical rigor and specification” (Ruggie 1998: 885). See also Abdelal et al. (2010), Wendt (1992, 1999) and Zehfuss (2002) on constructivism and its potential in terms of theorizing interactions in the international sphere and Blyth on the influence and impact of ideas in terms of progress in social science and international interactions (1997, 2002, 2003 2010).

106 In the same vein, Scharpf (2010) advocates the use and synthesis of multiple concepts in the European context in order to do justice to the complex reality that is European integration in the 21st century.
Drawing on the insights established throughout the preceding sections on the overarching rationales of cooperation and drivers of integration as well as the underlying fundamentals of conventional theoretical perspectives to conceptualize these, the following examines the theoretical discourse on European integration to explore and thereafter theorize why and how nation states engage in integration, examining why and how they strike grand bargains and – in order to govern cooperatively – conduct rule-making as well as financial regulatory and supervisory activities in integrated governance schemes – in other words, how they organize the ensuing cooperation – thereafter drawing on the latter, which includes insights from past dynamics in European integration, when analyzing reforms and synthesizing the challenges instituted governance regimes face as well as the shortcomings they exhibit in chapters five and six.\textsuperscript{107}

Framing the Debate on Political Integration Theories

Already at the turn of the millennium, economic and financial integration in the European Union had manifestly advanced far “beyond the original intent of negotiating parties at the conferences of Messina and Rome” (Scharpf 1999: 54ff; see also Scharpf 2001, 2010). This notwithstanding, i.e. in spite of the substantial sovereignty transferal and to a degree even mission creep that has transpired, in general, governments largely support, endorse and in many cases even actively promote ever increasing economic integration (Moravcsik 1998).\textsuperscript{108} This holds true to date and has, for the most part, endured throughout the era of the sovereign debt crisis albeit with some notable exceptions in economic and fiscal policy spheres. Approaches toward theorizing the nature and processes of cross-border cooperation are multifaceted, reflecting the complexity of the latter. When theorizing what incentivizes nation states to cooperate and integrate scholars have traditionally drawn on international relations theory on the basis of which European integration theories emerged – with similar epistemic and ontological bases, but differing with regard to their focus as European integration advanced far beyond integration witnessed both in the global context as well as within other regional formations and schemes. In broad general terms, theoretical perspectives on regional integration are either of a political or economic nature – in the case of the former, from the disciplines of either international relations or regional and EU integration theory.\textsuperscript{109}

Theories pertaining to the realm of political science are drawn on throughout as – given the degree of

\textsuperscript{107} Note that the analysis of challenges and constraints limiting the capacity of the established supranational regime is embedded in a framework informed by governance theory and presented in chapter six.

\textsuperscript{108} It is, however, important to note that this conviction and drive does not necessarily apply to all spheres of integration. Some policy domains remain marred in controversy and exhibit substantial divergence and reticence such as, for instance, immigration, fiscal and tax policy, and to a degree also defense and security policy.

\textsuperscript{109} In addition to the predominantly politically-oriented integration theories discussed in this chapter and drawn upon throughout – on the grounds that this research is in essence a governance analysis – a more focused discussion of theoretical insights on the economic rationales, benefits and challenges of regional integration (also in terms of market and regulatory integration) is presented in chapter three. Economic perspectives draw on arguments and concepts rooted in classical liberal economic theory such as pareto-optimality and the like though doing so critically with a view to the revelations of the crisis regarding the need for intervention to ensure both an efficient and equitable system (Mügge 2011a). Ultimately, however, though theories with predominantly economic orientations explanatory value regarding integration and cooperation is apparent, it is limited given its inability in accounting for political economy and knowledge-related factors and barriers to effective integration.
European interdependence in general as well as global and European economic and financial sector independence in particular – integration and reform as well as their respective consequences can only be assessed adequately with reference to political and institutional exigencies which influence the outcome. This is ultimately predicted on the political embeddedness of the financial system, i.e. its significance for the political sector.

The following now turns to the theoretical discourse on European integration, outlining the most prominent and in this context most significant politically-informed integration theories aimed at explaining the process and nature of integration.

2.4.2 Theories of European Integration: Neofunctionalism and Liberal Intergovernmentalism

Both the advances made in and the nature of the evolution of regional and European integration in the immediate post-war period as well as in terms of financial market and regulatory integration throughout the past three decades have given rise to a lively theoretical debate on the drivers, features, processes and prospects of cross-border integration in general and European integration in particular – with respect to both the process (how) and outcome (what) of integrative dynamics. Though a wealth of theoretical perspectives from a range of disciplinary traditions with insight into integrative processes exists, most approaches fall short and exhibit limitations in the European context. This notwithstanding, two particular theories offer useful perspectives and contributions, the elements of which the following revisits and contextualizes briefly. Thereby the present section sets outs the theoretical perspectives employed and serves as a theoretical basis for the analysis of reforms, the assessment of governance challenges, and the theoretical and practical contextualization of developments with respect to supranational financial governance thereafter.

From the very outset in the immediate post-war era when increasing interstate cooperation could first be observed, the analysis of the trajectory and nature of European integration by means of delegating to and pooling sovereignty at the supranational level as well as the respective factors driving the process has generated enduring paradigmatic debates. As a consequence, a host of theories focusing on explaining European integration emerged, differing with respect to their diverging perspectives on and interpretations of the causes, rationales, processes and outcomes of integration (see Schimmelfennig 2017b for an in-depth elaboration). In this context, two theories stand out as the most prominent and as such represent the so-called grand theories of integration – including, in their most rudimental forms, functionalism, later neofunctionalism, of which the most prominent scholars include Ernst Haas (1961, 1964) and intergovernmentalism (see, for instance, Hoffmann 1966), later liberal intergovernmentalism, which was spearheaded by Andrew Moravcsik (1993, 1998) as the most prominent scholar in this regard. They are discussed in order in the following.
The first wave of European integration theory – from which the neo-functionalist tradition emerged as one of the central or so-called grand theories of the discipline – revolved around functionalism.110 Functionalism, at its core, focused on process and structure as variables to explain the phenomenon of integration, with its main assumption being that economic interdependence would eventually produce functional cooperation (Haas 1958), while economic and social forces would induce political cooperation (Rosamond 2000) and ultimately unite jurisdictions in transnational governance arrangements. In short, form would essentially follow function (Mitrany 1966). It was, however, dismissed as being overly simplistic, i.e. not being sufficiently specific (Rosamond 2000) and overemphasizing the role of technocratic processes, while neglecting countervailing political forces. As a result, neo-functionalism emerged, adapting functionalist assumptions and upgrading the theoretical framework by complementing it with the notion of transnational organizational dynamics as being central in the process and the concept of functional spill over – a key concept which describes “the way in which the creation and deepening of integration in one economic sector would create pressures for further economic integration within and beyond that sector” (Rosamond 2000: 60). Its key premise is ultimately that “political actors […] are persuaded to shift their loyalties, expectations, and political activities towards a new centre, whose institutions possess or demand jurisdiction over the pre-existing national states” (Haas 1968: 16), whereby it essentially has sovereignty-eroding potential as it assumes that integration is essentially a self-reinforcing process in which multiple actors, among them, transnational interest groups, industries and European institutions support the process and create momentum for further integration. In principle, neo-functionalism has its merits and provides multiple valid insights in this context – with the most significant being the concept of spillover predicated on transnational interdependence as well as its focus on path dependencies and functional pressures militating toward further integration.

Another useful approach is an adaptation of intergovernmentalism, namely liberal intergovernmentalism. Spearheaded by Andrew Moravcsik (1991, 1993, 1998) as its main proponent in the European context (see also Moravcsik and Schimmelfennig 2009), its theoretical premises comprise elements of intergovernmentalism and liberalism. Stressing the role of variation in state preferences, it’s main argument is that member states are the prime actors in integration and bargaining is the central mechanism of integrative processes (Moravcsik 2008). Constellations of preferences and relative bargaining power are therefore decisive explanatory forces with respect to integration (Grieco 1988), while institutional arrangements ultimately mirror relative power constellations among states and are solely advanced to further the latter’s interests. Though it has been criticized on the grounds of its simplicity (Wincott 1995), it does indeed provide useful insights, inter alia explaining some of the challenges that remain in the post-crisis era.

In short, the latter two theories diverge with regard to the extent to which they ascribe the inclination toward integration to external forces, functional pressures, and internal drivers and facilitators, i.e. the

impact of agency and the significance of coalitions in the integration process. As such, they diverge as regards the factors to which they attribute integration and the respective outcomes and compromises attained, while also differing as to the potential they afford the Union in terms of its integrative capacity. While neofunctionalism is most apt to explain the integrative processes taking place in this context, liberal intergovernmentalism also delivers valuable insights with regard to the limitations that remain and the challenges that persist.

In the following section, limitations are discussed briefly in the context of elaborated theories’ utility, explanatory significance, and comprehensiveness with regard to the research interest, and with a view to their contradictions in this context – thereby presenting the basis for arguing in favor of integrating multiple approaches throughout.

2.5 Limitations of Conventional Integration Theories in Context

The following is an overarching assessment of the European integration theories elaborated above and drawn upon throughout to shed light on the process and nature of integration, and therefore also reform processes and outcomes, and which, importantly, incorporate insights for the research at hand, i.e. for the analysis of implemented reform measures and the instituted financial governance architecture in the European context. The goal throughout the thesis is essentially to employ theory critically, and in order to do so this section contextualizes the examined theoretical approaches’ explanatory significance and comprehensiveness, i.e. their viability in this context in both an overarching fashion and with a view to their respective shortcomings, first discussing limitations of underlying theoretical traditions and their respective approaches, and thereafter, as a consequence of these weaknesses, expounding the need to combine perspectives and synthesize insights from multiple, and potentially complementary, yet at times also contradictory approaches, rooted in diverging disciplinary traditions, which are nonetheless not necessarily regarded as mutually exclusive in this context.

In a nutshell, as will become clear in due course – in view of both the significant and tangible advances achieved in European integration in terms of their degree, scope and sophisticated nature, as well as the enduring constraints and challenges that persist to date – both of which theorizing must inevitably account for and which this research attempts to critically reflect upon and contextualize throughout the analysis in order to do justice to the complexity and facets of the developments, dynamics, reform processes and outcomes that characterize European integration as well as the continuous and progressive evolution of the European Union’s governance architecture in the current context, it is argued that the latter gives rise to the need to combine perspectives in a non-exclusive way when relevant (for examples of similar interpretations and approaches, see Chang 2015; Heipertz and Verdun 2010; Leuffen et al. 2013;
Ruggie 1998; Schimmelfennig 2017a; Zahrnt 2004), and therefore a synthesis is required, though the issue of the (in-)compatibility of theoretical approaches and models must be borne in mind.

The rationale on which this argument, and as a consequence the approach, is based is the failure of conventional perspectives to deliver comprehensive analytical frameworks and explanations. All theories exhibit limitations with regard to their applicability, while shortcomings are inherent in all approaches given the complexity and multidimensionality that characterizes the present-day European Union. It is argued that despite their explanatory potential in some instances, there are compelling arguments against rationalist and intergovernmentalist theories regarding integration and policy evolution in this context. Though they provide essential insights with respect to the political constraints integrative processes are subject to, for instance purporting the significance of intergovernmental bargaining – the outcomes of which are predicated on prevailing relative power constellations and the importance of strategic member state behavior in limiting supranational entrepreneurship, authority and autonomy expansion and sovereignty transferal – they are not sufficient to explain how integration could advance at a time of extreme political and economic turbulence and hardening stances toward further integration and burden-as well as power-sharing.

Given that at times – as is to be expected – there is in fact substantial political opposition to specific aspects of integration, this ultimately goes to show that institutional and ideational variables are also significant explanatory factors, while interests and preferences are not the sole causal determinants in and drivers of integration (see Schimmelfennig 2000, 2017a for a similar interpretation). In a nutshell, more integration has transpired than theories that emphasize lowest common denominator outcomes such as liberal intergovernmentalism can account for, yet substantial challenges remain, which implies that the likes of neofunctionalism and supranational institutionalism are also limited in their explanatory potential. In essence, while all approaches offer relevant insights for assessing the issues at stake, i.e. the degree of financial integration that has been attained as well as forces impeding integration and challenges militating against sustainable cross-border governance regimes, their monicausal and overly deterministic nature as well as their state-centrism fails in part to deliver a comprehensive account of change and neglects additional factors of relevance such as the strategic significance of supranational institutions and their ability to frame the debate in their favor as well as institutional factors driving the integration process and

\[111\] Though approaches drawn upon may be regarded as predominantly rationalist in nature, neofunctionalism does indeed factor in ideational elements to an extent (see e.g. Dyson and Featherstone 1999).

\[112\] The following serves as an instructive example of the shortcomings inherent in certain approaches in certain instances. There are intuitive arguments against the validity of rationalist and liberal intergovernmentalist theories' explanatory potential regarding integration and policy evolution. This is, for instance, the case with regard to the process of legal integration (see e.g. Burley and Matli 1993). Despite delivering important insights with regard to the political constraints it is subject to, purporting the significance of strategic member state and government behavior to limit the CJEU’s autonomy, they do not suffice to explain how legal integration could advance most at a time of waning support for supranationalism in the 1960s and 1970s (Alter 1998, 2000, 2010; Garrett 1995). Given that at times there is in fact substantial political opposition to integration, this ultimately implies that institutional and ideational variables are also significant and interests are not the sole causal factors in integration. In essence, these approaches' state-centrism fails to account for additional significant factors driving the integration process and militating toward change. ESMA’s mandate extension is another example in which supranational institutions were able to successfully lobby for increased European authority (see section 5.4).
inducing reforms that are not necessarily congruent with member states’ interests in their entirety. The rationale for combining theoretical approaches is therefore given (ibid.; see also Chang 2015) in order to do justice to the complexity of the dynamic developments and outcomes that characterize the European policy response. Drawn on due to their utility in terms of analyzing the integration of governance structures, the insights of the approaches analyzed are ultimately applied to the reform outcome in chapter seven when assessing the degree of integration as well as its significance and persistent challenges. It is argued throughout that substantial progress has indeed been attained in both eurozone and pan-European terms, though lingering constraints remain, owing to member state reticence with regard to centralization.

As a recapitulation of approaches that theorize the rationales and drivers as well as the trajectories and dynamics of European integration as well as an elaboration of the rationale for combining schools of thought, the above has been an attempt to establish a theoretical framework within which the post-crisis reform outcome, i.e. the design of instituted supranational institutional structures and policy elements as well as a synthesis of lingering governance challenges – in sum, a tentative attempt to gauge the degree of integration and the resulting governance capacity that has been attained – can be assessed. Thereafter, the elements of the framework are applied to the reform outcome in chapter seven in order to establish what it implies, whether progress and capacity expansion by means of integration have been witnessed and what shortcomings potentially entail in terms of the prospects of integrated financial governance given the severity of lingering challenges and the nature as well as the degree of interdependence and integration within the European Union. In this context, and with regard to conclusions drawn throughout the thesis, it is useful to refer to a divide with respect to encouraging signs in terms of European integration and governance cooperation (see Sandbu 2017a for a similar interpretation) versus worrying signs on the regulatory front, i.e. regarding genuine change in paradigmatic terms (or rather the lack thereof) with regard to the system properties and structural characteristics of finance – the flaws of which were laid bare and exposed by the financial crisis and are discussed throughout (see El-Erian 2017b for a similar take).

Given the complexity surrounding reform and integration, however, the analysis and assessment of the emerging post-crisis policy regime cannot be conducted on an exclusively theoretical basis and ultimately requires an empirical, sectoral and jurisdictional contextualization. The following therefore, in order to lay the foundation for the analysis, is an application and extension of the discussion of regional economic integration to the European context, specifically that of financial market integration and governance, revisiting pre-crisis integration dynamics in the realm of European finance and including a discussion of regulatory paradigms in this regard, which coupled with chapter four on the challenges the modern financial system gives rise to presents the backdrop for the analysis of conducted reforms.113

113 Again, in conclusion, two crucial strands of literature are drawn upon to theorize the challenges and potential of post-crisis systemic risk regulation and governance in supranational terms. These are system theory and European integration theory. System theory is valuable due to its ability to explain financial sector and system-specific dynamics. It is thereby essentially an additional perspective to highlight the difficulties confronting the governance of modern finance.
3. PART III: CONCEPTUAL FRAMEWORK I: PERSPECTIVES ON EUROPEAN FINANCIAL INTEGRATION

To complement the preceding discussion of theoretical and largely political perspectives on cooperation and integration in general, the following section sets out to construct the first part of the conceptual framework against the backdrop of which the analysis is conducted by revisiting pre-crisis and EU-specific integration dynamics in the realm of finance, encompassing the spheres of financial market and regulatory integration and the construction of a single market in financial services and capital, which – coupled with the second part of the conceptual framework in chapter four on the financial system, its characteristics, systemic properties and the respective regulatory implications of the crisis – presents the backdrop against which the subsequent empirical analysis of enacted post-crisis reforms, emerging schemes and their significance is assessed. In this context, it looks into the governance schemes and regulatory approaches of the pre-crisis era and their various flaws.

3.1 The Trajectory of European Regulation: From Negative to Positive Integration

As evidenced by the crisis, finance needs to be regulated, while market integration in general needs to be administered and governed so as to ensure that cross-border activities are not left unsupervised and escape the remit of public authority. Against the backdrop of increasing negative integration throughout the past decades, the demand for positive integration to offset the externalities became increasingly apparent. The following section looks into the schemes devised in the European context to cope with developments in the markets and foster cross-border activities as well their integrity. In overarching terms, these schemes were characterized by an insufficient degree of integration in view of the degree of market integration they were intended to mirror, and as discussed in depth later on they were primarily microprudential in nature, while the substantive regulatory approaches addressed thereafter lacked macroprudential, i.e. system-oriented perspectives and elements, presenting crucial deficiencies of the pre-crisis architecture and indeed impetus for reform. Both ultimately precipitated the formation of the new two-tier approach to financial governance and systemic risk oversight embodied in the new integrated European System of Financial Supervision at stake throughout the following chapters.114

3.2 Pre-Crisis Institutional Evolution and the Regulatory Status Quo

While the latter focused on the nature and dimensions of integration, i.e. of market integration and corresponding regulatory responses and approaches, this section briefly revisits the integration of

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114 To strengthen prudential supervision and oversight, reinforcing stability and enhancing efficiency in the process, the European Commission proposed an integrated two-tier system of financial governance, which is discussed in depth in chapter five (see also Haar 2014).
governance structures in the EU prior to the financial crisis and looks into the evolution of the regulatory and supervisory landscape. It is of central importance with respect to the discussion of reforms in chapter five and their contextualization thereafter in chapter seven. More specifically, it serves as the backdrop against which the evolution of governance structures in the post-crisis era can be assessed and judged in order to ascertain the degrees to which cooperation and coordination have been enhanced and centralization and integration have been advanced, and as such is significant for both the verdicts established and conclusions drawn throughout the analysis and the assessment.\textsuperscript{115}

\textit{From Lamfalussy to De Larosière: The Pre-Crisis Evolution of European Regulation and Supervision}

In the European context, the pre-crisis regulatory and supervisory architecture was composed of the newly established European Supervisory Agencies’ (ESAs) predecessors, the so-called Level 3 Committees, and based on the Lamfalussy procedure in which rules and regulations governing financial markets were devised by way of a three-stage process and embedded in a four level framework for rule-making and implementation (see e.g. Haar 2014; Moloney 2008). The underlying objective of the system, which was established in 2001 on the basis of the Final Report of the Committee of the Wise Men, chaired by Alexandre Lamfalussy and adopted by the European Parliament in 2002,\textsuperscript{116} was to construct a harmonized framework within which to devise rules and regulations for the governance of the internal market in financial services as well as supervise and coordinate their implementation (see e.g. Kudrna 2011). In addition, it was intended to simplify the rule-making process make governance arrangements more efficient, effective and flexible. Initially, the Lamfalussy process was implemented in the securities sector via the newly established Committee of European Securities Regulators (CESR),\textsuperscript{117} but was later extended to rule-making in the other financial market sectors in 2003 by constructing equivalent committees covering banking and insurance, the Committee of European Banking Supervisors (CEBS) and the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS).\textsuperscript{118}

The push toward more market integration and the creation of the single market throughout the 1990s and particularly at the turn of the century contributed to momentum for establishing corresponding governance approaches in the form of an integrated regulatory and supervisory regime to enable and

\textsuperscript{115} An analysis of the evolution of the governance regime with a view to pre-crisis constellations is also of significance with regard to judging the potential of and potential for integration as such.

\textsuperscript{116} The so-called Lamfalussy Report was devised by the Committee of Wise Men on the Regulation of European Securities Markets, Final Report, Brussels, February 15, 2001.

\textsuperscript{117} Increased supranational regulatory and supervisory coordination with respect to the investment services sector became a necessity early on given ambitious attempts of the community to foster the single market and the free movement of capital and services (European Commission 2000). New legislation such as the Investment Services Directive (ISD) attempting to deepen integration by significantly reducing barriers to cross-border activity as well as the principle of home country authorization embedded therein, which with respect to investment firms implied that once authorized by its respective national authority a firm could conduct business throughout the EU, had given rise to the need for further supervisory cooperation and harmonization.

\textsuperscript{118} These Level 3 Committees reflect sectoral divisions between financial market sectors often employed in the member states as opposed to, for instance, the functional division of regulation and supervision employed in the US, and were transformed into the European Supervisory Authorities during the establishment of the ESFS in 2011 (discussed in chapter five).
enhance the efficiency of rule-making and supervisory processes, which the Lamfalussy model via the reform of institutional arrangements ultimately delivered. In the context of the latter, financial market legislation was devised on multiple levels and in multiple steps (Haar 2014: 19ff.). The first stage of the legislative process is Level-1 where legislation is devised in formal supranational law-making processes, either in the form of regulations or directives, both of which are adopted by the European Parliament and the Council in ordinary legislative procedures established by the Lisbon Treaty (see TFEU Art. 289). As the foundation of the entire process, Level-1 measures essentially provided framework principles and defined the substantive scope of the respective legislation, while the more detailed Level-2 rules, which build upon the latter, were implementing measures of a more technical nature adopted by the Commission. As is to be expected given their interdependence, the processes of constructing framework principles and implementing measures exhibited substantial overlaps, often being negotiated simultaneously and at times giving rise to complications (Haar 2014: 23). Thereafter, Level 3, which is where the Lamfalussy, i.e. Level-3 Committees come into play, is based on the system of comitology in which committees execute activities for the European Commission within the remit of authority granted to the latter, i.e. with respect to its delegated law- and rule-making functions. As is the case with Level-2 processes, where sector-specific committees and regulators advise the Commission on the technical details of regulatory measures, Level-3 brings national regulators together, aiming to support the consistent implementation of rules established at former stages of the process at the national level by promoting enhanced national regulatory cooperation. Level-3 measures and activities include issuing guidelines for national implementation, devising joint interpretative recommendations and standards covering issues that are not necessarily covered by the framework principles, and defining best practices or conducting peer reviews (Lamfalussy Report 2001: 37; see also Ferran 2011b; Haar 2014). Finally, wrapping up the process, the fourth stage revolves around the enforcement of EU law which generally lies within the Commission’s remit of authority and is conducted in cooperation with the European Parliament, the member states, their national regulators and finally the private sector (Lamfalussy Report 2001: 40; see also Haar 2014: 25; Moloney 2008).

Within the Lamfalussy system, national supervisory or competent authorities (NCAs) remained in charge of day-to-day supervision, while the Level-3 Committees in the Lamfalussy framework took on “a supportive, facilitative and, in certain respects, supervisor-of-supervisor, role” (Ferran 2011b: 19). Yet though the supervisory prerogative of national authorities and the limited role of supranational bodies in

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119 Developments were driven by and operationalized via the ambitious FSAP described in the previous section. Reform had become imperative given both the inefficiency of the process in place and the sheer quantity of measures to be implemented in the wake of the substantive regulatory reform programs. See Ferran (2011b) for an in-depth elaboration of the institutional developments that transpired at the turn of the century.

120 The Lamfalussy Report (2001: 26) favored the use of regulations at Level-1 to speed up the legislative process as they are binding and directly applicable in the respective jurisdictions, whereas directives must be implemented nationally with potential adverse consequences for the degree of harmonization that transpires.

121 For an in-depth discussion of the procedure pertaining to Level-2 legislation, see Moloney (2008: 1048ff.).

122 Haar (2014) draws attention to the fact that the distinction was not as clear cut as it might appear at first sight, giving rise to regulatory complexity and complicating rule-making procedures in the process. See also Möllers (2010).
this respect has been framed as one of the crucial limitations of the pre-crisis supranational governance regime in the post-crisis discourse (see, for instance, De Larosière 2009; Haar 2014: 26), within the context of the Lamfalussy system the ESAs’ predecessors did indeed manage to carve out a role for themselves and leave their mark on European regulation and supervision – in a sense paving the way for their successors by way of both their achievements and their limitations (discussed below). The CESR, for instance, in a sense the prototype or governance experiment upon which the sectoral committees established thereafter were based, with careful maneuvering even managed to attain, to a degree, “a direct, market-facing supervisory role” (ibid.) which became increasingly pronounced in the run-up to the post-crisis reforms and its transformation into the ESMA.123

Yet despite what was achieved and though the Lamfalussy system was considered progress as it substantially enhanced rule-making processes and supervisory coordination at the European level, it had central flaws that became particularly apparent throughout the crisis, with one of the most significant shortcomings identified being the insufficient supervisory integration and coordination that had taken place in the pre-crisis era and therefore produced a vacuum of capacity when the crisis broke out (De Larosière 2009). Not only were the requisite substantive tools and policies that would have been required to resolve the crisis not at hand or non-existent (as is described in depth in chapter four), but institutional venues and channels for adequate crisis management, governance and cooperation had not been cultivated and institutionalized adequately, aggravating the ability of authorities to react to the unprecedented events that transpired and dynamics that took hold.

Indeed, despite the advances attained, i.e. enhanced rule-making processes, regulatory convergence and supervisory cooperation, challenges and limitations pertaining to the supranational financial governance regime of the pre-crisis era remained and can be divided into two overarching categories – with these being flaws in terms of substance and the approach to market regulation, which was predominantly microprudential in nature (the substantive regulatory dimension), and in terms of regulatory and supervisory design, integration and cooperation (the cooperative governance dimension). While the principle weakness of the regulatory and supervisory system that was exposed by the crisis and largely dominated, i.e. was the overriding issue on the regulatory agenda in the post-crisis era was its emphasis and reliance on microprudential regulation to provide system stability and its resulting inability to address or mitigate systemic risk in an adequate fashion (i.e. the substantive regulatory dimension, which is discussed at length throughout the following chapters; see also De Larosière 2009: 39–40), another central flaw was the fact

123 Examples with regard to which this was the case include, for instance, its explicit involvement in the assessment of proposals concerning MiFID’s implementation (CESR 2009: 52f.) as well as its participation in the regulation and supervision of credit rating agencies, which was continually expanded (ibid.), ultimately setting the stage for its successor’s (ESMA) assumption of outright supervisory power and authority. In this sense, i.e. with respect to its direct, market-facing role, it may be regarded as having been afforded distinct capacities much like its successor, and the evolution of both may also have unintended, potentially beneficial effects on the other sectoral authorities’ capacities in the long-run.
that microsupervisory arrangements at the European level were deficient. Not only was there a mismatch between rule-making (i.e. regulation) and supervision in the European context as the former was Europeanized, i.e. centralized to a degree, while the latter essentially remained at the national level (as mentioned above, the L3C’s took on a supervisor-of-supervisor role), implying that more robust, integrated and institutionalized supervisory cooperation was required to ensure adequate and uniform or at least comparable implementation at the national level (see Haar 2014: 25–26), but supervisory coordination and cooperation at the supranational level as such – in terms of both day-to-day activities as well as with respect to crisis management – was well below par and insufficiently developed resulting inter alia in the deficient, i.e. nationally fragmented rather than integrated cross-border supervision of multinational, i.e. cross-border financial institutions prior to and throughout the crisis, which was and still remains a prime source of systemic risk (see De Larosière Report 2009; Ferrarini and Chiodini 2012). Note, however, that microsupervisory shortcomings by no means only pertained to the supranational level. National schemes also exhibited substantial flaws in microprudential terms, not least with respect to robust and effective prudential regulation and oversight (see De Larosière Report 2009; Haar 2014: 26). The inability to regulate large complex financial institutions and cross-border groups adequately at the national level coupled with the lack of cross-border coordination in terms of their supervision was ultimately a toxic combination in need of revision and reform. Not only were risks such as for instance excessive leverage able to build up under national regulators’ watches, jeopardizing national economies and the single market at large, but the risks that home supervisors in one member state failed to address, were more often than not borne by host countries when they eventually materialized (ibid.).

The flaws identified ultimately gave rise to a lively debate in the regulatory community and resulted in the Union’s post-crisis Report, the 2009 De Larosière Report (discussed at length throughout chapter five) and corresponding reform proposals to remedy these flaws. Shortcomings had already been acknowledged to a degree prior to the crisis, providing fertile ground from which the reforms could advance. They will be discussed throughout the following chapters.

Having discussed the pre-crisis status quo of the supervisory and regulatory governance architecture, which serves as the basis for the analysis of institutional reforms in chapter five and for the analysis of their significance and implications thereafter, the following turns to the evolution of substantive regulatory paradigms in the pre-crisis era, i.e. the substantive content and nature of regulatory approaches that characterized financial governance as a prelude to the discussion of the financial crisis and its causes as well as its regulatory implications and governance imperatives.

124 The discussion of micro- and macroprudential regulation and supervision is discussed throughout the following sections. The latter ultimately results in deficient governance capacity, which is crucial in the event of crisis.
3.3 The Evolution of Pre-Crisis Regulatory Paradigms

With regards to the development of market and regulatory integration throughout the pre-crisis era: The timing of the crisis coincides with or rather was the culmination of an era in financial deregulation and financialization, which though originating in and initially being predominantly applied in the Anglo-Saxon sphere (see e.g. Johnson and Kwak 2011), was also in part adopted in the European context and even actively promoted by the European Commission (see e.g. Ferran 2012). This section briefly revisits and presents an overarching discussion of the issue of regulatory paradigms and dogmas of the past decades with reference to global developments and embeds them into the European context as the backdrop for the discussion of the crisis and its underlying causes. With regard to the global context, for instance, in overarching terms, the post-Bretton woods period was an era of deregulation marked by successive deregulatory waves though the latter were not linear and not equally implemented across the jurisdictions of the Western world.

To explain the crisis – or elucidate the factors which contributed to it (causes and explanatory approaches are discussed at length in the following chapter) – various scholars point to the deregulatory agenda in both Europe and the US which decisively contributed to the crash from the 1980s onwards, emphasizing either too little or deficient regulation or focusing on the limited effectiveness of key safeguards in unchecked markets prompted by decades of deregulation, in turn triggered by the assumption that regulation was essentially the problem (Perrow 2010; Wolf 2008; Smithers 2009; Turner 2009). In this context, they draw attention to the underlying neo-liberal assumptions and laissez-faire approaches embodied therein – which essentially revolve around the notion that less regulation is unequivocally beneficial for growth and efficiency. At the core of or rather the essence of these principles regarding the organization of the financial system and the interface of the political and the financial system was ultimately their faith in and adherence to the notion of the self-correcting potential, policing and regulating abilities of both markets and the institutions that constitute them, of which the logical consequence was the prevalence of increasingly light touch regulatory and supervisory approaches (IMF 2010), prioritizing growth over stability and private sector innovation over adequate oversight and intervention. Securitization and the products created in the process, for instance, were not only poorly understood by market participants, financial experts and regulators

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123 Section 4.3 discusses the developments with specific regard to the financial market developments in the deregulatory post-Bretton Woods era and their respective ramifications for the characteristics of the financial system which ultimately laid the foundation for the emergence of systemic risk.
124 Despite successive crises in emerging markets, the consensus largely prevailed in the Western world that its political, economic and financial systems were sufficiently sophisticated to withstand similar shocks and guard against similar dynamics (Johnson and Kwak 2011).
125 See Mügge and Perry (2014) for a discussion of the assumptions of equilibrium finance versus reflexive finance which is of relevance in this context.
126 An issue that often features prominently in regulatory debates is the trade-off between growth and stability. Ultimately, they should and can be two sides of the same coin, yet the former has often been misused to attain more lenient standards for the financial system under the guise of enabling more lending to the real economy and increasing allocative efficiency even as the marginal utility of financial development and innovation declined (see e.g. Turner 2009; 2012).
(Greenspan 2010), they were also actively endorsed in the pre-crisis era by many institutions, including the IMF (e.g. IMF 2005, 2007). Yet though deregulating markets did not entail dismantling all safeguards and infrastructures aimed at the financial system’s stability and integrity all together – traditional retail banking, for instance, was quite tightly regulated in the pre-crisis era – it did eventually entail that multiple sectors, market segments and products flew under the radar such as for instance the shadow banking sector or over-the-counter (OTC) derivative markets which essentially evaded adequate regulatory oversight, while the Basel II capital requirements (or structural elements and financial institutions’ characteristics) were clearly skewed in financial institutions favor (Admati and Hellwig 2013) (for instance via overturning the Glass-Steagall Act and the separation of commercial and investment banking in the US in 1999), and as such evidently not stability-oriented. In a nutshell, the underlying belief in financial markets’ efficiency ultimately “undercut a realistic appraisal of financial stability” (IMF 2010: 7), while even as academics “increasingly began to question the efficient markets theory, policymakers tended to ignore the implications for systemic stability” (ibid.) with disastrous implications.

These principles were also largely integrated in and central to the regulatory approach employed at the European level. Of particular relevance in this context is the concept of groupthink – which Mügge (2011a) refers to and theorizes under the heading of the permissive consensus on financial and regulatory integration – and which in regulatory terms may be defined as the existence of homogenous and streamlined assumptions in regulatory approaches. Homogenous regulatory approaches and groupthink played a crucial role in financial regulation in Europe throughout the 1990s and early 2000s after having been relatively heterogeneous in terms of both regulatory approaches and financial landscapes (see e.g. Story and Walter 1997) in accordance with the prevailing varieties of capitalism at the time (Hall and Soskice 2001) until the late 1980s – that is prior to the first major legislative and integrative initiatives in the aftermath of the Single European Act (SEA). Though most scholars concur that the prevailing regulatory paradigm in the European context might be more adequately described as regulatory liberalism (Gamble 2009; Mügge 2011a) as opposed to the market fundamentalist paradigm that Nobel laureate Joseph Stiglitz (2009b: 346) claimed had been “the prevailing religion of the West”, there was indeed a trend toward increasing liberalization and cross-border market and regulatory integration as described. In this context, it was both the member states and the European institutions which substantially contributed to advancing the largely deregulatory or at least staunchly market-friendly agenda (see e.g. Ferran 2012; Quaglia 2012).

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129 In an interview the former Chairman of the US Federal Reserve, Alan Greenspan, admitted “I’ve got some fairly heavy background in mathematics [...]. But some of the complexities of some of the instruments that were going into CDOs [collateralized debt obligations, CR] bewilders me. [...] I figured out that if I didn’t understand it and I had access to a couple hundred PhDs, how the rest of the world is going to understand it sort of bewildered me” (Greenspan as quoted in Sorkin 2010: 90).

130 These tendencies and dynamics (i.e. limited diversity) could also be witnessed in the academic community and in the markets.

131 For an incisive and persuasive account of dynamics of groupthink in the European regulatory community see Mügge (2011a).

132 One caveat should, however, be noted: liberalization and negative integration in the single market also resulted in reregulation and positive integration at the European level. Therefore, one cannot state that the development in the European context was unequivocally deregulatory and laissez-faire (as discussed above in section 3.3).

133 Examples include decisions to allow self-regulatory attempts in the alternative investment fund industry (Ferran 2011a).
Yet though the crisis does seem to have challenged the prevailing paradigms,\textsuperscript{134} catapulting neo-liberalism – at least in its most dogmatic sense – into crisis, and while regulatory stringency has indeed increased on many measures and in many respects (Wolf 2014a; 2017), the question remains as to whether pre-crisis paradigms have been replaced or sufficiently revised and the crisis marks a genuine break with the past.\textsuperscript{135} At the very least, the crisis does seem to have shattered faith in the most pernicious assumptions regarding market efficiency and financial innovation as well as markets’ self-regulatory capacity and their ability to provide for comprehensive and sustainable system stability, resilience and equity. The concurrent realization that more regulatory intervention and guidance is indeed required has given rise to more stability- and system-oriented – and potentially also more interventionist – regulatory approaches.

In this context, macroprudential regulation and supervision emerged on the post-crisis policymaking agenda as an attempt to address the pre-crisis flaws that came to light during the course of the crisis.\textsuperscript{136} As will be elaborated at length in the following chapter, the crisis exposed the weaknesses inherent in the largely microprudential and hence narrowly focused regulatory and supervisory frameworks in place in the pre-crisis era, which prioritized institutional stability, i.e. the assessment of financial risk and the implementation and enforcement of regulatory and supervisory measures at the level of individual financial institutions focusing on sound banking practices and depositor protection, over system stability, thereby essentially disregarding the potential impact of collective risk and the systemic implications of individual actors and institutions behavior and interactions at the system level (Borio 2003; Brunnermeier et al. 2009; Hanson et al. 2011). The microprudential focus of financial regulation in the pre-crisis era – based on the underlying assumption that system stability would automatically result from individual financial institutions’ stability and soundness (Gai 2013), and mirroring the absence of a genuine understanding of the system properties of finance and its inherent instability (which is discussed in the following chapter) – was integral to the capital regime established in the context of the Basel Committee on Banking Supervision (BCBS) (Acharya et al. 2010) and as such did not adequately mitigate or address systemic risk.\textsuperscript{137} Indeed, Basel II proved to be flawed in multiple respects and has since been revised and updated by Basel III (BCBS 2017; Frühauf 2017)\textsuperscript{138} though it remains questionable whether the changes are – with

\textsuperscript{134} In substantive regulatory terms they have indeed been challenged to a degree in the post-crisis context. Quaglia (2012) even goes as far as to claim that there has been a shift from an ‘old’ to a ‘new politics’ of financial services regulation in the European Union in which a market-shaping coalition has been able to advance its regulatory agenda in spite of the so-called market-making coalition’s reticence that had previously impeded regulation in areas such as the alternative investment fund industry or credit rating agencies (Quaglia 2010b, 2011).

\textsuperscript{135} For an in-depth discussion of the origins of the term and concept of macroprudential regulation, see Clement (2010).

\textsuperscript{136} Crouch (2011), for instance, refers to the ‘strange non-death of neo-liberalism’.

\textsuperscript{137} The internal ratings-based approach (IRR) of Basel II in the context of which banks were allowed to implement their own risk models to assess their risk profiles reflects this approach and presents one of the core deficiencies of the pre-crisis capital regime.

\textsuperscript{138} Basel III – discussed further in section 4.4 on the substantive foundations of reform – was in the making for quite some time. The EU and the US had long been divided on the issue, with the EU being more lenient with regard to the use of internal risk models for the calculation of risk profiles and respective capital requirements (Dombret quoted in Frühauf 2017). In the agreement, which aims to create a level playing field and render financial institutions’ risk profiles more comparable, they are still employed, but have been curbed and subject to more regulatory scrutiny (ibid.), with the end of the implementation phase ultimately being set for 2027. The objective of the Basel Committee in the context of the Basel III reform package was ultimately to facilitate the comparability of financial institutions’ risk profiles via curbing the use of internal risk models and thereby
regard to their underlying nature and fundamentals – sufficient (Admati and Hellwig 2013; Johnson 2013a; Kane 2014; Wolf 2010) as will be discussed in the following chapter.

The resulting post-crisis regulatory response – in addition to a set of substantive, behavioral and procedural regulatory reform measures – has ultimately been the overhaul of the pre-crisis regulatory architecture at the national, European and global level, which attempts to remedy the flaws of the pre-crisis microprudential focus of financial regulation by implementing a new macroprudential paradigm and establishing new institutional structures to increase system resilience.139 The goal of reform has been to establish new system-oriented institutional structures (e.g. systemic risk councils) that overcome the divide between micro- and macroprudential issues (the European System of Financial Supervision) and procedural mechanisms (e.g. resolution mechanisms) as well as to introduce or revise regulatory elements and tools (e.g. capital requirements and countercyclical measures) to supplement traditional microprudential approaches and methods of prevention and oversight including strengthened collaborative efforts to improve understanding of the sources of systemic risk and augment their crisis management and intervention capacities in order to better identify, anticipate and mitigate incipient threats to system and financial stability, while establishing or bringing together key authorities and institutional structures able to formulate effective regulatory and supervisory policies and take concerted action.

Though financial crises and to a degree regulatory reform have been a persistent feature of capitalism throughout the past eight centuries (Reinhart and Rogoff 2009), and even though macroprudential concerns and issues pertaining to systemic risk at that have been voiced and at issue before in policymaking circles (Clement 2010), with discussions at the Basel Committee on Banking Supervision (BCBS) located at the Bank for International Settlements (BIS) in 1979 being a case in point in this respect,140 the vigor with which it was advanced in the regulatory community in the post-crisis context and made a core mandate and objective at all levels of financial governance sets it apart this time.

As will be discussed in depth in the following chapter, the financial system evolved substantially and changed fundamentally throughout the thirty years preceding the financial crisis with respect to its complexity, its sophistication and global reach as well as its centrality to the functioning of advanced capitalist economies. The potential for and the consequences of instability in terms of wealth destruction,

139 At the global level, the new macroprudential focus is manifested in the transformation of the Financial Stability Forum (FSF) at the G20 summit in 2009 in London into the Financial Stability Board (FSB) which was given an upgraded mandate and more resources to enhance comprehensive macroprudential supervision. The FSB had been established in the 1990s by the Group of Seven to integrate and reconcile micro- and macroprudential perspectives and promote international financial stability.

140 Issues identified in a publication of the Bank for International Settlements (BIS) in the late 1970s included an exponential increase in financialization and financial activities and the fact that financial institutions underestimated tail risks as well as liquidity and funding risks all of which could be witnessed during the crisis (Clement 2010). It had called for, or rather drawn attention to the fact that microprudential supervisory measures “may need to be matched by prudential considerations with a wider perspective” and consider issues “that bear upon the market as a whole” (ibid.), yet to no or little avail.
i.e. the havoc financial instability and the disruption of elemental services at the heart of market capitalism could cause, were largely unanticipated by most actors involved, including market participants, regulators and policymakers. Though concerns were voiced and advanced throughout the 1980s and 1990s, and some developments and forces contributing to the crisis could have been predicted or were indeed put forward, they were, with the benefit of hindsight, either underestimated or not taken seriously (see, for instance, El-Erian 2017b; Johnson and Kwak 2011), while lessons that could in theory have been learned from previous crises, especially those at the turn of the millennium, were not heeded – in part due to the prevailing paradigms of the pre-crisis era and their underlying assumptions regarding market efficiency and system stability, which ultimately resulted in insufficient – or in some respects even the complete lack of – preventive mechanisms and crisis management capacities to cope with the crisis when it hit. The crisis ultimately exposed the mirage of self-regulating markets – a notion that had long prevailed in the developed world and guided its regulatory actions as well as infusing its regulatory paradigms (Stiglitz 2009b; see also Turner 2013b) – and exposed the illusion that the West was in a superior position as regards its capacity to harness the financial system and provide for financial stability.

Against this backdrop, the question arises as to whether circumstances have changed and whether this time will be different (Reinhart and Rogoff 2009). The host of reforms that have been enacted have been extensive, yet whether they represent a genuine break with the past remains unclear. Neither have all reforms been fully implemented, established or taken full effect (Basel capital requirements or the banking union’s single resolution fund) nor have the mechanisms and elements had a chance to be tested in real-life scenarios. Indeed, it is still unclear, as will be discussed and become clear throughout – even almost a decade after the outbreak of the crisis and though it has been labeled the most innovative of the post-crisis reforms and revisions (Mayntz 2012: 16) – whether the macroprudential paradigm and the new conventional wisdom it embodies (Black 2012; Wolf 2014a, 2014b) is sufficiently robust and the insights and approaches embodied therein are innovative enough to induce genuine change in terms of regulatory capacity and alter system dynamics so as to sufficiently guard against systemic risk and provide for system stability. In 2013, Admati and Hellwig (2013: 183) argued that “Basel III attempts to correct some of the flaws in Basel II, but it has not changed the overall approach”. The same may apply to other elements of reform. The discussion of the crisis and its implications in the following looks into this issue further and analyzes the developments and dynamics that prompted reforms and post-crisis paradigm shifts and traces and thereafter analyzes post-crisis developments and the overhaul in EU financial governance in response to the crisis against the backdrop of the insights presented above.
4. PART IV: THE CRISIS, SYSTEMIC RISK AND ITS REGULATORY IMPLICATIONS

The financial crisis of 2008 – arguably the worst crisis since the Great Depression (Financial Crisis Inquiry Commission 2011) and “the first truly systemic […] crisis to occur against the backdrop of the modern regulatory state” (Levitin 2014: 1) – led to the near-collapse of the global financial system, disrupted global trade and drove the European economy into a sovereign debt crisis and a multi-year recession. As the consequence of a system that had essentially become too large, complex and overextended with respect to its utility in terms of serving the real economy (Sheng 2013; see also Das 2014; El-Erian 2016; Turner 2009), it ultimately exemplified the dangers of unfettered financial capitalism like never before. Most importantly, however, it highlighted that the financial system could not be left entirely to its own devices due to the immense explicit and implicit costs financial crises give rise to in both monetary and socio-economic terms, and laid bare the need for rigorous cross-border regulation and governance.141

Chapter four introduces the phenomenon of systemic risk and the factors conducive to its emergence, taking an in-depth look at the evolution of the modern financial system and its foundations, which ultimately presented the basis for a crisis of such proportions. The aim throughout is to shed light on the revelations of the crisis in terms of systemic risk and its respective governance imperatives within the context of developments that transpired throughout the past decades. Whereas the previous section focused on pre-crisis developments in European financial and regulatory integration on the basis of which post-crisis reforms can be assessed, the following discusses relevant market and system-related dimensions at stake throughout the analysis – in short, the structural and institutional characteristics as well as the system properties and dynamics of an inherently unstable, highly complex and tightly coupled financial system. To summarize, the goal of this chapter as the second component of the conceptual framework is ultimately to bring coherence to a highly complex policy sphere. Presenting the conceptual underpinnings of the rationale for governance integration in light of the nature of systemic risk and the system properties of global finance, it serves as a backdrop for both the analysis of the outcome and potential of the supranational governance architecture’s overhaul, while also laying the basis for making the case for a build-up of cross-border reactive governance capacity to be achieved via robust, coherent and credible cross-border governance regimes.142 In more detail, systemic risk is analyzed throughout and its ramifications are presented, whereby a refined definition which combines political and economic perspectives is expounded – against

141 Indeed, as alluded to previously, both the economy and financial system survived “a near death experience” (Wolf 2010), while the implicit costs and knock-on effects of the crisis – the consequences of which are still being felt to date, an entire decade on – were immense, including trillions of dollars in lost output (Haldane quoted in Wolf 2010; see also Atkinson et al. 2013 and Wolf 2014b), not to mention the explicit costs resulting from bailouts as risks were essentially socialized with finance being the most subsidized industry in the world (Wolf 2010), showcasing the dangers inherent in a bloated, leveraged and overextended financial system (Sheng 2013) and why regulatory intervention and credible crisis management tools are paramount in order to reduce the probability of crises and mitigate their impact in the event of crisis – as will be elaborated and become clear throughout this chapter.

142 Note that while substantive regulatory challenges are discussed in the following, shortcomings pertaining explicitly to the regulatory and supervisory governance architecture, i.e. governance challenges exposed by the crisis – discussed under the heading of the financial trilemma to theorize both the challenges for and priorities of European reform and integration in this issue area – are not. Rather, they are analyzed thereafter in chapter five with reference to the pre-crisis status quo of European financial governance integration, and as such serve as a direct introduction to the analysis of institutional governance reforms conducted therein.
the backdrop of which the post-crisis reform outcome as well as the significance of resulting cross-border governance capacity are assessed. Thereby system-related challenges facing financial governance are theorized, while the insights are central to the argument advanced regarding the imperative of integration – both with respect to the inability of regulatory institutions to sufficiently mitigate crises and the financial system’s political embeddedness which contributes to systemic risk.

The following begins with a recapitulation of the financial crisis and its anatomy, thereby laying the foundation for systematizing and theorizing its causes, which includes a contextualization of partially competing narratives in order to make sense of a multidimensional, highly complex and indeed epochal event (Levitin 2014; El-Erian 2017b). This, then, is complemented by a discussion of the explicit revelations of the crisis in terms of systemic risk and the regulatory challenges it gives rise to as well as the properties and dynamics of a highly complex, tightly coupled and inherently unstable global financial system that facilitate the emergence of the latter. These revelations in turn are of relevance for deducing and formulating the resulting regulatory implications and governance imperatives of the crisis against the backdrop of systemic risk, the prevalence of system complexity and instability as well as the political embeddedness of the system and its centrality in the context of advanced modern economies more generally (see, for instance, Mügge 2011a; Kapoor 2013). Thereafter, despite being a governance analysis that focuses primarily on the institutional governance architecture constructed in the aftermath of the crisis, the research wraps up chapter four by presenting and contextualizing substantive elements of regulatory reform which are of relevance in terms of systemic risk, more specifically policy measures aimed at financial stability, i.e. those that are central to both crisis prevention and the build-up of crisis management capacities. Finally, the chapter is rounded off by a discussion of the shortcomings of reform in structural and substantive terms with a view to the system properties set out, which as is argued throughout, remain largely unaltered and therefore deficient as the system remains susceptible to systemic risk.

4.1 The Financial Crisis in Depth

Having led to the near-collapse of the financial system, while driving the global economy into a multi-year recession and precipitating a sovereign debt crisis in Europe with direct and indirect costs racking up the “largest peacetime deficits ever” (King 2010: 2), interpreting the financial crisis or Great Recession of

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143 The elaboration of the anatomy of the crisis is later complemented by a discussion of immediate policy responses in terms of crisis management in chapter five.
144 The discussion of the evolution of the global financial system as well as its significance with regard to systemic risk incorporates an analysis of the crucial phenomena of systemically important financial institutions and too big to fail and/or manage and regulate in order to highlight the intricacies of financial governance and shed light on the regulatory implications of the crisis. These notions are central to the refined concept of systemic risk employed.
145 In this context, the research differentiates between short-term crisis management tools and mechanisms (e.g. resolution regimes and bail-in instruments), medium-term substantive action in the form of macroprudential policy and revised prudential requirements, and long-term strategies of crisis prevention such as systemic risk oversight regimes and other preventive measures (e.g. living wills and stress tests). These substantive elements of the post-crisis policy response are essentially the pillars of the emerging supranational institutional governance architecture in which they are embedded and which are analyzed thereafter.
2008 as the worst economic crisis since the Great Depression in the 1930s (Financial Crisis Inquiry Commission 2011) is certainly not an understatement. Indeed, had governments not intervened a repeat of – or at least something akin to – the Great Depression would have been highly likely. To contextualize the sheer magnitude of the crisis and its effects, it is instructive to draw attention to its devastating consequences with regard to the real economy and society at large, both in terms of the explicit (i.e. direct) costs incurred via bailouts and the like as well as the implicit (i.e. indirect) costs it gave rise to with respect to lost output, declining productivity and sharp increases in unemployment (see, for instance, King 2010; Quaglia et al. 2009; Turner 2015; Wolf 2010, 2015), thereby contributing to the prolonged negative impact of the crisis on prosperity given the depth of the recession that ensued. In the European context, the crisis resulted in the “worst [economic] performance on record” (Hodson and Quaglia 2009) with a decline of approximately four percent of the EU’s GDP in 2009 alone, while growth remained far below pre-crisis levels throughout the last decade, in large part due to a decline in productivity growth throughout high-income countries (Wolf 2015), having recovered only now. In a nutshell, the financial crisis of 2008 and its knock-on effects in terms of the ensuing sovereign debt crisis it triggered as well as the lingering economic and socio-political tensions it gave rise to can undoubtedly be characterized as one of the worst crises in the EU since its inception and the worst financial crisis since the Great Depression in the 1930s.

Yet how was this possible and what made the crisis so destructive? In order to shed light on the issues it exposed – and accordingly deduce regulatory challenges and imperatives for the post-crisis reform agenda – before discussing its causes in more detail, an in-depth examination of the crisis and its anatomy is in order. With respect to the early dynamics of the crisis, April 2007 marked the beginning of the turmoil in the US mortgage market when subprime mortgage lenders began experiencing difficulties as rising interest rates coupled with falling property prices resulted in declining repayments and increasing defaults. Tangible knock-on effects and contagion from the subprime mortgage crisis – initially a crisis of liquidity – then started to emerge in Europe throughout the summer of 2007. In August, the interbank lending market essentially froze as debt refinancing in wholesale money markets was obstructed and short-term funding became increasingly difficult to obtain for financial firms due to widening spreads between overnight indexed swaps and inter-bank lending rates (Quaglia et al. 2009). As liquidity evaporated and fear gauges surged, the liquidity crisis, however, soon gave way to a full-fledged crisis of solvency,

146 Trade, surprisingly, was not hit as badly as one might have expected. Productivity levels, however, declined dramatically due to deficiencies with respect to the transmission of monetary policy, adversely impacting lending to the real economy (in some cases up to 30 percent, see Wolf 2015), while output in 2015 was, on balance, estimated to be over eight percent lower than pre-crisis trends had forecast – with the damage essentially being “as if Germany’s economy had disappeared” (ibid.). In addition to these largely indirect costs and effects, direct costs were incurred as a consequence of bailouts, recapitalizations and related measures for which public resources were drawn upon, while monetary and fiscal policy tools were employed to support financial institutions, revive credit markets and stimulate growth.

147 Note, however, that while crisis developments are discussed, immediate policy responses at the height of the crisis and explicit responses in thematic terms are elaborated thereafter in chapter five as a prelude to the governance reforms at stake therein.

148 These spreads reflect a combination of both liquidity and counterparty solvency risk. To illustrate the severity of developments in the European context, it is instructive to note that spreads rose to two percent after the collapse of Lehman Brothers in 2008, up from just 0.10 percent in the pre-crisis era (Quaglia et al. 2009: 65).
facilitated in large part by the fact that a vicious – indeed even counter-intuitive – cycle took hold, owing to the degree of instability, complexity and uncertainty that pervades modern finance – the effects and implications of which will be discussed at length throughout this chapter. Hit by large losses in the sphere of mortgage lending and on mortgage-backed securities, financial institutions’ attempts to remain liquid and functional by selling illiquid assets resulted in sharply declining asset prices, eroding bank capital in the process and thereby precipitating a crisis of solvency; ultimately, a downward spiral ensued as counterparties also attempted to sell their assets, driving down market prices even further. These dynamics and the resulting erosion of capital bases jeopardizing solvency were facilitated by pervasive uncertainty with respect to the actual value of (in large part toxic) assets on financial institutions’ balance sheets which gave rise to fears as regards the potential for counterparty defaults. Given the high degree of interconnectedness the global financial system exhibits due to among other factors the emergence of complex OTC derivatives (the ramifications of which will be put into context throughout), the result was ultimately pervasive and system-wide contagion of a scale and scope that had never been witnessed before.

Of significance in this context besides the immediate implications for the system and its sustainability as such, is the fact that spiraling credit losses and write-downs were well above, i.e. not matched by new private capital issuance, resulting in what is now in retrospect referred to as the credit crunch. In the eurozone, for instance, credit growth fell significantly from 130 billion in 2007 to 25 billion euro in 2009 (IMF 2009) with detrimental repercussions for the real economy as undercapitalized banks’ reluctance to lend to the non-bank private sector significantly reduced the amount of credit extended to the real economy, severely affecting economic activity as a consequence. In the European case, this is particularly significant as continental Europe can be characterized as a bank-based or bank-dominated system (De Larosière 2014), which exhibits limited capital market depth and is heavily reliant on wholesale funding, rendering the impact of liquidity crises and deteriorating credit conditions even more consequential.

Against this backdrop, in August 2007, the German IKB Deutsche Industriebank AG was among the first institutions to require public assistance in the European context due to extensive subprime-related losses given its exposure to the US mortgage market, while in the UK, Northern Rock collapsed despite being solvent, largely owing to losses on subprime mortgage lending coupled with refinancing difficulties given its heavy reliance on wholesale funding which made it particularly vulnerable to liquidity pressures.149 While other European institutions also experienced severe difficulties, among the most prominent or high-profile of which were, for instance, the UK’s Royal Bank of Scotland as well as the multinational banks Dexia and Fortis, Northern Rock and the bank run that ensued from its application for liquidity support ultimately serves as a prime example of the ramifications of the liquidity crisis and the dangers of

149 In the case of Northern Rock, the liquidity crisis in 2007 essentially presented the trigger for its demise, ending in its application for liquidity support from the Bank of England in September 2007 which precipitated the first bank run in the UK since 1866 (Hodson and Quaglia 2009: 941) and paved the way for its eventual nationalization in February 2008.
150 Immediate policy responses are discussed in depth in the next chapter and include the bailout, restructuring or nationalization of various affected institutions.
systemic risk in terms of the vicious cycle that results from contagion. Though it had in effect been solvent, the very fact that it applied for assistance triggered its downfall (see Hodson and Quaglia 2009). Yet though the crisis initially broke out in 2007, and warning signs such as turmoil at BNP Paribas and Northern Rock had long been visible, it only reached its peak and full international scale in 2008. In the US, the first high-profile victim of the subprime bubble was the investment bank Bear Stearns in March 2008. Owing to its high leverage and exposure to the subprime mortgage market, having invested heavily in mortgage-backed securities, it had become particularly vulnerable to turmoil in the markets and was eventually acquired by its rival J.P. Morgan Chase, a transaction brokered and backed by the US Federal Reserve. Ultimately, Bear’s failure may be regarded as an early tipping point, leading to the culmination of the crisis a few months later with the failure of Lehman Brothers in September 2008. Of importance in this respect is the fact that though Bear Stearns was not particularly large in comparison, it was integral to the critical refinancing market – the so-called repo-market which is key to the functionality of practically all financial markets – and was therefore considered too important to be allowed to fail, the implications of which will be discussed in due course. As a result, this incident was widely considered a harbinger of what was to come. Its rescue essentially reinforced moral hazard in terms of the bailout expectations it fostered, thereby making the fallout from the failure of Lehman Brothers – which was, in effect, a systemically significant institution – all the more consequential in terms of the panic and contagion it engendered.

When Lehman Brothers – the fourth largest US investment bank and the largest bankruptcy in US history to date – became insolvent, the US Treasury Department and the Federal Reserve were ultimately taken by surprise. While scrambling to adopt emergency measures, multiple publicly supported attempts or publicly orchestrated initiatives to broker private sector solutions and keep Lehman afloat failed. This notwithstanding, and though multiple other institutions had been or were soon to be rescued and bailed out, including the the insurance corporation American International Group (AIG), the largest insurer in

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151 Symptomatic of the wider investment climate throughout this period, BNP Paribas also serves as a good example. In the summer of 2007, it suspended three of its investment funds due to a “complete evaporation of liquidity in certain market segments of the US securitisation market” (BNP Paribas 2007), citing the inability to calculate and value reliable net asset values of underlying US asset-backed securities irrespective of their credit ratings – in what they presciently described as exceptional times.

152 This insinuates and ultimately lends weight to the claim that regulators and policymakers genuinely believed that the crisis could be contained. To a degree, they even appear to have been complacent, reflecting their inability to understand or indeed unwillingness to comprehend the structural weaknesses and vulnerabilities that had developed under their watches and the potential for instability and contagion throughout the developed world, having long thought financial crises of this sort were limited to less developed regions (El-Erian 2017b).

153 This instance of intervention is significant with regard to the issue of too big to fail which will be discussed throughout. In a sense, it set a precedent and reinforced bailout expectations, which – as Lehman was eventually allowed to fail a few months later – contributed to the chaos that ensued in financial markets due to the element of surprise inherent in regulators’ move to let Lehman go down after having rescued multiple other institutions. As the management of expectations is a central task of regulators and central bankers alike, these events illustrate why both credible ex ante and ex post policy measures are so important in the context of systemic risk in order to mitigate moral hazard and impede contagion as will become clear throughout.

154 Initiatives included an attempt to arrange a takeover bid by Barclays which ultimately fell through (among other factors due to concerns on the part of British regulators which eventually did not authorize the acquisition) as well as an attempt to orchestrate a rescue via a private consortium as had been the case with the collapsing hedge fund Long-Term Capital Management (LTCM) a decade earlier as a consequence of the Russian financial crisis. LTCM had invested heavily in interest rate derivatives and suffered greatly given its high leverage and the acute liquidity pressures it was subject to when Russia defaulted on its external debt in 1998, essentially being considered too big to fail by both the US government and the financial institutions in the consortium that eventually decided to contribute to its rescue (MacKenzie 2005; see also Becker 2016 and Black 2012 on the respective consequences).
the US,\textsuperscript{155} while other institutions had been or were in the process of being restructured and sold such as, for instance, the investment bank Merrill Lynch, which was acquired by Bank of America, a full-scale bailout of Lehman Brothers commanded neither political nor necessarily regulatory support. The potential fallout with respect to the reinforcement of moral hazard and the costs in terms of regulatory authorities’ credibility and reputation – in view of the wave of previous bailouts – were simply too high (FCIC 2011; see also Sorkin 2010 for more detail on institutions that failed in the US case).\textsuperscript{156} The question remains, however, whether the fallout from the Lehman bankruptcy has assuaged these fears or rather reinforced bailout expectations. The perverse effects of Lehman’s failure obviously have implications for policy on the other side of the Atlantic as well.

The events that succeeded the Lehman bankruptcy illustrated the destructive potential of contagion like never before (see section 4.3 on the respective regulatory implications). Despite governments’ and central banks’ best efforts to limit the fallout and contain the crisis, contagion spread rapidly throughout Europe. As had been the case in the run-up to the Lehman collapse, similar developments unfolded and dynamics took hold in the European context thereafter – with multiple institutions having to be rescued in order to maintain confidence in the system.\textsuperscript{157} Prominent failures and developments of significance in the post-Lehman era include the failure of the German commercial property lender Hypo Real Estate, which experienced difficulties due to acute liquidity troubles at its Irish subsidiary Depfa Bank, and was eventually bailed out by the German government (see e.g. Hodson and Quaglia 2009), while the third largest Dutch bank ABN AMRO was propped up by the Dutch government following its botched takeover and break up by a consortium composed of the Royal Bank of Scotland, Fortis and Banco Santander in 2007. In addition, in the British context, undoubtedly the most important in the European jurisdiction given the size of its financial sector as well as the latter’s centrality in financial markets, the mortgage division of Bradford and Bingley was nationalized, while Lloyds TSB, HBOS and the Royal Bank of Scotland were bailed out by the British government – with the tally of the rescue of the latter three institutions

\textsuperscript{155} In order to boost its profits, AIG had become one of the main sellers of credit default swaps, essentially insurance on assets that supported subprime mortgages. The very scale of its involvement in the mortgage market and its centrality in this sphere – though, in theory, it was merely conducting low-risk insurance business – implied a bankruptcy would ultimately have jeopardized the solvency of many of the institutions that had bought the insurance contracts. As an increasing amount of mortgages defaulted and the scale of the associated risks became apparent, it became increasingly difficult for AIG to cover payouts on these swaps. AIG merely serves as an exemplary case of the scale of the problem. Many financial institutions were major holders of its debt, while most mutual funds were shareholders – its centrality in the money-market fund industry was therefore undeniable and its failure would have had catastrophic consequences on many levels. Other institutions rescued in the US included the real estate giants and government-sponsored enterprises, Fannie Mae and Freddie Mac, the Federal National Mortgage Association and Federal Home Loan Mortgage Corporation, respectively, which were placed into conservatorship by the US Treasury.

\textsuperscript{156} Perhaps somewhat paradoxically, however, the US government rescued AIG in September 2008 – supporting the latter with a two-year loan, which at 85 billion dollars was one of the largest bailouts in US history – only days after Lehman failed, allegedly having done so as its failure would have had disastrous effects due to its centrality in global money markets, though initially the possibility of further bailouts had been denied by then Treasury Secretary, Henry Paulson. Lehman Brothers, by contrast, was not so fortunate. It did not have sufficient collateral and, therefore, a bailout simply could not be justified. Geithner lends weight to this claim, arguing that the failure of AIG would have been far worse than that of Lehman (Paletta and Scism 2014).

amounting to 47 billion euro in total. Finally, and of significance in the context of this research, in pan-European, i.e. cross-border terms, as financial integration in the decades preceding the crisis had resulted in multiple cross-border mergers, there were two particularly notable and instructive developments that transpired, though there was no cross-border SIFI bankruptcy in the EU as such. On the one hand, the Franco-Belgian Dexia Group was rescued in tandem by the respective national governments in 2008 at a cost of six billion euro, including both a capital injection and state guarantees of up to 150 billion euro, and may, on balance, be regarded as having been a success in terms of the cooperation it induced in the sense that there were no contentious and protracted negotiations. Rather swift and commendable decision-making on the part of the national authorities involved was displayed (Pisani-Ferry and Sapir 2010). On the other hand, with respect to the rescue or rather handling of Fortis – a Benelux-based institution in turmoil after the Lehman collapse owing to both liquidity pressures and excessive leverage given its participation in the acquisition of ABN AMRO in 2007 – negotiations were more contentious, illustrating the difficulties and complexities involved in the governance, rescue and resolution of pan-European institutions (Hodson and Quaglia 2009; Pisani-Ferry and Sapir 2010; Quaglia et al. 2009). Fortis was eventually broken up and resolved – and even partially rescued – along national lines after Belgian, Dutch and Luxembourger authorities failed to “agree on a workable rescue plan” (Hodson and Quaglia 2009: 941).

The implications of the above in terms of both substantive financial regulation and cross-border governance are multiple and multifaceted, and are discussed in due course. On the one hand, the financial system in its present state is so complex, unstable and interconnected that contagion is practically unavoidable, yet must be managed nonetheless, while on the other, in light of the cross-border nature of finance, corresponding transnational venues for cooperation, coordination and the construction of mechanisms for preventive regulation and crisis management are imperative in order to augment the capacity of the regulatory governance architecture and reinforce its credibility vis-à-vis the private sector. Turning once again to the failure of Lehman Brothers: though in theory the decision to let the latter go down was taken to curb moral hazard in the form of bailout expectations, it may, perversely – and this fact is of utmost importance – have further increased it on both sides of the Atlantic in light of the developments that ensued after its collapse, and this, unfortunately, despite global regulators’ and policymakers’ best efforts to construct fail-safe rules and mechanisms to inhibit it, devise robust crisis management tools, end too big to fail and credibly project their commitment to no-bailout claims in the post-crisis era. It is these

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158 This tally does not include the nationalization of Northern Rock preceding the Lehman collapse mentioned earlier. In the case of RBS, which was among the largest institutions in Europe to receive assistance, the institution was partially nationalized with the government owning 70 percent of its shares in early 2009. Its troubles were largely due to its overextension, high leverage and the extensive losses incurred given its participation in the misguided acquisition of ABN AMRO in 2007 (Robbins 2009).

159 It has, however, since been broken up and resolved in the context of the sovereign debt crisis due to large losses resulting from the debt haircut on Greek government bonds in 2011.

160 Turmoil at Fortis during 2008 resulted in the Dutch government obtaining full control of all its Dutch operations for a total of 16.8 billion euro, including the units of ABN-AMRO that belonged to the latter at the time, while it thereafter merged the two in 2010 under the brand name ABN AMBRO.
aims that cross-border schemes set out to contribute to and this claim that they aim to lend weight to. Whether they have managed to do so is a question that must be borne in mind throughout the analysis.\textsuperscript{161}

To conclude, the nature and scale of the crisis and its externalities in terms of its disruptions and the costs it engendered shed light on the destructive potential of the financial system and its underlying structural deficiencies, in turn exposing the need for both rigorous regulatory intervention and robust cross-border governance mechanisms if the system remains as complex, tightly coupled and interconnected as it is at present. This ultimately begs the question as to what the underlying causes of the crisis were, inter alia as the interpretation of causes is crucial for the regulatory imperatives that can – and indeed were – deduced from it in its aftermath. The following looks into approaches that have been advanced in this regard.

\section*{4.1.1 Systematizing and Contextualizing Causes of the Financial Crisis}

Roughly a decade after the onset of the financial crisis academics, regulators and policymakers still remain divided as to defining its precise root causes (El-Erian 2016).\textsuperscript{162} Yet though limited consensus as regards apportioning blame and assigning significance to respective causes of the crisis persists, even throughout the academic community as discussed in due course, multiple narratives have indeed been advanced, while a few key narratives managed to gain prominence in the debate. Evidently, any diagnosis or interpretation of crisis causes has implications with regard to both the governance imperatives deduced in theory and the respective regulatory ramifications that result in practice. As competing explanatory approaches – competing in the sense that they diverge in terms of the extent to which they prioritize certain aspects of contributing causes – inevitably impact regulatory reform propositions and policy responses, their careful scrutiny is, accordingly, of utmost importance so as to avoid drawing misguided conclusions.\textsuperscript{163}

Despite the discord mentioned, however, what has no doubt become clear is that the sheer complexity of the financial crisis of 2008 and its causes defy simple monocausal explanations. Suffice it to say that defining and differentiating as well as addressing the complex and interdependent factors at stake is inherently challenging (Admati and Hellwig 2013), while singling out and prioritizing one factor or

\textsuperscript{161} In a nutshell, as was the case at the height of the crisis in 2008, uncertainty as regards the utility of existing (and now newly established) policy tools and mechanisms prevails as they have never been tested. In terms of bailouts and rescue measures in crisis management there are no preset rules, while each bailout is essentially “a system unto itself” (Levitin 2011: 481). Unconventional action was a necessity in the previous crisis and will most likely be a necessity in the next crisis – while this principle (again, by necessity) will also apply to the cross-border European context. Nonetheless or perhaps precisely due to this fact, the build-up of reactive capacity is imperative.

\textsuperscript{162} Considerable controversy lingers, for instance, with respect to the extent to which the crisis of 2008 can be regarded as unique or one of a kind, having exhibited a qualitatively new nature and phenomenon in the form of systemic risk (as argued e.g. by Wilke et al. 2015). This issue pits scholars such as Levitin (2014) who advances the narrative of a perfect storm against, for instance, Goodhart (2014) with respect to their interpretations of the crisis having been truly systemic and qualitatively different from previous crises versus the crisis merely having been a normal instance of cyclical dynamics, i.e. a cyclical blip, as many policymakers seem to believe (see e.g. El-Erian 2017b). This research takes issue with this stance as will be discussed in due course.

\textsuperscript{163} In the European context, for instance, the crisis has been theorized by some scholars as an opportunity for policy entrepreneurs and advocacy coalitions espousing competing – and partially contradictory – policy paradigms and narratives to advance their respective policy preferences (see, for instance, Quaglia 2010a, 2010b, 2012).
another – for instance, claiming the regulatory system or the private sector had primarily been at fault – is clearly not feasible, though it often an imperative from a political perspective in light of crises’ socio-economic consequences. Mirroring this complexity, official reports on the crisis in the European context, the two most prominent of which are the De Larosière Report (EU) and the Turner Review (UK), do not explicitly assign responsibility to single factors or apportion blame to certain actors as such. Rather, the common denominator of these policy-oriented reviews, essentially aimed at devising propositions for reform, is their focus on the interplay of selected elements – that is the complex interaction of interdependent and self-reinforcing dynamics, structural characteristics and system developments. The latter include, for instance: (i) structural factors such as global macroeconomic imbalances, excessive increases in system complexity and financial industry growth, or unsustainable asset price inflation and credit expansions (De Larosière 2009; FSA 2009), (ii) private sector deficiencies and behavioral issues such as excessive risk-taking, obscure industry practices, deficient corporate governance and risk management, product-related issues, including complex and opaque OTC derivatives, inadequate mortgage-lending standards and rating agency practices in which risks were grossly understated (FCIC 2011; FSA 2009) in addition to market failure more generally (De Larosière 2009; FSA 2009), as well as (iii) policy-related issues, including inequitable monetary policy and inadequate or entirely absent regulatory standards, system oversight and capacities capable of coping with a crisis of systemic proportions (De Larosière 2009; FSA 2009).

Of importance in the context of this research is the fact that the European De Larosière Report explicitly focuses on – meaning a central narrative in the European debate and on the European reform agenda was – the issue of weaknesses and shortcomings pertaining to the governance architecture which was regarded as deficient and fragmented in a twofold sense: (i) in functional and horizontal terms (with regard to, for instance, the lack of macroprudential perspectives and policy instruments in the regulatory and supervisory architecture) as well as (ii) with regard to the vertical division of competencies in regulatory and supervisory terms, i.e. the allocation of authority and the location and division of de jure and de facto regulatory capacities between the national and supranational level – with the architecture not being commensurate with the nature of the single market and cross-border finance (De Larosière 2009: 13 and

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164 In effect, the crisis ultimately illustrated that the financial system, which imploded spectacularly in 2008, was deficient in multiple respects. Its constitutive actors, including large cross-border financial institutions, rating agencies, national regulators and supervisors as well as the global policymaking elite all had a stake in its downfall.

165 The High Level Group on Financial Supervision in the EU, hereafter De Larosière (2009), was commissioned by the European Commission in 2008 and produced its report on the crisis in 2009. The De Larosière Report – discussed at length in chapter five – included comprehensive proposals for pan-European reforms and an overhaul of the supranational regulatory and supervisory architecture, and is in effect the report that recommended the establishment of the European Supervisory Authorities and the European Systemic Risk Board. The Turner Review, hereafter FSA (2009), was devised by the UK’s Financial Services Authority and ultimately presents the basis for a White Paper on far-reaching reform in the British context. It also included propositions for more integration in the European context given the deficiencies the crisis had exposed. Finally, an additional contribution of relevance in this respect is the report of the National Commission on the Causes of the Financial and Economic Crisis in the United States, the so-called Financial Crisis Inquiry Commission (FCIC 2011), which primarily focuses on the role of complex derivatives and was produced on the basis of an investigation, including public hearings, in-depth interviews and reviews of organizational documents.

166 In the same vein, in addition to the neglect of system-wide risks, the US Treasury Department places emphasis on complacency in both the private and public sector (US Treasury Department 2009), while the UK Treasury claims the crisis and its respective causes arose from and pervaded all systems involved (HM Treasury 2009). What the reports lack, however, are systemic perspectives and analyses of system properties and their consequences as discussed below.
Consequently, reform in the European context has focused on restructuring, streamlining and integrating the regulatory system in both pan-European and eurozone terms (which is discussed at length in chapter five). This – i.e. both the European debate and the European response – is a feature that distinguishes it vis-à-vis, for instance, the United States. In the latter, though not making it onto the regulatory agenda, the fragmentation of the regulatory and supervisory architecture – as well as the dispersion of regulatory power therein – has been criticized strongly by academics and policymakers alike, including the former Chairman of the US Federal Reserve, Paul Volcker (Ferran 2014a; Scott 2011: 728ff.; Willke et al. 2013: 69ff.; Zandi 2008). In this context, in which “[c]lear cracks exist in the regulatory patchwork” and “[a]s regional barriers to lending came down, the nation’s Byzantine regulatory structure did not change, making its oversight of lenders increasingly unwieldy and ineffective” (Zandi 2008: 147), fragmentation not only contributed to regulatory overconfidence (Willke et al. 2013: 69ff.) and a false sense of security, it also hampered the regulatory system’s ability to provide and adopt holistic perspectives as well as giving rise to the opportunity for regulatory standard shopping (ibid.: 69; see also Levitin 2014). This has not been altered in the aftermath of the crisis though institutions mandated with system oversight have been established (see, for instance, Becker 2016; Willke et al. 2013). As will be discussed throughout, this fact is significant, even potentially beneficial, and – as we argue in line with Ferran’s (2014b; 2014c) legal analyses – analytical consequential in the sense that it attests to the Union’s innovative potential (elaborated further in chapter five) – going far further than, for instance, reform in international schemes and global frameworks in which, in overarching terms, institutional innovation has remained “minimal” (Underhill and Blom 2012: 291).167

Returning once again to the issue of systematizing causes: In terms of approaches that reflect the same rationale as the above, central narratives in the academic context generally revolve around factors that can be grouped into broad, if perhaps also somewhat simplistic yet nonetheless helpful, categories – though it should be noted that there are substantial overlaps and interdependencies between them.168 As an attempt to synthesize the causes of the crisis given the complexity noted above – and indeed the enduring contention in this regard – one potential approach is to single out three overarching categories (see, for instance, Willke et al. 2013: 178 for a similar approach),169 encompassing (i) public policy-related causes and issues pertaining to the public sector or regulatory sphere (regulatory failure and regulatory forbearance), including, for instance, the laxity of housing policy which incentivized home ownership (Interview with

167 In effect, from an international perspective there has indeed been “no genuine rethink of the global financial order” (Underhill and Blom 2012: 291).
168 Recall that the interplay and the combination of overlapping crisis cycles might be regarded as the defining feature of the crisis. In overarching terms, the crisis was multifaceted and multicausal: It was a structural crisis of private and public sector debt, the product of financial cycles and widespread global imbalances (Posner 2010), the logical consequence of inherent financial system instability (Minsky 1977, Kindleberger 1978), a crisis of the system in terms of system properties such as the externalities of complexity and interconnectedness, of excessive financial innovation related to processes and products such as credit derivatives (FCIC 2011; Haldane and Madouros 2012), a crisis of knowledge, and finally the product of market and regulatory failure and inadequate or insufficient regulation, i.e. the under-supply or inadequate use of tools at hand (Seabrooke and Tsingou 2010).
169 Another attempt to systematize causes is employed by Willke et al. (2013: 59ff.) and is based on five interrelated categories.
Andrew Bailey, January 29, 2013; see also Wolf 2008) and the lack or inadequacy of robust regulation and supervision (lacking authority or expertise vis-à-vis the private sector), especially the inadequacy of prudential regulation in the form of low capital and liquidity ratios coupled with high leverage and over-extension in banking markets, exacerbated in turn by (ii) structural causes including macroeconomic and monetary policy-related issues (pre-crisis structural weaknesses pertaining to underlying fundamentals of the financial and monetary system) such as international macroeconomic imbalances in the Post-Bretton Woods era (Pauly 2009) induced and fostered by volatile and unrestrained international capital flows in globalized markets (macroeconomic imbalances, imprudence and international policy failure), coupled with overly lax monetary policy, i.e. low real interest rates which declined from 6.25 percent to 1.75 percent in 2001 in the United States leading to rising household indebtedness, an excessive search for yield and unsustainable asset prices (credit expansion and interest rate downturn), exacerbated by an overreliance on easily accessible market liquidity (Tucker 2014) and increasing instability and volatility in the process (discussed further in section 4.3) (El-Erian 2016; Pauly 2009; Wolf 2008, 2014b), and finally (iii) financial system, i.e. private sector developments in the deregulatory period of the post-Bretton Woods era (market fundamentalism).

A more extensive look into the latter is in order given its significance in terms of presenting the rationale for regulatory intervention. Ultimately, regulatory flaws and structural weaknesses were exacerbated by developments in the private sector – both in banking and capital markets. One aspect of financial innovation, for instance, which is by no means unequivocally positive (the limits and consequences of which will be discussed in the following subchapters), in the form of securitization and securitized credit intermediation, of which the “maximum possible benefit in terms of allocative efficiency was at best marginal” (Turner 2009: 4) having grown to a “size unjustified by the value of its service to the real economy” (ibid.) despite creating large returns in the private sector, was particularly detrimental. Though products emerging from securitization (such as e.g. credit derivatives) were, for instance, employed to hedge against and mitigate risks, they did in fact foster complexity and increase risk by giving rise to “falling risk aversion and rising irrational exuberance of the sort to which all liquid traded markets are at times susceptible” (FSA 2009: 25), while obscuring risk profiles, limiting the utility of bank internal risk models and

170 In our interview with the Bank of England and UK Prudential Regulatory Authority’s Andrew Bailey, intriguing comments were made with respect to evidence as regards the potential for a bubble pre-2007 – which was, however, dismissed. As will be shown throughout, this was an overriding and common theme in the pre-crisis era.

171 In the eurozone, for instance, financial sector leverage rose by 70 percent between 1999 and 2007 vis-à-vis the US’s 40 percent. In effect, European institutions had been significantly less well capitalized than their peers having considered Basel II’s rules as de facto ceilings (Begg 2009).

172 Developments contributing to an excessively unbalanced global economy included, for instance, the influx of cheap credit from oil exporting countries and emerging markets to – in addition to excessive borrowing by – the United States and other developed nations, the effects of which were not addressed given the inability of nation states to address current account imbalances due to inadequacies in transnational macroeconomic policy co-ordination (see e.g. Financial Stability Forum 2008; Group of Thirty 2009; Pauly 2009).

173 Illustrating the interdependence between crisis causes particularly well is the fact that excessive credit expansion in the aftermath of 9/11 and the dot-com bubble (structural and policy-related causes) fostered destructive industry practices, for instance imprudent and excessive borrowing and lending which accordingly might be characterized as a symptom or consequence of flawed monetary policy (see e.g. Carmassi et al. 2009). The convergence of expectations regarding asset price dynamics was fostered by loose monetary policy in which risks were underestimated ultimately giving rise to irrational exuberance (Shiller 2005; Willke et al. 2015).
inhibiting the adequate analysis of asset quality in the process. In this respect, though product and process innovations were intended to spread risk throughout the financial system and in turn reinforce its resilience while supporting credit provision to the real economy, increasing allocative efficiency and thereby fostering growth, it – (especially in the case of securitization and credit derivatives) – did in fact increase system complexity and vulnerability with the result being the widespread and pervasive mispricing of risk, leading to overly risky behavior, excessive balance sheet expansion, leverage and the like (De Larosière 2009). In addition to the above, private sector weaknesses, and in particular banking sector deficiencies – which were undoubtedly facilitated by regulatory negligence, inaction and/or complacency, highlighting the interdependence of forces that contributed to the crisis – included, for instance: (i) low capital bases, (ii) weak and risky funding structures, (iii) deficient lending practices and trading investments, and lastly (iv) misguided mergers and acquisitions (Jenkins 2013a). To conclude, an alternative analytical approach to systematizing crisis causes – one that is largely neglected in the academic debate with some notable exceptions (Becker 2016; Levitin 2014; Willke et al. 2013), yet of crucial significance for our definition of systemic risk throughout this chapter – is to juxtapose systemic and behavioral narratives of which the former includes structural elements. Though behavioral aspects are crucial and the relevance of behavioral factors such as fear and greed or indeed irrationality and shortsightedness on the part of market actors is indisputable (see e.g. Lo 2011 who even interprets them as a key cause of the crisis), they cannot sufficiently, i.e. on their own explain either the nature of the crisis nor its timing, meaning when or why it broke out – as we will see in due course in the context of the discussion of systemic risk, the system properties and dynamics of global finance and the systemic nature of the crisis – though they no doubt contributed to the developments of 2007 and beyond in a critical way (see, for instance, Akerlof and Shiller 2009 on the effects of human psychology on the economy). In fact,

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174 As a model for credit intermediation securitization was endorsed and viewed as overwhelmingly positive by many official institutions, including the IMF (e.g. IMF 2005). As such, regulators are by no means free from blame and may even have contributed substantially to an increasingly complex and tightly coupled system (Guillén and Suárez 2010). In any case, the self-regulatory capacity and efficiency of financial markets was most certainly overestimated. See also Woolley (2010) on related inefficient and exploitative tendencies in financial markets.

175 An interesting fact in this respect is the fact that despite the prevailing post-crisis focus on complex structured products as the principle cause of the crisis, the most widespread cause of the failure of financial institutions was in fact deficient traditional lending, which regulation can do little to mitigate apart from regulating lending standards and credit conditions (see, for instance, Jenkins 2013a on this subject, citing the UK’s parliamentary commission on banking standards). The crisis was thus as much about deficiencies in traditional banking activities as about markets as such, implying that traditional banking is crisis-prone too, in which case the issue of resolution is paramount irrespective of bank structures and business models.

176 These categories were devised by the Financial Times in a study analyzing 34 financial institutions that failed during the crisis, singling out the principle reasons for their failure. As to whether they have been addressed appropriately, the study argued in 2013 that regulators had indeed addressed them to a degree via (i) higher capital requirements phased in via Basel III, (ii) a reduced reliance on short-term market funding via incoming liquidity and funding structure requirements fostering stability, (iii) legacy lending and bad investments are being offloaded and new rules on derivatives clearing and rating agency supervision have come into effect, while (iv) de facto curbs on large, cross-border mergers and acquisitions have been established (Jenkins 2013a).

177 Additional accounts from other scholars and practitioners include, for instance, those that can be distinguished in terms of their unorthodox, yet increasingly accepted nature, for instance those arguing that there has been a systemic failure of financial capitalism, democracy and/or neoliberalism (Crouch 2011; Streeck 2011), or those that apportion blame to paradigms – such as Fama’s (1970) Efficient Market Hypothesis or the Rational Expectations Theory – adhered to by regulators and market actors alike that did not allow for intellectual diversity – rather than focusing on systemic or behavioral factors as such (see, for instance, Gamble 2009; Mügge 2011a; Shiller 2003, 2010; Soros 2008). See also the prominent economist Andrew Smithers’ (2009) criticism of policymakers over-reliance on the efficient markets hypothesis and the self-correcting capacity of asset price bubbles.
as challenges that are rooted in human nature, including factors that can be traced back to human interaction, and therefore embedded in the system as such, behavioral elements are particularly relevant in the immediate crisis context as they can exacerbate crisis dynamics once a crisis has broken out – for instance, to name just one example, as the entire financial system is built on trust, fear has the potential to trigger fire sales – the implications of which are discussed later on.\(^{178}\)

Though the distinction between behavioral and systemic explanations with respect to crisis causes may not be entirely clear-cut and useful in a strict sense – as the elements of both factors are without doubt interdependent, their interplay is at the heart of most crises (as described above, multiple overlapping subcrises contributed to the crisis), and both must inevitably be taken into account for a comprehensive conceptualization and theoretical contextualization of systemic risk\(^{179}\) – it is indeed relevant in the sense that differing interpretations of crisis causes and their corresponding narratives – employed by regulators and policymakers as policy entrepreneurs to advance reform propositions (see Kingdon 1984 on policy streams; see also Lieberman 2002 on an application of theoretical elements in this respect) – significantly impact the policies adopted in the aftermath of crises, and as such are of crucial significance – most importantly, given their diverging implications for reform and their ramifications in terms of defining governance imperatives.

While official post-crisis assessments and reports – as alluded to above – do not attribute blame to single causes as such, i.e. in a strict sense – with the most prominent being the reports by De Larosière (2009), the FCIC (2011) and the FSA (2009) – they do tend to focus on selected elements, isolated processes and products, or individual actors – in which behavioral elements and human misconduct feature prominently among the factors advanced as central contributing causes (see Carmassi et al. 2009; Woolley 2010 for similar approaches and interpretations in academia). These factors include, for instance, OTC derivatives, mark-to-market accounting and rating agencies, flawed corporate governance and risk management, excessive borrowing and risk-taking, or misconduct within the industry in addition – or indeed due – to flawed incentive structures. They also often lay a large part of the blame on regulators and supervisors.\(^{180}\)

What they tend to lack, however, are systemic perspectives and analyses (see Willke et al. 2013 for a similar interpretation).\(^{181}\) In effect, what they often fail to do is progress beyond “individual items and

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\(^{178}\) Behavioral aspects are not characteristics of the system as such – though they can obviously have a substantial impact on system dynamics, and as such are of importance as, for instance, human misconduct or behavioral elements can have substantial systemic implications. Some scholars even argue that they were at the heart of, i.e. the main cause of the crisis (e.g. Lo 2011; Perrow 2010; Woolley 2010).

\(^{179}\) Indeed, it is argued that one cannot exclude either systemic or behavioral elements from a comprehensive analysis, though in the present research emphasis is placed on systemic explanations arguing that this crisis may indeed be distinguished from former crises on the basis of its systemic nature – with this having implications in terms of both the analysis of the crisis and its respective imperatives in terms of regulatory governance and the reform thereof.

\(^{180}\) See, for instance, the US Financial Crisis Inquiry Commission (FCIC 2011) and the European De Larosière Report (2009).

\(^{181}\) This applies to both the crisis causes and symptoms as well as the reform propositions advanced. Ultimately, “[i]solated details contributing to the disaster have been known quite well, and have been analyzed thoroughly in myriads of papers and reports, which have led to an impressive number of concrete proposals for reform. […] missing sorely is a concept for dealing with the systemic properties of financial systems and, in particular, with those properties which might engender systemic risk” (Willke et al.
isolated features” (Willke et al. 2013: 213) with respect to both the causes of the crisis and, accordingly, the respective elements of reform, which is, in essence, the very “point of a systemic view on systemic risk” (ibid.). This, unfortunately, gives rise to the danger of reacting “to surface symptoms without a deeper understanding of the special features of the system dynamics of global finance” (Willke et al. 2013: 54) which is ultimately a highly complex and tightly coupled system susceptible to normal accidents and systemic risks. While this research prioritizes the systemic variant or explanatory approach, it does take behavioral elements into account (for instance in section 4.2.2 when expounding a political economy definition of systemic risk). It should be noted, however, that it is above all the systemic consequences of behavioral and structural issues that are at stake in this context.

Systemic narratives, in contrast to behavioral explanatory approaches – with which, for instance, Levitin (2014), Palmer and Maher (2010) and Willke et al. (2013) concur, as do we – focus on the system properties that led to the crisis by giving rise to a qualitatively new phenomenon in the form of systemic risk, interpreting the crisis as systemic as opposed to merely system-wide or system-encompassing and arising from the normal operational mode of a tightly coupled and highly complex financial system such as the one that exists today in the 21st century. Theorizing the crisis and its causes as well as the respective implications for the policy response in this vein and against this backdrop requires looking into and carefully examining the evolution of modern finance throughout the past decades and in the post-Bretton Woods financial system and has substantial implications for the conclusions drawn in terms of resulting governance imperatives (in the context of post-crisis supranational regulatory reform. In sum, it is argued that due to the systemic nature of the crisis and the system properties of the modern financial system, cross-border financial governance and integration is inevitable in order to keep systemic risk in check and simultaneously deal with and mitigate the negative externalities it produces when it materializes.

In the context of systemic narratives and explanations of the crisis, it is useful to distinguish between structural weaknesses of the system conducive to crises as underlying causes and the triggers of crises as such, i.e. the factors that precipitate their materialization. A range of endogenous events such as for instance the disorderly failure of a financial institution that is perceived to be too big to fail (as was the case with the bankruptcy of Lehman Brothers in 2008) or shocks exogenous to the financial system may trigger a systemic crisis though they do not ultimately constitute the underlying causes of the crisis. Rather, the latter are structural flaws and weaknesses (among others macroeconomic imbalances, private and public debt overhang, 2013: 222). As will be discussed at length, this insight or rather the underlying insights embedded therein – that is the systemic consequences that arise from the normal operational mode of a tightly coupled system given the underlying system dynamics and properties of global finance – has substantial implications for both reform propositions and elements as well as for financial governance more generally.

Though the UK’s FSA (2009: 28) alluded to financial system characteristics and the potentially dangerous interplay of developments such as macroeconomic imbalances, increasing complexity and financial sector growth as well as an unsustainable credit boom and asset price inflation, while the European assessment, the De Larosière Report, argued the crisis had resulted “from the complex interaction of market failures, global financial and monetary imbalances, inappropriate regulation, weak supervision and poor macro-prudential oversight” (De Larosière 2009: 13) – of which the most important are the latter in this context – they did not explicitly address systemic issues and systematize or contextualize the system properties of global finance sufficiently – which is a key flaw of the post-crisis regulatory response as will become clear throughout.

This is in line with interpreting the crisis as a normal accident in accordance with Perrow’s (1981, 1984) definition.
excessive leverage, funding models prioritizing debt over equity and the like) and system properties (instability, complexity, interconnectedness, risk and uncertainty). If the implications of a systemic narrative of the crisis are taken to heart, it becomes evident that regulators and policymakers cannot mitigate all potential triggers and must therefore place their emphasis on attenuating the financial system’s structural weaknesses (Perrow 2007). As we will see throughout, however, the alteration of the system’s underlying structural tenets – and hence its weaknesses – is an extremely contentious endeavor, while system properties of finance such as instability and uncertainty (discussed at length in section 4.3) imply that crises cannot be impeded altogether. The imperative must therefore be the build-up of (cross-border) capacities to deal with the fallout from crises when they materialize given the prevalence of cross-border finance and the European single market. The construction of crisis resolution and management capacities also has indirect preventive and deterrent effects in a behavioral sense, i.e. mitigating moral hazard if resolution regimes and cross-border capacities are credible.

Ultimately, in the European context, the crisis may be interpreted as a catalyst for (i) more stringent (re-) regulation on the one hand, and (ii) the integration of governance schemes, i.e. the construction or overhaul of cross-border regimes on the other. With regards to the former – though it is perhaps too simplistic to state that there has been fundamental change in prevailing belief systems, a “massive rethinking of the role of the government and of the market” (Stiglitz 2009b: 345) or a wholesale paradigm shift toward reregulation, the trend in the immediate post-crisis era did indeed point in this direction. In terms of regulatory paradigms – if not with regard to the construction and fundamentals of the financial system as such – change is embodied in the concept of macroprudential regulation and supervision and its rise to prominence on the policymaking and reform agendas in the post-crisis era. While microprudential

184 Structural flaws include vulnerabilities in both the financial system as well as in the regulatory and supervisory architecture. They are inevitably intertwined and not only presented the basis for the crisis, but also amplified initial shocks (Bernanke 2010b: 1). In this context, underlying structural deficiencies of the financial system, which can be interpreted as causes that contributed to the crisis, include weaknesses in underlying macroeconomic and financial fundamentals such as pervasive over-indebtedness and undercapitalized financial entities coupled with overvalued assets in the context of which risk is underpriced further aggravating instability in the process (and in turn worsening the crisis in terms of its depth, reach and economic externalities). In essence, the burden of debt and overvalued assets can be borne by the participants of market economies if and only if losses can be absorbed so as to maintain the flow and supply of credit to the real economy (Tucker 2014). The situation becomes untenable, however, if system components (i.e. firms) are unsound from the outset and are consequently more vulnerable to impending liquidity crises. As evidenced in 2007 and 2008, system fundamentals were weak to begin with and when money markets broke down, reliance on short-term funding proved fatal as market funding effectively evaporated.

185 Predicting both random triggers and the interplay between structural weaknesses, the effects of human psychology and the unintended consequences of regulatory action and market developments is impossible. Triggers are indeed as unforeseeable as their consequences (Taleb 2007, 2012; Wille et al. 2013). The argument throughout is ultimately that both in the form of exogenous events or endogenous shocks they can neither be fully anticipated nor mitigated, while the system’s dynamics cannot be steered and controlled in light of the system properties of the financial system. In addition, underlying structural flaws are often path-dependent and self-reinforcing. The starting point for systemic risk is thus underlying structural flaws and weaknesses. Systemic narratives highlight that crises as such cannot be stopped and triggers are hard if not impossible to anticipate, and therefore governance regimes must be tweaked in order to deal with crises when they arise. The consequence of finance’s underlying instability and structural weaknesses in the system is ultimately that governance mechanisms are of utmost importance.

186 The imperative – as we argue throughout – is therefore either the build-up of cross-border capacity or fundamental system change.

187 With reference to the discussion of a potential paradigm change the question arises as to whether the concept of a paradigm shift from deregulation to reregulation is perhaps too simplistic as it has no bearing on the quality of the reregulation taking place. For instance, do regulatory developments reflect a change in technical paradigms rather than genuine change in terms of broader economic beliefs (see e.g. El-Erian 2017b)? This issue is revisited and should be borne in mind throughout.
regulation and supervision revolves around ensuring institutional safety and soundness at the micro-level of institutions and market infrastructures that given their size, business models, interconnectedness or political centrality and salience have the potential to precipitate systemic crises. Macroprudential regulation and supervision seeks to safeguard system stability, i.e. the stability of the system in its entirety. The two are inherently intertwined and both highly complex and challenging (De Larosière 2009). Yet while the microprudential agenda and regulatory toolkit has been implemented, under scrutiny and tweaked and continually adapted for some time, macroprudential policy is in its infancy. Despite the advances made to date, designing and implementing the tools and mechanisms of a macroprudential framework remains challenging, while the understanding of their impact is limited (Tucker 2014; Wolf 2014b). In addition, though the notion of system stability and the necessity of system-wide and system-related perspectives is at the heart of the post-crisis consensus in terms of regulatory takeaways and paradigms – it is indeed questionable whether the ‘macroprudential turn’ or ‘revolution’ represents – or the change embodied therein is sufficiently profound as to qualify as – a genuine paradigm change in the sense of an ideational shift (Baker 2013b, 2013c, 2014) or might rather be interpreted more appropriately as simply an additional perspective and new approach within the old architecture and its ideational framework (Baker 2013a, 2013c, 2014). Most important, however, is how its implementation, which is bound to be fraught by substantial difficulties in regulatory, political, organizational and technical terms, will play out throughout the next decades and whether it and its tools and mechanisms will be able to contribute effectively to mitigating systemic risk and managing crises when they arise.

Safeguarding financial stability essentially implies taking account of system-related and macro-level developments and dynamics in financial markets. This insight is at the heart of the debate on systemic risk – the overarching issue in the context of the financial crisis which in turn is at the core of the macroprudential agenda – and it is to the debate on systemic risk to which we now turn. The following introduces and frames the concept of systemic risk that emerged on the post-crisis agenda, assesses how the phenomenon has been analyzed and employed in the mainstream debate to explain the crisis and assess its underlying causes and dynamics, namely by distinguishing between partially competing economic and political approaches aimed at conceptualizing systemic risk, and thereafter constructs an integrated approach directed at defining it, which is then employed throughout to analyze the viability of the financial governance regime established in the European context in terms of its potential for systemic risk mitigation. It essentially casts systemic risk in a nuanced light and combines systemic and political economy elements to construct a comprehensive politico-economic definition and approach on the basis

188 As will be discussed in section 4.5, it is hard to clarify definitively whether and to what extent this is indeed the case and most likely it will require more time to research it and its implementation throughout the coming years. Yet though to a degree things have changed, macroprudential regulation is not a magic bullet and is to be taken with a grain of salt as it is employed in a system which is as fragile and contagion-prone and tightly coupled as ever – the question is therefore whether it will suffice or succumb to the same deficiencies as the pre-crisis approach. In addition, it is during booms and times of economic expansion in which these instruments (for instance countercyclical capital buffers) ought to be employed and unfortunately this does not appear to be the case to the extent that would be justified given the length and severity of the previous recession (El-Erian 2017b; Wolf 2017).
of Willke et al. (2013) which integrates both economic and political determinants as well as systemic and behavioral factors, reflecting the discussion above. This interpretation has significant implications for the analysis and evaluation of governance regimes at stake throughout – with respect to both what they have achieved in light of reform and what they should attempt to achieve in future.

In summary, and before proceeding, it is important to note that it is argued throughout – based on the insights established in the following – that the crisis and hence the emergence of systemic risk was not solely the cause of excessively loose monetary policy, lax regulation, deficient internal risk management systems, perverse incentives or faulty remuneration and the like in the private sector, but rather the consequence of an unprecedented new quality arising from the idiosyncratic concatenation of sub-crisis and triggered by the confluence of multiple behavioral, structural and systemic factors with substantial political implications given the scale of the turmoil it induced (Willke et al. 2013). This assumption and these two spheres, i.e. the behavioral and the systemic, are at the heart of the definition of systemic risk employed throughout and presented in the following section to which the research now turns.

4.2 Framing the Emergent Systemic Risk Debate

Systemic risk became a buzzword in the aftermath of the financial crisis as the latter was widely regarded as “the first truly systemic and acute crisis to occur against the backdrop of the modern regulatory state” (Levitin 2014: 1; see also Levitin 2011; Willke et al. 2013). And indeed, the crisis surpassed all that had been witnessed previously, while neither the regulatory and policymaking elite nor the financial community were prepared for its scale and destructive capacity (El-Erian 2017b). This does not imply, however, that systemic risk was not an issue on either academia’s or the regulatory community’s agenda previously. It had in fact been an issue in finance and economics as well economic policy for some time (see, for instance, Allen and Herring 2001; Davis 1995; De Bandt and Hartmann 2000; Freixas et al. 2000; Group of Thirty 1997; Hellwig 1998; Kaufman 1996), though its relevance in both theory (i.e. academia) and practice (i.e. policy) had been rather limited. Yet even then, in the pre-crisis era, research and debates on systemic risk were largely confined to the disciplines of finance and economics.

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189 Distinguishing this crisis as King (2010) notes is the fact that it dwarfs anything witnessed to date in terms of its scale and global reach despite recurrent bouts of instability throughout the past decades. The difference of this once in a lifetime crisis is the fact that its constellations and constitutive elements had never been witnessed before on a similar scale, i.e. in terms of their depth and breadth, including the underlying complexity, speed, pervasiveness and potential for contagion that the crisis exhibited as well as the degree of its cross-border externalities, global reach and the ensuing fallout in terms of recession and sovereign debt turmoil. Though the crisis in Asia at the turn of the century may have been the first genuinely international crisis (Tucker 2014), 2008 was undoubtedly the first systemic crisis (Levitin 2014; Willke et al. 2013) to challenge the modern regulatory state.

190 On the related issues of excessively large financial institutions in crises, including issues of failability and the moral hazard produced by bailouts at stake later on in this contribution see, for instance, Boyd and Gertler (1994), Feldman and Stern (2004), Mayer (1975) and Mishkin (2006).

191 Though concerns and issues pertaining to both systemic risk and the concept of macroprudential regulation and supervision, i.e. the need for holistic system-wide perspectives (discussed at length in section 4.4 with regard to its rise to prominence on the post-crisis regulatory reform agenda and its implementation therein), had indeed been voiced and addressed prior to the crash in
In the aftermath of the crisis, however, systemic risk-related research and analyses increased exponentially, including accounts from multiple different disciplines. A distinguishing feature of the post-crisis debate, for instance in theoretical terms, is ultimately the increasing involvement of adjacent disciplines, i.e. the widespread interest from multiple disciplinary angles in which, in addition to cutting-edge research from the realm of finance and economics (see, among others, Engle et al. 2012; Gai 2013; Hansen 2013), insightful additional perspectives and interdisciplinary analyses were contributed by sociologists (see, for instance, Lounsbury and Hirsch 2010), legal scholars (including, for instance, Anabtawi and Schwarcz 2011; Levitin 2011, 2014; Schwarcz 2008, 2014) and various other disciplines and traditions.

This notwithstanding, and though additional perspectives and insights have contributed significantly to clarifying the subject matter and laying the basis for both the policy debate and reform, there has been limited consensus as to systemic risk’s precise definition and nature (Willke et al. 2013). Interestingly, the post-crisis research wave did not necessarily deliver clarity with respect to succinctly theorizing and operationalizing the latter. This section therefore revisits the concept of as well as the debate on systemic risk, thereby distinguishing between the pre- and post-crisis debate in academia and regulatory circles. It first analyzes its nature and clarifies conceptual issues, whereafter it discusses diverging accounts of systemic risk that have been advanced in the theoretical discourse, more specifically economic and political perspectives, and combines both in an integrated and nuanced political economy approach based on the contribution of Willke et al. (2013). To construct a working definition of systemic risk and lay the foundation for the analysis, essentially building on the comprehensive approach set out by Willke et al. (2013), it thereafter delineates the elements of the conceptual frame against the backdrop of which the research is conducted by combining a systems theory perspective on systemic risk and the consequences of uncertainty and a political economy perspective on its political roots from which in turn – after the elaboration of the financial policymaking circles – as discussed previously in section 3.3 on regulatory paradigms – they could not, however, assert themselves on the policymaking agenda and were not seriously considered, let alone implemented or embedded in the policy approach of the time. Instances in which they were mentioned include, for instance, the late 1970s when the Bank for International Settlements (BIS) alluded to the concept of macroprudential regulation in a publication on the threats posed by an exponential increase in financial activities and the fact that financial institutions underestimated tail risks as well as liquidity and funding risks, all of which could be witnessed during the crisis, drawing attention to the fact that macroprudential supervisory measures “may need to be matched by prudential considerations with a wider perspective” and consider issues “that bear upon the market as a whole” (Clement 2010). It was mentioned again in 2003 by a BIS economist (Borio 2003), yet to little or no avail in terms of its relevance for practical policy.

192 These also include geographical and jurisdictional analyses of relevance. See, for instance, economic analyses on systemic risk in the European context (Engle et al. 2012), predominantly economic analyses on systemic risk regulation in Europe (Weder di Mauro and Klüh 2010), systemic risk in terms of supervisory fragmentation, or more specifically nationally fragmented supervision over multinational banks as a source of systemic risk applied to the European context (Ferrarini and Chiodini 2012), or analyses on risks and challenges inherent in designing the banking union to curb systemic risk (Wagner 2012) and cross-border capital flows and systemic risk as reference points for market integration (Haar 2014).

193 Additional perspectives and foci include, among others, political economy analyses such as, for instance, on systemic risk in the US context (see e.g. Coffee 2012), or analyses of global governance and systemic risk in the 21st century (see e.g. Goldin and Vogel 2010).

194 In this context, Willke et al. (2013) primarily draw on two prominent contributions by Schwarcz (2008) and Levitin (2011) which establish sophisticated frameworks for analyzing systemic risk.
system’s evolution and properties – governance imperatives with respect to the revelations of the crisis can be deduced in order to advance the debate on cross-border financial governance.195

4.2.1 Defining Systemic Risk: A Systems Theory Perspective

As alluded to above, and contrary to widespread perception, systemic risk as a rationale for regulation has been acknowledged in both the policy and academic community for quite some time. Weistroffer (2012), for instance, refers to the term’s usage at the turn of the century in Asian countries’ policymaking communities in their attempt to mitigate identified vulnerabilities.196 In addition, pre-crisis publications and analyses from both scholars and practitioners including, for instance, ECB and BIS officials that acknowledged systemic risk – including those that anticipated the crisis or at least predicted some of its features and dynamics – distinguish and assess foci like the role of large financial institutions and the concept of too big to fail (e.g. De Bandt and Hartmann 2000; Geithner 2004; Feldman and Stern 2004; Hellwig 1998; Mayer 1975; Mishkin 2006), the incompatibility of globally active institutions and nationally-denominated supervision (e.g. Group of Thirty 1997), the need for macroprudential perspectives (e.g. Borio 2003), issues of contagion given the high degree of interconnectedness in the system, and the potential adverse effects of complex products and processes such as OTC derivatives and securitization (e.g. Buffet 2002).197 Yet as discussed previously with respect to regulatory paradigms, though concerns pertaining to systemic risk, the concept of macroprudential regulation and the sustainability of developments in the financial markets more generally had been voiced prior to the crash in both academia and policymaking circles, they could not assert themselves on the regulatory agenda and were not sufficiently acknowledged or seriously considered, let alone embedded in the policy approach of the pre-crisis era. Ultimately, the paradigm that dominated throughout the decades preceding the crisis – subsumed under the rubric of free-market capitalism and characterized by progressive and unfettered liberalization and deregulation – prevailed, in consequence impeding the recognition of threats to the system and the acknowledgement of vulnerabilities building up under regulators’ watches (El-Erian 2017b; Johnson and Kwak 2011; Rajan 2010; Willke et al. 2013).

This changed, however, in both the post-crisis academic and policy debate and with respect to the regulatory approach adopted. The financial crisis ushered in a reversal of sorts – in terms of both the focus on systemic risk and the new emphasis on enhancing financial stability and crisis management

195 In analytical terms, the employed approach breaks the concept down further and explicitly differentiates between a systemic component and a political economy element to inform the subsequent analysis. Limited attention has been given to the interplay between these two elements, particularly in the European context, while discussions of the substance and content of governance on the one hand and institutional governance structures on the other are usually conducted in isolation (see Mügge and Perry 2014). It is in this context that this contribution is placed.

196 See Johnson and Kwak (2011) and El-Erian (2017b) for similar interpretations – especially with regard to the issue of complacency and the illusion that the Western political and economic system was superior in terms of providing for stability and mitigating moral hazard given the absence of crony capitalism in this jurisdiction. See also Borio (2003).

197 See also Rajan (2005) and Shiller (2005) for perceptive academic contributions in this respect.

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capacities by official sources (e.g. Financial Stability Forum 2008, 2009), think tanks (e.g. Warwick Commission 2009) and academia (for an early yet comprehensive literature review, see Galati and Moessner 2011). This notwithstanding, and despite the new found interest therein in the aftermath of the crisis, the phenomenon of systemic risk and related terms and notions such as macroprudential or systemically important were by no means established concepts – neither in the academic nor the financial policy community (Willke et al. 2013: 16). Accordingly, attempts to define the latter have proliferated and produced substantial confusion with approaches differing considerably. They will be discussed in the following.

Defining the Nature of Systemic Risk and its Central Features

On an overarching and abstract level, systemic risk can be framed as one of the most complex and multifaceted societal dilemmas facing governance in the present era which tests the limits of both democracy in its current constellation and static normative regulatory regimes in their current form (Willke et al. 2013: 7). Systemic risk is essentially the emergent property, i.e. the result of an increasingly complex, knowledge-intensive and tightly coupled as well as inherently unstable, crisis-prone and integrated cross-border financial system of global reach (International Organization of Securities Commissions 2011; Palmer and Maher 2010; Willke et al. 2013), a defining quality of which is the fact that it is produced by non-knowledge, uncertainty, opacity and surprise. Owing to the way in which the global financial system evolved throughout the past decades – essentially having undergone a fundamental transformation into a complex tightly coupled system and thereby exacerbating the instability to which finance is inherently prone – it has become increasingly vulnerable to black swans (Taleb 2007), which denote the occurrence of extreme and high-impact yet low-probability events, and normal accidents (Perrow 1984) in the context of which systemic risk is engendered by the normal yet dangerous operational mode of the system as such and may ultimately be interpreted as constituting a “qualitatively new” phenomenon (Willke et al. 2013: 8) in view of the manner in which global finance has evolved. Both black swans and normal accidents which give rise to systemic crises are unpredictable and therefore constitute imminent threats that governance must inevitably prepare for. Ultimately, the dangers inherent in the system as such present a fundamental lesson of the crisis – confronting both national regimes and cross-border schemes with the dilemma of governing an increasingly complex and to a degree ungovernable system.

The emergence of systemic risk is, by definition, unpredictable. In this context, it is crucial to distinguish between the concepts of risk and uncertainty as originally set out by Knight (1965; see also Willke et al. 2013). While the former pertains to the existence of uncertain future outcomes despite certainty with respect to their probability, the latter applies to situations in which variations in future outcomes as well as “the probabilities associated with possible future outcomes – indeed, possibly even the nature of future outcomes – are not known ex ante” (Stout 2012: 1180; emphasis added) which is analytically consequential as it would, in theory,
imply that we are in fact dealing with system-wide uncertainties in the context of systemic crises (Willke et al. 2013: 9).

In terms of governance – as a core dilemma thereof – this implies that preventive regulatory measures and attempts at preemptive policy invariably contain “considerable margins of error, uncertainty and non-knowledge” (Willke et al. 2013: 18) and are therefore inevitably fallible. The resulting challenge and indeed imperative in terms of governance is to construct a modus vivendi of dealing with systemic risk as there is no solution to systemic risk as such. While this does not imply that prevention is futile – indeed, in view of a constantly evolving system ongoing systemic risk analysis is imperative in order to monitor developments in financial markets and foster a more fine-grained and contextual understanding of the conditions that engender financial instability as well as causal relationships in this regard – the financial crisis made clear that the creation of robust crisis management structures and contingent reactive capacities – in the European context preferably in the form of a cross-border governance regime – is of utmost importance as crises are essentially unavoidable, while regulatory caution and reflexivity must prevail (Mügge and Perry 2014) given the role regulation and the political system as such can play in engendering systemic risk.

Explanatory Approaches to Systemic Risk in the Post-Crisis Debate

While the above presented an introductory account of the fundamental nature of systemic risk and its governance implications, the following provides a brief yet critical account of the respective approaches to defining systemic risk advanced in the post-crisis debate, which is followed by an in-depth analysis of the constitutive elements of the definition of systemic risk employed throughout from which the rationale for extended cross-border governance regimes and reactive capacities can be deduced.

In an attempt to define systemic risk, official international and European financial institutions and governmental reports largely adopted economic approaches to systemic risk. In a joint report in the immediate aftermath of the crisis, the Bank for International Settlements (BIS), the Financial Stability Board and the International Monetary Fund, for instance, argued systemic risk was essentially the risk of disruptions to the system precipitated by “an impairment of all or parts of the financial system” with “the potential to have serious negative consequences for the real economy” (BIS, FSB and IMF 2009: 5–6), while the ESRB maintained it was the “risk of disruption in the financial system with the potential to have serious negative consequences for the internal market and the real economy” (ESRB Regulation: Article 2) in large part mirroring the former.

Many scholars first and foremost economists concur with this definition, for instance, drawing attention to the fact that systemic risk is the risk of a “localized” adverse shock such as the failure of an individual institution or market negatively affecting the economy at large (Anabtawi and Schwarcz 2011: 2), while many pre-crisis definitions of systemic risk from the academic and policy sphere are in line with this...

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198 For the sake of simplicity, however, the term systemic risk is employed throughout reflecting the dominant trend in the academic debate.
narrative. The Group of Thirty (1997: 3), for instance, defines it as a “sudden, unanticipated event that would damage the financial system” and impact the wider economy adversely as a consequence, arguing that to be labeled systemic crises must *reverberate throughout and threaten the financial system* (ibid.).

While it is no doubt “difficult to define” (IMF 2009: 36) despite being employed widely and no “precise definition of a ‘systemic’ problem exists” (French et al. 2010: 36) as such, what definitions that focus on economic elements and define systemic risk exclusively in economic terms omit, however, are the potential political ramifications that flow from the impact of systemic crises in broader sociopolitical terms, while simultaneously often lacking a discussion of what systemic ultimately implies beyond being merely system-wide (discussed in the following).

*Systems Theory Perspectives on the Emergence of Systemic Risk in More Detail*

The financial crisis of 2008 was undoubtedly a manifestation of the harm a system can cause that has become too complex and overextended in relation to its underlying purpose. As set out in the introduction, contributions to the topic of systemic risk increased exponentially in the aftermath of the financial crisis.\(^{199}\) What the post-crisis debate lacked, however, especially in political science, was a systematic discussion of what is genuinely systemic and what truly constitutes systemic risk.\(^{200}\) On the basis of the research conducted by Willke et al. (2013), it is argued that systemic risk is ultimately an emergent property of, i.e. a risk that emanates from a highly complex and tightly coupled system, essentially resulting from the normal, yet also dangerous operational mode of the financial system in its current form – as opposed to scholars that interpret systemic risk as a risk that threatens the entire financial system and is essentially – or in fact merely – of a system-wide nature as, for instance, most economists do (see e.g. Anabtawi and Schwarcz 2011; Schwarcz 2008). In this context, when describing the financial system’s basic properties, features and dynamics, defining systemic risk and elucidating the regulatory governance imperatives, the research builds on critical insights from systems theory.

The notion of systemic risk challenges mainstream assumptions of the economics discipline which largely fails to incorporate concepts such as uncertainty, systems or complexity theory adequately (Kay 2016). Without systems thinking, for instance, systemic risk is merely employed metaphorically (Willke et al. 2013: 19). At the heart of the phenomenon of systemic risk is *not* that the system however defined may crash, but rather “that the completely normal, regular operational mode of the system, as it is, can lead to the self-destruction of the system” (ibid.). As is the case in other (e.g. social or ecological) systems and contexts, the financial system, which exhibits practically all features of complex dynamic systems “such as opaqueness, nonlinearity,

\[\text{(199) Though, *systematic or systemic risk* – which in economics denotes undiversifiable, market or aggregated risk (i.e. macroeconomic or aggregate risks that cannot be mitigated via diversification) (Hansen 2013) – was an issue in finance research previously, it was not subject to intense or systematic scrutiny, while it was virtually nonexistent in political science.}\]

\[\text{(200) Indeed, there was substantial confusion as to “what types of risk are truly ‘systemic’” (Schwarcz 2008: 196).}\]
counter-intuitive behavior, self-referentiality and operational closure” (Willke et al. 2013: 217), is an “unpredictable accumulations of effects” and “suddenly occurring irreversibilities” (Luhmann 2008: 186; see also Becker 2016; Willke et al. 2013) and gives rise to the emergent property (described below) of systemic risk which essentially refers to the risks inherent in the normal yet dangerous workings of a complex, interconnected and tightly coupled global system.\(^{201}\)

Composed of autonomous actors which predominantly interact in a non-linear fashion,\(^{202}\) the modern financial system is a complex and tightly coupled system (IOSCO 2011; Palmer and Maher 2010; Schneiberg and Bartley 2010; Willke et al. 2013)\(^{203}\) which—in contrast to linear and loosely coupled systems—is characterized by a high number of interconnections which in turn exhibit diverse types of connections, including branching relationships and feedback loops in addition to direct common mode connections, and as such is exceedingly difficult to govern. In this context, the nature of the relationships between and the interactions of these actors become increasingly incomprehensible and unpredictable for both agents within the system conducting the transactions as well as those intending to oversee them (Becker 2016; Palmer and Maher 2010; Senge 1996; Willke et al. 2013).\(^{204}\) Characterizing interactions in complex systems are both the nature of the relationship between the actors to one another and the nature of their interactions. While actors are mutually coupled and adaptive, their interactions are non-linear, implying that in complex systems constituent components interact in a non-simple and unpredictable way, while the whole is essentially more than the sum of its parts (Minsky 1988).

Of significance in this context is that complex and tightly coupled systems are robust yet fragile (Gai 2013) and exhibit a low degree of resilience—which ultimately gives rise to and exacerbates the inherent instability that characterizes the modern financial system (Kindleberger 1978; Minsky 2008; Turner 2015). The characteristics of the system that underpin and foster these qualities are the fact that performance standards inherent in the system are high, implying that if certain requirements are not fulfilled, the entire system breaks down, while design requirements are rigid in the sense that there is limited scope for alterations and swift revisions when unforeseeable developments arise, a low degree of redundancy prevails, implying if a system component fails, the entire system is likely to do so as well, and that at rapid speed once a tipping point is

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\(^{201}\) Similar crises, such as for instance natural or technical desasters, have occurred in other complex systems as well. Examining an accident at the US nuclear power station Three Mile Island, Perrow (1984) established the Normal Accident Theory, which Palmer and Maher (2010) draw on to explain the financial crisis of 2008.

\(^{202}\) Non-linear interactions are ones in which there are no simple cause and effect relationships (Helbing 2010; International Risk Governance Council 2010).

\(^{203}\) A tightly coupled financial system (the evolution and properties of which are discussed in depth in the following chapter) may be defined as differing from a loosely coupled financial system with respect to (i) the degree of interdependence between the system’s components and the nature of their relationships, (ii) the increasing integration of national financial systems into a global entity, blurring the boundaries between the nation state and the global system in the process, (iii) the increasing abolishment of financial market segments resulting in the re-emergence of financial conglomerates, (iv) the increasing influence of non-state and partially unregulated actors such as rating agencies, as well as (v) the increasing homogeneity with respect to regulatory paradigms, economic assumptions and risk strategies (Willke and Willke 2012: 42; see also Becker 2016).

\(^{204}\) The financial system has indeed become increasingly interconnected and evolved from a linear to a complex system in which financial integration and the evolution of products and processes such as, for instance, securitization have altered the nature and composition of the system as well as the degree of interdependence within the system in turn making it far more complex, unpredictable and unstable. These developments will be discussed and contextualized in depth in the following subchaper.
reached \cite{Becker2016;PalmerMaher2010}. Also of significance in this context is the high degree of 
reciprocity — in a sense interdependence — that prevails in complex systems such as the financial system in
which system connections and system interactions need not be direct in any shape or form, but may rather
be and often are constituted by indirect mechanisms and processes. Distrust or rumors stoking fear and
panic, for instance, are sufficient to induce substantial reverberations throughout the entire system and
engender self-reinforcing, recursive and cyclical dynamics of which fire sales and contagion are prime
examples and which contribute to and increase the instability of the system as such \cite{Becker2016;Schwarcz2008;Willkeetal2013}.

Against the backdrop of the described characteristics of complex systems it is clear why they — and
thereby also the financial system — exhibit a high degree of fragility and why the cautious and pragmatic
governance thereof is both so important and so difficult. In addition to those elaborated above, however, the
modern financial system exhibits additional features of relevance, i.e. attributes that characterize complex
systems and are conducive to systemic risk.\footnote{The overarching system characteristics that serve as the basis for the complex tightly-coupled financial system that exists today and lay the basis for these dynamics to unfold are conceptualized in the following section 4.3.} Another characteristic of complex tightly coupled systems
of utmost importance for the analysis at stake is, for instance, the fact that complex systems give rise to
emergent properties which are produced by the non-trivial interaction of the system’s elements \cite{Minsky1988}. In this context, new system properties — which can only be explained with reference to the overall
operational logic of the system they are a part of yet not by the nature of their individual components
\cite{Willkeetal2013:19} — are produced by the systemic coupling of the system’s elements, producing “a
particular pattern that closes itself through a cycle of operations” \cite{Allport1954:288} and giving rise to
“new levels of organized complexity” \cite{Willkeetal2013:20} via emergence — a central notion in systems
thinking.\footnote{See Willke et al. \cite{Willkeetal2013:20–22} for an in-depth discussion of the concept of emergence in this context.} Emergence as a feature of complex systems describes the incremental and per chance
evolution of a coherent context which emerges as a viable and novel system and may ultimately be framed
as an improbable order. The emergent properties that arise cannot be explained via their constituting
components (i.e. from a micro-perspective), but rather must be explained with a view to the systemic
context and their interaction. The consequence of such emergent properties, which are essentially novel
patterns arising from interactions within the system, is that complex (e.g. social) systems come into being
via evolutionary processes and evolve dynamically and in an unpredictable manner \cite{Hayek1988;Helbing2010;Willkeetal2013}.\footnote{Mechanisms such as communication, memory and resilience play a crucial role in stabilizing and constituting a systemic order
and providing for operational closure. With reference to Miller and Rosenfeld \cite{MillerRosenfeld2010}, Willke et al. \cite{Willkeetal2013:21} draw attention to an
example of a danger inherent in emergence in the form of emergent communicative patterns (i.e. the consequence of established
rules of information flows) in the context of finance in the form of the upholding and reinforcement of conceptual biases that
have emerged and thereby also intellectual hazard by substituting simple clear thinking with misleading operating procedures.} In this sense, the whole is more than the sum of its parts.\footnote{In this sense, the whole is more than the sum of its parts.\footnote{In this sense, the whole is more than the sum of its parts.}} This quality of complex
systems ultimately produces the uncertainty and unpredictability that characterizes the financial system.
The notion of emergence is of particular significance in the context of the financial system. It is also particularly consequential for political actors’ ability to handle systemic risk and keep threats to financial stability in check. With respect to the above, the fact that system internal events or external shocks are not the only sources or triggers of systemic risk and financial crises, i.e. a breakdown of the system is of significance for this analysis. Threats to financial stability can emerge without an external impetus, implying systemic risk can also be engendered by regular financial activity (OFR 2012; Willke et al. 2013). A feature of complex systems is that while major developments may have no ramifications for the system, small changes may have a substantial impact (Helbing 2010; see also Becker 2016), while interactions in complex systems such as the financial system cannot be simulated and hence the ramifications of developments can never be fully apprehended ex ante. In this context, Becker (2016) refers to Weber (2012: 691) who notes that “no marriage of economics, computer science, and physics is anywhere close to being able to create a complete model of real financial markets”. Further complicating this conundrum is essentially the centrality and significance of human behavior, i.e. the human element distinguishing the financial system from many other complex systems which adds an extra element of uncertainty and further frustrates its governance.

The evolution and fundamental transformation of the global financial system throughout the past decades (discussed in detail in section 4.3) into a tightly coupled and inherently crisis-prone system conducive to systemic risk (International Organization of Securities Commissions 2011; Willke et al. 2013), which is complex as opposed to merely complicated (Weber 2012) and exhibits a robust-yet-fragile tendency (Gai 2013) due to the system characteristics and structural weaknesses alluded to previously (section 4.1.1), and thereby increasing the severity of crises when they arise despite decreasing their occurrence or rather resulting in their declining frequency, had gone largely unnoticed or perhaps unheeded, yet the dangers inherent therein present the fundamental lesson of the crisis. In sum, having evolved from a loosely coupled to a strictly coupled system, finance has become a highly interconnected, complex and contagion-prone system of global reach, becoming increasingly vulnerable to black swans (Taleb 2007), i.e. the occurrence of extreme high-impact yet low-probability events, and giving rise to normal accidents (Perrow 1984) in the context of which systemic risk – as an emergent property of the system as such – is engendered by the normal yet dangerous operational mode of the system as the latter is essentially more than the sum of its parts – and as

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208 Examples include, for instance, the market’s ability to transform fragmented and dispersed local knowledge into emergent systemic knowledge, which in the context of financial markets is embodied, for instance, in the constitution of credit or asset price cycles (Willke et al. 2013: 21–22).

209 Of significance with respect to the crisis is also that something entirely new has transpired. The interplay of partial crises (the developments of which are described in 4.3) gave rise to emergent properties of the system that had not – and indeed could not – be predicted in their entirety.

210 The underlying structural weaknesses that ultimately led to the crisis discussed previously included among others the substantial advances in global economic and ensuing financial integration, the increasing importance of a selection of extremely large financial institutions reinforced by mergers and acquisitions (Johnson and Kwak 2011), the emergence of an increasingly important shadow banking sector and host of nonbank financial institutions (such as alternative investment funds, money market funds and central clearing and settlement structures) as well as overly complex risk and compliance management mechanisms (see also Becker 2016; Geithner 2004).
such is an imminent and unpredictable threat which governance must inevitably prepare for as systemic crises will no doubt happen again.

Operationalizing Systemic Risk: Concept and Policy Implications

Understanding and conceptualizing systemic risk is at the heart of the operationalization of policy and reform in order to mitigate it. In this context, the degree to which systemic risk can be measured in both quantitative and qualitative terms is the central question, of crucial importance for regulatory and supervisory policy as well as financial governance more generally. Given the fact that the defining feature and essence of systemic risk is essentially its unpredictability as discussed previously, regulators and supervisors must remain wary of any set of predetermined and allegedly definitive measures that define and constitute systemic risk or a potential threat to financial stability owing to the ever present potential of threats arising from other sources of instability that are not on the regulatory radar, in a sense mirroring the shortcomings of the narrow microprudential approach discussed previously. As will be laid out in depth throughout this chapter, the logical consequence of systemic risk being unpredictable and regulators being unable to prepare for all contingencies as prevention and preemption is inevitably fallible is the fact that in order to render systemic risk manageable crisis management structures and contingent reactive governance capacities are required, while caution is of the essence in order to forestall the regulatory forbearance, leniency and complacency that characterized the pre-crisis era (El-Erian 2017b).

Systemic risk is hard – if not practically impossible – to both “define and quantify” (IMF 2009: 113, emphasis added) definitively, and, therefore, also difficult to conceptualize and operationalize for analytical and policy purposes. Yet to cope with and manage systemic risk, it must inevitably be measured, or rather the measurement and operationalization of metrics must at least be attempted for systemic risk and stability-oriented regulation to be of any use. Though there have been and indeed are attempts to measure, i.e. quantify and systematize systemic risk variables and metrics in order to operationalize them for oversight and ensuing policy purposes by multiple institutions or initiatives – established to either (i) principally conduct macroprudential oversight and systemic risk analysis (e.g. in the form of systemic risk councils), (ii) devise, implement, or supervise and coordinate systemic risk oversight and macroprudential policy (e.g. prudential supervisors), or (iii) aid the latter in data collection, data aggregation and the build-up of expertise in general – and this is no doubt essential for effective financial governance, it is paramount to

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211 An issue of importance to bear in mind throughout is whether (i) the discourse has changed, (ii) the understanding has evolved, and if so what the implications in terms of policy are.

212 This applies to both the self-regulatory capacity of the system itself and the notion of Western regulatory superiority.

213 Such as, for instance, the US Financial Stability Oversight Council (FSOC), the European Systemic Risk Board (ESRB) at the supranational level and the Financial Policy Committee (FPC) at the national level in the UK and elsewhere.

214 Examples in this respect include, for instance, the US Office for financial Research (OFR), which is mandated to collect data and information on systemic risks and advise federal agencies regarding threats to financial stability, devised an overview of quantitative systemic risk measures in a Survey of Systemic Risk Analytics by Bisias et al. (2012), while the ESRB in the European
bear in mind and of essence for the regulatory architecture and the regulatory and supervisory approach and paradigm embedded therein that – with this constituting the essence of systemic risk – there is and most likely never will be a single measure with which to capture systemic risk. Indeed, neither is it “realistic to expect a single measure of systemic risk to cater to all purposes” (Borio 2011: 6) nor is it necessarily “desirable” (Bisias et al. 2012: 2) in view of the system properties of finance discussed above in view of the properties discussed as it “invites a blindsided surprise from some unforeseen or newly emerging crisis mechanism” (ibid.; see also Becker 2016) – again, much like the shortcomings of a narrow microprudential approach.

What are the implications of this conundrum? A core dilemma for governance that results from the above is, for instance, that financial analyses and risk assessments as well as the corresponding policy tools employed on the basis thereof inevitably and invariably contain “considerable margins of error, uncertainty and non-knowledge” (Willke et al. 2013: 18). Yet mechanisms for system oversight and systemic risk analysis and prevention are no doubt needed despite their inevitable fallibility. What the crisis has made clear, however, is that regulatory caution and reflexivity (see e.g. Mügge and Perry 2014) must prevail in the long-term over industrious and often short-lived reform efforts followed by regulatory complacency in order to stop the regulatory confidence cycle (Roe 2014; see also Johnson and Kwak 2011). Multiple issues are evidently at stake simultaneously in this context, reflecting the very nature of systemic risk itself. The financial crisis illustrated that there is a rationale for (i) ongoing systemic risk analytics in order to monitor developments in financial markets and foster understanding in this regard in view of a constantly evolving system, as well as for (ii) robust crisis management as crises are essentially unavoidable, and finally (iii) the related issue of cooperation in view of cross-border finance can be deduced, while all three may be subsumed under the heading of the need to build cross-border reactive capacities to construct a modus vivendi of dealing with systemic risk – an objective that is reinforced by the arguments inherent in the next lens on systemic risk presented in the following.

We now turn to the regulatory implications the system properties of the financial system and the nature of systemic risk – deeply embedded in the inherent instability of the financial system which in turn is rooted in pervasive uncertainty, complexity and knowledge-deficiencies on the part of all actors involved – give rise to in political terms and the effects they have on political structures as well as the issue of how the political system as such facilitates the emergence of systemic risk. It is important to note that while system properties and characteristics – such as, for instance, instability, uncertainty, interconnectedness and the
resulting potential for contagion – impact the emergence of systemic risk in the political context (e.g. facilitating moral hazard and reinforcing bailout expectations), the structure of the politico-economic nexus as such, i.e. the embeddness of the financial system due to its centrality in the overarching political and economic system, as a separate issue and facilitating factor is at stake in the following. They are, however, inevitably intertwined as two distinct yet interdependent sources of systemic risk. The following looks into the causes and implications of systemic risk in political terms, which is essentially the second central component of the political economy approach which specifically integrates the elements set out above (the systemic roots of systemic risk) and the factors set out in the following (the political causes of systemic risk arising from the embeddedness of the financial system).

4.2.2 The Embeddedness of Finance: A Political-Economy Approach to Systemic Risk

It is widely acknowledged that financial crises – precipitated for instance by the disorderly failure of a large systemically relevant financial institution or the collapse of an entire market – can have a disastrous impact on the broader, i.e. real economy, in many cases leading to severe recessions (Greenwood et al. 2017). In the case of the Great Recession of 2008, both the economy and the financial system survived “a near death experience” (Wolf 2010) with the implicit hidden costs of the crisis including “tens of trillions of dollars in lost output” (Haldane quoted in Wolf 2010; see also Reinhart and Rogoff 2009), outstripping the direct costs of bank bailouts and liquidity assistance by far. As market actors are both unwilling and unable to provide for system stability on their own, financial institutions and financial markets cannot be left entirely to their own devices.

This fact, i.e. the potential impact of financial crises – owing in large part to the financial system’s centrality in terms of fostering growth as the lifeblood of the economy – is at the heart of the conundrum surrounding systemic risk or rather the dilemma that systemic risk gives rise to. At the core of the argument in favor of a political economy definition of systemic risk is the following. The crux is ultimately that the interdependence of the financial and the political system – or, in other words, the political consequences of systemic risk present the essential ingredient of moral hazard. Given the economic and political fallout of crises of systemic proportions in the sense that the latter threaten the credibility and legitimacy of public policy and thereby also public authority in the form of the political system (Levitin 2011, 2014; Willke et al. 2013) – as financial losses must be allocated and in the case of the past crisis were largely socialized as public debt (Wolf 2010)216 – the political system is more or less forced to react to crises and must inevitably intervene given the potential repercussions of non-intervention. Owing to the financial system’s and banking sector’s size and concentration, which increased exponentially relative to

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216 In effect, during the crisis risks were socialized via widespread bailouts and recapitalizations – with the financial sector essentially being by far the most subsidized industry in the world (Wolf 2010).
GDP throughout the past decades with financial institutions essentially becoming *too big to fail* (TBTF) (Johnson 2013a, 2013b; see also the following subchapter for an in-depth discussion), and coupled with their centrality to the economy, governments are therefore assumed to have no other choice but to intervene and offer assistance, ultimately giving rise to a so-called *catch 22*. While intervention in the financial crisis ultimately led to Western governments racking up the “largest peacetime deficits ever” (King 2010: 2), non-intervention and the failure to act quickly may – and most probably would – have had substantially worse repercussions, possibly even resulting in a repeat of the Great Depression of the 1930s.\(^{217}\) Intervention, however, reinforces moral hazard and bailout expectations. Resolving the issue of TBTF is therefore at the heart of mitigating systemic risk and a crucial policy objective.

The crux is the interdependence between the financial and the political system which is, at its core, produced by the inability of the financial system to *internalize the costs and effects of failure and instability within the system itself.*

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**The Political Economy Element of the Definition: Political and Societal Dimensions of Systemic Risk**

Systemic crises typically span and impact multiple institutions, sectors and countries. Most importantly, however, they affect the broader economy as well as society at large with significant ramifications for “safety and security, the environment, economic well-being and the fabric of societies” (International Risk Governance Council 2010: 9), ultimately making them so consequential and rendering political intervention imperative so as to avert complete collapse.\(^{218}\) Of particular significance in the context of this research is also the fact that though systemic risks and crises impact many institutions, sectors and countries and therefore require concerted cooperative action and coping mechanisms, no single regulatory entity or indeed jurisdiction is (or was in the pre-crisis era) responsible for managing systemic risk or indeed capable of doing so – that is equipped with the remit, authority, competencies and expertise required – complicating the task of dealing with systemic risk and making the fallout all the more dangerous, thereby inter alia also increasing moral hazard.

Before proceeding it is important to note in this context that the insights established in the preceding sections are central to the analysis and the conclusions drawn throughout. In addition to the governance imperatives resulting from systemic risk as such, i.e. the consequences of uncertainty and embeddedness, the inherent features of modern finance discussed after the following section underscore and have significant implications for the rationale for integration set out thereafter under the heading of the *need for the build-up of reactive governance capacity* at the European level.

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\(^{217}\) Though the US is regarded as having reacted presciently to the crisis in monetary and regulatory policy, the EU’s disjointed response is often criticized and may indeed have contributed to its long recession and sovereign debt crisis.

\(^{218}\) Systemic risk is thereby of an all-encompassing nature. Economic decline and recession, pervasive economic instability and uncertainty as well as ramifications for other systems and the societal implications from downturns are all welfare(-)reducing and symptomatic of its negative and destructive potential.
4.2.3 The Regulatory Implications of Systemic Risk and the Crisis of 2008

The crisis may ultimately be interpreted as the first instance of systemic failure in the 21st century (Goldin and Vogel 2010; Willke et al. 2013) in the context of which systemic risk presents a prime example of the shortcomings of nationally-denominated governance and indeed also the weaknesses of democratic governance more generally. The argument throughout is that cross-border governance is required; particularly intricate governance innovations are essential if political governance is to come to terms with systemic risk in finance and render it manageable.

When approaching the issue of regulatory implications and governance imperatives, the central question arises as to what specifically distinguishes the crisis of 2008 from previous crises. As noted previously, it is argued throughout that the crisis of 2008 was ultimately the systemic crisis (see also Becker 2016; Levitin 2011, 2014; Willke et al. 2013) and assumed that the systemic nature of the crisis, not, however, the fact that it affected the system at large, i.e. its system-wide nature, is its distinguishing feature. Though the crisis did indeed exhibit parallels and similarities with previous crises – in the US context, for instance, the banking crisis of 1907 or the crisis that precipitated the Great Depression in the 1930s are cases in point, while in the international context the crisis in East Asia at the turn of the century may be considered the first genuinely international crisis (Tucker 2014) – the complexity, scale and speed of both the dynamics that unfolded during the crisis of 2008 (Becker 2016; Bruner 2008) and the financial system and its operations as such, i.e. the context within which the crisis transpired, as well as the degree of the resulting economic and political fallout set it apart from previous crises. Though there had been crises throughout the preceding decades, distinguishing the crisis of 2008 was ultimately the fact that it dwarfed anything witnessed to date in terms of its scale, i.e. its depth, breadth, global nature and reach (King 2010) as well as in terms of the degree of contagion observed and the constitutive elements at play. There was, therefore, a difference in terms of both its scale and its nature.

This interpretation has substantial implications with regard to the ability of the financial sector to solve crises without external intervention and the respective limitations involved.219 In other crises private sector actors were often able to solve the fallout without explicit government participation (Bruner 2008).220 Yet though government involvement in crisis management is by no means an inevitability nor an outright necessity, in a systemic crisis of these proportions it is conclusive to hypothesize that in view of the complexity, scale and speed that generally characterizes unfolding developments in such situations as well as the potential economic and political ramifications of slow or misguided reactions, genuinely systemic crises largely preclude exclusively private sector-based solutions and capacities, rather requiring systematic,

219 See section 4.3.1 on complexity and the limitations both the public and private sector are confronted with when attempting to govern the financial system.
220 Examples include, for instance, the banking crisis in the US in 1907 and the collapse of the highly leveraged hedge fund Long-Term Capital Management (LTCM) which was rescued via a consortium of banks in a 3.5 billion dollar recapitalization in 1998. LTCM had invested in interest rate derivatives and was badly hit by liquidity pressures when Russia defaulted on its external debt in 1998 as a consequence of the commodity crisis.
credible, resolute and indeed publicly orchestrated solutions if they are to preclude a complete meltdown as was the case in 2008. In short, the policy implications of this financial crisis are that systemic crises render private sector solutions improbable and a public backstop more or less inevitable – at least as long as the financial system remains as tightly coupled and complex as it is at present.

A second implication is also of importance. Though to a degree there was a pre-crisis awareness of sorts with respect to the implications of systemic risk (see e.g. De Bandt and Hartmann 2000; Group of Thirty 1997; see also chapter 4.2), induced primarily by crises in East Asia, Mexico and Russia in the preceding decade, Western policymakers undoubtedly underestimated the risk and potential of a systemic crisis in their constituencies – both in terms of its magnitude as such and in terms of its political ramifications (e.g. El-Erian 2017b; Johnson and Kwak 2011). As some contributing crisis causes were pointed out yet remained unheeded, which Reinhart and Rogoff (2009) attribute to the so-called *this time is different bias* with respect to the system’s stability, complacency prevailed – with failings in this respect and the inability to learn from crises elsewhere showcasing the *false sense of security* and *groupthink* that dominated throughout the regulatory and policymaking community in the decade before the crisis (Mügge 2011a; Tett 2010), mirroring the general mood in the markets which typically precedes crises. In view of the inevitable limitations of financial governance, the resulting imperative is essentially the need for regulatory humility against the backdrop of which preemptive systemic risk analysis and policy can be conducted.

What are the main takeaways and insights that can be deduced from the elaboration above? Distinguishing the crisis of 2008 was undoubtedly its systemic nature and the ramifications of the concatenation of multiple sub-crisis in terms of scale and scope that it exhibited (Levitin 2014; Willke et al. 2013). The overarching dilemma and challenge in the context of regulating and governing an inherently unstable, unpredictable and highly complex and dynamic financial system is the fact that systemic crises are always a potential threat – no matter and irrespective of the precautions taken by policymakers and regulators. Crises are unlikely to exhibit the same causes, patterns and dynamics – even the top brass of the regulatory community acknowledge this fact (Yellen 2010). Hence, it is impossible to prevent systemic crises altogether. As long as the underlying system properties and structural weaknesses (defined below) remain intact, crises will mirror the financial systems within which they emerge: They will be highly complex, unpredictable and reflect the continually evolving nature of the financial system as such in addition to giving rise to and being rooted in the unintended consequences of regulatory action. Regulators and policymakers will, therefore, not be able to prevent systemic crises altogether.

Before discussing the governance imperatives that the latter gives rise to the following looks into the developments of the past decades that laid the foundation for the crisis to emerge, i.e. the evolution of the financial system and its components as well as its transformation into a complex and tightly global

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221 This perception was fostered inter alia by the fact that other crises had largely been contained, while regulatory and market sophistication in the West was also considered a decisive factor (Johnson and Kwak 2011).
coupled system. It ultimately sets out to deliver an analytical perspective on both the regulatory revelations of the crisis and the system properties and characteristics of the financial system that contributed to systemic risk and make regulatory intervention and governance integration necessary.

4.3 The Foundations of Modern Finance: Market Dimensions and System Developments

Throughout the thirty years preceding the financial crisis, the financial system evolved at breathtaking speed in terms of the degree of its sophistication, complexity, global reach and centrality to the functioning of advanced capitalist economies. The consequences of this development – with respect to the potential for instability and ensuing wealth destruction that could flow from it, i.e. the havoc financial instability and the disruption of elemental services at the heart of market capitalism can cause – were largely inconceivable at the time and unanticipated by most actors involved, including market participants, regulators and policymakers alike. With the benefit of hindsight, some developments and key contributing elements of the crisis could have been predicted or were even explicitly pointed out, were not, however, taken seriously or perhaps underestimated (see, for instance, El-Erian 2017b; Johnson and Kwak 2011; Rajan 2005, 2010; Shiller 2005, 2010), while lessons that could have in theory been learned from previous crises, especially those at the turn of the century in countries that were still developing at the time, were not heeded. In effect, warnings that were advanced in the regulatory community were largely incompatible with the prevailing paradigms and beliefs of the era, while groupthink throughout the top brass of the regulatory elite was no doubt a central factor contributing to regulatory reticence in this regard (El-Erian 2017b; Mügge 2011a; Shiller 2010; Tett 2010). The crisis essentially exposed misconceptions with respect to the dominant belief in self-regulating markets based on the viability of laissez-faire capitalism, a notion that had long prevailed in the developed world and guided its regulatory actions as well as infusing its regulatory paradigms (Stiglitz 2009b), while it also discredited claims that the West was, for instance vis-à-vis developing countries due to their susceptibility to crony capitalism, in a superior position in terms of its capacity to harness the financial system and provide for financial stability (see e.g. Johnson and Kwak 2011). This is, however, evidently not the case, and as the crisis powerfully demonstrated manifestly inaccurate. Neither are Western political systems in a superior position vis-à-vis other constituencies nor have they managed to preclude systemic crises altogether. This is inter alia due to the way in which the system has evolved and the nature of finance as such.

Indeed, as evidenced by developments throughout the past centuries, crises are reoccurring events inherent in market capitalism (Reinhart and Rogoff 2009), which serve as mechanisms of natural selection

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222 The inability to learn from crises elsewhere mirrors Western regulators' incapacity to implement macroprudential regulatory approaches, the need for which had been put forward in the decade preceding the crisis as alluded to previously (see e.g. Borio 2003; De Bandt and Hartmann 2000). The Mexican, Russian and Asian financial crises had after all been contained rather successfully. Both failings may essentially be rooted in a false sense of security embedded in the so-called regulatory confidence cycle (Roe 2014).
with a corrective function of sorts in the vein of Schumpeter’s *creative destruction* (Schumpeter 1942, 1978; see also Kay 2013, 2016) to the extent that the externalities and costs of these crises can be internalized by, i.e. *within* the financial system as such as opposed to impacting the sociopolitical system at large and thereby essentially breaching the threshold of the socially acceptable and producing systemic risk in the process (as described in section 4.2.2; see also Willke et al. 2013). Yet, not only do crises reoccur periodically (El-Erian 2016; Goodhart 2014; Reinhart and Rogoff 2009), they also tend to exhibit parallels such as similar causes and logics as well as following similar patterns and having comparable regulatory consequences in terms of the ensuing regulatory reform debates they generally set in motion – with the history of financial reform, therefore, essentially being a history of financial crises and post-crisis reforms, presenting attempts to react to past regulatory failures. Crises are therefore not necessarily anomalies, but much rather indicative of the underlying inherent instability of finance as such as well as the pervasive threats finance – and particularly a financial system of the sort that exists at present, i.e. a highly complex, unstable and tightly coupled system – gives rise to owing inter alia to its evolutionary potential.

This notwithstanding, as argued above, this crisis was in fact distinct, implying that though there were parallels, there were also significant differences. What set this crisis apart was ultimately the fact that its constitutive elements and their interplay had never been witnessed before, while its scale – in terms of its depth and breadth, including the complexity of and the speed with which developments unfolded and contagion spread as well as in terms of the degree of its cross-border externalities, its global reach and the ensuing fallout in terms of recession and sovereign debt turmoil – was considerably greater. Though in theory one could argue that the jury is still out as to whether this crisis is in line with other crises or is in fact different, it is argued throughout that 2008 was ultimately the *first genuinely global and systemic crisis* (see e.g. Becker 2016; Levitin 2011, 2014; Willke et al. 2013). While there have indeed been other notable crises with similar traits such as, for instance, the Russian, Mexican and Asian crises (see El-Erian 2017b; Weistroffer 2012), with the latter arguably being the most significant and Tucker (2014) therefore labeling

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223 In this sense, crises can be interpreted as beneficial catalysts, which serve to foster innovation, increase efficiency, weed out uncompetitive market actors and reorder markets, while in regulatory terms, crises can shed light on remaining regulatory shortcomings or, as in the case of the European Union, encourage further integration. They are only beneficial, however, if they do not impinge on other systems, essentially implying that institutional failures should only have system-internal ramifications. If this is not the case, regulation and supervision must attempt to mitigate the propagation of systemic risk by tackling its underlying causes and finding ways to attenuate its impact by devising credible crisis management tools.

224 Given the incapacity to anticipate all future contingencies and legislate accordingly, financial governance and regulation in general are inevitably recursive and repetitive processes (Hart 1961; Hennessey 2011). As uncertainty in this issue area is particularly high, regulatory outcomes are highly unpredictable and require reactive adaptive regulatory and supervisory capacities – capable of continuous modifications and adjustments – as long as the system remains as complex as it is. This argument is extended further in section 4.3.3.

225 Indeed, the crisis of 2008 exhibited multiple features that had been witnessed in previous crises as well such as risks related to short-term funding, high leverage and mark-to-market accounting as well as threats resulting from opaque OTC derivatives and reinforced by pro-cyclical capital requirements, revealing the fragility of highly-leveraged institutions, their susceptibility to contagion in a highly unstable system and exposing the fallacy that diversification via complex securitization was sufficient to mitigate market risk (see section 4.1.1). What was new, however, was the fact that in this crisis, multiple sub-crises essentially culminated in a qualitatively new phenomenon (Willke et al. 2013), ultimately giving rise to the emergent property of systemic risk.

226 A former member of the Bank of England’s Monetary Policy Committee, Charles Goodhart, for instance, opposes the notion of the 2008 crisis being distinct (Interview with Charles Goodhart, January 2013, London; see also Goodhart 2014). This divide ultimately reflects the fact that the precise causes of the crisis are still contested (as discussed in section 4.4.1).
it the *first genuinely international crisis*, their scale was neither as substantial nor were they truly global or systemic – after all, they were contained for the most part without too much damage to the system.227

Against this backdrop, the question arises as to how a crisis of such scale could emerge. Like never before the crisis of 2008 ultimately showcased (i) the dangers inherent in finance as such, (ii) its limited governability and the limitations financial regulation is inevitably subject to given its inherently incomplete nature as well as the complexity, evolutionary potential and dynamic and innovative qualities of the policy sphere at stake, and finally (iii) the ramifications of cross-border finance in terms of the need for robust integrated governance. The following looks into the way in which the financial system developed throughout the past decades and puts its evolution in the era of the so-called Great Moderation (Tett 2013; Turner 2015; Wolf 2014b) into perspective with reference to the preceding definition of systemic risk, taking an in-depth look at the trajectory of modern finance in terms of the system properties and structural features that make finance so unstable and destructive, and ultimately render regulatory intervention and cross-border governance imperative.228 In short, it presents an analytical perspective on its underlying characteristics and their consequences as well as the regulatory revelations of the crisis and resulting reform challenges, and lays the basis for the governance imperatives deduced thereafter in section 4.3.3.229 It is argued throughout that the crisis of 2008 was, in essence, the result of fundamental changes that transpired in global finance throughout the past decades, ultimately laying the basis for the emergence of systemic risk, and it is these changes that are assessed and contextualized in the following.

4.3.1 The System Properties of Finance: Inherent Fragility and Multi-Level Complexity

In the opening section of its annual *Global Financial Stability Report* in April 2007, the International Monetary Fund (IMF) proclaimed that “favourable global economic prospects, particularly strong momentum in the euro area and in emerging markets led by China and India, continue to serve as a strong

227 Note in this context that though there has indeed been a crisis of similar proportions, namely the Great Depression in the 1930s, the crisis of 2008 was the “first truly systemic and acute crisis to occur against the backdrop of the modern regulatory state” (Levitin 2014: 1).

228 The evolution of the financial system throughout the past decades took place in an environment which was characterized by limited heterogeneity in the regulatory community and the epistemic community at large, i.e. throughout the ranks of political and business elites (Mügge 2013a; Shiller 2010) giving rise to groupthink and cognitive biases – an environment in which the doctrines at the heart of the dominant market-friendly regulatory paradigm of the pre-crisis era were not challenged (see also Miller and Rosenfeld 2010 and Willke et al. 2013 on intellectual hazard arising from conceptual biases). A light-touch approach to regulation, cognitive homogeneity, and limited contestation with respect to developments in the financial industry were ultimately central factors contributing to the crisis (Johnson and Kwak 2011) with examples including the uncritical adherence to the principle of diversification as a recipe for stability (see section 4.1.1). In this context, they were also central to the substantial increase in complexity that transpired in the pre-crisis era – a trend that was explicitly fostered by regulatory action, for instance by the repeal of the Glass-Steagall Act as well as decisions to exempt the shadow banking system from regulation or monitor and clear over-the-counter derivatives (Interview with Andrew Bailey, January 29, 2013; see also Admati and Hellwig 2013; Guillén and Suárez 2010; Muggle 2011a; Willke et al. 2013). This is the backdrop against which system developments took place.

229 Note in this context, before delving into the specifics, that underlying system properties, structural determinants and institutional characteristics are inherently intertwined and contribute to the dangers the system gives rise to. For instance, structural determinants such as interconnectedness foster the dynamic of contagion and give rise to instability, an inherent system property.
foundation for global financial stability” (IMF 2007). This was only months before the first serious signs of stress surfaced in the markets, triggering the worst financial crisis in eight decades. Therefore, in retrospect, it can be “viewed […] as a spectacular misjudgment” (Wolf 2017). It also illustrates quite well just how fragile the system is, the fact that tipping points in economic cycles can be reached quickly even though underlying economic fundamentals appear to be robust, and the extent to which it is more or less impossible to predict crises – or rather the precise interaction of structural weaknesses and crisis triggers.

The underlying features and core system properties contributing to this conundrum include the sheer complexity of the modern financial system in terms of both its structures and dynamics as well as its inherent instability (Kindleberger 1978; Minsky 2008; Turner 2010a, 2013a, 2015), resulting not only from the widespread uncertainty and knowledge-intensity that generally prevails within this policy sphere (Becker 2016; Willke et al. 2013), but from the very essence of finance as such, or more specifically from the purpose it fulfills and the services it provides, most importantly the intermediation and allocation of credit which facilitates economic activity and fosters growth.230 The latter, i.e. both system complexity and the inherent instability of finance, have been exacerbated by the way in which the financial system evolved over the past decades, and it is the evolution of modern finance in all its facets during the era preceding the crisis that is at stake in the following in order to contextualize the system properties that contributed to the materialization of systemic risk and continue to present the basis on which it can emerge in future.

Before progressing, however, it is important to stress again that though periodic crises are symptomatic of the inherent instability of finance, this crisis was more detrimental than anything witnessed to date and was ultimately a consequence of the pervasive threats a system such as the one existing at present – a highly complex and tightly coupled global financial system – gives rise to.231 In this context, it was argued previously that though many contributions attempt to single out core contributing crisis causes,232 a key insight from post-crisis analyses is that there is no decisive overriding cause to attribute blame to. Rather, as is argued in the following, it is in large part the fundamental and consequential system change that transpired in global finance throughout the past decades, albeit in an incremental evolutionary manner, that was at fault, which as Willke et al. (2013: 58) note, very few commentators recognized. Not only were changing system characteristics and their interplay afforded insufficient attention, but many actors failed to comprehend the significance of the tightly coupled global capitalist system that had emerged (IOSCO 2011; Palmer and Maher 2010; Schneiberg and Bartley 2010; Willke et al. 2013) and acknowledge that the issues the crisis exposed were to a large extent systemic and structural as opposed to merely behavioral (see e.g. Rossi 2011: 75;

230 See Kapoor (2013) for an in-depth discussion of the central functions of finance and the risks arising from the maturity transformations the system performs. See also Turner (2010a) for central public policy debates in this regard.

231 The crisis did indeed exhibit multiple features that had also been witnessed previously, such as risks related to short-term funding and high leverage or threats resulting from opaque OTC derivatives and pro-cyclical capital requirements. Yet as argued, it was the scale as well as the encompassing and qualitatively unique systemic nature that distinguishes this crisis.

232 See, for instance, Lo (2011) who focuses on behavioral factors or French et al. (2010) who cite inadequate bankruptcy procedures and a combination of private-sector and regulatory deficiencies as pivotal factors.
Accordingly, and in line with these insights, changes in behavioral regulation are insufficient as a crisis response as they simply cannot impact “the working of the economic system as a whole” (Rossi 2011: 62) in a comprehensive and adequate fashion, whereby a genuinely sustainable “solution can only come by changing the rules of the financial system” (Johnson and Kwak 2011: 190). As is argued throughout, the consequence thereof is that either and preferably both of the following options are essential in future: (i) either system fundamentals and properties must be altered in order to reduce complexity and render the financial system more resilient and less crisis-prone, essentially transforming it into a more loosely coupled one, for instance, by way of fundamental structural reform and the use of principles-based regulation (see e.g. Willke and Willke 2012), or (ii) reactive, reflexive and cross-border governance capacity must be augmented in order to mitigate and deal with crises when they arise (see sections 4.3.3 and 4.5).

The Evolution of the Modern Financial System throughout the Past Decades – A Brief Introduction

If systemic risk is defined as an emergent property of global finance in its current state, it is useful for the purpose of this analysis to theorize the developments that culminated in the modern financial system and set the stage for the evolution of the system properties and characteristics that are conducive to the emergence thereof. Relevant in this context is the fact that the system in place at present which developed throughout the pre-crisis era is essentially a highly complex, tightly-coupled and market-driven global financial system, having evolved well beyond the classic, moderately international financial system of the Bretton-Woods era. While the latter was heterogeneous and loosely connected, inhibiting extensive cross-border activity due to the multitude of diverse and idiosyncratic financial systems and legal regimes that existed and limited business along national and regional geographical lines, the former is tightly coupled and far more homogenous, characterized by a substantial increase in the geographical reach, scale, speed and complexity of financial system activity coupled with a concurrent increase in direct and indirect linkages throughout the system (Gai et al. 2011; Sheng 2013), essentially having morphed into an increasingly integrated, complex and tightly connected network. This evolution was ultimately driven by three overarching trends that took hold from the 1970s onwards, namely globalization, the successive deregulation of national financial systems in line with the dominant belief in the self-regulatory capacity of

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233 As argued throughout, the most significant ramification of the system that emerged is the fact that it produced emergent properties that cannot be explained by the system’s elements alone (Eatwell 2004 quoted in Willke et al. 2013). Contributing regulatory factors that are considered particularly important in this regard include the deficient oversight of large, interconnected and highly leveraged institutions and the exemption of over-the-counter derivatives from regulation in the pre-crisis era. For an overview of determinants that characterize and contributed to the evolution of the financial system, see Willke et al. (2013: chapter two).

234 On financial system variations and their implications in terms of systemic risk, see Willke et al. (2013: chapter two).

235 A feature of the new system in behavioral terms and with respect to homogeneity is that over time, as it became increasingly international, standard operating procedures emerged as did ever more homogenous institutional structures and business models. The environment in which this convergence took place largely precluded ideological contestation and diversity as was the case in the regulatory context and with respect to the regulatory elite alluded to previously (Lounsbury and Hirsch 2010; Mügge 2011a; Willke et al. 2013).
the market (see section 3.3), and finally widespread financialization (Das 2014; Sheng 2013). On a more technical level, it was facilitated by (i) technological advances which accelerated the scale and speed of the dissemination of information and hence financial transactions (IOSCO 2011), (ii) the advent of sophisticated financial instruments, including innovative products and processes such as complex derivatives and securitization (Goldin and Vogel 2010) as well as (iii) the emergence of increasingly large and complex systemically significant institutions of global reach which became increasingly central to the global economy and gave rise to the too big to fail phenomenon—all of which were factors that contributed to an increasingly complex, connected and integrated system. The latter two, i.e. the advent of highly sophisticated products and the emergence of institutions that are perceived as being too big or too significant to fail, are particularly significant in this regard and, being at the heart of systemic risk, were central to the crisis. They will be discussed in depth after the following in section 4.3.2.

In essence, the transformation of the financial system which commenced in the 1970s catapulted the latter “from an (almost) trivial system into a decidedly non-trivial system” (Willke et al. 2013: 56). The system properties and qualities that this development gives rise to produce unpredictable dynamics and limit the ability of regulators to govern global finance, a fact that the crisis highlighted. The following looks into the system properties of the post-Bretton Woods financial system that underpin this development and thereafter discusses the system’s structural characteristics and system-level dynamics that exacerbate these qualities and ultimately give rise to the need for cross-border governance capacity.

Defining the System Characteristics and Properties of the Modern Financial System

The backdrop of the pre-crisis trajectory can, in short, be summarized as including the overarching categories of increasing complexity and sophistication of the financial system as such, crucial technological breakthroughs and advances, regulatory laxity as well as globalization and financial liberalization as the backdrop against which the latter took place (Kapoor 2013). These serve as crucial determinants in the evolution of the modern financial system, both being conducive to increasing instability and, by consequence, the potential for systemic risk. As alluded to throughout: The centrality of finance on the grounds of its being a crucial part of the critical infrastructure of modern capitalism cannot be understated. This makes system fragility, i.e. the inherent instability of finance, all the more consequential. The inherent fragility stems, for instance, from the nature of the core functions the sector performs, among them maturity transformations via credit creation and allocation (Turner 2015; Minsky 2008;

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236 Financialization is defined as “the growing importance of finance in daily activities, both at the national and global levels” (Sheng 2013). A key consequence of the trend of increasing financial turnover was that the financial system essentially became a “power in its own right” (ibid.) rather than serving as an agent of the real economy. In this context, Sheng (2013) argues that a central lesson of the crisis is the need to move away from short-termism “towards long-term financing of the real economy” as well as the promotion of “the quality (not quantity) of assets that contribute to GDP growth”. See El-Erian (2017b) for a similar conclusion and the argument that this lesson has yet to be learned.
Kapoor 2013; Kindleberger 1978), but it is also exacerbated by other system properties and developments that have transpired throughout the past decades.

In this context, complexity – as one of the key causes of systemic risk – can be framed as a, if not the, greatest challenge in terms of financial market governance and will undoubtedly remain a central challenge in future (Schwarcz 2008). In their seminal article in 2012, the Bank of England’s Andrew Haldane and Vasileios Madouros wagered that “[m]odern finance is complex, perhaps too complex” while the “[r]egulation of modern finance is complex, almost certainly too complex” and that this ultimately “spells trouble” (Haldane and Madouros 2012: 19). And indeed, markets have no doubt become too complex to understand, both for regulatory actors as well as for market participants and financial experts – a fact that even Alan Greenspan, the former Chairman of the Federal Reserve, of which he was at the helm in the run-up to the crisis, a period in which, in hindsight, the institution has been derided for its excessively loose monetary policy and laxity as regards the financial system – acknowledges (Greenspan 2010).

Ultimately, it appears that many high-profile actors in positions of authority did not fully understand the risks involved in their own businesses and throughout the wider industry (see, for instance, Becker 2016 quoting Einhorn 2010 on the failure of Lehman Brothers’ top management to correctly assess the risks on its books), and it is precisely these knowledge deficiencies on the part of all actors involved in the financial system, its activities and their regulation, resulting in large part from the high degree of complexity that prevails, that present one of the most intricate and demanding challenges with respect to financial governance as will become clear throughout.

And indeed, complexity is a central contributor to instability and systemic risk. Having increased on multiple levels, including among the most significant the system level, the institutional level, and the level of processes and products devised by the financial industry (see e.g. Stiglitz 2009c), complexity as an inherent feature of the financial system as a complex system implies that the latter is characterized by unpredictability and uncertainty as alluded to previously in the analysis of systemic risk (see section 4.2.1), which ultimately precludes or frustrates regulatory oversight and control (see Becker 2016; Weber 2012;

237 As noted previously, in an interview he had admitted that some of the instruments comprised in collateralized debt obligations bewildered him, stating that “I figured out that if I didn’t understand it and I had access to a couple hundred PhDs, how the rest of the world is going to understand it sort of bewildered me” (Greenspan as quoted in Sorkin 2010: 90). In addition, to illustrate all actors’ limited competencies in the face of systemic risk the following is instructive: As Alistair Darling, the British finance minister at the time recounts, shortly before the Lehman bankruptcy in March 2008, a period of substantial distress, a senior banker had claimed “we have decided that we only take on risks that we fully understand” (as quoted in Darling 2009) which soon proved absurd and false, suggesting that rather than exhibiting hubris and pervasive complacency, many market participants “simply did not understand the risk” (ibid.) they were taking on.

238 Defining the concept of complexity in terms of complexity theory, which is generally insufficiently integrated in economic analyses (Kay 2016), Luhmann (1995) employs it in a problem-oriented sense, conceptualizing organized complexity with reference to system formation, elements and relations, rendering it applicable to the environment. Thereby an “interconnected collection of elements [is] “complex” when, because of immanent constraints in the elements’ connective capacity, it is no longer possible at any moment to connect every element with every other element” (Luhmann 1995: 24). In this context, complexity is self-conditioning and self-referential in the sense that when elements are integrated into a given order they are already complex before being integrated into a higher level of system formation which as a result becomes even more complex. Complexity, therefore, “means being forced to select; being forced to select means contingency; and contingency means risk” (Luhmann 1995: 25).
Given the dilemmas complexity ultimately gives rise to in terms of governance and the central role it played in engendering the crisis, the question arises as to whether and if so how this phenomenon is to be dealt with. More specifically, should regulators attempt to reduce it or match it in terms of regulatory complexity?

The following now looks into the system’s structural characteristics as well as system-level dynamics that exacerbate these i.e. the elaborated system properties and ultimately give rise to the need for reactive and cross-border governance capacity as long as the system remains in its current state.

Structural Determinants and System-Level Dynamics: Interconnectedness and Contagion

Of crucial importance in the context of systemic risk are the phenomena of interconnectedness and contagion. While the former is a structural characteristic rooted in the very nature of the financial system as such, which in turn is embedded in the broader socio-economic system at large, the latter is a dynamic that results from the former – with both being central elements and qualities of the system contributing to its inherent instability (a principle system property discussed above).

Against the overarching backdrop of increasing complexity throughout the system, the implications of interconnectedness and the dynamics of contagion are central to the emergence of financial instability and systemic risk. 2008 illustrated the dangers of the ways in which the financial system had developed, including, as just one example, the flaws inherent in the just in time approach of most firms to liquidity. The evolution toward a system in which a dependence of most financial institutions on short-term interbank funding and market liquidity prevailed went hand in hand with declining liquid assets they generally held given the resulting opportunity costs and lower returns (Kapoor 2013: 14) as certainty prevailed as to their ability to raise necessary funds in the asset and interbank markets – symptomatic of the short-termism the sector has tended to espouse and the trend of financialization identified earlier (Sheng 2013).

Interconnectedness as a feature of the system has increased markedly throughout the past decades. Thereby, it is a key factor with respect to system-level complexity and is regarded as having been a central cause of the crisis (Scott 2012). Within highly connected systems, contagion is transmitted directly

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239 With respect to the definition of multi-level complexity, the following dimensions can be distinguished. System level determinants such as increasing interconnectedness (macro-level complexity), institutional and organizational determinants such as the increasing size and scale of the operations of financial institutions (meso-level complexity), the increasing intricacy of financial products and processes (micro-level complexity), and finally regulatory complexity may be included. They are obviously interdependent, though they may require nuanced policy responses (see Becker 2016 for a classification and an in-depth discussion; see also Haldane and Madouros 2012).

240 For instance due to the principle of leverage in the system which gives rise to liquidity pressures in the event of a crisis.

241 System properties discussed above are rooted in the very nature of finance and the purpose the financial system serves as well as the activities it conducts. This does not, however imply that system properties and qualities are immutable and unchangeable. Structural change, for instance, could mitigate their effects and the scale and scope of their impact. For this to transpire, however, fundamental change and political will is required and this is unfortunately, as of yet, woefully lacking.

242 In this context, two types of interconnectedness can be distinguished (Scott 2012: 2). Defined with reference to their implications in terms of contagion, asset interconnectedness pertains to the threat of contagion and adjacent failures via the direct
between financial entities via contractual relationships or indirectly. In the case of the latter, the prevailing degree of interconnectedness is irrelevant (Becker 2016).

Contagion which exacerbates the system’s inherent instability is ultimately facilitated by financial system complexity. Much like and as argued with respect to operationalizing systemic risk in the preceding section, financial complexity – which is increased by intra-financial system transactions and produced by direct and indirect links within the system in the form of contracts that lay the basis for conducting financial activities such as lending, borrowing, hedging or clearing between participating financial actors and institutions which in turn serve as nodes within financial networks – is impossible to measure and quantify definitively (Becker 2016; Gai et al. 2011: 17). In effect, each transaction or rather link between the constitutive nodes contributes to a complex web of claims and obligations and increases the prevailing degree of complexity within the system (ibid.). The emergence of sophisticated financial instruments such as complex derivatives in the pre-crisis era – among the most prominent collateralized debt obligations and credit default swaps, a majority of which were sold over-the-counter, contributing to the system’s opacity in the process – only exacerbate complexity as these innovative products essentially, in their interplay, produce and indeed in and of themselves constitute a complex web of contractual relationships between a variety of different stakeholders – among them borrowers, insurers, mortgage originators and investment banks. When the crisis hit, though practically all institutions were exposed to distressed institutions and asset classes in some way or another, it was hard to definitively define to what degree (Sheng 2013; Weber 2014), giving rise to substantial uncertainty and showcasing the destructive potential of these instruments in a stark fashion (discussed in more detail below).

It is within this context that contagion thrives. While direct contagion – which for the most part results from interconnectedness, though some economists dispute that the latter is really as relevant and consequential as widely presumed, maintaining, for instance, that direct exposure to Lehman Brothers did not trigger the failure of any other significant institution (see e.g. Scott 2012) – is generally easier to compute, define and therefore predict or even manage as most exposures can be determined by way of assessing legal contracts in order to map counterparty exposures within the system, indirect contagion is unpredictable, induced and exacerbated by rumors and behavioral factors such as fear and distrust, essentially implying it does not require direct linkages in order to take hold, and propagated by self-reinforcing mechanisms which cannot, as such, be controlled as the Lehman Brothers failure illustrated. Systemic crises are generally characterized by the evaporation of trust and confidence (De Larosière 2009) against the backdrop of which indirect contagion can flourish – both via formal rules (e.g. minimum capital

credit exposure of healthy firms to struggling institutions, while liability interconnectedness can lead to struggling firms which normally act as sources of short-term funding to causing the failure of institutions that are dependent on them.

243 There of course been attempts to model behavior in dynamic and complex systems, with network theory being the most widely employed approach which focuses on the impact network structures’ qualities in terms of their completeness/openness and complexity/simplicity have when a local shock materializes.

244 It should be noted, however, that even this is not entirely foolproof given the degree of complexity financial innovation in the realm of financial instruments and products – predicated on the process of complex securitization – has induced.
requirements) and behavioral elements (e.g., fear), spreading throughout the system via a range of self-reinforcing mechanisms, including inter alia adverse feedback loops that result from fire-sale effects in asset markets and liquidity hoarding. In the case of the latter, individual institutions’ decisions to retain, or rather hoard, liquidity makes it increasingly difficult for their counterparties, or rather institutions previously borrowing from them to obtain funding without adopting the same behavior (see Gai et al. 2011: 11 for a network simulation illustrating this dynamic). Yet though it may be rational for single institutions to hoard capital, it is by no means rational for all institutions to do so (Luhmann 2008; Willke et al. 2013).

Indeed, though an important institution’s failure (or impending failure) may result in fear and distrust among market participants and therefore trigger panic throughout the system, it also has significant and consequential structural ramifications in the context of which self-reinforcing dynamics are also at play. When large distressed entities engage in asset sales to obtain fresh liquidity, the sudden and usually substantial increase of supply in certain asset classes results in significant drops in the latter, which in turn results in increased liquidity needs and further asset sales, depressing asset prices even further – with this process essentially constituting an adverse feedback loop and with the danger being that liquidity crises ultimately morph into solvency crises as was the case in 2008 (Quaglia et al. 2009). In this context, an increasing number of firms are implicated and affected as, for instance, mark-to-market accounting requirements transmit pressures to other institutions, particularly those that need to sell assets immediately to remain liquid with ensuing fire sales inducing a general downward spiral. The following figure visualizes the described processes and the emergence of systemic risk.

Figure 1: The Emergence of Systemic Risk

![Figure 1: The Emergence of Systemic Risk](image)

Source: Figure based on Willke et al. (2013: 29) and OFR (2012: 56)

In order to tackle the most pernicious system qualities and dynamics at play in the context of systemic crises, policymakers have instituted multiple reforms to mitigate self-reinforcing crisis mechanisms and other sources of instability – such as, for instance, more stringent and countercyclical capital requirements
or resolution mechanisms for failing institutions – thereby attempting to render the financial system more resilient. The question remains, however, as to whether they are sufficient to preclude or mitigate systemic risk. The following advances from the ramifications of complexity at the systems level to the second pivotal structural element contributing to the highly complex and tightly coupled nature of the system and therefore to systemic risk, namely institutions (such as banks, funds or clearing houses) that are too big, too interconnected or otherwise too significant to fail and to a degree also too complex to manage, assessing both their role and nature in the modern financial system as well as the implications of their centrality.

4.3.2 The Characteristics of Financial Institutions: The Challenge of Too Big to Fail

Mirroring and contributing to the exponential increase in the complexity of the financial system in the aftermath of the Bretton Woods era described above, one of the most significant structural characteristics of the system impacting the instability thereof is that of too big to fail (TBTF) institutions, to which the corresponding phenomena of too-complex-to-manage (TCTM), too complex to supervise and too big to jail can be added as central issues reinforcing systemic risk and complicating sustainable and robust financial governance. This section puts regulatory challenges that result from the developments of the past decades into perspective.

With the exception of the United Kingdom, Europe is largely composed of bank-based financial systems, in which the real economy, i.e. non-financial companies are dependent on bank credit for their funding needs implying both that (i) equity and corporate debt market depth is limited, and (ii) that a strong bank–industry link exists (Howarth and Quaglia 2013b, 2015). This has significant implications for financial institutions’ political clout and is of importance when discussing the challenge of too big to fail (TBTF) and its perverse implications in the European context. Goldstein and Véron (2011) offer insights into the development of the financial landscape in Europe and the centrality of the banking sector which is of relevance for its clout and its potential in terms of systemic risk, particularly given the fact that the resolution mechanisms instituted in the wake of the crisis – and discussed later on in this chapter – are essentially untested and would most likely fail to be viable in a truly systemic crisis.

Both finance in general and banking in particular evolved dramatically throughout the past few decades. A benign (de-)regulatory environment as well as a profitable international commercial environment were ultimately conducive to the growth of the financial sector and the trend of financialization mentioned above (Goldstein and Véron 2011; Sheng 2013), while two developments – both at the heart of the crisis – were particularly consequential for the evolution of the system properties and dynamics described: The emergence of large, complex, highly diversified and global systemically significant institutions on the one hand and the
advent of sophisticated financial instruments on the other.\textsuperscript{245} With respect to the former, significant contributing factors that can be singled out include a substantial increase in the relative size of existing institutions coupled with a declining number of entities throughout the system as such, resulting in a higher degree of concentration in banking (Haldane 2010) – a trend that continued to increase in the aftermath of the crisis with the largest global systemically significant institutions’ share of assets rising steadily (Sheng 2013). Boosted by favorable legislative and regulatory developments in both the EU and the US, these institutions also became increasingly complex, evolving rapidly with respect to their institutional structures and increasingly diversified business models, with a key trend that contributed to the development of a tightly coupled system being the emergence of financial conglomerates that united banking, securities and insurance activities (Goldstein and Véron 2011).\textsuperscript{246} After the crisis, consensus largely prevailed as to the fact that these developments, particularly increasing institutional complexity and concentration, present key sources of systemic risk (Becker 2016; Carmassi and Herring 2012), ultimately prompting a debate on the too big to fail phenomenon – discussed in the following in combination with related phenomena such as the moral hazard it gives rise to, followed by an account of their implications in terms of supranational governance and an analysis of substantive post-crisis reforms which inter alia attempt to address them.

\textit{Defining Too Big to Fail and Related Phenomena}

While the term too big to fail featured in the policy debate prior to the crisis (see e.g. Stern and Feldman 2004; see also section 4.2.1), the phenomenon rose to particular prominence in the post-crisis era, and in combination with the need for macroprudential policy and system-wide perspectives, the need for its mitigation has been one of the central themes or lessons of the crisis. TBTF is at the heart of systemic risk due to the fact that the failure of an institution that is deemed systemically significant can trigger a systemic crisis and is, in essence, as existential a threat as it is a seemingly unresolvable policy challenge in the current environment. Ultimately, its significance as well as the importance of its resolution for the functionality and integrity of modern market economies cannot be understated, while there have been multiple attempts to address it as will be discussed throughout, though skepticism remains as to whether it has indeed been resolved.

\textsuperscript{245} The latter are central components of the so-called shadow banking system that evolved throughout the post-Bretton Woods era, presenting another key development of the pre-crisis period. The shadow banking system is composed of both lightly regulated and largely unregulated products and services (e.g. complex derivatives that are traded over the counter) as well as institutions that conduct bank-like activities (e.g. hedge funds) (see e.g. Pozsar et al. 2010; Pozsar and Singh 2011; Turner 2012). It contributed to the crisis in the sense that it substantially increased the prevailing degree of opacity in the system, thereby increasing uncertainty, while it continues to do so in spite of European and global attempts to regulate it (see e.g. FSB 2014).

\textsuperscript{246} See Johnson and Kwak (2011) for an account of concrete legislative and regulatory developments contributing to these trends such as, for instance, the repeal of the US Glass-Steagall Act in 1999. Particularly significant in the European context is the fact that the emergence of large, globally active and in some cases genuinely pan-European banking groups was facilitated by a wave of national and cross-border mergers and acquisitions that took place throughout the 1990s and 2000s and was actively encouraged by the European Commission (Goldstein and Véron 2011: 6), though it should be noted that in spite of intra-country and pan-European consolidation, Europe also paradoxically suffers from being overbanked, meaning that there are too many small banks (Véron 2014b; see also section 5.5). Both developments ultimately contributed to the complexity and overextension of the system.
As the crisis illustrated, the phenomenon TBTF – or more accurately *too big to be allowed to fail* (Becker 2016) – is not only about size. Indeed, it is far more complex and goes well beyond the metric size. Various factors can be central to its emergence as the crisis illustrated, including among the most prominent the size, complexity and interconnectedness of an institution, the nature, scale and scope of its activities as well as its substitutability if it fulfills a critical function in the market. Accordingly, having become more tangible, TBTF can also be substituted with alternatives, including *too interconnected, too complex or too important to fail* (see e.g. Carmassi and Herring 2012; Ötker-Robe et al. 2011). Throughout, TBTF is employed as a synonym for *systemic significance* for the sake of simplicity.

A key factor contributing to the phenomenon of TBTF and giving rise to institutions that are regarded as systemically significant is concentration in the financial sector (Carmassi and Herring 2012) which increases the threat of systemic risk (Gai 2013) and is still on the rise – even in the immediate aftermath of the crisis. For instance, assets of the top 28 global systemically significant financial institutions rose from 47.7 percent in 2002 to 63.3 percent of global GDP in 2011 (Sheng 2013). In the past, the prospect of government support and intervention was rather implicit as the market could never be certain whether assistance would be forthcoming in the event of a default as the Lehman collapse later demonstrated. In the European context, however, multiple factors must be taken into account, which influence general perceptions and play into underlying bailout expectations. Goldstein and Véron (2011: 7) describe these as being rooted in (i) *historical experiences*, including the disastrous repercussions of a wave of bank defaults in the 1930s, which are interpreted as having facilitated the rise of fascism, hence producing an aversion to bank failures, (ii) the *structure of European financial systems*, which are mostly bank- as opposed to market-based, inter alia entailing a reliance of both corporates and governments on banks for funding, and finally (iii) *political institutions*, including their interconnectedness with, stakes in, and reliance on the banking sector for funding at both the national and state level. Accordingly, and in addition to both the fixation of member states on their respective *domestic champions* which tend to be sizable and given the sheer size of some of Europe’s biggest banks, policymakers tend “to see bank failures as politically ominous disasters to be avoided at all costs” (ibid.). The problem that results from these diffuse factors, however, is the implicit safety net and government guarantee embedded therein and the fact that it appears to have become increasingly explicit over time – an issue that has become even more pressing since the FSB and Basel Committee started publishing lists of systemically significant institutions. The externalities are multifaceted and potentially disastrous. Though few institutions actually ever require public assistance, the theoretical possibility or likelihood of support as such represents a competitive advantage. The latter essentially engender competitive distortions which are produced by increasing confidence in the

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247 Different products and asset classes can, in theory, also be defined as TBTF depending on their social function, their complexity and opacity and the extent to which they connect institutions throughout the system (see e.g. Tarullo 2011).

248 Even in the US context, in which corporate insolvencies tend to be viewed with less suspicion, the implicit guarantee was made rather explicit in 1984 in a government official’s testimony after the seventh largest US bank had been bailed out in which it was admitted that the largest US banks may be systemically significant, thereby officially recognizing the existence of TBTF (Becker 2016; see also Goldstein and Véron 2011).
respective institutions as well as substantial upgrades of ratings which factor in government guarantees and hence entail lower funding costs, inadequate risk pricing and a positive impact on stock prices – ultimately presenting an incentive for institutions to become increasingly systemically relevant. As a result, TBTF can be described as a self-reinforcing mechanism and can also in part be equated with the phenomenon of implicit government guarantees, and hence also indirect government subsidies in the billions – a notion that is widely agreed on by both policymakers and academics though they are not easy to measure (Becker 2016; Haldane 2010; Johnson 2013a; Ueda and di Mauro 2012).

Of importance in regulatory terms is that when significant cross-border institutions fail, losses must be allocated (Levitin 2011; Willke et al. 2013), implying that at its core TBTF is a distributive issue and must be prioritized. This is relevant in both the national and European context, and increasingly contentious in the case of the latter as distributive consequences arise not only when allocating losses to the private and public sector, but also to national constituencies and institutions (see sections 4.4.1 and 5.5.3). It must, nonetheless, be resolved at the European level to achieve credibility and capacity without creating moral hazard due to the nature of finance as a cross-border sector and the nature of system risk as an unpredictable phenomenon. What must be born in mind, however, is that in order to address systemic risk which as long as the financial system cannot internalize the effects of failure and the inequities and inefficiencies of the system at large (Woolley 2010), an exclusive focus on SIFIs and TBTF is overly narrow. Mirroring the insights of system theory, even absent SIFIs, systemic failure is still a threat; in effect, systemic risk as an emergent property of a highly complex and inherently unstable system can arise from an infinite combination of factors. Therefore, addressing systemic risk by default implies addressing TBTF, the latter is, however, only part of the equation.

Though TBTF is at the heart of systemic risk and both phenomena are intricately linked, they should not be equated with one another (Becker 2016). The former is essentially a structural characteristic that is conducive to the latter, which is a far more complex and encompassing phenomenon. Indeed, though TBTF is a central focus of post-crisis reforms, it is only one constitutive element of systemic risk (see chapter 4.2.1 on emergent properties). To illustrate this point, the following is illustrative: Though the failure of a SIFI as an endogenous or system-internal trigger can precipitate a systemic crisis, exogenous events such as a terrorist attack (Wolf 2008) or political turmoil can do so as well, as can the normal operation of the complex, tightly coupled financial system as such. This insight is highly consequential and must inform all reform efforts.

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249 In the US context, Becker (2016) argues that though, for instance, the Dodd-Frank Act has established measures to monitor and resolve SIFIs, in addition to officially designating systemically significant financial institutions in order to in theory reduce the risk of failure and in the event of the latter trigger a resolution mechanism designed for entities that are considered TBTF, the government has not yet been successful (see also Johnson 2013a, 2013b). The same logic largely applies to the EU case. Ultimately, it is all about perception and credibility.

250 The former is particularly significant in the case of the eurozone. A national election, substantial increases in sovereign debt or a host of other events might in theory trigger an implosion of the system. In the case of the latter, the emergence of a potentially dangerous asset class such as CDOs containing subprime mortgages can lead to a breakdown (see e.g. Tarullo 2011).
Also at the heart of the crisis and intricately linked with the process of financialization and the rise of large systemically significant institutions was the advent of large-scale financial innovation. As another central development in terms of the evolution of system characteristics in the pre-crisis era, innovation, primarily in the form of the emergence of sophisticated financial instruments such as complex derivatives – among the most prominent collateralized debt obligations and credit default swaps, a majority of which were sold over-the-counter – increased the system’s overarching complexity and opacity substantially (Gai 2013), for instance, by way of contributing to the increasing interconnectedness of the institutions described above. In their interplay these innovative products constitute a complex web of contractual relationships and as alluded to previously the risks they entail with respect to leverage and counterparty risk had largely been underestimated (El-Erian 2017b). Ultimately, when the crisis hit, it was hard to definitively ascertain to what degree individual institutions were affected as practically all institutions were exposed to these instruments in some way or another, triggering widespread panic (Sheng 2013; Weber 2012).

Though finance theory had advanced the thesis that risk must be diversified and in this sense innovation was beneficial, geographical diversification against the backdrop of globalization “disguised the fact that everything was interconnected” (Sheng 2013) and had become increasingly interdependent, in addition to downplaying the risks emanating from simply repackaging low-quality assets. The crisis then highlighted the destructive capacity of these sophisticated instruments as well as the fact that both regulators and market participants had largely been oblivious to the fact that excessive amounts of credit had been generated and moved off balance sheets, while the knock-on effects of volatility would affect all actors involved (ibid.). Widespread scepticism of the prevailing conventional wisdom as to the utility of financial innovation accordingly ensued in the post-crisis debate (see e.g. Mayntz 2013). Until then, the dominant view had been that excessive regulation would adversely impact innovation, competition and growth, while dissenting voices were ignored – a case in point is the investor Warren Buffet’s stark warning with respect to the destructive potential of derivatives in 2002 (Buffet 2002).

Yet, not only were the benefits of some innovations of marginal utility (see Turner 2009; Volcker 2009; see also section 4.1.1) and in certain respects even highly questionable, merely serving to increase intra-financial system activity and the prevailing degree of financialization (Das 2014; Sheng 2013), they were...

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251 Derivative contracts, which include futures, options and swaps, were originally employed to hedge risks, though their scale and complexity increased exponentially throughout the 1990s and 2000s; in this period, they were increasingly employed for speculating as they enable substantial increases in leverage (Goodman et al. 2007). In the context of structured finance, collateralized debt obligations (CDOs) are highly complex derivatives that pool asset-backed securities (ABS). Structured into tranches according to their default risk (i.e. the higher the risk of default and the interest rate, the lower the tranche), CDOs repackage lower-rated tranches of a set of ABSs to diversify risk and in theory make these financial products less risky (ibid.). These CDOs’ lower-rated tranches can then be repackaged again into a CDO squared. Credit default swaps (CDS) in turn are employed to hedge risks related to these and other products, essentially providing insurance with the difference being that the underlying asset must not be owned by the buyer of a CDS, thereby also enabling the use of the latter as a tool for hedging and speculating. The markets for these sophisticated products grew in tandem with the booming US housing market and increased system complexity to such a degree that no one understood the full impact of the increasingly opaque interdependencies that had emerged (for in-depth analyses of the subprime mortgage crisis, see Lewis 2011; Fligstein and Goldstein 2010).
also in a sense interpreted as a strategy for *regulatory circumvention and arbitrage* (Anabtawi and Schwarcz 2011), contributing to the system’s overall complexity, exacerbating inevitable information and knowledge asymmetries between regulators and regulatees (Becker 2016; Hu 2012), and complicating their regulation and supervision in the process. While regulatory complexity can and indeed often does match the degree of complexity that prevails in the financial sphere caused by innovation,\(^{252}\) it cannot match the speed with which innovation advances (Becker 2016; De Larosière 2009; Schwarcz 2008), essentially implying that continually ratcheting up regulatory complexity is a futile if not counterproductive endeavor (Haldane and Madouros 2012). A crucial takeaway from the crisis, however, and thereby also an argument in favor of simplifying and fundamentally reforming the system in line with the assumptions and perspectives of system theory set out previously is the fact that it is not only regulators that lack sufficient expertise to regulate the outcome of innovation adequately, it also seems the sector at large, i.e. financial experts as such did not fully comprehend the broader effects and implications of the instruments they were employing (Sheng 2013).\(^{253}\)

To summarize, what are the main takeaways that can be deduced from the elaboration throughout? It has been argued that distinguishing the crisis of 2008 was its *systemic nature* as well as its scale, scope and the concatenation of multiple sub-crises that it exhibited (Levitin 2014; Willke et al. 2013). The overarching challenge of regulating and governing an inherently unstable, unpredictable and highly complex and dynamic financial system is, ultimately, the fact that systemic crises are always a potential threat, irrespective of the precautions taken by policymakers and regulators. Crises are unlikely to exhibit the same causes, patterns and dynamics, hence it is impossible to prevent systemic crises altogether, even the top brass of the regulatory elite acknowledge this fact (Yellen 2010). As long as the underlying system properties and structural weaknesses defined above remain unchanged, crises will mirror the financial systems within which they emerge: They will be highly complex, unpredictable and reflect the continually evolving nature of the financial system as such in addition to giving rise to and being rooted in unintended consequences of regulatory action.

So what are the implications of these system developments, particularly if the system remains – or indeed becomes increasingly – complex and unstable? In this context, it is important to emphasize the inevitable fallibility of regulatory actors and market participants once again. As noted by Willke and Willke (2012: 48f.), the limited predictability and capacity to comprehend the financial system in its entirety is “less dangerous when actors understand their inability to (fully) understand […] complex systems. It is most dangerous when people, in particular professionals, disregard their ignorance and feel certain about the

\(^{252}\) See Kane (1986) on the *regulatory dialectic*, i.e. the mutual and recursive adaptation of regulation and industry practices.

\(^{253}\) As noted previously, the former Federal Reserve Chairman, Alan Greenspan, admitted that some of the instruments comprised in collateralized debt obligations were simply incomprehensible (Sorkin 2010: 90), while the former British finance minister recounts that shortly before the Lehman bankruptcy a senior banker had claimed “we have decided that we only take on risks that we fully understand” (Darling 2009), suggesting that rather than merely exhibiting complacency and hubris, many market participants “simply did not understand the risk[s]” (ibid.) they were taking on.
systems they are dealing with”. In order to address systemic risks arising from interconnectedness, contagion, instability and complexity, reactive, reflexive and cross-border governance – at stake in the following – is imperative. Against the backdrop of the insights established throughout such as (i) the dangers inherent in the financial system, its limited governability given inherent instability and uncertainty, and (ii) the account of market dimensions, system properties and problematic system developments, the following looks into the respective regulatory consequences thereof, the challenges of reform and the ensuing governance imperatives that can be deduced from the latter before progressing to the discussion of the resulting regulatory response.

4.3.3 The Significance of Reactive Governance Capacity

The preceding chapter highlighted the challenges regulators and policymakers face in terms of regulating finance. Systemic risk is a test case for governance capacity. Its pervasive global and unpredictable nature as illustrated by the crisis renders it, by definition, a challenge for cross-border governance. In view of the challenges at stake – among others the persistence of uncertainty and complexity, but also the reduced autonomy of nation states and the cost of inaction – cooperation is inevitable and indeed desirable from an interest-based perspective. The outcome of reform and the ensuing cross-border governance capacity – assessed at length in chapters five and six – is of particular significance in the case of financial regulation given the financial system’s propensity for instability and the destructive knock-on effects that ensue.

As will become clear throughout, national policies exhibit substantial shortcomings as regards their capacity for the provision of collective goods such as financial stability. And indeed, “[t]he most serious problems are not confined to national territories, but instead derive in large parts from global concatenation” (Willke et al. 2013: 227). Given the complexity and system characteristics of finance, cross-border coordination is indispensable as stability and reform outcomes in terms of governance are inextricably linked and inherently challenging at the national level, the supranational level and indeed beyond. The crux, however, is that the effectiveness of national reforms in terms of both their design and implementation is in large part dependent upon cooperation and indeed integration to ensure consistency, coherence and credibility – with the strength and consistency of regulatory frameworks, the credibility of resolution regimes and mechanisms of burden-sharing being cases in point in the European context, especially due to the existence of a single financial market and a common currency. Ultimately, cross-border financial intermediation – despite partial retrenchment and fragmentation (ECB 2017a, 2017b; Schoenmaker 2013d) – is here to stay, particularly in the European context (Grossman and Leblond 2011; Lane and Milesi-Ferretti 2017), increasing the risk of and potential for systemic risk and contagion. Therefore, in order to mitigate externalities, integrated cross-border governance remains imperative.
Of crucial importance in this context is the significance of what is defined throughout as reactive cross-border governance capacity, i.e. the build-up of capacity via institutions and mechanisms at the supranational level – an assumption deduced from the preceding analysis and a central issue throughout with regard to the regimes at stake as the very nature of systemic risk and the financial system’s inherent instability give rise to the necessity and make the case for (i) regulation and supervision as such as self-regulation is insufficient to attain system stability on the one hand, and (ii) integrated and robust supranational governance regimes, capable of conducting cross-border regulation, supervision, crisis prevention and crisis management on the other – particularly in view of the single market in the European context.

Before progressing to the analysis of policies and governance reforms instituted in the aftermath of the crisis, a brief clarification of what is ultimately meant by governance capacity against the backdrop of the definition of systemic risk elaborated previously is in order. Thereby, the central premise upon which the analysis throughout rests is that integrated governance capacities, i.e. European integration and centralization are the optimal solution, and therefore the end goal, for increasing governance capacity in view of integrated markets. The prospect of attaining consistency and coherence as well as signaling and projecting predictability, credibility and neutrality vis-à-vis financial market actors (as central elements of curbing moral hazard) that may flow from the build-up of common governance structures and capacities for crisis prevention and management at the European level are central criteria/aspects in this respect. The analysis is therefore conducted on the premise that integration and centralization are, in theory, and if conducted diligently, desirable. Against this backdrop, the analysis sets out to assess the degree of integration that has transpired essentially equating governance capacity to the degree of integration that has been achieved with the premise being the following: capacity is ultimately dictated by the degree of integration.

In order to attain the goal of reactive governance capacity two components are crucial: substantive policy on the one hand and institutional elements of the governance architecture on the other. The latter essentially implements the former and is essential for the emergence of governance capacity and credibility required to inhibit systemic risk and moral hazard (the political component) and deal with fallout/effects of unexpected crises that will inevitably arise (the systemic element). Again, this research is a governance analysis and focuses on the institutional governance architecture constructed in the aftermath of the crisis. The following dives into the policy reform elements which actors in the governance institutions then implement as a basis for the governance reforms at the heart of this research to which it turns thereafter. Of significance throughout is that given the inevitable shortcomings of substantive policy reforms such as new bail-in rules and resolution regimes for failing financial institutions given their contingent nature and the fact that their utility has not yet been tested in a systemic crisis (Wolf 2014b; Véron 2013a; Véron and Goldstein 2011), cross-border integration and robust cooperation schemes become all the more important to enable regulators and policymakers to react to all eventualities. In crises, when time constraints and
resources are in short supply, crisis management capacities are crucial. Due to the systemic nature of systemic risk and the fact that the system’s *modus operandi* (Willke et al. 2013) largely remains intact integrated governance capacities are of the essence.

Before proceeding, however, it is important to briefly discuss the merits of regulation and integration, i.e. the rationale for the latter, and in this context the rationale for regulatory integration and governance at the supranational level – the main assumption throughout our analysis in terms of the outcome of reforms and governance integration. Functional markets are central to macro-economic performance and overall prosperity (Herring and Santomero 1996; Levine 2005). Thereby, financial regulation is an essential component of economic governance and indeed a crucial factor in ensuring sustainable growth (see Djankov et al. 2006 on the nexus between regulation and growth), while being central to mitigating market failures and the negative tendencies to which markets are prone (*opportunistic behavior, monopolies etc.*), ensuring institutional soundness, consumer protection (Goodhart et al. 1998; Llewellyn 1999) and safeguarding the stability of the financial system as a whole. Ultimately, financial regulation and supervision are indispensable. Despite their inherent temporal flaws, the incomplete nature of law and regulations and the inherent instability of the system – which implies they will never be able to forestall crises altogether – they are not entirely futile. They ultimately structure markets and construct incentive systems to ensure the functionality and equity of the system as such. In this sense, authorities must do “things which at present are not done at all” (Keynes 1936: 46), i.e. the things markets cannot provide for themselves.

In this context – and against the backdrop of the systemic risk definition set out above – this implies (i) taking on the role of a contingency planner as systemic risk is by definition unexpected and cannot be adequately planned for, and (ii) attempting to mitigate moral hazard and perverse incentives by constructing credible mechanisms and structures for stringent ex ante regulation and equitable and cooperative crisis prevention and ex post crisis management, thereby curbing the potential for the political system to be taken hostage by financial market actors. This is what EU-level structures attempt to achieve. The rationale is ultimately that competence transferal and centralization are – in view of tightly interconnected transnational markets which require concerted cross-border cooperation, and by removing regulators, supervisors and policymakers from their cozy and at times destructive relationships with national financial institutions – the best bet to achieve this (Weder di Mauro and Klüh 2010; Sandbu 2017a). What has been done to attain this is presented in the following: first in substantive terms and thereafter by tackling institutional reforms.

4.4 The Substantive Foundations of Governance Reform: Crisis Prevention and Management

In addition to an array of overhauled or newly instituted institutions and governance arrangements, various pan-European regulatory reform measures were introduced in the aftermath of the financial crisis
– mostly, yet not exclusively, in line with international developments (Quaglia 2012). Even though the immediate post-crisis era was dominated by regulatory initiatives that targeted behavioral changes (Mayntz 2013), the overarching issue on the regulatory agenda in the aftermath of the financial crisis was ultimately that of financial stability. The crisis essentially exposed weaknesses inherent in the microprudential regulatory frameworks in place, which had prioritized institutional stability over system stability (Borio 2003, 2011; Brunnermeier et al. 2009; Hanson et al. 2011). The resulting regulatory response, accordingly, focused on the overhaul of the pre-crisis regulatory architecture, attempting to remedy highlighted flaws and increase system resilience by implementing a new **macroprudential paradigm**.254

Indeed, in the post-crisis era, the significance of financial stability became increasingly prominent. In 2010, the former Internal Market Commissioner, Michel Barnier (2010a), stated “prevention is less expensive than the cure”, also citing the need for a “new approach to risk-taking” and a revised “crisis management and foresight culture” (ibid.), integrating micro- and macroprudential elements and coupled with a European outlook to sustain the internal market, capturing the general mood that characterized the post-crisis regulatory environment. Though it has not quite been the case that there has been a “massive rethinking of the role of the government and of the market” (Stiglitz 2009b: 345) and the “consensus for a liberal market economy” (Saggar 2012) has largely remained intact in the post-crisis era, there was indeed momentum for an at least partial revision of the pre-crisis regulatory paradigms as the crisis underscored the fact that markets cannot be left to their own devices. Central to the revision were substantive policy elements, procedural mechanisms and institutional structures that acknowledge the centrality of system stability and revolve around crisis prevention and crisis management as complementary and interdependent dimensions of financial governance.

The examination of the crisis ultimately revealed various fundamental shortcomings pertaining to both the financial and the regulatory system, while the analysis of the nature and ramifications of systemic risk shed light on the governance imperatives cross-border finance gives rise to, i.e. the necessity of robust cross-border governance regimes capable of conducting holistic system oversight and supervision (**system-wide risk assessments and macroprudential analyses**), implementing preventive ex ante regulatory measures (**via prudential policy and pan-European supervisory approaches**) and tackling the ramifications of financial turmoil when it arises (**e.g. in the form of countercyclical prudential policy, resolution regimes and cross-border burden-sharing arrangements**).

In the following, substantive dimensions of reform, designed or revised in the aftermath of the crisis to fulfill these functions and serve as the foundations of financial governance and the provision of system stability, are at stake. In this context, the section presents and contextualizes reformed substantive policy elements of the regulatory framework aimed at crisis prevention and management and put in place as a

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254 Of relevance in this context is the fact that the macroprudential paradigm implemented in post-crisis reforms is at the core of both substantive policy elements (**e.g. countercyclical capital requirements**) and newly instituted institutional structures (**e.g. the pan-European Systemic Risk Board**) of which the former are at stake in this chapter and the latter thereafter in chapter five. For an in-depth discussion of the origins of the term and concept of macroprudential regulation, see Clement (2010).
response to the crisis, essentially serving as an elaboration of the toolbox regulators now have at their disposal and presenting the underlying conceptual basis for assessing institutional governance reforms in the following chapter. It does so by briefly visualizing the respective stages of regulation and supervision directed at attaining financial stability in the form of system oversight, prevention and crisis management – all of which are required in view of the systemic risk definition employed – and thereafter looks into how they have been reformed and upgraded, while also assessing the respective implications. Substantive elements of the reform effort aimed at the mitigation and management of future crises include an array of regulatory policy tools and procedural mechanisms and can be grouped into different categories according to their objectives, nature and time frames, essentially constituting elements in and phases of prevention and crisis management within the regulatory and supervisory framework. As alluded to when discussing the anatomy of crisis, the latter exposed substantial regulatory shortcomings when dealing with the ensuing fallout, among other factors in terms of governance structures and mechanisms for crisis management, as the crisis was both unexpected and unprecedented. In an attempt to remedy these flaws, policymakers implemented policies and devised instruments and mechanisms to preempt crises and counter instability. These include (i) short-term crisis management tools for immediate action in the event of crisis, such as resolution regimes and bail-in instruments, regulated in the pan-European context under the Bank Recovery and Resolution Directive (BRRD) and implemented in the eurozone within the context of the banking union (section 4.4.1), (ii) medium-term substantive tools to stabilize the financial system in the long run, including macroprudential policy and revised prudential requirements (section 4.4.2), and finally (iii) long-term and system-wide prevention in the form of systemic risk oversight measures, including the establishment of systemic risk oversight bodies and tools, such as stress tests and resolution plans (section 4.4.3). Though the latter two constitute the preventive dimension in the provision of financial stability, it should be noted that there are substantial overlaps between all three spheres. Countercyclical capital instruments can, for instance, be employed in both a preventive sense and as crisis management instruments, while advances in resolution planning have deterring effects and long-term preventive qualities as well as offering tools for immediate crisis management and stabilization. They are discussed in order throughout, whereby the approach is as follows. To start off, as an introduction to dimensions of financial governance directed at the provision of financial stability, components of crisis prevention and crisis management are visualized in overarching terms in the context of regulation and supervision as such, i.e. embedded in the overarching supervisory context, and with a view to their nature and time horizons.\footnote{Note in this context that there are thematic overlaps with chapter five on the policy response in the European context in which the deficiencies of the pre-crisis governance architecture are discussed. Reforms in this context are contextualized thereafter throughout chapters 5.4 and 5.5 on institutional schemes within which substantive reform elements are implemented.} Thereafter, substantive elements of post-crisis reform are discussed in order, which in turn is followed up by chapter five which shifts the focus to the post-crisis policy responses at the European level, drawing on the insights set out in this subchapter and shedding light on deficiencies of
the pre-crisis regulatory and supervisory architecture. This, then, serves as the introduction to the institutional responses and reforms discussed throughout the remainder of this contribution.

The rationale for including substantive reform elements in this context is the fact that they present a direct result of the challenges highlighted throughout. Thereby, the goal of this section is essentially to present reform measures directed at short- to long-term crisis prevention and crisis management and instituted in the aftermath of the crisis as a consequence of the latter’s revelations. It also, however, casts them in a critical light and highlights their potential shortcomings from which in turn the rationale for cross-border governance structures can be deduced. In this sense, what is ultimately argued throughout is that the latter, i.e. substantive policy tools are inevitably fallible, while events such as the crisis of 2008 are bound to reoccur. With a view to the unpredictable nature of systemic risk, in order for national and supranational actors to be able to react to all contingencies and eventualities, the need for contingent crisis management capacities and fora within which these can be devised, instituted and coordinated are of the utmost importance and will most likely contribute to the socialization of participating actors in the process. This is essentially the goal of common supranational structures with which not only the scope for certainty and capacity at the European level can be increased, but with which the uncertainty emanating from the considerable and enduring size and complexity of financial behemoths, the untested nature of newly devised resolution tools and the ensuing moral hazard this gives rise can potentially be mitigated. As an example, every bailout is “a system unto itself” (Levitin 2011: 481), rendering contextual and at times unconventional action a necessity no matter the precautions taken in preparation of the next potentially systemic crisis. These are crucial issues of significance that must be borne in mind.

Before progressing with the discussion of substantive reforms, a visualization of the governance framework in which crisis prevention and crisis management are embedded is in order. The following figure depicts the stages and functions of the supervisory and regulatory framework in which the reconciliation of crisis prevention and crisis management is envisioned and attempted.

Figure 2: Stages and Functions of Supervision and Crisis Management in Financial Governance

Source: Figure based on Schoenmaker (2013c)
The following now turns to the respective elements at stake and discusses them in order before turning to the institutional reforms enacted as a response to the crisis within which these activities can be conducted and coordinated.

4.4.1 Immediate Short-Term Crisis Management: Resolution Regimes and Bail-In Instruments

The financial crisis of 2008 illustrated that regulators and policymakers were unprepared for a crisis of such proportions as the one that unfolded. Having neither the explicit mandate for widespread bailouts nor the mechanisms, tools and requisite data at hand that would have been required for resolution procedures of such scale or magnitude – in addition to being unable to draw on conventional bankruptcy procedures, not to mention the acute time pressure to which they were subject – regulators were faced with a conundrum and indeed even existential threat not yet witnessed in the context of the modern regulatory state (Levitin 2014: 1). In an attempt to tackle the issues exposed by the crisis and mitigate the prospect of a similar scenario – for instance, by rendering regulatory threats and claims such as those made by then US president Barack Obama and the former EU internal commissioner Michel Barnier as regards the fact that too big to fail no longer exists and no more taxpayer money will be spent on bank rescues more credible (Barnier 2010a; Obama 2010) – one dimension of the reform agenda – the most significant elements of which in terms of system stability are discussed in the following sections – pertains to tools and mechanisms for immediate and in effect also short-term action, in essence constituting the first line of defense in crisis scenarios.256 The latter have multiple dimensions and are first and foremost crisis management tools. They can, however, also be interpreted as having preventive qualities as they can, in theory, also serve as ex ante deterrents, yet only if they are genuinely credible. In this sense, the construction of viable resolution regimes – in the context of which the devising of so-called living wills or resolution plans and ex ante resolution planning in general are essential components, and in turn are integrated into the overarching framework for system oversight and crisis prevention (see section 4.4.3) – is critical for financial governance as such. It should therefore be noted in this context that there are substantial overlaps between the three categories of reform at stake throughout the remainder of this chapter.

As mentioned previously, in order to contain systemic risk when dealing with crises the ex post resolution of failed financial institutions and the concurrent process of allocating losses are crucial elements of crisis management (Levitin 2011). The most significant crisis management tools in this context are ultimately resolution regimes and the newly devised bail-in rules that are to be applied in resolution processes (ibid.; see also Sandbu 2017a on their significance in the European context). Not only have they been designed to hold private sector actors to account to a greater extent, but they are also intended to offer templates

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256 Depending on the perspective it might, however, also be interpreted as the last line of defense – if, for instance, system oversight and prevention are seen as constituting the first line of defense.
for the resolution of institutions on both a national and cross-border basis with which certainty and credibility vis-à-vis the private sector can, in theory, be increased. As such, they are supposed to mark the end of “the old paradigm” of bank bailouts (Barnier 2014a), though it remains to be seen whether this is indeed the case (Alexander 2017). Governing resolution in the pan-European context is the Bank Recovery and Resolution Directive (BRRD) and the banking union as the institutional frame in the eurozone within which the latter is implemented (discussed in the following chapter). As of January 2015, the BRRD is applicable across the entire Union and its rules – which are an integral part of the EU’s single rulebook and attempt to attain Union-wide coherence in order to reinforce the single market (see section 5.6 on differentiated integration) – must be applied by all member states when resolving banks and large investment firms as specified in the directive. In essence, the BRRD is a harmonized regulatory regime for intervention and resolution, putting comprehensive and cooperative arrangements in place to “improve the tools for dealing with bank crises across the EU” (European Commission 2014d; see also Ferran 2014b) and facilitating cooperation among home and host authorities, granting them powers to allocate losses to shareholders and creditors and resolve institutions in a manner that maintains most critical functions, while affording the pan-European EBA a central role in this context (ibid.).

In principle, the overarching goal of resolution mechanisms is – among other aims such as, for instance, the disciplining of financial firms and the mitigation of moral hazard by upgrading public authorities’ capacity to handle failure – to prevent contagion from national and international shocks and crises eliciting a wholesale collapse of the banking system. Both the utility and viability of the tools and schemes devised to mitigate chaos in this context, however, are contested and remain subject to debate, particularly with regard to their suitability for handing the potential failure of systemically significant institutions (see Alexander 2017; Vickers 2016). The reason is inter alia that large complex institutions with cross-border operations exhibit highly complex legal structures that have not necessarily been sufficiently streamlined in the post-crisis era so as to make them conducive to resolution, thereby considerably frustrating crisis management. Though substantial advances have transpired in this regard (for instance, with respect to resolution planning), it is widely agreed that too big to fail remains an issue (Bair 2014; Bott and Jenkins

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257 The European Commission (2014d) has stressed its commitment to making “shareholders and creditors of the banks pay their share of the costs through a “bail-in” mechanism” time and again, claiming the BRRD “equips public authorities for the first time across Europe with a broad range of powers [and] it will be the bank’s shareholders and their creditors who will bear the related costs […] of a failure” (ibid.).

258 See Goldstein and Véron (2011) for an in-depth discussion of approaches to resolution, Krimminger and Nieto (2015) on structural differences between the US and the EU in this regard, and finally Ferran (2014b) on resolution in both the eurozone and pan-European contexts.

259 In 2013, Kapoor argued that the status quo as regards the complexity of large financial institutions’ legal structures was unsustainable (Kapoor 2013). Citi’s 2400 subsidiaries, for instance, rendered the institution too big to fail, ultimately making it too complex to evaluate, regulate and manage. This interpretation is in line with the view of many other academics and prominent financial commentators – including, for instance, Johnson (2013a, 2013b), Kane (2014) and (Wolf 2014b, 2014c) – and applies to many other institutions in the Western world as well. Ultimately, the uncertainty as regards the utility of established policy tools persists and is compounded by the persistence of the excessive size, complexity and systemic relevance characterizing individual institutions – a worrying trend that has only increased in some respects in the post-crisis era (Bott and Jenkins 2017).
The reduction of system complexity and an increase in the level of transparency as well as explicit and concerted cross-border regulatory action is certainly required in this context in future (Kapoor 2013).

Notwithstanding the changes that have been made to render financial behemoths more stable, manageable and indeed resolvable – the foundations of which are set out throughout this subchapter – it remains subject to debate to what extent higher capital requirements and ex ante determined resolution schemes coupled with resolution plans and stress tests – which present the basis on which resolution planning is ultimately conducted – will actually make the next systemic crisis of a similar magnitude more manageable.

With reference to the definition of systemic risk above, the argument has been that systemic risk is, in effect, unpredictable and can give rise to endless scenarios and threats. In this context, the issue of unintended consequences is of central importance. Most importantly, the fact that regulators cannot preclude its emergence entirely nor predict its precise nature or ramifications, all ex ante attempts to stabilize the system and devise procedures and mechanisms for orderly crisis resolution are inevitably fallible – i.e. are contextual, with their viability dependent on the context within which they are applied (Goldstein and Véron 2011; Levitin 2011) – and must therefore be regarded in a critical light, i.e. cannot be interpreted as a magic bullet as such.

In sum, these developments are doubtlessly laudable, but unfortunately they do exhibit potential shortcomings. The latter include remaining uncertainty as to the viability of the tools depending on the crisis scenario that emerges in future. The question ultimately arises as to whether if a Lehman style bankruptcy transpired again or multiple institutions of a similar scale threatened to default simultaneously, authorities would be able to allocate losses adequately in resolution procedures or public bailouts would again be the inevitable (i.e. default) option. In addition, the issue of unintended consequences continues to loom large with the question ultimately being from where the next risks materialize will and whether regulators are truly prepared to resolve crises without engendering contagion. Given the fact that TBTF seems to persist owing to the fact that most institutions are as large and complex as ever (Bott and Jenkins 2017),

260 In this context, it is important to note that the US approach appears "for the most part focused on the orderly liquidation of an individual institution and not the system as a whole" (Richardson 2011: 33). The same applies to the European context – though it must be noted that the US framework is considered more stringent and comprehensive as it allows for the resolution of non-bank financial institutions and stipulates that all institutions subject to resolution must ultimately be wound down, while the European system is more lenient and allows for greater flexibility as regards the handling of failing institutions (Krimminger and Nieto 2015) – though this may, in turn, be due to structural differences as Europe is essentially a bank-based system, implying it is also more dependent on the banking system for credit provision and economic activity than the US. Notwithstanding their differences, however, their common focus on individual institutions is of significance as in systemic crises multiple institutions – or indeed even entire markets – tend to be affected simultaneously, which implies that devised contingency plans and established procedures may fall short if authorities are overburdened and cannot deal with the fallout in a holistic manner. See also, in the context of unintended consequences, Willke et al. (2013: 69–70) on related issues pertaining to the issue of fragmentation in the US structure of regulatory power (see also Ferran 2014a; Scott 2011: 728ff.; Zandi 2008) which is significant in terms of the complications this constellation may give rise to.

261 In the US, for instance, the DFA grants the FDIC – revered for its track record in resolving insured depository institutions – resolution and liquidation powers for institutions that pose significant stability risks to avert Lehman-style bankruptcies. Yet uncertainty remains as to the ability of authorities and precautions taken to resolve SIFIs, for instance, whether living wills are both reliable and sufficient as they remain untested. Skeptics on the feasibility of new tools and mechanisms in view of the complexity that prevails include the former FDIC chairwoman Sheila Bair (Bair 2014). See also Miller and Horwitz (2012), lawyers involved in the Lehman bankruptcy, who argue that an orderly unwinding of the latter would have taken up to ten years.
the viability of short-term crisis management measures remains questionable – or at the very least uncertain – and with it the reduction of moral hazard vis-à-vis the private sector via bolstering credibility.

In a nutshell, as was the case at the height of the financial crisis of 2008, uncertainty as regards the utility of existing and now newly established policy tools and mechanisms prevails as they have never been tested and every bailout is, in essence, “a system unto itself” (Levitin 2011: 481) – thereby making reactive and contextual – and at times also unconventional – action a necessity no matter the precautions taken and the structures established – inter alia also given the unintended consequences that result from both regulation and the evolution of the financial system as such. Unconventional action was a necessity in the previous crisis and will most likely be a necessity in the next crisis – while this principle, again by necessity, will also apply to the cross-border European context.

Ultimately, as the utility and viability of established procedures remains in doubt and has yet to be tested in full-scale crisis scenarios – that is in systemic crises in which multiple institutions are in danger of defaulting simultaneously and rampant uncertainty takes hold – regulators and policymakers devised, instituted and revised complementary, more medium-term, and for the most part preventive, instruments to accompany short-term and immediate crisis management tools and measures, and to attain stability and prevent crises in the first place. They are at stake in the following.

4.4.2 Medium-Range Reforms: Macroprudential Policy and Revised Prudential Requirements

While the above focused on immediate crisis management measures, the following category has a more medium-term horizon, though it combines multiple dimensions and spans elements that serve both as preventive measures and crisis management tools. The following embeds them into the international context and thereafter briefly evaluates both their stability-inducing potential and sufficiency in this regard.

On Capital Requirements and Prudential Regulation: The International Context

The international regulatory context and global framework for prudential regulation in Europe is the so-called Third Basel Accord (or Basel III) devised by the Basel Committee on Banking Supervision (BCBS) which is located at the Bank for International Settlements (BIS). Building on its predecessors Basel I and II, Basel III was introduced in the aftermath of the crisis. Published in 2010 and revised gradually and continually in the years thereafter as part of a continuous effort to enhance the regulatory regime governing the banking sector, it includes lengthy transition and implementation periods to phase in the

262 In addition, the degree to which institutions remain systemically significant can only be definitively determined after their failure – further complicating regulatory cost-benefit calculations and actions in crisis situations. Monetary policy on both sides of the Atlantic during the crisis is exemplary in this regard. The logic that is most often applied to justify extra-legal actions in changing circumstances is that of output legitimacy. See Dyson (2013) on the ECB’s role in supreme emergencies.
revised requirements (BCBS 2011a, 2014, 2017). In essence, it seeks to establish a global regulatory framework that increases the resilience of the banking system, strengthening its capacity to deal with financial stress, absorb economic shocks and withstand downturns, which essentially entails putting more private capital at risk and ensuring financial institutions’ ability to absorb losses in future crises, while simultaneously ensuring the ongoing provision of credit to the real economy (Greenwood et al. 2017).

As a regime governing capital adequacy and liquidity, the set of reforms introduced in this context include more stringent rules pertaining to levels of capital, liquidity and leverage ratios, and countercyclical capital measures designed to enhance the regulation and supervision of the banking sector as well as risk management and transparency within it. With capital requirements essentially having tripled, Basel III has substantially increased regulatory capital ratios, i.e. the amount of capital that must be held as a percentage of risk-weighted assets (RWAs) with both the minimum Common Equity Tier 1 (CET1) capital ratio and Additional Tier 1 capital (AT1) requirements increasing. Whether this represents substantial progress – in combination with additional changes in Basel III – will be contextualized throughout.

Capital requirements are complemented by leverage ratios and liquidity requirements to curb excessive risk-taking, borrowing and lending, while reducing overall leverage and strengthening capital bases in order to ensure institutional resilience in times of crisis. The approach to liquidity requirements, for instance, is two-pronged. The Liquidity Coverage Ratio (LCR), a short-term measure for internationally active banks, requires that the latter hold sufficient high-quality liquid assets to cover total net liquidity outflows over a period of 30 days, while the Net Stable Funding Ratio (NSFR) underpins the LCR as long-term structural solution (ibid.). The leverage ratio, on the other hand, which is non-risk based and is defined as Tier 1 capital divided by an institution’s total exposure, i.e. total consolidated assets including all on- and off-balance sheet assets, remains at three percent (BCBS 2011a, 2014, 2017). It is essentially a supplementary measure to decrease banking sector leverage and serves as an additional safeguard against errors of measurement and risk assessment on the part of financial institutions and supervisors alike by introducing a simpler metric based on overall gross exposures. Ultimately, these are no doubt worthy objectives given the sheer complexity of the endeavor of assessing institutions’ risk profiles and the flaws

263 In the European context, global agreements are subsequently integrated into corresponding supranational regimes. In the case of the Basel reforms, they are implemented in the form of the Capital Requirements Directive IV (CRD IV) and the Capital Requirements Regulation (CRR) which, taken together, constitute a pan-European legislative package that covers prudential regulation for banks, building societies and investment firms, and which in the case of directives are in turn transposed into national legislation. The legislative package based on Basel III was approved in 2013, replacing the previous Capital Requirements Directives (2006/48 and 2006/49) and comprising both the Directive 2013/36/EU (CRD IV) and the Regulation (EU) No. 575/2013 (CRR) on prudential requirements for credit institutions and investment firms. See Howarth and Quaglia (2013b) on the respective preference constellations in the European context in this regard.

264 Risk-weighted assets are drawn on to determine the amount of capital financial institutions are required to hold as a cushion for potential losses and are essentially an institution’s assets weighted in accordance with their risk coefficients, i.e. based on an assessment of all assets classes in accordance with credit ratings in which the higher the respective credit risk is, the higher its risk weight is. The guidelines for their definition have for the most part remained unchanged vis-à-vis Basel II (BCBS 2017). Regulatory capital in turn is divided into tier 1 and tier 2 capital. The former is composed of common equity tier 1 capital and additional tier 1 capital, while the latter includes unsecured subordinated debt with a maturity of at least five years.

265 Final adjustments based on a so-called parallel run period in which supervisors tracked and disclosed leverage ratios in their respective jurisdictions were made in 2017, while mandatory requirements were scheduled to take effect in 2018 (BCBS 2014).
they inevitably exhibit owing to human fallibility, collective irrationality, and the prevalence of non-knowledge as well as the complexity of the issues at stake as such (see Willke et al. 2013; see also section 4.2.1). The question, however, remains as to whether the changes that have been introduced are stringent enough to offset the externalities that may result from inadequate risk assessments, which are bound to arise in future given the nature of finance.

Finally, in line with the new macroprudential paradigm, a novelty in the revised regime is also an increasing focus on the application of measures such as countercyclical capital buffers for large systemically significant institutions in order to strengthen the latter’s balance sheets and insulate them from cyclical swings (see Weistroffer 2012 for an illustration of countercyclical measures). In this context, Basel III has, for instance, introduced two additional capital buffers: (i) a mandatory capital conservation buffer of 2.5 percent of risk-weighted assets, and (ii) a discretionary countercyclical buffer which enables national regulators to require additional capital during periods of prolonged credit growth (BCBS 2011a, 2017). These measures are aimed at inhibiting excess credit growth and reducing procyclicality, and therefore have system-level, i.e. system-stabilizing ramifications. Yet though the new Basel framework aims, in sum, to augment the quality, consistency and transparency of financial institutions’ capital bases, while strengthening overall risk coverage and risk management (e.g. by incentivizing the use of central counterparties), prudential regulation is essentially a behavioral regulatory tool (Weber 2012) and its focus largely remains on fostering resilience at the micro-institutional level. As discussed previously, this is potentially problematic from a systemic perspective (see sections 3.3 and 4.2).

Critique has been put forward by two camps: By those that oppose and those that support more stringent regulation. Criticizing the newly instituted measures as overly drastic, the financial industry has been particularly critical of the new framework (Calomiris 2013; Frühauf 2017), while critique regarding the insufficient stringency of the new requirements is advanced primarily by think tanks and academics that argue that Basel III merely extends the reach of Basel II without, however, fundamentally altering the overall approach (see Admati and Hellwig 2013; Johnson 2013a; Wolf 2014b; see also below on remaining limitations). Issues criticized heavily by the latter camp also include the overall level of minimum capital requirements, the previously noted theme of bank internal risk-weightings and their continued use (albeit

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266 In the case of countercyclical capital buffers, for instance, additional capital must be set-aside during a credit expansion, while these buffers may in turn be drawn down during a downturn or credit contraction.

267 For an early high-quality study on Basel III’s macroeconomic impact from the OECD, see Cournède and Slovik (2011). Therein, it is estimated that the medium-term impact on growth would be approximately -0.05 to -0.15 percent per year in large part due to an increase in bank lending spreads as rising bank funding costs are passed on. These estimates are substantially lower than estimates put forward by the industry (see, for instance, Institute of International Finance 2010). The latter had argued vehemently that it would hamper growth, though their claims do indeed appear to have been exaggerated (Frühauf 2017).

268 European banks had long lobbied against Basel III and restrictions on the use of internal risk models, proposing a complete revision thereof in the form of Basel IV. They have, however, since come to terms with the compromise attained. In retrospect, though their claims may have some merit, they appear to have been exaggerated – both in terms of their impact on lending as such and their impact on funding costs for the real economy (Dombret quoted in Frühauf 2017). In this context, a member of the German central bank’s Executive Board, Andreas Dombret, dismissed the industry’s core claim, namely that the new regulations would be overly burdensome and unduly restrict lending (ibid.). Where the banking industry has, however, been successful was in 2013 when attaining the significant easing of rules in terms of broadening the definition of liquid assets and extending the implementation phase (Sorkin 2013; BCBS 2017).
with some restrictions) as well as the opaque treatment of derivatives and the risks they give rise to, which is particularly significant given the uncertainty they produce (Sorkin 2013). Also, though capital requirements can be employed for macroprudential purposes as alluded to, the focus of post-crisis capital regimes in both the European and international contexts remains largely microprudential and behavioral in nature, implying systemic risk considerations may not be regarded sufficiently. Though the goal of institutional soundness is ultimately to reduce the risk, i.e. the potential for as well as the impact of system-wide shocks (BCBS 2017), the underlying fundamentals seem to have remained unchanged and have been described as woefully inadequate (Vickers 2016) with Basel ultimately being “the mouse that did not roar” (Wolf 2010) and most likely will not do so in future. This position is in line with both critical scholars and leading economists that have questioned the rigor and efficacy of reform and whether the regime’s upgrade represents sufficient change (Admati and Hellwig 2013; Kane 2014; Wolf 2014b), and even with assumptions of regulators involved in the post-crisis reform debate and process (Vickers 2016).

Advocating a smaller and safer financial system, Wolf (2010) has argued that despite tripling the size of the capital reserves to be held against losses, reforms ultimately fail to deliver a credible regime to reduce the incentives for risky behavior and excessive risk-taking as the initial baseline for capital requirements and related measures was so low from the outset, and therefore equity levels are substantially lower than what markets would require were there no implicit guarantees at play, as evidenced by historical experience (see also Kane 2014; Wolf 2014a, 2014b). Key issues of his critique are that (i) leverage remains excessive, and (ii) the new rules on capital requirements ultimately exhibit the same shortcomings as Basel II – with a case in point being their continued reliance on the largely discredited principle of internal risk-weightings, albeit to a lesser extent (see above). Both flaws are not justifiable on the basis of the argument of growth being impeded, as industry estimates of the damage an increase in capital requirements would do consistently lie above those of official institutions such as those of the FSB or the OECD (Cournède and Slovik 2011).

In short, subsidizing the “entire banking system is grotesquely inefficient” (Wolf 2010), while the logical consequence is ultimately that equity ratios need to be far higher. The fact that this demand “seems so outrageous” (ibid.) – though the need for it is evident inter alia as bail-in rules and resolution regimes are likely to fall short in the event of a truly systemic crisis with multiple large complex institutions or market segments in jeopardy simultaneously – is largely due to the fact that “we have become [so] used to these extraordinarily fragile structures” (ibid.), not, however, that they are innately rationale or required as such. Yet the dilemma inherent in implementing fundamental transformations is not necessarily more expensive than debt if one takes into account that increased equity ultimately means reduced risk for both creditors and taxpayers, though the latter is an argument put forward by the industry time and time again (Admati 2010). Were debt genuinely unsubsidized and creditors to actually bear the true costs of failure, the consequence of a higher equity ratio would imply cheaper debt and “changing the ratio of equity to debt should not affect” funding costs (ibid.; see also Wolf 2010).

Were the targeted subsidization of lending to particular segments of the economy (e.g. small and medium-sized companies) desirable from a public interest perspective, this could and indeed should be done directly, according to Wolf (2010). Variations of contingent capital, which are “far more likely to exacerbate panic in a crisis than assuage it” (ibid.), could then be dispensed of.

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269 See Weistroffer (2012) for a classification of prudential regulatory measures and section 4.4.3 for a distinction between micro- and macroprudential measures and policy tools (see also section 3.3). Section 4.5 provides an overarching verdict thereafter.

270 Of relevance when assessing the alleged costs of more stringent prudential requirements is also the fact that equity is not necessarily more expensive than debt if one takes into account that increased equity ultimately means reduced risk for both creditors and taxpayers, though the latter is an argument put forward by the industry time and time again (Admati 2010). Were debt genuinely unsubsidized and creditors to actually bear the true costs of failure, the consequence of a higher equity ratio would imply cheaper debt and “changing the ratio of equity to debt should not affect” funding costs (ibid.; see also Wolf 2010).

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that “[a]ny such transition will be like taking drugs from an addict” (Wolf 2010) and therefore gives rise to opposition, widespread lobbying and political economy pressures that result in lacking political appetite and eventually obstruct fundamental reform (see e.g. Johnson 2013a, 2013b; Johnson and Kwak 2011), which ultimately implies that too big to fail remains a threat despite the changes instituted (see e.g. Bair 2014; Bott and Jenkins 2017; Johnson 2013a, 2013b; Turner 2010b). The same logic and dynamic largely applies to the issue of structural reform in the form of bank break-ups and related measures, which has not gained traction in most jurisdictions (see e.g. Johnson 2013a, 2013b; Barker 2014), though it could in theory have the same effect as higher prudential standards, i.e. stabilizing the system and making it less crisis-prone, as it would reduce the systemic significance of individual institutions and thus also reduce – yet by no means eliminate – the threat of systemic risk as threats according to the definition employed can arise from sources other than individual institutions.

Whatever the effect of more stringent requirements, regulators must be highly wary of the potential for arbitrage and unintended consequences. No matter where levers are implemented to stabilize the system, risks can always arise elsewhere owing to the innovative potential of finance in a highly complex environment, mirroring the regulatory dialectic (Jenkins 2013b; Kane 1986, 2014; Kay 2016; Schäfer 2013). Higher prudential standards are therefore necessary, yet not sufficient and require complementary measures such as those discussed throughout on substantive reforms directed at crisis prevention and crisis management. This, however, by no means excuses the leniency with which prudential reform is being implemented at present. In this context, and even though the Bank of England may be regarded as somewhat less lenient than most other authorities, for instance instituting the widely lauded structural measure of ring-fencing commercial banking to stabilize and protect the UK banking system, a measure which has largely eluded EU institutions and most other national European authorities, the British example is instructive. The Chairman of the UK’s influential Independent Commission on Banking (ICB), Sir John Vickers, criticizes the Bank of England and its Financial Policy Committee’s approach to capital requirements and systemic risk buffers (Vickers 2016). The ICB had already criticized the Basel baseline for equity capital in 2011 and recommended extra equity capital buffers of three percent of risk-weighted assets which goes well beyond global requirements (see Independent Commission on Banking 2011a, 2011b), yet the Bank of England has since softened its stance in this regard – even though the ICB’s estimates had in turn been well below those advocated by leading economists (see e.g. Admati and Hellwig 2013; Johnson 2013a). Among other factors, the Bank of England has defended its policy shift with reference to (i) the enhanced supervision that is already being implemented, (ii) allegedly effective resolution arrangements, and (iii) the use of counter-cyclical capital buffers designed to restrict excess

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272 A systemic risk buffer is additional capital that systemically important institutions must hold as a percentage of risk-weighted assets (RWAs) and is added to the Basel III baseline which requires equity capital equivalent to at least 8.5 percent of RWAs. The Financial Policy Committee in turn is the UK’s national entity for system oversight, the European equivalent is discussed later on.

273 Their judgment on requirements for the system as a whole were set at eleven percent of RWAs, which though substantially lower than earlier estimates, is more stringent than in other parts of Europe.
credit growth. Vickers (2016), however, argues supervision is inevitably imperfect, while resolution regimes by no means offer “a proper substitute for effective loss-absorbency in the first place”.

In conclusion, though progress has been made in terms of prudential regulation and its contribution to stabilizing the system and making individual institutions more resilient in the event of crises, substantial limitations remain. Higher capital requirements would aid the internalization of the costs of failure within the financial system and the institutions that create systemic risk endogenously, namely banks. That this has not fully transpired – i.e. that the revision of requirements has not resulted in changes that are sufficiently stringent and no alternative structural measures have been instituted to compensate for this weakness – casts doubt on the capacity of reforms to provide for financial stability and be of use for crisis prevention and management. Even the other substantive measures cannot fully offset these underlying shortcomings. As inadequate regulation and leniency in this regard was a core cause of the crisis, this fact – and the regulatory omission it denotes – is almost comical. Though regulators “are trying to make the existing financial system less unsafe, incrementally” (Wolf 2010), and changes in this vein are indeed “better than nothing” (ibid.), they will most likely insufficient to mitigate systemic risk, rendering the following measures and reforms all the more significant.

4.4.3 Long-Term Prevention: Systemic Risk Oversight Bodies and Measures

The third and final category of substantive policy changes aimed at system stability, devised and implemented by policymakers in the aftermath of the crisis, pertain to those that constitute the first – or last, depending on the perspective – line of defense against the emergence of systemic risk in terms of crisis prevention; or, more precisely, macroprudential and system oversight. As stated by the EU’s former Internal Market Commissioner, Michel Barnier (2010a), prevention is “less expensive than the cure” with the implication of the crisis ultimately being that both a new foresight approach and foresight culture are required (ibid.; see also Barnier 2010b) – in spite of the inevitable fallibility of this endeavor in terms of attempting to prevent crises and the emergence of systemic risk altogether. In an attempt to construct a robust and comprehensive approach to – and governance regime for – systemic risk prevention, member states’ governments and European institutions constructed entities, mechanisms and tools aimed at the provision of stability via the conduct of holistic system oversight and supervision as advised in multiple post-crisis inquiries and reports (De Larosière 2009; FSA 2009; FCIC 2011). These are at stake in the

274 An additional argument drawn on by the Bank of England pertains to the value of the instituted structural reforms in the British context in the form of ring-fencing which is essentially the shielding-off of banks' retail operations. While there is no European equivalent – with proposals advanced by the Liikanen Group (2012) having languished in the Commission (Barker 2014) – even beneficial structural change is no justification for regulatory laxity in this respect (Vickers 2016). With reference to Anat Admati, Vickers criticizes the Bank of England's analyses as being “fundamentally flawed” and refers to the “large range of uncertainty” inherent in its estimates (ibid.).

275 As will become clear in the concluding section of this chapter, which synthesizes the shortcomings of substantive reforms before advancing to the institutional overhaul, this is a central insight to be borne in mind throughout.
following and essentially comprise institutions and policy measures of a genuinely preventive and partially even preparatory nature with a long-term horizon, including (i) institutional bodies mandated with data collection, system-wide risk assessments and macroprudential analyses as well as either executing (such as the FSOC in the US) or recommending (such as the ESRB in the EU) corresponding regulatory and supervisory action, and (ii) measures and tools directed at both prevention and crisis management, including elements such as stress testing and resolution planning, aimed at both the mitigation of the build up of vulnerabilities and sources of instability and the preparation of crisis management measures for the next crisis. Both dimensions of preventive regulatory measures are long-term in the sense that they have a longer time horizon with respect to their usage and implementation vis-à-vis macroprudential policy instruments discussed previously which have more immediate stabilizing objectives.

To a degree, these reform measures heed the lessons of the crisis regarding the nature and ramifications of systemic risk in light of the prevalence of cross-border finance, including the governance imperatives they give rise to, i.e. the necessity of both cross-border and system-wide oversight and corresponding policy approaches. Whether they, i.e. these institutional innovations are, however, up to par in view of the system properties discussed previously and the knowledge-related constraints they are inevitably subject to is the issue at stake and should be borne in mind throughout the remainder of this research. The insights of the previous sections 4.2 and 4.3 are crucial in this respect. Finally, it is important to note in this context that there are substantial overlaps with both of the previous sections and categories as the measures do indeed dovetail. For instance, while resolution planning and stress testing as mechanisms that contribute to the conduct of oversight exhibit long-term preventive elements and qualities, supplying the respective competent authorities with the requisite data they require for system oversight and supervision, they essentially lay the foundation and offer tools for immediate crisis management and stabilization in the event of crisis. In addition, countercyclical capital instruments can be employed in both preventive terms and as immediate crisis management instruments.

The first and indeed the most significant of both categories in terms of their novelty and the change their establishment signifies is that of the new institutions constructed for system oversight at the national, European and global levels, reflecting the weight and importance they have been afforded in the dominant and indeed international post-crisis regulatory discourse. As the crisis demonstrated with regards systemic risk, the narrow microprudential focus of the pre-crisis era, complemented by institution-centric views and regulatory measures, defied the insight that collective risk was just as relevant in terms of engendering instability as the risks emanating from individual institutions and their activities. In terms of

276 In this context, it is also important to note that there are inevitably substantial overlaps with chapter five in which the implementation of the crisis lessons regarding systemic risk oversight and macroprudential policy in institutional terms are discussed further.

277 At the global level, the new macroprudential focus is manifested in the transformation of the Financial Stability Forum (FSF) at the G20 summit in 2009 in London into the Financial Stability Board (FSB) which was given an upgraded mandate and more resources to enhance comprehensive macroprudential supervision. The FSF had been established in the 1990s by the Group of Seven to integrate and reconcile micro- and macroprudential perspectives and promote international financial stability.
policy tools for the provision of stability in the pre-crisis era, there was a clear division between monetary and prudential policy in the pre-crisis era (see e.g. Goodhart et al. 2002). While the former targeted price stability by controlling the money supply, the latter ensured institutional soundness. Absent, however, were holistic system-oriented institutions, perspectives and instruments that could be employed within the regulatory and supervisory architecture aimed at and mandated with system stability in its entirety (Goodhart and Tsomocos 2007). The core assumptions of the pre-crisis paradigm were highly dangerous from a systemic viewpoint (Gai 2013; Willke et al. 2013). Table two contrasts macro- and microprudential objectives and perspectives as outlined by Borio (2003). The macroprudential sphere is the realm on which these new institutions now focus in order to ensure financial stability.

Table 2: Schematic Overview of Macro- and Microprudential Perspectives

<table>
<thead>
<tr>
<th></th>
<th>Macroprudential</th>
<th>Microprudential</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Policy objective</strong></td>
<td>Limit system-wide distress</td>
<td>Limit individual firms’ distress</td>
</tr>
<tr>
<td><strong>Ultimate goal</strong></td>
<td>Avoid output and GDP costs linked to financial instability</td>
<td>Consumer, depositor and investor protection</td>
</tr>
<tr>
<td><strong>Characterisation of risk</strong></td>
<td>Endogenous and dependent on collective behaviour</td>
<td>Exogenous and independent of individual agents’ behaviour</td>
</tr>
<tr>
<td><strong>Firms’ correlations and exposures</strong></td>
<td>Important</td>
<td>Irrelevant</td>
</tr>
<tr>
<td><strong>Calibration of prudential controls</strong></td>
<td>Top-down and in terms of system-wide risk</td>
<td>Bottom-up and in terms of firm risks</td>
</tr>
</tbody>
</table>

Source: Based on Borio (2003)

The institutional overhaul ultimately attempts to remedy pre-crisis flaws by implementing the new macroprudential paradigm (see Alexander and Schwarze 2017 on the principles thereof). The goal thereby is to establish new system-oriented structures that aim to overcome the divide between micro- and macroprudential issues and complement traditional microprudential approaches and methods of prevention and oversight, while also seeking to strengthen collaborative efforts and improve understanding as regards the sources of systemic risk, while augmenting preventive, crisis management and intervention capacities in order to better identify, anticipate and mitigate incipient threats to financial stability, bringing together key authorities able to formulate effective regulatory policies and take concerted action to mitigate the buildup of risk and increase the resilience of the system to systemic shocks (Weistroffer 2012). Inevitably, the efficacy of newly instituted entities is dependent upon the implementation of their mandate, the quality of

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278 See Schoenmaker (2013a) on the distinct objectives and interdependence of macro- and microprudential policies based on the groundbreaking work of the Nobel Laureate Tinbergen (1952, 1954) and Goodhart and Schoenmaker (1995, 1997) on the separation between supervisory and monetary agencies and the respective implications of this divide (see also Goodhart 1995).
their analytic activities, their collaborative potential, and the effectiveness of their policy tools, and may ultimately prove difficult (ibid.). These issues are discussed in more detail in the following chapters.

The second category pertains to stress testing and resolution planning with the latter including the devising of resolution plans and living wills (see e.g. Goodhart 2010, 2012 for in-depth discussions). These are tools and mechanisms designed to facilitate both the conduct of preventive policy and oversight, for instance, by delivering insights into individual firms’ risk profiles and their system-related implications as a basis for designing prudential policy responses (stress testing) and preparations for crisis management (living wills).

On Inevitable Limitations Pertaining to All Categories

Substantive reform elements implemented in the post-crisis era include preventive structural measures as well as stabilizing policy instruments and tools for tackling the ramifications of financial turmoil when it arises. Together, they are intended to provide a holistic toolkit for mitigating and managing systemic risk. Yet while they heed the lessons of the crisis regarding the nature of systemic risk, they are not necessarily sufficient in view of the knowledge-related constraints regulators are inevitably subject to. When viewed through the lens of the systemic risk definition employed throughout and against the backdrop of the system properties discussed previously, preventive reform measures and regimes for system oversight are essential, yet they are also inevitably fallible. Whatever their effects in terms of providing for stability with regard to known risks, policymakers must be wary of the potential for regulatory arbitrage as well as the potential unintended consequences of their actions. No matter what levers are implemented, risks can always materialize elsewhere in the system owing to the innovative potential of finance and mounting in the inability of system-wide oversight to preclude and detect all potential threats to financial stability (Becker 2016; Kane 1986, 2014). The point is not that preventive policies are futile, but rather that regulatory restraint, caution and reflexivity must prevail (Mügge and Perry 2014), while the consequence thereof is ultimately that integrated governance schemes for crisis management are of utmost importance as systemic crises will no doubt happen again.

The chapter is now rounded off by a brief discussion of the reform outcome’s shortcomings in terms of reform aimed at system stability and with respect to genuine structural change by casting substantive reforms – which are in large part of a behavioral nature, i.e. directed at behavioral as opposed to fundamental or radical reform of the underlying system dynamics and properties of finance as such – in a critical light before advancing to the institutional reforms at stake in this contribution. Due to space constraints, this section will be brief, while it nonetheless seeks to lay the basis and present the context for
the ensuing assessment of governance reforms and is effectively based on the analysis of the reform elements discussed throughout the previous chapter and presents an overarching synthesis thereof.279

4.5. A Short Note on Substantive Shortcomings and Limited Structural Change

It has been widely acknowledged by critical economists that the response to the crisis exhibited serious flaws in substantive, structural and system-related terms as the structure of the system as well as its dynamics and properties essentially remain intact, implying that the financial system remains an accident-prone, highly complex and tightly coupled system (Willke et al. 2013) in which the foundations of debt-fueled growth prevail (Bridges et al. 2017; El-Erian 2016, 2017b; Mian and Sufi 2014; Turner 2015) and inherent instability and radical uncertainty persist (Kay 2016), ultimately aggravating the latter, while bank funding models remain inadequate (Admati 2010; Admati and Hellwig 2013; Kane 2014; Wolf 2014b) and global regimes governing capital requirements – though attempting to remedy the underlying flaws of Basel II – have not as such “changed the overall approach” (Admati and Hellwig 2013: 183; see also Kane 2014).280

Though the substantive reforms that have been instituted are necessary they are neither sufficient in terms of strengthening the financial system as such and making it more resilient nor in terms of laying the foundation for credible crisis prevention and viable financial governance more generally. This is, in large part, due to the fact that the causes and factors generating crises are almost always related to the system as such rather than to individual entities or markets, i.e. pertaining to the underlying system properties and dynamics identified, while the financial system remains as fragile, complex and crisis- and contagion-prone as ever in overarching terms (El-Erian 2017b) despite some advances and improvements in terms of regulatory stringency and with regard to attempts to streamline, simplify and strengthen the components of the system, i.e. its constituting actors and infrastructures. The resulting consequence is, ultimately, that altered system fundamentals and system properties must be prioritized in future (Willke et al. 2013: 47).281

Ultimately, it should be noted, however, that though efforts aimed at monitoring the implementation of substantive reforms such as increased capital requirements are underway and studies on their impact are

279 In this context, it is important to stress that while substantive and institutional governance elements must dovetail in order to be effective, shortfalls in terms of substantive and structural change make cross-border governance schemes within which actors can come together and coordinate system oversight and crisis management all the more important inter alia in order to augment their reactive capacities and the effectiveness of their actions in crisis scenarios.

280 With reference to the discussion of a potential paradigm change at the outset of this chapter, the question arises as to whether the concept of a paradigm shift from deregulation to reregulation is perhaps too simplistic as it says nothing about the quality of reregulation. Indeed, in substantive terms reforms appear to fall short with respect to what would have ultimately been required to tackle the issues exposed by the crisis. In the European context, for instance, attempts at structural reform such as ring-fencing commercial banking, which might ultimately have induced a degree of system change by attenuating the most destructive system properties such as complexity, have been shelved (Barker 2014). Structural reforms as proposed by the High-Level Expert Group on Reforming the Structure of the EU Banking Sector (Liikanen Group 2012) had ultimately proven too controversial and had long languished in the European Commission as a result.

281 Recall that “the point of a systemic view on systemic risk is to look beyond individual items and isolated features of reform, and instead envision alternative system properties of global finance” (Willke et al. 2013: 215). This is a central insight to be borne in mind throughout.
being conducted (see e.g. FSB 2016 on the implementation and effects of the G20 regulatory reforms), financial regulatory reforms’ ultimate impact cannot be assessed as of yet. Attempts are therefore necessarily provisional. Nevertheless, of crucial significance when assessing the progress attained in the context of substantive reform is the fact that in terms of industry developments in the post-crisis environment, unintended consequences of regulatory reform – such as, for instance, the reduced reliance on banks as an externality of tightening the regulatory requirements in this domain, with the effect being that risks arise in other parts of the system and reduced lending may impact growth and productivity – are inevitable and potentially disastrous. The true scale and effect thereof will only become apparent in the coming decades (Mayntz 2013; Schäfer 2013), just as macroprudential instruments’ and resolution regimes’ worth will only become clear after a genuinely systemic crisis.

This notwithstanding, in overarching terms and with regard to the above, consensus exists as to the fact that reforms remain insufficient to prevent another crisis of similar proportions given the very nature of finance, the inevitable fallibility of substantive ex ante policies and mechanisms (most importantly capital regimes) and the predictability of their effects (e.g. the utility of resolution regimes in the event of a systemic crisis). One example pertains to the issue of prudential regulation – a if not the central instrument to provide for stability in a system such as modern finance in the 21st century (Mayntz 2013). Back in 2010, when the process of devising Basel III was still in its infancy, critics already pointed to the fact that the new regime was too lenient (see e.g. Hellwig and Admati 2013; Johnson 2013a; Wolf 2010). The logical consequence, they argue, is ultimately that equity ratios need to be far higher – somewhere in the range of 20 to 30 percent. As noted, the fact that this demand – though evidently legitimate in light of the revelations of the crisis and as bail-in rules and resolution regimes are likely to fall short in the event of a truly systemic crisis with multiple large complex institutions or market segments in danger of failing simultaneously, while systemic risk oversight can by no means detect, preclude and mitigate all sources of systemic risk – seems so ludicrous is due to the world having “become [so] used to these extraordinarily fragile structures” (Wolf 2010) and the forces opposing change being so strong (Johnson and Kwak 2013).

Forces obstructing fundamental reform in this vein and resulting in lacking political appetite to act apply to both behavioral regulation such as the prudential regimes that have been instituted (Weber 2012) as well as to structural reform such as, for instance, bank break-ups and measures with similar effects, which have not been seriously considered in most contexts (see e.g. Johnson 2013a, 2013b; Barker 2014), though they could potentially have the same impact as higher prudential standards by making the system both less complex and fragile. As both approaches would ultimately reduce the systemic significance of individual institutions and thus also mitigate the threat of the emergence of systemic risk, the fact that both fall short of expectations – in the sense that they do not duly account for and reflect the revelations of the crisis, having been implemented in a half-hearted fashion with the updated Basel compromise of December 2017 extending implementation deadlines being a case in point (BCBS 2017) – implies that too big to fail
remains a threat despite the changes instituted (see e.g. Bair 2014; Bott and Jenkins 2017). This is extremely regrettable as too big to fail is, among other factors, at the heart of systemic risk. This is, however, not the only issue at stake in terms of structural and substantive reform. Adding to this – whatever the effects of the newly instituted measures in terms of providing for stability with regard to known risks and potential crisis causes – regulators and policymakers must be highly wary of the potential for regulatory arbitrage and the potential unintended consequences of their actions. No matter where levers are implemented to stabilize the system, risks can always arise elsewhere owing to the innovative potential of finance in a highly complex environment (Becker 2016; Jenkins 2013b; Kane 1986, 2014; Kay 2016) and the inability of system-wide oversight to preclude and detect all potential threats to financial stability. Robust resolution mechanisms, higher prudential standards, diligent system oversight, periodic stress tests and the like, though undoubtedly necessary may, therefore, not necessarily be enough to prevent and manage crises comprehensively – as the system’s fundamentals and properties essentially remain unchanged. This has substantial and potentially disastrous implications.

The crucial insights of the preceding chapter pertain to the nature of systemic risk as well as the intricacies and multifaceted challenges political entities face in terms of governing a highly complex, unstable and constantly evolving cross-border financial system at the very heart of the global economy as illustrated by the crisis, thereby contextualizing the obstacles at stake when tackling the task of instituting viable reform measures and governance structures. Drawing on these insights, the following chapter now turns to the empirical analysis of the institutional response to the fault lines exposed, focusing on institutional innovations designed to upgrade the European governance architecture. Whether and to what degree genuine integration and therefore viable reform has been achieved, challenges have been addressed and governance capacity has been increased, is thereby at stake in this context. On the basis of the elaborated theoretical foundation and the conceptual framework, the thesis now focuses on instituted reforms, specifically on institutional developments, examining their rationales, mandates, functions and elements of design in an attempt to assess the degree of integration that has transpired and their potential in terms of the challenges identified in order to thereafter evaluate the challenges they face as well as the capacity they give rise to. The assessment of the post-crisis reform outcome in terms of the regulatory and supervisory architecture – followed by an analysis of the challenges the latter faces as well as an evaluation of the resulting degree of integration and the overall significance of the governance system’s evolution – is conducted against the backdrop presented above; importantly, with particular regard to the systemic risk definition set out and the regulatory imperatives deduced. The conclusion and verdict against the backdrop of the definition of systemic risk is nuanced and cautiously optimistic.

282 Note again that in the following governance capacity pertains to the degree of integration that has transpired.
283 Again, the conceptual framework serves as the backdrop for the discussion of reform as it shed light on the challenges cross-border finance gives rise to, the factors that contribute to the emergence of systemic risk, and the elements of policy reform that constitute integral tools of the new regulatory and supervisory architecture.
5. PART V: ANALYSIS: EUROPEAN POLICY RESPONSES TO THE FINANCIAL CRISIS

The financial crisis or Great Recession of 2008 – as the near-collapse of the global financial system, which disrupted international trade, drove the global economy into a multi-year recession and Europe into a sovereign debt crisis – was the worst economic crisis since the Great Depression in the 1930s (Financial Crisis Inquiry Commission 2011) and one of the worst crises in the EU since its inception. It can ultimately be interpreted as the result of a combination of many diverse factors, among them, for instance, flawed incentive structures and excessive risk-taking in the financial industry, or loose monetary policy, lax regulation and inadequate oversight in advanced economies. It was, however, also the manifestation of the dangers of unrestrained financial capitalism and the symptom of a system that had increasingly spiraled out of control and grown too large and sophisticated in relative terms, meaning its size and complexity was essentially “unjustified by the value of its service to the real economy” (Turner 2009: 4), the very entity it is meant to serve (see, for instance, Das 2014; El-Erian 2016; Turner 2009). But most importantly in this context, it underscored the fact that (i) the financial system cannot be left to its own devices entirely given its inherent instability and its inability to mitigate crises and provide for system stability and equity on its own, i.e. without external intervention, and highlighted the ramifications of market failure and systemic risk as such, i.e. the immense explicit and implicit costs crises give rise to in monetary, economic and broader socio-political terms as discussed in the previous chapter, as well as (ii) exposing the need for rigorous regulation and cross-border governance, i.e. showcasing why regulatory intervention capacities and credible crisis management tools are paramount in order to reduce the probability of crises on the one hand and mitigate the impact of crisis when they arise on other.

While the previous chapter shed light on the challenges inherent in financial regulation and the complexities involved in designing policies and structures to tackle systemic risk in substantive terms (incapacity in terms of policy), the following chapter is an empirical analysis of institutional innovations designed to correct a second central fault line highlighted by the crisis, namely the lack of cross-border institutions and mechanisms to cushion its effects (incongruence and incapacity in terms of governance), laying bare the economic and political cleavages that existed in the pre-crisis era, precluding both effective crisis prevention and swift crisis management in the process (Kissinger 2009; Willke et al. 2013). Indeed, the crisis underscored that political governance schemes’ reach did not match economic realities and that cross-border and reactive capacities are paramount in the governance of finance, and it is these that are at stake in the chapter at hand. Before discussing the schemes devised to contribute to the build-up of these capacities, however, it is important, with reference to the theoretical foundation set out in chapter two, to shed light upon the overarching global backdrop against which this is taking place – making cooperation in general, and European integration in particular, all the more important in the financial sphere.

284 The implicit costs and knock-on effects of the crisis – the consequences of which are still being a decade after the event – were extremely high, including trillions of dollars in lost output, millions of lost jobs and a sharp decline in global trade, in addition to the explicit costs resulting from bailouts (Wolf 2010; Wolf 2014b). In short, the destructive potential of crises is immense.
In the 21st century, more than ever before, the need for cross-border cooperation is becoming increasingly apparent – and with it the so-called sovereignty paradox that prevails in an increasingly interconnected and interdependent world (De Grauwe 2017). The financial crisis of 2008 is only one instance of systemic risk and one example of the many threats facing nation states and the global system at large – from tax evasion and terrorism to climate change and beyond. In an era in which we are confronted with increasingly complex realities on the ground, nuanced and innovative governance approaches are required to increase collective governance capacity at both the global and the regional level, while the general sense of disillusionment within most societies with respect to the structures that exist presently, which has, paradoxically, increased in tandem with the former, i.e. increasing complexity and the need for collective governance schemes, must also be tackled – raising the stakes for political actors in the process. Policy-makers need to demonstrate to their electorates – and in turn must ensure – that the schemes in place are capable of coping with contemporary challenges and effectively governing issue areas of a cross-border nature – and indeed constitute their best bet in this regard – in order to counteract these tendencies and mitigate the risk of a complete break-down of existing systems. This issue is especially significant against the backdrop of the troubling developments transpiring at the global and European level which include – to varying degrees – fragmentation, disintegration and the transition to an increasingly multipolar world order, which contributes to uncertainty and detracts from the credibility of Western governance regimes (El-Erian 2017a).

In the current context, in which we are witnessing global – and to a degree also European – discord and disintegration, this may be interpreted as the result of pervasive nationalism rooted in dangerous misconceptions and flawed notions, which De Grauwe (2017) summarizes as being fuelled by (i) the myth of oppression by an external force, arbitrarily imposing its will upon the allegedly oppressed, (ii) arguments in favor of independence and the desire for sovereignty which are often based on a monolithic concept of identity, refuting the possibility of multi-layered identities and allegiances, and finally (iii) the fallacy that independence will automatically generate economic prosperity. This is clearly not the case in

285 This tendency is manifested, for instance, in the election of Donald Trump, the outcome of the Brexit referendum and independence efforts in Catalonia. Indeed, an overarching trend or dominant theme of the past years has been the increasing threat of disintegration coupled with increasingly complex governance challenges and increasingly high requirements directed at the latter. Ultimately, the imperative must be to counteract this tendency.

286 They must also communicate to their electorates that it is not necessarily these very schemes of cooperation that are at fault, but rather national systems’ incompetence, including policymakers’ inability to conduct fundamental structural reforms as well as the broader system changes and transformational power shifts that have taken place throughout the past decades that are to blame (see, for instance, Deaton 2017). This, however, is highly unlikely and may have grave consequences in the long run.

287 Notwithstanding the case for integrated governance and the need for cooperation in economic affairs in general and finance in particular, and though the forces of globalization seem unstoppable, it appears that as a consequence of the nationalist and separatist tendencies witnessed in the recent past, the multilateral system’s underlying structures are increasingly under strain as advanced economies retreat from global and regional economic schemes and support for globalization and regionalism declines, particularly in the US and UK with potentially catastrophic consequences (El-Erian 2017a). In addition, the unwillingness of the latter to reform the global governance architecture – coupled with political obstacles impeding domestic structural reform and anti-establishment forces threatening political systems from within – may spell potential trouble for cross-border governance (ibid.). Turbulence in global terms, however, only strengthens the case for European integration in order to offer a potential counterweight to forces jeopardizing the liberal world order.

288 This projection pertains to European authorities in the case of Brexit and the Spanish state in the Catalan case.
the European context, however, as participating nations are not only afforded high degrees of autonomy, they have also attained substantial prosperity and reaped the considerable benefits that generally go hand in hand with membership in such schemes. Not only does European integration foster credibility and capacity vis-à-vis private sector actors as will be discussed throughout this chapter, it also increases and leverages nation states’ status and strengthens their hand at the global level which – in view of the emerging and increasingly power-oriented multipolar world order – is increasingly ruthless and cut-throat. European integration, including cooperation and coherence in regulatory and governance terms, therefore, becomes all the more significant as globalization undermines national sovereignty. Not only to mitigate the negative externalities of globalization and European market integration and extend regulatory capacity vis-à-vis the financial industry, but also in order to counter the tendencies of weakening multilateral arrangements, and strengthen the position of European member states and the interests of the Union on a global stage, increasing its clout and influence in the process and potentially mitigating the potential for and effects of regulatory competition, competitive deregulation and the like.

The corollary of the governance dimension discussed above is, in essence, that the developments that transpired throughout the past decades have not only compromised regulators’ capacity to govern the complex, tightly coupled and unpredictable system that emerged, but have increasingly undermined the nation state’s exclusive authority and its hold on power vis-à-vis the private sector. In terms of finance and its governance, the phenomenon and challenge of incongruence is manifested in the mismatch between global – and in this case European – finance on the one hand and largely nationally-denominated policymaking, regulation and governance schemes more generally on the other (as set out in chapter two and as is common in the governance of complex cross-border issue areas). The crisis of 2008 is a prime example of the consequences this constellation can have. To illustrate what this means in practice, that is in technical financial and regulatory terms – and in order to connect the discussion of the loss and gains in terms of sovereignty discussed above to issues of financial governance – when faced with the prospect of the failure of a large, complex, globally active and systemically significant institution, nation states’ capacity to act is dangerously limited. Indeed, during the crisis, it was largely restricted to widespread liquidity injections, recapitalizations and outright bailouts given the perceived lack of alternatives for fear of contagion and further uncertainty. The resulting externalities of the crisis – both in direct and indirect terms as mentioned – were immense. Not only must preventive and crisis management capacities therefore be developed, but cross-border capacities must be extended by means of constructing institutionalized mechanisms for cooperation in terms of both crisis prevention and crisis management.

As a consequence of the shortcomings the crisis exposed, including the inability to preempt crises and act when the crisis erupted, while the crisis was inter alia perceived as a crisis of the system and governance, the response at the supranational level was the comprehensive overhaul of the European governance architecture. The previous chapters looked into how reforms address the challenges identified and
contribute to the governance imperatives singled out, i.e. increase capacity via integration. Thereby, the goal of the analysis in this chapter is to assess institutional policy responses to the crisis and reforms instituted at the European level to tackle these challenges and achieve this goal, focusing primarily on architectural governance reforms as this is essentially a governance analysis, yet drawing on insights from the discussion of substantive policy reforms, while assessing the overhaul of the supranational governance regime and taking stock of reform and integration more generally.289 Yet though in overarching terms the European response to the crisis has been multipronged and multifaceted with a vast range of issue areas and sectors affected and subsumed under a host of directives and regulations (Véron 2012; Barker and Stafford 2014) – covering regulatory themes from market infrastructure issues such as short-selling to the regulation of remuneration practices and beyond, many of which are only indirectly related to the issue of system stability – it is important to note that the analysis of reform elements and efforts is by no means exhaustive. Rather, it is limited to reforms of relevance in the context of systemic risk prevention, the provision of financial stability and in terms of governance, i.e. the build-up of both preventive and crisis management capacities at the European level. The empirical analysis ultimately begins with an overview of the pre-crisis regulatory deficiencies to set the stage for the analysis of post-crisis regulatory reform and is followed up by a review of the outcome of the post-crisis reform process, (i) taking stock of reforms and contextualizing their characteristics and nature as such, as well as (ii) assessing the resulting degree of integration and the overall significance of the evolution that has transpired from the undertaken reform efforts against the backdrop of the definition of systemic risk employed.290

In order to correct some of the most pernicious deficiencies of both the financial system and the regulatory architecture, the crisis presented a window of opportunity for fundamental reform and genuine change. As argued throughout, while some reforms have yet to be fully implemented or take full effect such as, for instance, in the case of capital regimes in the context of Basel III and the banking union’s single resolution fund, or have yet to be tested, for instance, resolution mechanisms and bail-in instruments in the event of a truly systemic crisis, it remains too soon to definitively conclude – even a decade after the outbreak of the crisis – whether we have indeed witnessed a break with the past in the

289 Note again that the substantive reform elements devised as a direct response to and result of the financial system-related reform challenges arising from the system properties of modern finance and the underlying structural weaknesses and issues exposed by the crisis set out previously in chapter four (section 4.5) are drawn upon in this context. As such, the previous section – which included an elaboration of underlying fundamentals in terms of dimensions and stages of regulatory and supervisory policy and practice in terms of crisis prevention and crisis management as well as substantive policy elements, including the content of policies and mechanisms and tools employed within the institutional architecture to attain stability as well as prevent and manage crises – serves as a conceptual basis for and prelude to the institutional reforms and governance-related responses discussed throughout this chapter.

290 Note that the challenge throughout when assessing multiple institutions simultaneously is to balance an assessment of both pan-European as well as eurozone schemes. Though at times different issues are at stake given their diverging remits, both have been put in place to foster cooperation, contribute to financial stability and provide member states with robust cross-border governance structures and crisis management capacities. This chapter is therefore also an attempt to bring coherence to the overarching European response to the crisis in the attempt to improve financial governance. It is also important to note that the sections on the ESFS are, with respect to both structure and content, in large part based on chapter five in Willke et al. (2013), while, throughout, the research draws heavily on an in-depth analysis of the legislation establishing the institutions at stake as well as expert interviews conducted by the author.
European context, i.e. whether reforms are sufficiently robust, or rather present yet another instance of symbolic politics (Edelman 1964).

5.1 Early Crisis Developments and Immediate Policy Responses

When the French bank BNP Paribas limited investors’ access to 2.2 billion dollars’ worth of deposits in multiple funds in the summer of 2007, regulators and policymakers throughout Europe had yet to realize what would ensue and comprehend the magnitude of instability and scale of the contagion to which the global financial system would be subjected, eventually spreading throughout most advanced economies and bringing the global financial system to the brink of collapse. The events that transpired throughout the first half of 2007 (in the US and EU these include, for instance, turmoil at Bear Stearns, BNP Paribas and the like) were the first signs of the widespread financial stress that would surface in late 2008 and take hold throughout early 2009 – giving rise to liquidity and full-blown solvency crises and plunging the financial system and global economy into turmoil. Given the scale of the problems and the lack of tools and mechanisms available to deal with them, either at a national or cross-border level as revealed by the crisis and alluded to throughout, it is fair to assume that policymakers and regulators were not only unprepared and ill-equipped to deal with a crisis of such proportions, but also completely caught off guard by the crisis (El-Erian 2017b) – with both factors severely affecting their ability to respond in an adequate and timely manner.291

The immediate policy response, i.e. the dimensions and dynamics of European crisis management and cooperation at the height of the crisis discussed in part in chapter four is instructive as it sheds light on and helps understand the pressures regulators and supervisors face in these highly complex, rapidly evolving and for the most part unprecedented crisis events as well as the constraints and limitations their (re-)actions are inevitably subject to (see Quaglia et al. 2009 for an in-depth and thematic recapitulation of immediate post-crisis policy responses in the European context).292 It also serves to contextualize the overarching developments and shortcomings revealed, underscoring the necessity of further integration and, importantly, both more robust and integrated crisis management instruments and mechanisms293 as

291 The issue of complacency is of importance in this context. Ultimately, regulators and policymakers had not paid sufficient attention to the lessons and insights the previous crises in emerging markets offered (El-Erian 2017b; Johnson and Kwak 2011).

292 It would evidently go beyond the scope of this research to discuss explicit national responses and specific instances of crisis management and related measures such as in-depth recapitulations of bailouts, rescue schemes and other programs of assistance. In addition, extensive research has already been conducted in this regard. For further in-depth discussions of the specifics of national responses in the wake of the crisis, see for instance Grossman and Woll’s (2012) analysis of bank bailout schemes in the European Union from a comparative perspective though limited to continental Europe as well as Woll’s (2014) assessment of bailout programs in selected European member states in which different national approaches are discussed, highlighting that despite similar exposures, responses differed substantially and had markedly different financial consequences.

293 Note in this context that glaring deficiencies in terms of the pre-crisis supervisory and regulatory framework as well as the crisis management architecture were revealed at both the European and the national level. To attribute failure in terms of the response to the crisis – and indeed pre-crisis financial governance in general – to European institutions and the inability to cooperate would be incorrect, or rather – as we argue throughout – would ultimately be a case of applying double standards. The
well as highlighting the significance of coordination and ad hoc cooperation dynamics at the European level in the immediate aftermath of the crisis, i.e. the acute crisis management phase, which are potentially of significance for the analysis given the insights they render in terms of future potential. These insights are of relevance for the analysis of contemporary reform developments and in combination with the former present the backdrop for the discussion of shortcomings pertaining to the architecture of financial governance in the European Union, including the so-called financial trilemma (section 5.3), which in turn serves as the backdrop for and prelude to the institutional policy reforms instituted at the supranational level and analyzed throughout the remainder of the chapter.

5.2 The European Policy-Making Context: Examining Post-Crisis Preference Constellations

With respect to EU cooperation and policy coordination in the immediate aftermath of the crisis, i.e. the policy response in the acute crisis management phase discussed previously (see section 4.1), scholars have argued that there were significant and noteworthy instances of solidarity via quiet burden-sharing (Pauly 2009), exhibiting the Union’s perhaps somewhat unexpected ad hoc coordinative potential (see also Quaglia et al. 2009). These developments ultimately set the stage for the post-crisis reform process at the supranational level – a process that yielded more integration than many would have thought. Indeed, though generally most scholars have in the past not been very optimistic as regards the EU’s potential to overcome hurdles associated with diverging preference coalitions and varieties of capitalism (see e.g. Hancké 2001; Sabatier 1988, 1998; Story and Walter 1997) – even going as far as to maintain that there was a battle of the systems (Story and Walter 1997) – with a view to the prevailing constellations of actors and their respective preferences in the post-crisis context, including those of member states, European institutions and additional actors of relevance in this context such as domestic industries, Ferran (2012) argues that the pre-crisis stylized characterizations of preference constellations are no longer apt to describe post-crisis realities. Drawing attention to the “subtle and variegated influences that affect national responses” (Ferran 2012: 13) across a wide variety of issues, she uses the UK as an example to underscore her claim (see also Macartney 2009, 2011). Characterizing the pre-crisis British position on EU regulation, for instance, as adamently anti-European or categorically opposed to regulation for that matter is indeed a gross oversimplification, as is a polarized view equating German and French interests, given their

infrastructure at both the European and the national level was in dire need of revision and reform and must at all costs dovetail and be both compatible and complementary in order to be of use in terms of crisis mitigation and management.

294 And indeed, in terms of supranational coordination in the immediate aftermath of the financial crisis – despite all the flaws exposed in the regulatory architecture and corresponding crisis management frameworks – there were indeed some positive surprises, which may bode well in terms of cooperative potential in future.

295 Note, however, that some unilateral action was indeed taken in the immediate aftermath of the crisis – for instance, with regard to deposit guarantees issued by the Irish and German governments – undermining the spirit of cooperation in the process and jeopardizing stability throughout Europe. Can these tendencies be reconciled at the supranational level so as to mitigate moral hazard, or will national interests always trump economic logic and collaborative pressures? These are crucial objectives of post-crisis reforms.
distinctive structural features (Ferran 2012; see also Grossman and Leblond 2011). The British were in fact key sponsors of post-crisis reform (see e.g. FSA 2009). Though it would go beyond the scope of this research to define preference constellations in depth (see Chang 2015; Howarth and Quaglia 2013a, 2015; Quaglia 2012 for more insights in this regard), the above is nonetheless instructive and highlights how change could eventually transpire in addition to boding well for the future as preference constellations were not set in stone, essentially presenting fertile ground from which reforms could advance. The following now looks into the shortcomings these reforms intend to remedy.

5.3 The Financial Trilemma: Institutional Deficiencies of the Pre-Crisis Architecture in Context

Against the backdrop of the regulatory and system-related challenges discussed throughout chapter four, the research now turns to challenges relating specifically to the governance of the financial system that the crisis exposed and dives into an analysis of obstacles European financial governance faced in the pre-crisis era as well as the priorities for reform that can be deduced accordingly. Thereby, the priorities that flow from the shortcomings identified mirror the financial trilemma (Schoenmaker 2011; 2013c) that exists in the supranational cross-border context and became increasingly apparent during the crisis.

In the context of the post-crisis debate, a core insight that became increasingly clear, indeed even glaringly obvious, was the fact that in addition to upgrading, strengthening and streamlining the regulation of the financial system as such given the latter’s increasing complexity, its innovative and destructive potential as well as its regulation-evading tendencies (see e.g. Becker 2016; Kane 1989, 2014), collective schemes for the cross-border governance of cross-border financial institutions are imperative – in effect, the logical conclusion that can be drawn from the crisis – as financial institutions are not only “international in life and national in death” (former Governor of the Bank of England, Mervyn King, quoted by Beck et al. 2012: 1), but their failure can have disastrous implications beyond the financial and economic system as such as well as beyond national borders, essentially presenting a if not the core conundrum in the European context. The prevailing governance architecture had not proved commensurate with developments in and the nature of the modern financial system in a twofold sense: On the one hand, the microprudential regulatory approaches that prevailed neglected macroprudential perspectives and their implications for system stability (Borio 2003; Brunnermeier et al. 2009) in addition to exhibiting multiple weaknesses with respect to financial market regulation as such, while on the other – and of utmost importance in the European context – the regulatory and supervisory structure at the supranational level did not mirror the cross-border nature of finance as well as the activities of cross-border firms and the prevalence of a single market.296

296 This ultimately gives rise to the phenomenon of the tragedy of the commons quality of cross-border finance in which the provision of vital public goods such as, in this case, financial stability becomes increasingly difficult (Olson 1965). As became clear
The acknowledgement of the latter – in light of a single market and cross-border intermediation as well as the corresponding necessity of providing for stability collectively and constructing collective reactive capacities to conduct effective and credible crisis management – ultimately induced and facilitated the ambitious overhaul that ensued in the post-crisis era attempting to make the regulatory and supervisory architecture more integrated and robust, and the financial system more stable, sound and resilient (Willke et al. 2013: 168). Yet though reform was inevitable, as it ultimately presents the default response in the case of most crises (see chapter four), attaining political compromise was also profoundly challenging given the sovereignty-related intricacies involved and the contention arising from national sensitivities and issues of burden-sharing and the like, limiting the depth and reach of reform in terms of both regulatory stringency and governance integration (the respective challenges are discussed at length in chapter six). Before looking into the governance response more extensively, the issues exposed by the crisis and corresponding reform priorities in governance terms are presented in more detail, ultimately setting the stage for the assessment of instituted reforms and the degree of integration it signifies as well as the build-up of capacity it denotes. Thereby, the analysis throughout is conducted against the backdrop of the question as to whether supranational institutions and regimes possess the potential to mitigate the governance deficiencies identified and contribute to the conduct of sustainable regulation and supervision in view of the challenges and imperatives described in the previous chapter.

As alluded to previously, the official report focusing on the causes of the crisis and its implications in the European context, the De Larosière Report, was devised by the High Level Group on Financial Supervision in the EU and published in February 2009 (hereafter De Larosière Report or De Larosière 2009). Chaired by Jacques de Larosière, it had been commissioned by the European Commission in the immediate aftermath of the crisis and entrusted with the task of conducting a comprehensive review of the supervisory status quo as well as regulatory and supervisory weaknesses of the pre-crisis system in view of the lessons that could be drawn from the crisis and put forward corresponding recommendations for an efficient and sustainable governance regime – the result of which is analyzed in the following chapter. In overarching terms, and mirroring the elaboration of crisis causes and narratives in section 4.1, the De Larosière Report argued that the crisis had resulted “from the complex interaction of market failures, global financial and monetary imbalances, inappropriate regulation, weak supervision and poor macro-prudential oversight” throughout the discussion of the crisis, the immediate post-crisis response and the respective shortcomings identified, the limited ability of authorities at all levels of governance to preclude systemic crises and manage them effectively when they materialize is indisputable. Indeed, even the US response was ad hoc and extremely chaotic as the scale of the crisis was simply too great to contain and the mechanisms required were not in place. Given the existence of the single market and the prevailing degree of integration in the EU, however, the lack of sufficiently robust cross-border governance regimes and the shortcomings inherent in pre-crisis regulation is particularly significant due to the heightened potential for negative externalities and spillovers. The crisis ultimately underscored the necessity of governance integration and exposed shortcomings in terms of reactive capacity with respect to cooperative frameworks for both crisis prevention and crisis management.

297 Statements of European heads of state, such as French President Nicolas Sarkozy and German Chancellor Angela Merkel signalled the early acknowledgement of the architectural deficiencies of the regulatory system, displaying a political mood receptive for reform (see e.g. Ferran 2011b; Quaglia et al. 2009).

298 In order to analyze the post-crisis evolution and contextualize the implications in terms of systemic risk, this section presents a critical assessment of the pre-crisis regulatory landscape.
(De Larosière 2009: 13), the most important of which in this context are the latter three, presenting the core drivers of the regulatory overhaul. In more detail, pre-crisis deficiencies of the regulatory and supervisory architecture identified in the aftermath of the crisis and of relevance in this context can be grouped into distinct categories and summarized as follows.

Shortcomings with respect to the governance architecture in both macro- and microprudential terms, all of which create negative externalities in both crisis situations and otherwise, pertain to:

1. inadequate frameworks for macroprudential regulation, supervision and oversight, in which single-entity-based supervision was insufficient and did not adequately control for systemic risks (Trichet 2010a),
2. the related absence of early warning mechanisms and the ineffectiveness of segmented national financial stability monitoring,
3. the lack of attempts at comprehensive governance approaches to integrate micro- and macroprudential arrangements and policies in order to reconcile the interdependence between them,\(^{299}\)
4. an insufficiently robust supranational microprudential supervisory regime in which the Level 3 Committees were not afforded the requisite resources and competencies required,\(^ {300} \)
5. insufficient cross-border cooperation and coordination between national supervisors, including the absence of a clear framework for the oversight of cross-border financial groups (FSA 2009: 100), and finally
6. deficient and inconsistent supervisory rules, powers and sanctions across member states.\(^ {301} \)

In addition, in the context of the above and with respect to crisis management in particular, core deficiencies of the pre-crisis governance structure can also, i.e. for analytical purposes, be divided into two central categories: On the one hand, tools and mechanisms for mitigating systemic risk had remained national and differed considerably, including, for instance, divergence in terms of deposit insurance schemes, resolution regimes, and resources for crisis management, while on the other – and this is of central importance – the latter were largely deficient, implying that not only was further coordination and integration necessary, but an overhaul of the regulatory and supervisory regime as such.\(^ {302} \)

Shortcomings with respect to European financial governance, specifically the Lamfalussy system which had been charged with promoting regulatory convergence and consistency at the turn of the century, had

\(^{299}\) The crisis may ultimately be attributed to both micro- and macroeconomic policy errors (Litan 2011). As a consequence, the consolidation, coordination and convergence of the latter must inevitably be advanced.

\(^{300}\) Issues that may be subsumed under this category, i.e. the promotion of convergence and consistency include, for instance, the failure to challenge supervisory practices on across-border basis and the ineffectiveness of peer review arrangements (De Larosière 2009). In this context, however, it is also important to note that national supervisors also failed to conduct their oversight duties adequately (FSA 2009). In sum, supervisory capacity in general was insufficient.

\(^{301}\) The development of a EU-wide single rulebook is central in this respect. Having been a long-standing goal in the European context, it has now received new momentum, whereby the rationale of the integrated governance of the single market is ultimately that a “well-functioning internal market for financial services presupposes stringent, efficient and harmonized rules for all operators, coupled with an effective supervisory framework [...] and clear enforcement mechanisms” (European Commission 2010: 3).

\(^{302}\) It is also important to stress yet again in this context that in light of the deficiencies revealed by the crisis in terms of the pre-crisis supervisory and regulatory framework as well as the crisis management architecture at both the European and the national level, to attribute failure in terms of financial governance to European institutions and the inability to cooperate would be incorrect or rather as argued throughout would ultimately be a case of applying double standards. The infrastructures at both the European and the national level were in dire need of revision and reform, while it is imperative that they dovetail in future in order to be of any use for crisis prevention and crisis management.
already been acknowledged in the pre-crisis era (Kern and Ferran 2011: 17). As the crisis unfolded, however, policymakers soon realized that more radical and comprehensive changes were required (ibid.: 19). The crisis can therefore be perceived as a trigger that reinforced the momentum for more fundamental reform, while the De Larosière Report may be interpreted as the initiator and facilitator of a “new bolder phase” (Ferran 2011b: 33) of supranational financial governance. Though revisions had been on the agenda prior to the crisis, the latter no doubt enabled more fundamental reform and integration than would most likely have been feasible without its impetus and the sense of urgency it induced.

The pivotal issue in this context is that markets had essentially outpaced policy integration (see e.g. Haar 2014). Though the decades preceding the crisis had witnessed substantial advances in European financial market integration, policy integration and the construction of common governance structures had lagged behind and did not match the cross-border dimension of the single market (see e.g. Pisani-Ferry and Sapir 2010; Véron 2013a for contemporary perspectives). Dating back to the Single European Act and the First Banking Directive in the 1980s, the principles on which European governance was based were the notions of mutual recognition and home country control rather than integration or institutionalized cooperation (Davies 2014). Yet while these principles were adopted due to the fact that they were the only politically feasible options available to foster the single market at the time, the governance constellation they produced also gave rise to substantive challenges, the most significant of which ultimately pertains to their implications in terms of financial instability due to the financial trilemma mentioned previously, which is essentially the inability to reconcile both cross-border financial intermediation and the provision of transnational financial stability with national policies and governance (Schoenmaker 2011; 2013c), mirroring the impossible trinity of monetary policy (Mundell 1961) and the globalization trilemma (Rodrik 2007). One must yield to the others as all objectives cannot be attained simultaneously, and in the pre-crisis era this was, unfortunately, financial stability. The result essentially lent weight to the rationale for further governance integration in pan-European and eurozone terms. And indeed, given the scale of the complexity and limited governability the financial system exhibits in its current form as well as the shortcomings witnessed with respect to both cooperation and in terms of reactive capacity and crisis management, European policymakers were faced with two alternatives. In line with the interpretations of both the Turner Review (FSA 2009) and the De Larosière Report (De Larosière 2009), these were essentially the chacun pour soi or

303 See also chapter three for a brief recapitulation, European Commission (2007d) for a review of supervisory convergence within the Lamfalussy framework and De Larosière (2009) for an overview of pre-crisis attempts to improve the system.

304 Financial firms were allowed to operate in other member states – for instance via branches in the case of banks – yet were supervised by their home country authorities, i.e. by authorities in the countries in which they were headquartered. Regulatory cooperation or convergence was not explicitly required. In supervisory terms, for instance, this substantially complicated the resolution of cross-border institutions during the crisis. Other areas of divergence and fragmentation that contributed to instability when the crisis unfolded included, among others, varying deposit insurance schemes which threatened to destabilize banks in member states with less generous and accommodative schemes and mostly nonexistent or deficient national and supranational resolution schemes and funds. Recall, however, in this respect that other Western countries affected by the crisis suffered from similar weaknesses, wherefore factors fostering instability are not exclusively a European phenomenon.

305 Fonteyne et al. (2010) complement the trilemma with the incompatibility of transnational solvency and liquidity needs to foster financial stability, issues of accountability when dividing authority between home and host country supervisors to enable financial integration as well as ensuring that national political sovereignty and fiscal authority are not unduly jeopardized.
beggar-thy-neighbor approach, or, alternatively, “enhanced, pragmatic, sensible European cooperation for the benefit of all to preserve an open world economy” (ibid.: 4) which the latter preferred, laying the basis for the institutional reforms elaborated in the following.

Finally, as set out in the previous chapter, recall again that the lack of an overarching system-wide and stability-oriented, i.e. macroprudential approach to financial regulation was one of the key lessons drawn from the crisis. In an attempt to remedy the flaws of the pre-crisis era, the institutional governance architecture was revamped and transformed into a new two-tier pan-European system of macro- and microprudential supervision and regulation. In addition, the eurozone was equipped with a banking union to complement Economic and Monetary Union (EMU). The institutional overhaul and innovations that were instituted in this context are analyzed in depth throughout the following sections. The challenge throughout as alluded to above is to balance an assessment of both pan-European and eurozone institutions as both have been put in place to foster cooperation, mitigate systemic risk and strengthen cross-border crisis management and governance capacities. This chapter is therefore an attempt to bring coherence to the overarching attempt to improve governance structures in the aftermath of the crisis.

Note in this context that the inclusion of the pan-European European System of Financial Supervision (ESFS) and the eurozone banking union in the case selection is justified on the grounds that the research interest has a pan-European remit, whereby both constitute institutional structures of relevance for capacity in terms of systemic risk analysis, prevention and crisis management as both incorporate elements relating to governance capacity such as substantive rule creation, regulation, and institutional supervision, with potential positive effects and repercussions in terms of the stability and integrity of the single market as a whole. The focus is thereby on reform and the attempt to attain financial stability in its entirety and in this context banking union – regarding the discussion of causal nature between integration and differentiation which will be discussed below – may well have a centripetal as opposed to centrifugal effect on pan-European integration (Ferran 2014b). The analysis begins with the pan-European response (i.e. the ESFS) and is followed up by the eurozone’s banking union. The goal thereby is to scrutinize developments and showcase and synthesize the intricacies of constructing cross-border governance schemes, while assessing and contextualizing the corresponding challenges involved.

5.4 The European System of Financial Supervision: A Framework for ‘More Europe’?

Micro- and macroprudential regulation and supervision are inevitably intertwined and interdependent. The latter “cannot be meaningful unless it can somehow impact on supervision at the micro-level; whilst micro-prudential supervision cannot effectively safeguard financial stability without adequately taking account of macro-level developments” (De Larosière 2009: 38). This insight captures the essence of the post-crisis consensus in terms of regulatory takeaways, shifts and paradigms – though it is indeed
questionable whether the ‘macroprudential turn’ or ‘revolution’ represents – or the change embodied therein is sufficiently profound in order as to qualify as – a genuine paradigm change in the sense of an ideational shift (Baker 2013b, 2013c, 2014) or might rather be interpreted as an additional perspective and new approach within the old architecture and ideational framework (Baker 2013a, 2013c, 2014).

Be that as it may – i.e. as it is not as of yet to be clarified definitively whether a genuine paradigm change has transpired, changes merely represent an instance of symbolic politics (Edelman 1964), or the reality is a variation thereof and lies somewhere in between the two – from a technical regulatory perspective, this theme has been at the heart of the overhaul of the financial governance architecture at the supranational level and throughout the European jurisdiction (De Larosière 2009). In a nutshell, and in light of the lessons of the crisis, the European response in its various institutional and substantive iterations and dimensions – of which the Union-wide European System of Financial Supervision (ESFS) at stake in this chapter is a central element – is the European Union’s attempt to address the issues exposed by the crisis and resolve the financial trilemma discussed in the preceding section, reflecting the revelations of the crisis in a twofold sense. On the one hand, it aims to reconcile micro- and macroprudential regulation and supervision and construct a sustainable financial governance framework to mitigate the regulatory deficiencies exposed by the crisis (the regulatory theme), while it also seeks to centralize and streamline governance functions and competencies at the European level to increase governance capacity with regard to the regulation of the single market and address the governance flaws exposed (the governance theme) on the other.

In the immediate aftermath of the crisis, it soon became clear that the financial system was deficient in multiple respects and that all actors, including financial institutions, rating agencies, national supervisors and the global policymaking elite had played a role in its downfall. Yet as alluded to previously, the sheer complexity of the crisis and its multifaceted causes renders simple monocausal explanations impossible (Admati and Hellwig 2013). Mirroring this complexity, while not explicitly assigning responsibility to specific actors, factors or dynamics, the De Larosière Report on the crisis in the European context did, however, take aim at the supranational regulatory and supervisory architecture in its reform proposals (De Larosière 2009). It argued that the crisis had exposed shortcomings inherent in cooperation between supervisory and regulatory entities in the EU – both on the supranational level between EU-bodies and national entities on the one hand, and at the national level between national institutions on the other.307

Following the recommendations of the report, the EU eventually established the ESFS, which brings

306 As alluded to in section 4.5, it is hard to clarify definitively whether and to what extent this is indeed the case. Though recent reports show substantial strides have been made, it will require more time to research the macroprudential paradigm’s implementation and effects throughout the coming years. Yet though in principle much has changed, macroprudential regulation is by no means a magic bullet and instituted changes must be taken with a grain of salt as the paradigm is employed in a system that is as fragile, contagion-prone and tightly coupled as ever. The question is, therefore, whether it will suffice and genuinely alter financial governance or succumb to the deficiencies of the pre-crisis era. In addition, it is during booms and times of economic expansion in which its instruments – for instance countercyclical capital buffers – ought to be employed, yet unfortunately this does not appear to be the case to the extent that would be justified given the length and severity of the recession induced by the crisis (El-Erian 2017b; Wolf 2017).

307 This had also been the case in the US with respect to coordination among individual federal agencies. In this sense, the EU is not an anomaly though it is, as established previously, in effect sui generis as a governance construct.
together the respective European and national authorities and aims to ensure a stable and single financial market by integrating supervisors “within a strong Union network” (EBA Regulation). As noted previously and of significance in the context of this research, a central narrative in the European reform debate and an explicit focus of the De Larosière Report pertains to the issue of weaknesses with respect to the governance architecture which was regarded as deficient and fragmented in functional and horizontal terms (with regard to the lack of macroprudential perspectives and policy instruments) as well as with regard to the vertical division of competencies in regulatory and supervisory terms (i.e. the allocation of authority and the location and division of de jure and de facto regulatory capacities between the national and supranational level) – and therefore did not match the nature of the single market (De Larosiè re 2009: 13 and 38). Consequently, reform in the European context has focused on restructuring, streamlining and integrating the regulatory system in both pan-European and eurozone terms – which essentially sets the European response apart in comparative terms.308

Within this context, the overarching objective of the ESFS is two-pronged. One aim is to promote and serve as an integrated, comprehensive and sustainable EU-level framework for the regulation and supervision of the financial system and the provision of financial stability in the post-crisis era within which both micro- and macroprudential perspectives and approaches can be integrated and reconciled. As the Union’s attempt to devise a robust, holistic, inclusive and Union-wide approach to financial stability – in line with the trend of institutional re-ordering in the developed world (see e.g. Ferran 2014a) – the ESFS has undoubtedly been given a monumental task.309 The imperative thereby is to ensure that that micro- and macroprudential regulation and supervision dovetail so as to reap the benefits of synergies between the two for the conduct of both system oversight and the implementation of their respective and interdependent policy tools. This is essentially the contribution or added value it is intended to deliver.310

To enable the above, the second overarching objective is ultimately to facilitate and foster EU-level cooperation and coordination in financial regulation and supervision, specifically system oversight and policy implementation. Rather than being segmented in horizontal and sectoral terms as was the case in

308 In this context, both the European debate and the response is a feature that distinguishes it from other jurisdictions, including international and global schemes. In the US, for instance, the fragmentation of the regulatory and supervisory architecture as well as the dispersion of regulatory power therein has been criticized strongly by academics and policymakers (Ferran 2014a; Scott 2011: 728ff.; Willeke et al. 2013: 69ff.; Zandi 2008), and though “[c]lear cracks exist[ed] in the regulatory patchwork” (Zandi 2008: 147), the theme did not make it onto the regulatory agenda as such and was not been fundamentally altered in the aftermath of the crisis. It is argued throughout that this fact is significant, and – in line with Ferran’s (2014b; 2014c) legal analyses – analytical consequential in the sense that it attests to the Union’s innovative potential – going far further than, for instance, reform in international schemes and global frameworks in which, in overarching terms, institutional innovation has remained “minimal” (Underhill and Blom 2012: 291) and in which there has been “no genuine rethink of the global financial order” (ibid.).

309 One might even argue it has been set up to fail. Chapter six takes a closer look at the shortcomings the EU-level institution mandated with macroprudential oversight and systemic risk mitigation exhibits and the challenges it is confronted with.

310 Also of central importance in the context of financial stability is the ECB which not only serves as the eurozone’s new supervisor, but monitors financial stability and integration throughout the entire Union (European Commission 2014a: 8). In this context, it aids the institutions of the ESFS in their attempts to conduct continuous system-wide monitoring, identify and prioritize as well heighten the general awareness for risks and threats to financial stability, and supports their efforts to transform risk assessments into effective risk warnings and suitable macroprudential policy recommendations, thereby also potentially augmenting their quality.
the ESAs’ predecessors, and in vertical terms via national central banks conducting risk analyses on a national basis, the ESFS’ goal was to transform the segmented pre-crisis arrangements for financial stability analysis, monitoring and regulation into an integrated system.

Depicted in the following figure, the ESFS integrates multiple regulatory and supervisory actors into a multipronged and multilevel framework in an attempt to harness or rather come to terms with the complexity and multifaceted nature of finance and its governance within the European context and construct a system that mirrors, i.e. is commensurate with the latter, while rendering it – that is its regulation, supervision and overarching governance – more comprehensive and coherent. The institutional architecture of the new – or rather reformed and upgraded – system visualized in figure three provides a framework within which to integrate and bring together multiple actors and regulatory and supervisory entities within an overarching institutional framework in order to foster and facilitate EU-level cooperation and coordination as well as increase its coverage, coherence and consistency. In terms of structure, the institutional edifice of the new pan-European architecture is based on two key pillars, which in combination with the European Commission present the macro-institutional regulatory and supervisory context in the European Union. More specifically, the actors and entities comprised in the ESFS as specified in the establishing legislation include the three newly established European Supervisory Authorities (ESAs) as independent pan-European agencies, namely the European Banking Authority (EBA), the European Securities and Markets Authority (ESMA) and the European Insurance and Occupational Pensions Authority (EIOPA). The latter reflect the traditional financial market segments (Quaglia 2008a), succeeded their predecessors, the so-called Level-3 Committees in 2011, are required to closely cooperate with the respective national authorities, and present the basis of the microprudential component of the ESFS, aiming to provide the context for enhanced regulatory and supervisory convergence and coordination. The microprudential component also includes the Joint Committee of the ESAs311 and integrates, i.e. unites the respective national supervisory or competent authorities (NCAs). Finally, the European Systemic Risk Board (ESRB), presenting the macroprudential component of the new system, complements the new network for regulatory and supervisory cooperation and integration (as well as systemic risk oversight) (European Commission 2014b).312

311 The Joint Committee of the ESAs is composed of the ESAs Chairpersons and comprises the Board of Appeal through which appeals can be launched.
312 For more information, confer the respective regulations establishing the latter.
The European Commission’s overarching reform objective when proposing the new regulatory and supervisory architecture was essentially to establish a pan-European construct designed to span the entire single market, contribute to more harmonised and holistic governance and “provide the backbone for reinforced cooperation” (European Commission 2010: 3; see also European Commission 2014b).

The legislation establishing the ESAs and the ESRB in the context of the construction of the new financial governance architecture came into effect in January 2011 in line with the recommendations put forward in the De Larosière Report in February 2009 (De Larosière 2009). The High Level Group on Financial Supervision which produced the report had been appointed by the European Commission in the aftermath of the crisis and as discussed in the previous section had been given the task of conducting a comprehensive review of the regulatory and supervisory weaknesses of the pre-crisis system (governance theme) against the backdrop of the lessons that could be drawn from the crisis in substantive regulatory terms (regulatory theme) and devising corresponding proposals and recommendations for an integrated,

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efficient and sustainable governance architecture. The new supranational regime was endorsed in principle thereafter at the highest political level in the presidency conclusions of the European Council in June 2009 (European Council 2009), while the respective legislative proposals to reform and strengthen the regulatory and supervisory institutional structure were put forward shortly afterward by the Commission and a compromise package was adopted by the co-legislators, the Council and European Parliament, a year later, while the institutional innovations were operational as of 2011 (see Ferran 2011b for an in-depth recapitulation). Though in general terms broad support prevailed which ultimately facilitated reform, intense trilogue negotiations ensued as disagreements pertaining to the details remained.314

In essence and in conclusion, the ESFS may be interpreted as an additional layer of – or perhaps rather an umbrella for – the financial governance architecture in the European context.315 What this means is essentially that the supranational regime does not intend to replace but rather complement national schemes by drawing on the expertise and resources of national authorities, which are closer to the supervised entities, and as such in most cases best placed to supervise and regulate the entities within their jurisdictions, yet retaining the institutional layer on top to facilitate convergence, information exchange and cooperation in times of crisis and beyond by means of integrating and upgrading the European governance architecture.316

The financial crisis precipitated fundamental reforms – including changes and alterations of such a magnitude rarely witnessed before in the European jurisdiction and the most transformational in roughly two decades (Ferran 2011b; Howarth and Quaglia 2013a) in spite of the multiple limitations they continue to exhibit. In overarching terms, the importance of accommodating cross-border finance – which in the European context implies a single market in financial services and beyond – and financial regulatory and supervisory arrangements and strategies – which are, by definition, intertwined and inevitably require further integration – has indeed become increasingly apparent. In particular, in the post-crisis era, systemic risk prevention has become one of the new priorities placed front and center on the post-crisis regulatory agenda – highlighting the significance afforded to prudential concerns and the centrality of financial stability – the ramifications of which the research now sets out to explore in institutional terms. After having discussed substantive reform dimensions, the research now analyzes the institutional outcome and ramifications of the instituted reform initiatives. Against the backdrop of the evolution, reform and status quo of pre-crisis governance structures set out in chapter three and on the basis of the shortcomings of the pre-crisis

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314 The fact that compromise was attained despite significant divergence in terms of preferences is indicative of the capacity for integration in times of crisis and intense external pressures as will be highlighted throughout.

315 Ultimately, it is an additional layer of the multidimensional financial governance architecture regime for regulatory and supervisory coordination and the mitigation of systemic risk. As such, it offers the umbrella under which to subsume and integrate vertical and hierarchical levels of regulation and supervision and their respective institutional structures. Note in this context that the SSM for the eurozone cooperates with the ESAs and national competent authorities on the microprudential level.

316 Evidently this argument does not necessarily apply to the eurozone context as will be discussed in the following section (5.5) given the greater degree of integration and the single currency – both giving rise to the rationale for integrated supervision located at the supranational level in the case of large cross-border financial institutions.
regulatory and supervisory architecture exposed by the crisis and elaborated in the preceding section – which, among other issues, as established throughout reflected the microprudential approach, integrating predominantly microprudential elements and perspectives, and therefore fell short of what was required as they were demonstrably neither sufficiently robust or comprehensive in terms of system stability nor sufficient in terms of reflecting the composition of the single market and the degree of market integration that prevails in the European context so as to overcome the predicaments that arise from the financial trilemma (FSA 2009; Turner 2009) and induce sufficient cooperative potential which in theory should also translate into or contribute to increased governance capacity – the research now turns to pan-European reform initiatives and outlines institutional arrangements in the pan-European sphere that emerged from crisis-induced legislation establishing the ESFS in the context of the post-crisis micro- and macroprudential supervisory overhaul in detail.

5.4.1 The Microprudential Component: The European Supervisory Authorities: The EBA, ESMA and EIOPA

Fulfilling several overarching objectives, whereby they juggle a number of responsibilities and integrate multiple functions related to prudential regulation, system stability and beyond simultaneously, the European Supervisory Authorities (hereafter ESAs) constitute the microprudential component of the ESFS. In this context, they are not as such market-facing supervisors in the conventional sense, but might rather be classified as supervisors of supervisors which have their own remit of authority, yet are also mandated with facilitating cooperation and coordination among national supervisors as well as promoting the delegation of tasks and responsibilities between national supervisors (ESA Regulations: Article 28; see also Ferran 2011c, 2014a on variations of supervisory models). This section sets out to assess the significance of their construction and evolution in governance terms and with respect to the issues at stake throughout whereby, in an attempt to conduct a critical assessment of the ESAs, the aim is to go beyond a mere description and analysis of the microprudential element of the new institutional governance structures and assess the reform outcome with a view to the issues and challenges discussed in the previous chapter, i.e. with a specific focus on the nature and degree of integration that has transpired and their impact on governance capacity at the supranational level as well as issues pertaining to the governance of systemic risk and the implications of financial stability-related elements embedded in the new architecture.

317 Another way to characterize and systematize the shortcomings in overarching categories of relevance for the purposes at hand is to distinguish between national and European shortcomings as well as with respect to cooperation schemes and their potential (i.e. in vertical terms) and in terms of functional policy spheres (i.e. in horizontal terms).

318 The recognition of the necessity thereof is reflected in the components of the ESFS and – regarding underlying supervisory structures – reflected in the construction of the ESAs. Note, however, that the transition, meaning the shift to a macroprudential paradigm, its corresponding regulatory measures and further integration is by no means complete – in part due to the fact that the interaction between them hangs in the balance and has yet to be consolidated – such as, for instance, the implementation of micro- and macroprudential regulation and the issue of proximity versus neutrality, which will be discussed throughout.
After (i) a general introduction and depiction of the institutional elements at stake in terms of their legal foundation, institutional set up, internal governance structures (section 5.4.1.1) as well as with regard to their rationale, mandate, and competencies (section 5.4.1.2) – first in general including overlaps and commonalities, then with respect to the individual ESAs, the analysis turns to (ii) the extent to which they, i.e. the reforms and the changes embedded therein, i.e. the capacity extension in regulatory terms and supranationalization in governance terms that they signify are significant, thereafter followed by (iii) an elaboration of shortcomings regarding capacity, authority, funding etc. The latter two are integrated in the final section on the ESAs (section 5.4.1.3), which summarizes and contextualizes the developments that have transpired, presenting the basis for the overarching evaluation of the ESFS later on, in turn serving as part of the foundation for the overarching verdict on the reform outcome in its entirety, including with regard to progress in terms of increasing Europeanization and hence what is defined in this context as capacity.

In spite of contextual differences, the ESAs’ founding regulations are largely identical, meaning there are substantial substantive overlaps with respect to their provisions in terms of their structural composition, institutional set-up, largely overlapping mandates and authority. Yet despite similarities regarding their founding legislation, they evolved quite differently (as discussed later on).

As was to be expected as the devil is in the details, the transposition of proposals into legislation in the legislative process was controversial and involved compromises, bargaining and log-rolling. In stylized terms, the European Parliament advocated – i.e. may be described as a proponent of – regulatory (intensity and) stringency as well as (substantial) integration and centralization, with its proposals even going beyond the De Larosière Report’s (2009) original propositions.319 Both the Commission and the Council were, however, more cautious.

In short, summarizing the ESAs’ core mandate concisely, their principle objectives include contributing to the smooth and orderly functioning as well as the stability and integrity of the internal financial market by way of promoting sound, coherent and consistent, i.e. coordinated or integrated regulation and supervision, thereby ensuring the adequate coverage and regulation of risks that transcend national borders and inevitably includes the mitigation of systemic risk as well as the prevention of regulatory arbitrage and unfair competition at the microprudential level with respect to both individual financial institutions and markets at large (EBA 2017a). In order to fulfill these objectives the ESAs are afforded the authority to devise legally binding and non-binding rules in cooperation with the Commission and make both legally binding and non-binding decisions in emergency situations and otherwise.

319 The Parliament, for instance, was in favor of combining the supervisory authorities in one location and even constructing a single authority in order to streamline the supervisory system and increase its efficacy, which it interpreted as the logical step forward for the supranational supervisory system, in addition to complementing the ECB’s new supervisory mandate (Davies 2014; see also Ferran 2011b: 34 on the Rapporteur of the Parliament’s support in this regard).
The following first looks into how the ESAs are structured and operate before progressing to their overarching mandate, tasks and powers, and thereafter assessing the respective significance of their construction and evolution with a view to issues of relevance throughout – that is with respect to governance capacity and the extension thereof at the European level and in terms of systemic risk governance.

5.4.1.1 Legal Foundation, Institutional Structure and Internal Governance in Depth

In the context of the ESFS, the European Supervisory Authorities (hereafter ESAs), which are essentially independent European agencies, exhibit largely similar or even identical features and attributes, for instance being structured identically and governed in the same fashion. Having replaced their predecessors, the so-called Level 3 Committees elaborated in chapter three (Quaglia 2008a; see also section 3.3) which had been established on the basis of the 2001 Final Report of the Committee of the Wise Men320 and adopted by the European Parliament in 2002 (see e.g. Haar 2014; Kudrna 2011; see also section 3.3), the ESAs are independent supranational Union bodies with legal personality under EU law (ESA Regulations: Article 5 para. 1) and are located in the same locations as their predecessors (ESA Regulations: Article 7).

As regards similarities, in terms of their organizational governance structure, institutional set-up and internal governance procedures – the legislative basis for which is laid out and clarified in the ESA Regulations (Articles 40–57) – the ESAs are largely identical, i.e. exhibit substantial overlaps and similarities.321 Each ESA is composed of a Chairperson and an Executive Director as well as a Management Board and a Board of Supervisors. The Board of Supervisors (BoS) unites the relevant, i.e. competent national supervisory authorities’ chairpersons as voting members, while the ESA Chairperson, the Executive Director, a Commission representative, an ESRB representative and representatives of the other two ESAs respectively are represented as non-voting members.322 Ultimately, the Board of Supervisors, which is the principal decision-making body that makes all the relevant policy decisions, guides the ESAs’ activities, and in light of its agenda-setting capacity, is afforded a, if not the, dominant role in the new authorities, i.e. being responsible for approving the ESAs work. The Management Board in turn includes the ESAs’ Chairpersons and six additional members drawn from and elected by the Board of Supervisors, which are essentially representatives of national supervisory authorities, whereby the ESA Regulations require proportionate representation with respect to the balance between eurozone and non-

320 See the so-called Lamfalussy Report for further information (Committee of Wise Men on the Regulation of European Securities Markets 2001). See also Haar (2014).
321 For a detailed overview of governance structures, see Ferran (2011b).
322 In the EBA, the ECB is also present in meetings as a non-voting participant, as are national central bank representatives that are not also supervisors. EEA participation in all ESAs is possible, yet is limited to observer status and at present includes Iceland, Liechtenstein and Norway.
eurozone members elected (ESA Regulations: Article 45), while a Commission official and the Executive Director are included as non-voting members. The Management Board effectively ensures that the ESAs fulfill their missions and perform their tasks and duties correctly (see e.g. EBA 2013), guiding on-going work as well as ensuring compliance with applicable EU regulations while being responsible for annual work programs, reports, budgeting and staff-related issues.

On similarities in terms of internal governance relating to decision-making processes and voting modalities and provisions, applied within the context of — and of importance with respect to — the fulfillment and execution of the mandate, tasks and competencies the ESAs have been afforded, which are at stake in the following section, decisions made by both the Management Board and the Board of Supervisors are taken by simple majority, though qualified majorities are required in some instances and on certain issues in the context of the latter (i.e. the BoS). The recourse or resort to simple majority voting in this context is particularly significant and should be underlined as it could potentially contribute to considerably boosting governance capacity at the European and ensure the new authorities functionality by facilitating decision-making and impeding dead lock, which can be particularly significant in crisis situations, yet is also relevant with respect to day-to-day regulatory and supervisory activities.\[323\] This is in line with Ferran’s (2011b: 36) interpretation, which draws attention to the “significance of the shift” to simple majority voting as the default mode of decision-making in the post-crisis era. While the ESAs’ predecessors initially relied on consensus and qualified majority voting was merely employed later on as an exception in delimited issue areas, simple majority voting lowers the threshold considerably, easing and accelerating decision-making in the process.\[324\] With respect to its potential in terms of facilitating governance and increasing capacity at the European level, this development or rather measure should be borne in mind when assessing the significance of instituted reforms.

With respect to the issue of supervisory accountability and liability in this context the following is relevant: To ensure the administrative and judicial accountability of their actions, ESA decisions an be contested by national supervisors and indeed any natural and legal persons via appealing to the ESAs joint Board of Appeal (ESA Regulations: Article 58), while member states and European institutions (in addition to natural and legal persons) can also appeal to the CJEU (ESA Regulations: Article 61; TFEU: Articles 263 and 265).\[325\] In terms of formal control mechanisms with respect to internal governance, central positions, i.e. the ESA Chairperson and Executive Director, are generally elected internally by the BoS.\[326\]

\[323\] Indeed, these voting modalities are of relevance with respect to the ESAs mandate and their respective competencies as EU agencies at stake in the following section.

\[324\] It potentially also increases the chances of success, i.e. the chances of coming to a conclusion. Indeed, the ineffectual mode of consensus-based decision-making and its inhibiting effects had become apparent prior to the crisis and had been an issue of contention for some time. As alluded to in chapter three, reforms in this respect and an uprading of supervisory agencies had already been on the agenda in the pre-crisis era. Also of significance in this context, is the fact that the changes were contentious. Due to the sheer size of its financial sector (30 percent of the entire EU), the UK felt its stake in this context had not been accounted for adequately. The fact that they were instituted nonetheless is noteworthy.

\[325\] The ESAs assumed various soft tools from their predecessors which include, among the most significant, devising non-binding guidelines and recommendations, conducting peer reviews and non-binding supervisory dispute settlements as well as addressing
With respect to funding – and hence also affecting the degree of independence the ESAs are granted – the ESAs rely on mixed funding. The financing arrangement is based on a combination of Union funds from the General Budget (40 percent) and national contributions (60 percent), and is regarded as having secured sufficient independence for the ESAs from either of its sources of funding (Wymeersch 2010, 2011).327

With respect to the above, reforms signify an extension of authority and governance capacity at the European level – albeit to a lesser extent than might have been required. The research now look into the ESAs mandate, tasks and competencies to complete the assessment of microprudential reform elements.

5.4.1.2 The ESAs Rationale, Mandate and Competencies in Context

With respect to their overarching mandate and tasks – including their respective competencies, powers and the degree of authority and independence they have been granted more generally – the ESAs have experienced a significant expansion of capacity. In broad terms, they have assumed the functions and tasks of their predecessors (the Level 3 Committees CEBS, CESR and CEIOPS) and have been afforded additional competencies (Ferran 2011b; Mayntz 2013).328 Their principle objectives as regards their micro-prudential role within the ESFS are laid out in the legislation establishing the ESAs whereby the respective regulations stipulate that the ESAs are mandated to “protect the public interest” by ensuring “the short, medium and long-term stability and effectiveness of the financial system” (EBA 2017a: 14), which inevitably includes the mitigation of systemic risk and is to be achieved by way of the fulfilling the goals listed in the following.329 Note, however, that the following enumeration includes only selected tasks and objectives – subsuming and consolidating those included throughout in the regulations in accordance with their relevance in terms of the issues at stake (see the respective regulations for a comprehensive elaboration). The tasks and objectives are, for instance:

1. improving the functionality of the single market by ensuring the efficiency, integrity, transparency and orderly functioning of financial markets,
2. ensuring sound, coherent and efficient regulation and supervision by contributing to the establishment of common

opinions to other EU institutions (see ESA Regulations: Articles 16–35).

326 European Parliament involvement in appointments is, however, guaranteed. The latter can object to a designation and must confirm both extensions of terms of office and the formal removal of a Chairperson and confirm the Executive Directive in office (ESA Regulations: Art. 48 and 51; see also Ferran 2011b: 36–37).

327 Generally, EU agencies are funded by the EU budget, though some are also partly funded by fees levied on regulated entities under their jurisdiction. ESMA, for instance, relies in part on fees collected from the credit rating agencies it supervises directly for its revenue (ESMA Regulation: Article 62; see also the respective section on ESMA below).

328 The ESAs assumed various soft tools from their predecessors which include, among the most significant, devising non-binding guidelines and recommendations, conducting peer reviews and non-binding supervisory dispute settlements as well as addressing opinions to other EU institutions (see ESA Regulations: Articles 16–35).

329 For the original regulations presenting the legislative bases of the ESAs, including an in-depth elaboration of their mandates, see Regulation (EU) No 1093/2010, Regulation (EU) No 1094/2010, and Regulation (EU) No 1095/2010 which are quoted in full above. For a comprehensive academic discussion thereof, see Ferran (2011b).
regulatory and supervisory standards and practices of high-quality in their respective areas of competence.\textsuperscript{330} Contributing to the effective and consistent application of legally binding EU acts in their respective areas of competence and scope of action, for instance, by facilitating the development of a common supervisory culture,\textsuperscript{331} strengthening supranational and international supervisory cooperation, coordination and convergence, especially by contributing to the efficiency, effectiveness and functionality of supervisory colleges by increasing the consistency and coherence of the supervision of cross-border institutions,\textsuperscript{332} cooperating closely with the ESRB within the context of the ESFS, specifically providing the latter with the requisite data and information required for the effective conduct of macroprudential policy and ensuring a proper follow-up as regards the ESRB’s warnings and recommendations, \textsuperscript{333} monitoring, measuring and assessing market developments in their areas of competence conducting economic (market) analyses to inform the fulfillment of their functions, including monitoring, measuring and assessing systemic risk, developing and coordinating (the devising of) recovery and resolution plans, including assessing the need for appropriate financing instruments, (and taking actions, inter alia, in emergency situations), \textsuperscript{334} promoting and facilitating the delegation of tasks and responsibilities among national supervisory authorities, conducting peer reviews of the latter, issuing guidelines, recommendations and identifying best practices so as to strengthen consistency in supervisory outcomes (the reconciliation of home and host issues), \textsuperscript{335} fostering consumer protection by promoting transparency and fairness (including the protection of investors, depositors, policy holders, pension scheme members and the like),\textsuperscript{336} and finally \textsuperscript{337} collecting, sharing and publishing data and information relating to their activities and areas of competence.\textsuperscript{338}

Summarized in broad terms, the focus is laid on ensuring the effective and consistent supervision (the two themes) of financial institutions and market participants via various diverse channels so as to ensure the stability and effectiveness of the financial system (EBA 2017a: 14) – though the degree to which this is attainable is inevitably an ever present question. The ESAs mandate ultimately includes legislative, regulatory, supervisory, cooperative and coordinative functions and dimensions – reflecting the holistic and comprehensive regulatory and coordinative approach they are intended to attain and contribute to.

The ESAs, in essence, have a dual purpose – as does the entire ESFS as alluded to throughout – with the dimensions essentially being regulatory and supervisory vis-à-vis the private sector and coordinative in terms of vertical and horizontal governance coordination between public authorities. The ESFS can therefore be interpreted as an additional layer of the financial governance architecture. The EBA, for instance, is pivotal – and indeed to a degree unique – in this regard. Of central significance in terms of financial stability due to its central position in the midst of the European architecture, it serves as a linchpin in pan-European terms as it unites eurozone and non-eurozone members and offers a venue within which to provide for both convergence and coordination between the two spheres.

\textsuperscript{330} This includes providing opinions to the EU institutions that devise the latter, i.e. by advising the Commission, which in turn makes legislation binding, and by developing non-binding guidelines, recommendations as well as binding draft regulatory technical standards (RTS) and implementing technical standards (ITS) on their own account.

\textsuperscript{331} This, for instance, entails preventing regulatory arbitrage and includes mediating and resolving disagreements between national competent authorities, which in turn is intended to ensure the effective and consistent supervision of financial institutions and financial market participants.

\textsuperscript{332} In combination with the latter, this is aimed at promoting and monitoring compliance and convergence as well as creating equal conditions of competition, ensuring the taking of related risks are appropriately regulated and supervised.

\textsuperscript{333} As in the US, consumer protection has been afforded more prominence in the new architecture (ESA Regulations: Article 9).

\textsuperscript{334} Of significance in this respect are, for instance, central supervisory databases maintained by the ESAs and comprising collected information on registered financial institutions.
The EBA, as a hub and spokes network of member state and European entities involved in banking regulation and supervision, plays a vital role in the provision of financial stability due to its centrality in pan-European terms and its role in the regulation of banking institutions, for instance, in its function of advising the Commission in devising banking legislation as well as by way of its broad mandate to strengthen multilevel supervisory coordination and convergence, by consequence ensuring a level playing field and inhibiting regulatory arbitrage. ESMA in turn is mandated with contributing to and safeguarding system stability by ensuring the efficiency, transparency and integrity of securities markets. Consumer protection is also included in its mandate as is cooperation with other ESAs, including regulatory and supervisory convergence, the coordination of supervisory actions and the adoption of emergency crisis measures within the sphere of the securities sector as well as across financial sectors. A distinguishing feature of ESMA is its direct supervisory mandate for credit rating agencies, which may be regarded as a central cause of the crisis. What this implies in terms of its implications for sovereignty transferal and European integration at large will be discussed throughout. Finally, reflecting the ESFS’s attempt to establish a holistic approach to and comprehensive system of financial governance, EIOPA – though of less immediate significant for the mitigation of systemic risk in the classical sense – contributes to crisis prevention and the provision of financial stability in the EU by identifying and monitoring “trends, potential risks and vulnerabilities at the micro-prudential level, across borders and across sectors” (EIOPA 2012: 15; emphasis added) within its respective area of expertise, ensuring the consistent, i.e. harmonized and coherently applied as well as effective regulation and supervision of the insurance sector and, importantly, contributing to the coherent oversight of cross-border banking groups and conglomerates (ibid.) in collaboration with the other ESAs and national authorities.

On Tasks and Competencies: The ESAs’ Powers and Authority in Emergency Situations

With respect to their mandate and competencies and of significance in this context, i.e. in the context of reactive capacity at the European level, the ESAs have been afforded the authority of coordinating supervisory responses in the event of emergencies (ESA Regulations: Article 18), while now also being able to formally intervene on their own behalf if backed by a determination of the Council confirming an emergency, which is issued upon the request of an ESA, the Commission or the ESRB and after deliberations with the Commission and the ESRB, with the latter essentially presenting a new power (ibid.; see also Ferran 2011b: 51; Haar 2014; Wymeersch 2012b). If confirmed, the ESAs can adopt decisions, which merely require a simple majority, stipulating actions required to ensure supervisors’ and regulated entities compliance with EU law. Setting apart its authority in this context, for instance, vis-à-vis the

335 In certain instances, in the case of non-compliance by a national authority – either in the form of failure to apply EU law or a manifest breach in terms of its application – the ESAs can even direct the decision toward the regulated institution directly (ESA Regulations: Article 18, Para. 4). This is highly significant as it enables the ESAs to bypass national authorities, albeit only in certain situations with significant limitations, i.e. must be directly related to relevant EU financial markets legislation and required
direct enforcement power discussed above, is the fact that if given the green light, i.e. fulfilling requisite requirements, intervention in an emergency situation is accelerated and need not be administered by the Commission (Ferran 2011b: 51), which may substantially augment reactive capacity and as such is potentially significant, though restrictive conditions do apply. This emergency power is by no means a carte blanche for proactive ESA action, i.e. does not provide it with generalised discretionary power, and must therefore be regarded in a nuanced or critical light.

The following sections look into the individual entities devoted to microprudential regulation and supervision in more detail, analyzing both their distinctive features and attributes as well as their respective significance, and are followed by an assessment of their significance in terms of the degree of integration they exhibit and their implications in terms of – or rather their contribution to – the mitigation of systemic risk before progressing to the macroprudential element of the pan-European reforms.

5.4.1.2.1 The European Banking Authority
The European Banking Authority (EBA), the successor of the Committee of European Banking Supervisors (CEBS), was initially situated in London as of January 2011 as a concession to the UK, reflecting the latter’s prominence in the financial services industry. It has since been relocated to Paris on the grounds of the UK’s intention to withdraw from the EU so as to guarantee a smooth transition as well as a seamless continuation of its activities and the fulfillment of its mission in light of Brexit (EBA 2017c). Embedded in the micro- and macro-prudential nexus, its overarching mission objectives are to contribute to financial stability and safeguard “the integrity, efficiency and orderly functioning of the banking sector” (EBA 2017c), which it does, primarily and most importantly, by (i) assessing risks and vulnerabilities in the European banking sector, i.e. by conducting ongoing oversight of the financial system, (ii) contributing to secure financial market stability and integrity. This notwithstanding, its very existence signifies a degree of authority transferal that would have been highly unlikely in the pre-crisis era and may substantially increase reactive capacity at the supranational level.

Restrictions lessening the potential effect of this emergency power include that exceptional circumstances endangering financial market stability and integrity which require coordinated supranational action must exist in order for the Council to confirm an emergency situation (ESA Regulations: Article 18, Para. 3), decisions regarding actions to be taken may only pertain to issues that are explicitly set out in EU financial markets legislation, i.e. no open-ended authority, potentially significant in view of the flexibility required to attenuate crises and mitigate systemic risk in view of the definition employed throughout, and finally a fiscal safeguard clause applies, stipulating that member states’ fiscal responsibilities should not be unduly affected (ESA Regulations: Article 38). If the latter is the case, a protracted and lengthy process may ensue as member states are allowed to appeal to the Council and even apply for a re-examination if their claims are rejected (ESA Regulations: Article 38, Para. 3 and 4), potentially attenuating the effect of this new power and its utility in crisis situations, presenting a crucial drawback. For further analysis of this issue, see Ferran (2011b: 51–53) and Wymeersch (2012b).

As discussed in chapter four, stress tests aid both supervisors and financial institutions in assessing and addressing shortcomings in the banking sector and as such can be considered effective tools for the provision of stability in a preventive sense, though they are by no means to be regarded as magic bullets, but much rather as helpful additions to the supervisory and regulatory toolkit. Of particular importance is their contribution to transparency if conducted rigorously and hence their potential to boost confidence throughout the financial industry. The EBA is a central actor in this respect. In its attempt to strengthen the transparency and resilience of the banking sector in Europe, it is engaged in an “ongoing process of balance sheet repair” (EBA 2017a: 60). Since its establishment in 2011, it has conducted three EU-wide stress tests to monitor risks and market developments and describes it as “one of the primary supervisory tools to identify trends and individual vulnerabilities stemming from the microprudential level, and also a significant contribution to the overall assessment of systemic risk in the EU financial system”
to the creation, development and maintenance of the European Single Rulebook in banking, in this context supporting the development of sustainable prudential regulation and supervision and thereby contributing to and ensuring the construction of a robust regulatory regime, and finally (iii) promoting the convergence of supervisory practices across the European regulatory and supervisory landscape, thereby contributing to sustainable and equitable cooperation to ensure its mandate. Given the fact that Europe is mostly composed of bank-based economies, its role and significance should not be understated. Indeed, the EBA is arguably the most important of the ESAs in terms of contributing to financial stability and regulatory convergence in light of the dominance of the bank-based model in continental Europe (EBA 2017a; EBA 2017b).

Arguably the most important of the ESAs in terms of stability and convergence as well as prevention and preemption in light of the dominance of the bank-based model in the European context and due to its centrality in pan-European terms (Ferran 2016; see also section 5.6), the EBA takes on a pivotal position when it comes to financial stability-related activities – for instance, focusing on Basel III implementation within the remit of its coordinative, supervisory and regulatory functions, while participating in the devising and conducting of pan-European stress tests in cooperation with the ESRB (EBA Regulation: Article 21) and contributing to the devising of recovery and resolution plans (ibid.: Article 25; see also EBA 2011, 2012b). In addition, in terms of microprudential policy which feeds into stability provision, its tasks include data collection, oversight and collaboration with the ESRB and the other ESAs.

Early on in its evaluation of the overall performance of the EBA in the context of its 2012 Financial Sector Assessment Program, the IMF maintained that despite limited resources and ongoing crisis management at the time, the EBA has made significant progress measured “against its mandates, given [the] economic conditions prevailing in the banking sector” (IMF 2013d: 6). Potential limitations do, however, remain and include its lacking enforcement authority as well as limited binding powers. There is certainly room for improvement in this regard in future. Yet as the case of ESMA shows, this is indeed possible.

5.4.1.2.2 The European Securities and Markets Authority

The European Securities and Markets Authority (ESMA) is situated in Paris and has – in comparison with the other two ESAs – been afforded the most new and wide-ranging competencies as well as the broadest mandate and remit of authority, ultimately rendering it unique in the new regulatory architecture in certain respects. The successor of the Level 3 Committee of European Securities Regulators (CESR), as is the

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338 This it does, for instance, by way of the adoption of binding technical standards and guidelines.

339 In line with this fact, it is possible to deduct the significance of both the EBA and the ECB as prudential supervisors.
case with respect to the EBA discussed above, was established in 2011 and is central in terms of its role in the provision of financial stability (see ESMA 2012; IMF 2013b). Mandated as in the case of the other ESAs with contributing to a single rulebook for the single market within its area of competence (thereby fulfilling a central regulatory function), ESMA’s primary objectives include the construction of a robust market infrastructure via the promotion of the integrity, transparency, efficiency and proper functioning of financial markets (orderly financial markets), the strengthening of the financial system, fostering its resilience and capacity to withstand shocks and the unraveling of financial imbalances while encouraging economic growth (financial stability), and finally investor protection. In this context, subsuming the responsibilities of its predecessor, its activities can be summarized as encompassing (i) overarching oversight functions, including the assessment of risks pertaining to investors, market functionality and financial stability, (ii) explicit regulatory functions, aimed specifically at devising technical standards in order to complete the single rulebook and advising EU institutions on the development and adoption of new laws so as to improve the single market, (iii) supervisory functions, including both the supervisory authority for the direct supervision of selected financial institutions, more specifically credit rating agencies and trade repositories – which in future might be extended to further entities – and the promotion of cross-border supervisory convergence, i.e. the standardization of supervisory practices, and finally (iv) coordinative functions, including taking action in the event of crises by coordinating or adopting emergency measures and crisis management tools as well as coordinating national supervisory activities and measures in this domain, e.g. by sharing best practices with respect to both the financial industry and national supervisory authorities.

In 2013, its workforce encompassed a total of 200 staff members, having increased fourfold from 2010 when it took over from its predecessor (IMF 2013b). This substantial increase is ultimately in line with the expansion of its mandate, its authority and potentially also its significance as it underlines the fact that serious effort has indeed been put into revamping the institutional architecture. For instance, the extension of ESMA’s mandate and remit of authority to the direct supervision of certain institutions, as recommended by the De Larosière Report (De Larosière 2009: 20), was eventually implemented, albeit grudgingly on the part of some member states, signifying the acknowledgement of the necessity of further centralization in certain issue areas in order to ensure both the efficiency and effectiveness of cross-border governance.340 In this sense, i.e. with respect to its direct, market-facing supervisory role, it may be regarded as having been afforded distinct capacities (much like its predecessor, see section 3.3), and as such is unique in the context of the ESFS, while this development may also have unintended, i.e. positive effects on the other sectoral authorities’ capacities in the long-run. Its distinctive traits ultimately include its enforcement authority vis-à-vis the institutions it regulates as well as the greater degree of independence it is granted due to an alternative funding model that is not entirely dependent on member state contributions (Masciandaro et al. 2011; see also ESMA 2011, 2012).

340 This pertains, for instance, to its assumption of authority with regard to the registration and supervision of credit rating agencies.
The European Insurance and Occupational Pensions Authority (EIOPA) is based in Frankfurt and is the successor of the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS). Its mandate is, in a nutshell, to “support the stability of the financial system, ensure the transparency of markets and financial products and protect policyholders, pension scheme members and beneficiaries […] monitor and identify trends, potential risks and vulnerabilities at the micro-prudential level, across borders and across sectors” (EIOPA 2012: 15; emphasis added) and with regard to its area of expertise and its jurisdiction. Its principle objectives and the issue areas it sets out to contribute to can be summarized in three overarching categories as (i) supervisory and regulatory, (ii) financial stability and crisis prevention, and (iii) consumer protection.

During the initial phase of its construction and operation, EIOPA’s activities primarily focused on the development and implementation of the so-called Solvency II Directive, whereby the drafting of Solvency II insurance standards was a key objective and cornerstone of its mandate and activities. After having been in the making for over a decade, Solvency II, which EIOPA’s predecessor CEIOPS had begun issuing Level 3 guidance for in 2010 (Ferran 2011b: 31), and which was originally intended to be implemented by 2012, was finalized in 2015 and eventually entered into force in 2016. Additional tasks include ongoing Solvency II implementation which has been “intense and relevant” (IMF 2013c: 30) from its inception onward, the regulation and supervision of insurance-related products and activities, and finally cooperation with the other ESAs and the ESRB for stability purposes.

Challenges remain, however, for EIOPA as they do for the other ESAs. With respect to obstacles facing EIOPA in particular, structural issues and financial dependence could hinder the effective conduct of its activities. Consequently, in 2013, EIOPA’s Chairman argued in favor of independent funding and direct access to data in order to increase its efficacy (Bernardino 2013: 2; see also Directorate General for Internal Policies 2013 for a comprehensive review of the ESA’s respective challenges).

The following now turns to an assessment of the new microprudential entities. Though challenges specific to each ESA have now been alluded to briefly in the respective sections, it aims to contextualize, i.e.

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341 EIOPA’s predecessor CEIOPS was also located in Frankfurt and comprised of EEA states’ and member states’ high-level insurance and occupational pensions supervisors. Its core features were largely in line with those of the other Level-3 Committees discussed previously. Similarities included the organizational architecture, the lack of a legal personality and funding arrangements, which were dependent on EU funding from 2008 onward. Its primary task was its advisory function with respect to the technicalities of legislation advanced by the Commission, in particular the Solvency II Directive devising solvency requirements for the insurance sector. It also cooperated with CEBS on financial conglomerates, monitored market trends and contributed to other Level-3 activities. With respect to the external or international dimensions of its mandate, its tasks included involvement in consultations and regulatory dialogues with third parties such as non-EU governments and international standard-setting bodies. In CEIOPS’s case, for instance, it was granted observer status on the Basel Committee and attempted to adapt its activities in accordance with those on the global agenda. For in-depth recapitulations, see CEIOPS Annual Report (2009) and Ferran (2011b).


343 The delays in the development, adoption and implementation of Solvency II reflect the contentious nature and complexity of the issues at stake in this area.

344 The industry will have 16 years to phase in the new rules and this process will likely dominate EIOPA’s activities.
systematize and put into perspective the challenges these constellations give rise to in an overarching fashion, in light of and juxtaposing them with the progress and the advances that have been attained in order to deduce the significance of their evolution from the latter.

5.4.1.3 The Developments in Context: Gradual Europeanization in Progress?

The intention in this section – which serves as a brief interim evaluation of the ESAs – is to present a tentative conclusion and nuanced verdict on the microprudential component of the ESFS in terms of both its functioning and development as regards the supervisory and regulatory policy convergence it signifies as well as its significance with respect to the degree of European integration that has transpired in pan-European microprudential terms. Ultimately, the conclusion is that there have indeed been significant and laudable advances in the direction of genuine pan-European regulation and to a lesser extent supervision (see, for instance, Davies 2014; Ferran 2011b). The brief assessment in the following ultimately presents the basis for the verdict below (section 5.4.3 on the ESFS).

The post-crisis years witnessed a substantial overhaul of the EU’s regulatory and supervisory architecture – in the form of the establishment, modification or upgrading of institutional structures, procedural mechanisms and substantive policies. Despite the institutional complexity and diversity that prevails and characterizes the European system of financial governance, the overarching objective and general direction of reform has been the integration, consolidation and streamlining of national structures and regimes in the form of an integrated supranational system of and framework for integrated internal market governance. Countervailing and inhibiting forces linger, however, contributing to reforms’ substantial limitations. Indeed, as alluded to despite progress, issues of contention and challenges applicable to all ESAs remain, including, most importantly, the fact that powers, competencies and their authority remain limited and have not been as far-reaching as some had hoped for. This argument is often coupled with the claim that their funding structure is deficient and that the ESAs lack sufficient financial and structural independence from other European and national authorities, a claim that has also been advanced (see e.g. IMF 2013c: 18). While on the one hand, a take over of substantial comprehensive supervisory authority was unrealistic from the outset, given the logistical and resource limitations that apply, national authorities have a stake in cooperation. It can, therefore, be contended that the assumption of structural dependence is too simplistic. In addition, to be fair, the Commission as the guardian of the Treaties is an agent of the EU,

345 A remaining sticking point and issue of contention with respect to the microprudential overhaul (discussed in depth later on in section 5.4.3) is, for instance, the fact that it upholds the horizontally-segmented pre-crisis supervisory model at the European level of which the defining feature is its division in market segments rather than implementing the objectives-oriented or twin peaks model in which prudential (i.e. banking and insurance) and conduct of business (i.e. market) supervision is separated and located in two distinct authorities. The latter is essentially the option many economists favored and which became popular in many national contexts in the aftermath of the crisis such as, for instance, in the UK (Ferran 2011c). Though the former was essentially adopted as it was seen as being the most practical approach, given its merit an objectives-based approach may yet be adopted in future (see, for instance, Ferran 2011b, 2014a).
and not the member states’ tool, which is beneficial in terms of neutrality and supports the ESAs in their endeavor of conducting activities in the interest of the EU as a whole.

Yet, though in theory and as regards their founding legislation, the ESAs are indeed similar – including with respect to common institutional features and key roles, structural composition and institutional set-ups as well as largely overlapping mandates, i.e. in spite of their overlaps and similarities (see above) – they evolved quite differently. While the EBA, for instance, was almost immediately confronted with a severe and indeed even existential banking crisis (much like the ESRB at stake in the next section), threatening the very foundations of the eurozone and substantially complicating its mandate, i.e. the conduct of its activities and the fulfillment of its tasks and objectives, it was also – as a consequence of the latter and in light of the developments and progress in the eurozone in terms of constructing a banking union – confronted with a rapidly evolving regulatory environment, which ultimately resulted in changes to its founding legislation, which was modified in accordance with the establishment of the Single Supervisory Mechanism (SSM) in the context of the banking union in 2014 (European Court of Auditors 2014; Ferran 2016). ESMA in turn has witnessed the scope of its mandate expanded significantly – for instance, being afforded the power of direct EU-wide supervision of credit rating agencies – and as such may be regarded as unique in this constellation. Lastly, EIOPA - as the odd one out of sorts – is the ESA that has neither witnessed substantial capacity expansion nor fully succeeded in leaving its mark on pan-European regulation. Despite being fairly active in the first years of its existence, notably in terms of devising the Solvency II Directive, its work was “hampered” in many respects with regard to the construction of an integrated single rulebook in the issue area of insurance – with, for instance, its implementation being postponed multiple times (for perspectives in line with this claim, including internal and external, i.e. commissioned reports on the functioning of the ESAs in their initial phase of operation, see Directorate General for Internal Policies 2013: 26f.; European Commission 2014b).

In order to put the developments that have transpired and the reform outcome in microprudential regulatory and supervisory terms into context – and thereby argue in favor of progress – it is instructive to draw attention to the fact that, as alluded to above, the ESFS may, in essence, be interpreted as an additional layer of – or rather an umbrella for – the financial governance architecture regime. In this context, the ESAs are mandated to cooperate closely with the respective national supervisory authorities – such as, for instance, the British Prudential Regulatory Authority (PRA) or the German Bundesanstalt für Finanzdienstleistungen (BaFin) – so as to provide for a comprehensive and holistic regulatory and supervisory construct – and thereby take on a both a supervisory and regulatory as well as a coordinative function of sorts, presenting the venue in which harmonization and convergence can transpire, and cooperation and

346 For an in-depth analysis of the European Banking Authority and its role in the European supervisory landscape in a changing context, see European Court of Auditors (2014). For an academic perspective and contextualization, see Ferran (2016).
coordination as well as crisis management can be conducted at the supranational level.\footnote{Ultimately, it is an additional layer of the multidimensional financial governance architecture for regulatory and supervisory coordination and the mitigation of systemic risk, offering the umbrella under which to integrate vertical and hierarchical levels of regulation and supervision and their respective institutional structures. The EBA, for instance, is pivotal – and indeed to a degree unique – in this regard. Of central significance in terms of financial stability due to its central position in the midst of the European architecture, it serves as a linchpin in pan-European terms as it unites eurozone and non-eurozone members and offers a venue within which to provide for both regulatory convergence and supervisory coordination between the two spheres.} Yet though they took on their predecessors’ tasks and have seen their mandates, governance systems, powers, and operational autonomy strengthened significantly (see e.g. Ferran 2011b; Fonteyne et al. 2010) – in effect increasing their overall de facto authority, note the concept or notion of a step by step transfer or assumption of power and authority in this context – their day-to-day, i.e. direct supervisory powers are limited – with the home country principle discussed previously remaining the dominant reality in certain areas, and with ESMA being an exception in this regard, as discussed above– ultimately implying day-to-day supervision largely remains within the remit of national supervisors.

Some commentators, including academics and regulators, argue the new micro-supervisory architecture is deficient, i.e. the degree of supervisory integration and centralization attained is insufficient given the degree to which supervision remains at the national level and therefore closer to the supervised entities. The same argument is made – i.e. that of proximity and the issue of risks and opportunities inherent in supervisory centralization – in the case of the Single Supervisory Mechanism (SSM) and is discussed further in the following section (5.5.2.2). The interpretation and perspective adopted in this analysis of governance capacity differs somewhat in this respect, i.e. with regard to the issue of the division of labor in terms of the supervisory mandate in the pan-European context in the case of the ESAs – as is the case with regard to the SSM discussed in the following chapter. Rather, it is argued that the division of labor that has been decided on is, in fact, beneficial with regard to the insights of the crisis – with the issue of a regulatory and supervisory overload being a case in point in this regard – and the argument being that another constellation, or even an overbearing centralized supervisor would not respect or not be in line with the principle of subsidiarity. Note in this regard that this presents a central compromise or inherent trade-off in supranational supervision, and indeed with regard to supervision in general.\footnote{This is, in fact, not necessarily detrimental. A direct comparison with national schemes such as, for instance, with US agencies such as the SEC or CFTC, is not necessarily fruitful in this context given the differences in terms of institutional composition. Indeed, the EU is unique in terms of the interplay between national and supranational structures and therefore not necessarily comparable. This notwithstanding, regulation – in terms of standard-setting – has largely been Europeanized. With regard to the issue of regulatory policy and standard-setting in general, there is a debate as regards the viability or utility of rules that are defined ex ante, rules devised both at the European and national level, which might be interpreted as inflexible and rigid (Ferran 2012).} In sum, though substantial progress has been made, reforms are by no means unequivocally positive. The potential shortcomings briefly revisited above are substantial, yet to an extent also inevitable and by no means condemn the ESAs to failure by default. Indeed, it is important to note, the tradeoffs involved are
inevitable given the political exigencies involved in integration, and nonetheless signify a step-by-step assumption of authority at the EU-level, ultimately constituting a positive development indicative of the EU's adaptive and evolutionary potential.

Obstacles pertaining to the integrated governance of systemic risk are discussed and contextualized further in chapter six in tandem with the other institutional innovations discussed. Before doing so, however, the second element of the ESFS is presented in the following.

5.4.2 The European Systemic Risk Board: Oversight and Prevention

The European Systemic Risk Board (ESRB) was established in 2011 as the European Union’s macro-prudential supervisor.\footnote{The legislation on which it is based is the ESRB Regulation, or Regulation (EU) No 1092/2010 of the European Parliament and of the Council of 24 November 2010 on European Union Macro-prudential Oversight of the Financial System and Establishing a European Systemic Risk Board, [2010] OJ L 331/1.} It is an autonomous supranational, i.e. EU-level institution and serves as the macroprudential component or policy institution of the new overarching regulatory and supervisory governance architecture, and as such is at the core of the new system stability-oriented approach to financial market regulation in the post-crisis era. In addition to its function as the EU’s macroprudential regulator – or perhaps more accurately coordinator as the macroprudential policy coordinated at the European level is then implemented at the national level by the respective competent national supervisors (Interview with Dirk Schoenmaker, January 2013, Amsterdam; see also Schoenmaker 2013a, 2013b) – its centrality in the ESFS architecture should be noted at the outset as it serves as the nexus for the institutions involved in system oversight – on the grounds of its central position in the ESFS, resulting in its coordinating and mediating role in the new regulatory structure (see figure three above on its position within the ESFS).\footnote{It is important to stress its functional nature as a mediating and coordinating body, i.e. in the sense that it is an umbrella organization (Interview with Dirk Schoenmaker, January 2013, Amsterdam) that coordinates ESCB’s and ECB’s actions.}

Located in Frankfurt – with its proximity to the European Central Bank (ECB) by which it is hosted and whose president chairs it in this context being both vital and indeed intentional in accordance with and reflecting the prevailing post-crisis regulatory and supervisory trends\footnote{Note in this context that its functional connection to the ECB is crucial, presenting the underlying reason for its location. See section 5.5.2.1 for perspectives on supervisory design and post-crisis developments in this respect.} – the ESRB is the European Union’s attempt to attain holistic, inclusive and Union-wide financial system stability in line with the trend of institutional re-ordering that prevailed in the developed world throughout the immediate post-crisis era (Ferran 2014a). Mandated with the monitoring of systemic risks and the build up of vulnerabilities via data collection and analysis (i.e. risk assessments) in collaboration with the ESAs and NCAs, as well as their potential mitigation by way of issuing warnings and recommendations, which if made public may lend
weight to their propositions via their potential capacity to *name and shame* the addressees as will be discussed throughout, it has undoubtedly been given a monumental task.

As elaborated above, as a central component of the new regulatory architecture, the ESRB was established as a consequence of the recommendations put forward by the De Larosière Report (De Larosière 2009) which resulted in the supervisory package and institutional reforms adopted in November 2010. The following is an examination of its overarching rationale, mandate, legal foundation and tasks as well as its institutional features and procedural mechanisms, including an evaluation of its competencies, authorities and powers against the backdrop of what its sets out to achieve, which is followed up by a brief discussion and evaluation of its inherent limitations, shortcomings and overarching significance before progressing to an overarching verdict on the ESFS as such – with its, i.e. the ESRB’s shortcomings, both in institutional governance and cooperative terms and in terms of systemic risk mitigation and management in terms of knowledge-related issues, being addressed thereafter in chapter six in the context of the overarching challenges of cooperative governance in the post-crisis era. The analysis is in large part based on a case study conducted in Willke et al. (2013: chapter five) and draws extensively on interviews conducted in the context of this research with relevant actors.

5.4.2.1 The ESRB’s Rationale, Mandate, Legal Foundation and Institutional Structure

Along with national macroprudential authorities, central banks as well as national and European financial supervisors, the ESRB is responsible for operationalizing the task of system oversight and implementing the recently adopted macroprudential regulatory and supervisory approach in the post-crisis European governance framework. In this context, the respective legislation establishing the ESRB stipulates that the latter is ultimately intended to “contribute to the prevention or mitigation of systemic risks to financial stability in the Union that arise from developments within the financial system and taking into account macro-economic developments, so as to avoid periods of widespread financial distress” (ESRB Regulation: Article 3). It is to do so while contributing “to the smooth functioning of the internal market” and ensuring “a sustainable contribution of the financial sector to economic growth” (ibid.). The latter showcases and poignantly illustrates the trade-offs and in certain respects conflicting objectives macroprudential regulators and supervisors face. Not only must they conduct robust and system stability-enhancing policies, attempting to preempt risks to financial stability that might arise from a practically infinite number of sources with limited knowledge and a limited amount of tools to do so, but must attempt to not unduly jeopardize economic growth in the process. Reconciling both objectives in light of

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352 Endorsed in principle in June 2009 at the highest political level in the presidency conclusions of the European Council as a central component of the new supranational regime (European Council 2009), the respective legislative proposals were advanced in September 2009. After intense negotiations a compromise package was subsequently adopted in September 2010, while the institutional innovations were operational from 2011 onward.
the nature of systemic risk and the inevitability of non-knowledge that regulators face in this regard is undoubtedly a monumental task and authorities must tread carefully, while catering to the needs of both the economy (in this case stability) and the political system (in this case growth). Indeed, threats loom large from both policy- and governance-related challenges, pertaining, for instance, to knowledge, expertise and the quality of analyses and oversight as well as the timing of the use of macroprudential tools and regulatory and supervisory cooperation – and importantly also political pressures frustrating the conduct of macroprudential policy and its proper establishment as a functional element of the policy regime.

Whether the ESRB and the prudential supervisors that ultimately implement macroprudential policy are able to resolve this tension, bridge the divide between the two and conduct credible and effective macroprudential policy more generally remains to be seen. The following looks into the issues at stake in this context in an attempt to assess the ESRB’s prospects in this regard as well as in the context of the broader supranational attempt to establish a stability-enhancing policy framework. More specifically, this section includes an analysis of the ESRB’s rationale, i.e. its mandate and role as well as its legal basis and its institutional structure, which is followed up by a discussion of the policy instruments and competencies it has been granted in order to fulfill its mandate and conduct the activities it has been charged with, drawing attention to and laying a particular focus on issues of relevance as regards its capacity, with the complications and shortcomings involved being contextualized at the end and discussed at length in chapter six on the challenges of post-crisis reform in all its facets and its various dimensions.

**The ESRB’s Rationale and Mandate**

With respect to its rationale and mandate, its core objective is *system oversight* in line with the *crisis lessons* discussed throughout, i.e. the lack of macroprudential oversight and the limited dovetailing of macro- and microprudential perspectives and policy elements.

Its tasks may be categorized as follows – in broad terms and in accordance with the founding legislation (ESRB Regulation (EU) No 1092/2010: Article 2). It is ultimately mandated:

1. to determine, gather and analyze relevant and necessary data and information (*data collection, analysis and assessment*),
2. to identify and prioritize systemic risks (*identification, assessment and prioritization of systemic risks*)\(^\text{353}\),
3. to issue warnings regarding these (potentially systemic) risks made public where appropriate and when deemed significant (*issuance of risk warnings*),
4. to issue recommendations for remedial action in order to contain the risks identified, again made public to where appropriate (*issuance of recommendations*),

\(^{353}\) In this context, the ESRB devises and releases regular risk dashboards containing a set of quantitative indicators as threats and risks pertaining to financial stability (see, for instance, ESRB 2015). It is aided by the Macroprudential Research Network (MaRs) – a European initiative established by the General Council of the European Central Bank in 2010 mandated to provide research support on behalf of the European System of Central Banks as well as contribute to the analytical underpinnings of macro-prudential policies by developing conceptual frameworks, models and tools to improve macroprudential supervision throughout the EU (European System of Central Banks 2014).
(5) to keep the European Council informed as regards these risks and monitor the respective compliance with its warnings and recommendations (monitoring of follow-up and compliance),

(6) to cooperate closely with other ESFS entities, including, for instance, the participation in the ESFS’s Joint Committee, the provision of the requisite data and information vis-à-vis the ESAs, which they require to perform their tasks, as well as, importantly, the development of indicators for systemic risk identification and measurement in cooperation with the ESAs (European regulatory and supervisory cooperation), and lastly

(7) to carry out related tasks and reconcile its actions with those of third parties and international financial organizations, among them the IMF and FSB (international regulatory and supervisory cooperation and coordination).

In this context, it is important to note, however, that the ESRB may rather be characterized as a forum for coordination rather than a regulator with teeth. Against the backdrop of the monumental tasks the ESRB – and indeed macroprudential institutions in general – have been given, a look into its legal mandate is instructive in terms of assessing its prospects and potential.

The ESRB’s Legal Foundation

With respect to its legal foundation and treaty basis, which is of significance with respect to the authority it can be or has been afforded, the following is relevant. As mentioned throughout, the ESRB is effectively an advisory body. As it has been established under article 114 of the Treaty on the Functioning of the European Union (TFEU), it has neither a legal nor statutory personality and has not been equipped with direct intervention tools (Ferran and Kern 2011). It therefore relies on the member states and its own capacity to build its credibility in due time. This may, evidently, be problematic, though it has been argued that a flexible approach based on soft law may actually be beneficial in the long run (ibid.; see also European Commission 2009). Whether this is indeed the case, remains to be seen.

The ESRB’s Institutional Structure

The institutional composition of the ESRB is evidently of importance for the conduct of macroprudential policy in terms of both its efficacy and efficiency. An elaboration of its set-up is therefore followed by a review of its features against the backdrop of its mandate. The ESRB’s institutional structure is composed of five entities, including a General Board, a Steering Committee, a Secretariat, an Advisory Technical Committee and an Advisory Scientific Committee (ESRB Regulation: Article 4; for in-depth analyses, see Ferran and Kern 2011: 21ff.; Willke et al. 2013: chapter five). The General Board is the ESRB’s main decision-making body. Composed of 65 members of which 37 are members with voting rights and 28 are non-voting members, the General Board is mandated to oversee the diligent execution of the tasks delegated to the ESRB (ESRB Regulation: Articles 4–6). Simple majority voting is the standard operating procedure, while qualified majority voting is applied, i.e. a majority of two-thirds is required if

354 A comparison of the ESRB and the US’s Financial Stability Oversight Council’s (FSOC) mandate is instructive in this respect. Though there are overlaps, there are also crucial differences (see e.g. Weistroffer 2012).
recommendations are to be adopted and warnings or recommendations are to be issued and made public (ESRB Regulation: Articles 10 and 18), whereby voting members are requested to act impartially and “solely in the interest of the Union as a whole” when conducting activities within the context of the ESRB (ESRB Regulation: Articles 7). Voting members include all of the EU’s national central bank governors, a member of the European Commission, the ESAs’ three Chairpersons, the Chair and two Vice-Chairs of the Advisory Scientific Committee (ASC), and the Chair of the Advisory Technical Committee (ATC) as well as the Vice-President and President of the ECB. The latter also served as its first Chairperson, having been elected for a term of five years as recommended by the De Larosière Report (De Larosière 2009). Non-voting members in turn include a representative of the national and competent supervisory authorities of each member state and the President of the Economic and Financial Committee (EFC) (ESRB Regulation: Article 5–6).

Yet how is the ESRB to achieve the tasks it has been given? The following looks into the instruments and competencies it has at hand to fulfill its macroprudential mandate, the significance of the authority it has been granted and the obstacles that remain before progressing to the overarching verdict of pan-European reforms.

5.4.2.2 Competencies and Instruments: Hard and Soft Law in Perspective

On the basis of the above on the ESRB’s rationale and mandate as well as its legal basis and institutional structure, this section turns to its competencies, specific tasks and policy instruments, laying a particular focus on issues of relevance as regards capacity (with reference to section 4.4.3). In this context, it also discusses and contextualizes complications and shortcomings which are discussed at length in chapter six on the challenges of post-crisis reform in all its facets and various dimensions with specific reference to the distinction between hard and soft law – given the fact that the ESRB is in essence a soft law body, which in addition to other e.g. knowledge-related obstacles severely limits its capacity.

For the fulfillment of its tasks and the conduct of systemic risk oversight as well as macroprudential policy implementation in collaboration with relevant supervisors, the ESRB draws on the following policy cycle depicted in figure four, particularly when employing the tools it has been given: warnings and recommendations – both mechanisms of a soft as opposed to hard nature in terms of their legal ramifications.

355 The General Board also has two Vice-Chairpersons. One is the Chairperson of the ESAs’ Joint Committee, the other is a central bank governor elected by the members of the General Board that are also on the ECB’s General Council, which is essentially a pan-European body comprising all European central bank governors (ESRB Regulation: Article 5). With respect to the election of the second Vice-Chair as alluded to in the case of the ESAs the principle of balanced representation of eurozone and non-eurozone members is mandated. Of importance in this respect is the fact that though the fact that there was no fixed arrangement as regards non-eurozone representation in central positions drew some criticism given its potential implications in terms of legitimacy and accountability, the ECB’s interpretation was that eurozone composition was in flux and therefore inclusion in formal legislation was not warranted (ECB 2009; see also Ferran and Kern 2011: 21).
In this context, the exchange of data and information is evidently vital and the smooth and efficient conduct of the process of data exchange is crucial – particularly in the event of crisis, yet also for the mitigation of systemic risk, i.e. for the conduct of system oversight and the conduct of stability enhancing macroprudential policy. Within the ESFS, the ESAs and NCAs are required to cooperate with the ESRB and provide it with the requisite information required to conduct its tasks (see figure three for a schematic illustration of actors involved in this process).

An essential issue in this context is the issue of soft law, i.e. the fact that the ESRB has no legally binding powers or legal personality. Being an advisory body, it has not been equipped with direct intervention powers and cannot force action, relying on the member states and its own credibility as well as essentially being dependent on the moral authority and influence it commands (Trichet 2010a, 2010b). Yet the criticism it has been subject to ultimately defies the logic of the ESRB as an umbrella forum for national regulators with teeth and appropriate authority and legitimacy to deliberate and discuss their actions, while its coordinative nature is no doubt a step forward. Particularly when contrasted with the FSB its potential is significant (Interview with Brooke Masters 2013, London; see also Ferran and Kern 2011). A comparison between the two is instructive and highlights the ESRB’s potential significance with a view to its nature and position within the multilevel European polity. In light of the principle of subsidiarity, its intent is not to duplicate tasks, but much rather to ensure coordination between national entities, facilitate synergies, complementarity, and at the same time consistency and coherence. Though limitations undoubtedly remain, its impact may nonetheless be positive and beneficial.

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5.4.2.3 Obstacles and Constraints in Brief

While obstacles and constraints pertaining specifically to the ESRB and its institutional attributes and composition are briefly contextualized in the following, explicit challenges with respect to supranational governance challenges and constraints pertaining to theoretical knowledge-related issues are discussed in depth in the following chapter on regulatory challenges.

With a view to the very nature and unpredictability of systemic risk (see chapter four), it goes without saying that the challenges involved in constructing a functional macroprudential supranational regime are numerous, multifaceted and sizable – as they are at the national level. The dilemmas macroprudential regulators inevitably face – and limitations their analyses and actions are inevitably subject to – pertain to the considerable scope for uncertainty and margins of error inherent in regulatory, i.e. human judgment – an issue that is exacerbated by the degree of complexity, sophistication and evolutionary and innovative potential of modern finance as set out previously – with potentially catastrophic consequences. Yet, in addition to these overarching policy-related constraints, which relate to issues pertaining to the inevitability of the persistence of knowledge-related shortcomings, institutional and political economy-related issues hamper macroprudential oversight in the European context as noted. Institutional dilemmas include both restrictions in terms of its mandate and authority, leading experts to question its ability to overcome or curb the myopic and short-sighted tendencies of politically motivated prudential regulation (Interview with Andrew Bailey, January 2013, London; Interview with Daniel Gros, January 2013, Brussels), which is highly problematic and must be tackled at the European level – again, by means of the moral authority and influence the ESRB commands (Trichet 2010a, 2010b). Ultimately, its efficacy is dependent upon the quality of its analytic activities, and its potential to induce cooperation and action despite the highly sensitive nature of macroprudential policy (Mazzaferro 2012; see also Weistroffer 2012).

5.4.3 Evaluating the Pan-European ESFS: An Interim Assessment

As set out in the previous sections, the lack of an overarching system-wide and stability-oriented, i.e. macroprudential approach to financial regulation as well as the prevalence of insufficiently integrated cross-border, i.e. supranational governance schemes, including the absence of robust and workable resolution mechanisms and crisis management tools as well as adequately institutionalized mechanisms for cooperation in this regard, were key lessons and takeaways drawn from the crisis. In an attempt to remedy the flaws of the pre-crisis era, among other measures the institutional governance architecture in the EU was revamped and transformed into a two-tier pan-European system of micro- and macroprudential supervision and regulation by way of establishing the ESRB as the EU’s macroprudential body and
upgrading the EU’s microprudential supervisory entities to independent EU-level authorities with revised mandates and enhanced competencies.\textsuperscript{357}

The crisis essentially induced a wave of potentially far-reaching, consequential and innovative reform initiatives. The institutional overhaul and innovations instituted in pan-European terms were analyzed in the latter. Though limitations and obstacles persist on multiple fronts – including, for instance, resistance to genuine or full-scale integration with implications for sustainable governance in line with our definition of systemic risk as well as shortcomings with respect to technical and knowledge-related issues explicitly pertaining to regulatory capacity with respect to macroprudential policy and systemic risk mitigation – substantial progress has indeed been made, particularly in terms of institutional integration and the evolution of innovative governance schemes (Ferran 2011b; Mayntz 2013).\textsuperscript{358} In effect, one might even refer to the sweeping reforms as heralding or ushering in and being indicative of a “new era” (Wymeersch 2012b: 232) in European financial governance. In a nutshell, among other issues in microprudential terms, yet with ramifications for the provision of system stability as it strengthens the capacity to cooperate and therefore also increases governance capacity as such, constituting one of the governance reform efforts’ main feats or central achievements at the pan-European level is the fact that they have managed to bridge the gap between national systems’ retaining supervisory authority for national institutions in view of their proximity to the respective regulated institutions at stake – a central issue in the post-crisis debate, which is also at stake in the following section – with an additional supranational governance layer on top.

This section sets out to take stock of governance revisions and changes to the regulatory and supervisory architecture in pan-European terms and deliver an overarching verdict in this respect, thereby focusing on the degree of integration that has been attained in order to thereafter assess the respective implications. Ultimately, in light of the systemic risk definition and against the backdrop of the insights set out previously, the overarching verdict and the conclusions drawn with a view to the potential capacity that has been generated via integration are, on balance, cautiously optimistic. It should, however, be noted yet again – as emphasized throughout and as will be taken due account of in the following chapter – that substantial limitations and challenges remain in multiple respects, including national, i.e. member state resistance to integration and further sovereignty transferal so as to enable credible governance on the one hand (\textit{governance dimension}) and political resistance in general to institute fundamental (i.e. structural and substantive) reforms that would be commensurate with and mirror the qualities financial system

\textsuperscript{357} In addition to these pan-European reforms, the eurozone’s banking union, which is intended to complement and indeed complete Economic and Monetary Union (EMU), and is relevant with respect to both micro- and macroprudential regulation and supervision in the eurozone, was also established. It is at stake hereafter in the following chapter.

\textsuperscript{358} It is of paramount importance in this context to take care to capture the multiplicity of the issues at stake in this context. In a nutshell, post-crisis reforms, i.e. the ESFS in this context, are the European Union’s attempt to address and resolve the financial trilemma discussed at the outset of this chapter by centralizing, streamlining and/or coordinating governance functions and competencies at the European level.
properties give rise to on the other (regulatory dimension) due to entrenched vested interests and political economy constraints throughout advanced economies.\textsuperscript{359}

The conclusion of the preceding analysis against the backdrop of the assessment of the pre-crisis status quo in chapter three is ultimately that more Europe has indeed transpired (see section 5.4.1.3), and this generally has positive implications for the outlook concerning the mitigation and management of systemic risk, which is essentially a cross-border phenomenon, owing to the reactive capacity it gives rise to in the sense that it creates venues for cooperative analysis and oversight as well as institutional capacities for concerted and coordinated supervision and intervention, though monumental challenges undoubtedly remain.\textsuperscript{360} In microprudential terms, for instance, there have been considerable changes made to the institutional architecture. Ferran claims that “whilst the recent EU institutional reforms are at the boundaries of current legal, political and practical feasibility, they include some key breakthroughs that bring the prospect of the European scene becoming dominated by euro-authorities with direct supervisory power over significant swathes of financial market activity considerably closer” (2011b: 1, emphasis added). And indeed, the newly established ESAs have been afforded certain binding powers and have seen their mandates upgraded from those of their predecessors. Though the process of capacity expansion, competence assumption and the transferal of authority to the European level has been incremental, it follows a pattern and as such is path dependent, while being significant nonetheless in the sense that the “step-by-step assumption of supervisory responsibilities by bodies that have a pan-European remit […] is likely to lead eventually to the emergence of powerful European supervisory authorities” (Ferran 2011b: 4). Though this may perhaps be a slight exaggeration, their mere existence is indeed “highly significant” (Ferran 2011b: 5) and is encouraging in the sense that it potentially bodes well for the future.

In macroprudential terms on the other hand, with respect to the ESRB, the added value and hence its significance is that it provides pan-European structures within which system oversight can be conducted for the first time and collaborative efforts can be strengthened so as to increase synergies in crisis prevention and potentially mitigate negative externalities in crisis management – structures that prior to the crisis neither existed at the national nor the European level and which are largely interpreted as being beneficial and up to par (European Commission 2014c; ECB 2015; ESRB 2013a). This is in itself progress. In 2013, with respect to the development of the ESFS in terms of ESA-ESRB coordination and macro-micro interaction, EIOPA Chairman, Gabriel Bernardino, claimed the ESRB is “proving to be a useful platform” (Bernardino 2013). There is, however, no doubt room for improvement.

The following now turns to the second institutional element of post-crisis reforms, the eurozone’s banking union. The goal is to scrutinize developments and assess advances with regard to integration in

\textsuperscript{359} The shortcomings pertaining to preemptive macroprudential policy and preventive system oversight conducted by national and supranational systemic risk councils and prudential regulators as well as explicit governance challenges in both micro- and macroprudential terms are at stake and contextualized in more detail in chapter six.

\textsuperscript{360} It is important to stress, however, that capacity – defined here as the degree of integration attained – does not equate to effectiveness.
the eurozone and thereby also highlight the intricacies involved in constructing cross-border governance schemes in this context. It subsequently attempts to draw conclusions with respect to and expound an overarching narrative for the institutional developments that have transpired in both pan-European and eurozone terms, thereafter assessing the challenges obstructing attempts to construct a supranational governance architecture capable of effectively inhibiting and managing systemic risk, challenges that essentially feed into constraints limiting cross-border governance capacity.\footnote{Note again that the challenge throughout is to balance the assessments of – and bring coherence to developments with respect to – both pan-European and eurozone institutions involved in the attainment of financial stability. Both the ESFS and the banking union constitute institutional structures that contribute to the build-up of capacity in systemic risk analysis, prevention and management and set out to foster cooperation by upgrading governance structures and strengthening cross-border crisis management capacities. Though it could be argued that non-eurozone member states may not be unequivocally welcoming of integration in the eurozone as this could potentially jeopardize their influence in the EU’s decision-making fora, they will undoubtedly profit from the stability it is likely to engender which will inevitably have positive implications for the single market as a whole and may therefore have a centripetal effect on pan-European integration (see e.g. Ferran 2014b).
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5.5 Centralized Eurozone Supervision and Resolution: Fragmentation and Instability Averted?

The European banking union, essentially the cornerstone of post-crisis policy responses instituted in the eurozone context, has been described as the most ambitious and significant integration project since the introduction of the single currency and the construction of Economic and Monetary Union (EMU) in the early 1990s (see, for instance, Chang 2015; Howarth and Quaglia 2013a, 2015). In a nutshell, it is the European Union’s – or rather the eurozone’s – attempt to resolve the financial trilemma (Interview with Dirk Schoenmaker, January 2013, Amsterdam; see also Schoenmaker 2011; 2013c) and address some of the issues exposed by the sovereign debt crisis with regard to the structure of EMU and the sustainability of the single currency by way of centralizing and streamlining supervisory competencies and regulatory governance functions at the European level so as to increase regulatory capacity and credibility in this regard. Paradoxically, though originally a response to the sovereign debt crisis that ensued from the knock-on effects of the financial crisis (Mügge 2013; Schelkle 2011), implying that it was essentially the sovereign debt crisis that triggered reforms in the issue area at stake, i.e. in eurozone financial regulation, the banking union is crucial for the provision of system stability in the eurozone context and the Union at large, and as such is a response to systemic risk in all its forms – both risks that produce and emanate from banking crises and those that result from sovereign debt turmoil as well as the interdependencies between the two.\footnote{In essence, the paradox in this case – despite the fact that causality as regards the links “between the subprime, banking and sovereign debt crises” remains a matter of debate (Mügge 2013: 467) – is that it was the sovereign debt crisis as opposed to the financial crisis that triggered reforms required to mitigate and manage systemic risk and in theory should have been instituted in the immediate aftermath of the crisis in 2008.}

It is important to bear this in mind throughout.

To date, the institutional edifice of the banking union comprises two main pillars. The first is the Single Supervisory Mechanism (SSM), institutionally and geographically located at the European Central Bank (ECB) with the SSM essentially being the hub in the context of which the ECB, while being the direct
supervisor of significant financial institutions and banking groups, is also afforded the overarching prudential supervisory mandate for institutions in all participating member states (SSM Regulation: Article 6 para. 5 on the respective requirements; see also Ferran and Babis 2013 and Wymeersch, 2012a, 2014). It assumed these competencies in November 2014. The second element is the Single Resolution Mechanism (SRM) which is essentially an institutional hybrid of sorts, comprises both the Single Resolution Board (SRB) and a Single Resolution Fund (SRF), and has been fully functional as of 2016. Both banking union institutions’ legal frameworks are based on instruments of EU and public international law (Ferran 2014b). Taken together, the components of the banking union centralize large swathes of both the activities and competencies pertaining to the prudential supervision and resolution of financial institutions headquartered in the eurozone, though substantial limitations and caveats persist nonetheless, implying reforms are not as unequivocally positive as one might assume at first glance. Indeed, despite the comparative success of banking union – particularly of the SSM as will be discussed throughout – as well as the significance of its establishment as such, it should be noted that in its entirety banking union is only half-baked. The final element of banking union has yet to be finalized in the context of broader eurozone reform and is currently on the agenda of both European leaders and the community’s institutions.

The following examines the new institutional architecture’s underlying rationale as well as its key elements and objectives before delving into an analysis and assessment of its individual components.

5.5.1 The Rationale of the Banking Union in Depth: Definition and Framework

Finance in general and banks in particular are essential for economic growth. Both governments and private sector actors depend on financial institutions for the provision, allocation and intermediation of credit, and their significance in terms of ensuring the orderly functioning of market economies ultimately gives rise to their centrality in the nexus of the political and the economic system as alluded to with respect to the embeddedness of finance. Yet while or precisely because they are the lifeblood of the economy, their failure and the impairment of their efficacy and efficiency is also capable of wreaking havoc on entire socio-economic systems, effectively giving rise to the rationale for not leaving financial markets and institutions to their own devices. They are, in effect, in need of being regulated to enhance their functionality and equity as well as ensure the integrity of their business models, their contribution to productivity and growth, and the stability of the economic and financial system at large.


364 These are essentially the criteria against which the efficacy of regulatory and supervisory systems can be judged.
In a nutshell, and relating to the context of our research, the rationale for banking union can ultimately be summarized as resulting from the incongruence between a single European financial market and predominantly national banking policy frameworks. It has been argued that the unique degree of financial market integration in the Union “has not been matched by corresponding adaptations of the banking policy framework [and] the case for banking union thus predates the crisis” (Véron 2013a: 4). The take away, however, is that governance in general and EU governance in particular must be advanced. As mentioned in previous chapters, a long-standing goal of the EU has been the promotion of financial market integration and the construction of an integrated single market. The assumption on which this objective has been predicated throughout the past decades is ultimately based on the notion that a single market fosters cross-border economic activity, contributes to the efficiency and efficacy of markets, and hence supports participating states’ economies, underpinning their smooth functioning and fostering growth. In this context, financial integration is seen as enhancing and indeed being decisive for the overarching efficiency and competitiveness of European economies (ECB 2017b). As such, excessive fragmentation, essentially implying the reversal of the trend of integration, is considered damaging and is to be avoided.365

In a speech in 2013, ECB President, Mario Draghi, signaled strong support for reforms in this vein, arguing early on that EU-level supervision should raise confidence among financial institutions to “lend to one another across borders, in particular in the interbank market” (Draghi 2013) and encourage cross-border mergers and acquisitions which would counteract eurozone fragmentation, deepen financial integration and enhance the financial sectors’ overall resilience (ibid.). The following puts the banking union’s rationales, principal objectives and respective components into perspective.

At their core, the goals of banking union are multifaceted (Ferran 2014b, 2014c; Howarth and Quaglia 2013a; Véron 2013a), while key objectives include, among others, to counter the flaws exposed by the crisis, reverse the trend of fragmentation that took hold in the aftermath of the crisis and enhance efficacy as regards the efficient allocation of capital in the eurozone.367 In more detail, the primary objectives of the upgraded regulatory and supervisory architecture include (i) the stabilization of financial institutions in the eurozone and the system at large, while restoring both the banking system’s credibility and stability (Howarth and Quaglia 2013a), (ii) rebuilding and reinforcing the single market by mitigating its frag-

365 See the ECB’s Annual Financial Integration Report (2017a) for insights on the current state of financial integration in the eurozone. See also ECB (2017b) for the respective indicators drawn on in the assessment.

366 In a speech on the future of Europe in 2013, Draghi (2013) stated that the ECB’s “long-term vision for the SSM involves an environment where a creditworthy firm or household can get a loan from any bank in Europe at comparable conditions”, whereby considerations as regards location would no longer dominate. The hope is ultimately that banking union – if perceived as an improved and credible system of supranational financial supervision – will mitigate the renationalization of financial markets and the decline in cross border capital flows, deepening financial integration by facilitating the resurgence of the cross-border interbank market (see Schoenmaker 2013d; see also Draghi 2014). And indeed, the state of financial integration does seem to have improved in the period following the establishment of the banking union (see ECB 2017a, 2017b), even though, to name one example, divergence with respect to market and funding conditions persists to a degree (EBA 2015).

367 The latter is particularly important in the eurozone context due to the existence of a monetary union, which is reliant upon functional monetary transmission mechanisms.
mentation and reversing its disintegration as well as the nationalization of financial markets (ECB 2017a; Ferran 2014c), (iii) upgrading Economic and Monetary Union, effectively presenting an (albeit only partial) response to the latter’s asymmetric nature (De Grauw 2013), (iv) resolving or at least mitigating the negative feedback loop between sovereigns and their domestic banks, to a degree severing the two from one another and attenuating the effects of future crises as a consequence, and finally, and in fact most importantly, in this context (vi) install a more centralized and credible supervisory regime.

The institutional components of the banking union and the pillars underpinning it, which are essentially also key elements or cornerstones of banking policy in general and are depicted in the following figure in accordance with the time horizon of their establishment, can be subsumed under four broad categories. These include (i) an EU-wide single rulebook for financial institutions and services, (ii) banking supervision, (iii) a resolution framework, and (iv) a deposit guarantee scheme. In other words, banking union – designed as a construct to overcome and remedy deficiencies detected during the crisis and its aftermath – provides an institutional framework for the eurozone within which substantive policies are implemented and supervisory and regulatory activities are conducted. To be strictly accurate, however, only the last three are institutional components of the newly devised banking union as the single rulebook is a pan-European construct and serves as a foundation for financial governance throughout the Union as a whole, while the final component of banking union, a single deposit guarantee scheme, remains under consideration and has yet to be finalized, and a fifth element of effective governance – not listed, yet nonetheless of central importance – is a common fiscal backstop (see section 4.4. and figure 2). The first and most general, i.e. comprehensive and inclusive component, essentially serving as a basis for the build up of capacity, both given its substantive nature and the degree to which it contributes to harmonization and convergence, and thereby fosters cooperation, is the single rulebook.

368 In this context, banking union is also an attempt to complete EMU as originally envisioned by its founders in the Maastricht Treaty, which had essentially left its creation incomplete, effectively sidestepping significant elements (De Grauw 2013).

369 Additional policy spheres of relevance in the context of banking union owing to their impact on system stability and the extent to which they have essentially become Europeanized include competition policy, EU state aid control, conduct-of-business regulation, including consumer protection and anti-money laundering, and finally the taxation of financial services and institutions as well as housing policy (Interview with Daniel Gros, January 2013, Brussels).

370 Whether some form of system of common deposit protection and insurance will materialize within the context of the banking union remains unclear at present. Though initially endorsed and envisioned as a third and final pillar – or indeed fourth pillar if one includes the pan-European rulebook – it remains controversial and its future still hangs in the balance. The IMF has been in favor of this measure from the outset (see Fonteyne et al. 2010; Goyal et al. 2013) as have most European policymakers (see e.g. Coeuré 2014), though some commentators have argued it is either of limited urgency (Véron 2013a) or not necessarily of relevance with respect to systemic risk prevention as deposits are largely guaranteed and a bank-run is therefore unlikely, i.e. the risk is no longer systemic (Willke et al. 2013). It should be noted, however, that an overhauled and harmonized pan-European framework for deposit guarantee schemes already exists at the supranational level at present (see Directive 2014/49/EU).

371 The European Stability Mechanism (ESM), established by an intergovernmental treaty, serves as a backstop in resolution to deliver financial support to eurozone member states in the event of distress. Its use, however, is subject to strict conditionality and the Commission’s state aid rules (see Ferran 2014c; see also section 5.5.3).

372 In effect, the single rulebook is of particular relevance with respect to the Union as a whole and serves as a central force for harmonization and consistency in the pan-European context (see section 5.6 for an in-depth discussion in this respect). Of significance with respect to the governance of systemic risk is the fact that the single rulebook covers prudential regulation, including the regulation of bank capital, leverage, liquidity and risk management. The drive to attain more stringency and consistency in this respect was reinforced by the crisis and has become a policy priority in the European context as it is in essence
Yet though the banking union has been described as “the most important step in European integration since the launch of EMU” whereby the establishment of the SSM “is, in itself, one of the most significant leaps forward since 1999” (Howarth and Quaglia 2013a: 120), significant limitations persist and have thwarted progress. They are discussed throughout.

5.5.2 The Single Supervisory Mechanism: An Introduction

The first leg of the European Banking Union, the new Single Supervisory Mechanism (SSM), is essentially an attempt to centralize the supervision of the eurozone’s banking sector. As the first significant step toward a fully functional and complete banking union at the European level, it was introduced in 2014, entering into force and beginning its operations in November.373

The Commission’s initial proposal for a regulation conferring tasks concerning policies relating to the prudential supervision of credit institutions on the ECB advocated strong and robust powers and a comprehensive remit for the ECB in the context of the SSM, for instance being in favor of including all banks in the latter’s jurisdiction (European Commission 2012a). The SSM was then eventually established

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373 The SSM is an attempt to remedy the financial trilemma discussed at the outset of this chapter by centralizing and streamlining governance functions and competencies at the European level. Despite the comparative success of the SSM as will be discussed throughout, it should be noted that the banking union in its entirety is only half-baked – the final element of banking union has yet to be finalized in the context of broader eurozone reform and is currently on the agenda of European leaders and institutions.
in 2013 and became fully functional in November 2014, from then on being responsible for the direct supervision of the most significant banks – more precisely, 130 of the eurozone’s 6000 banking groups and institutions, with an approximate share of 85 percent of the euro area’s aggregate banking assets.\footnote{With respect to the financial institutions subsumed under the SSM, the ECB’s responsibilities and remit of authority pertains to the supervision of “credit institutions, financial holding companies or mixed financial holding companies, or branches, which are established in participating Member States, of credit institutions established in non-participating Member States” (SSM Regulation: Article 6 para. 4).}

The handover of supervisory authority to the ECB in the context of the Single Supervisory Mechanism was preceded by a comprehensive two-pronged assessment, including (i) an extensive and rigorous Asset Quality Review (AQR) of 130 of the largest financial institutions in the eurozone, covering approximately 82 percent of total i.e. all eurozone banking assets and conducted by the ECB in cooperation with national supervisors between November 2013 and October 2014, and complemented by (ii) an EU-wide stress test conducted by the EBA in close cooperation with the ECB (for SSM member countries) and non-eurozone supervisory authorities in 2014, employing a baseline scenario and an adverse scenario to assess the strength and resilience of all relevant European institutions’ balance sheets as well as the vulnerability and resilience of the financial system as such.\footnote{While the baseline scenario was provided by the European Commission and based on its projections regarding economic developments, the adverse scenario was based on the assumption that macroeconomic indicators deteriorate substantially and devised by the EBA and the ESRB in collaboration with the ECB, whereby the ESRB’s expertise was employed to design, develop and assess scenarios for potential system-internal and external shocks.}

The goal of the supervisory review and evaluation process – particularly in the case of the AQR – was ultimately to foster transparency and assess, among other determinants, individual institutions’ capital levels and risk profiles as well as the adequacy of their governance arrangements in order to prepare the banking sector for the SSM and, importantly, shield the ECB from blame owing to supervisory failures of the past and thereby safeguard its credibility. Full transparency, rigorous assessments and corresponding regulatory responses are regarded as key by many in this respect (see, for instance, Véron 2013a, 2014c).\footnote{See the EBA’s press release on the common methodology devised for the stress tests and the determinants employed in the respective scenarios (EBA 2014). The EBA explicitly cites the restrictive nature of the determinants it incorporates in its stress tests, which draw on a diverse set of risks, including, for instance, credit and market risks, sovereign and funding risks as well as various thresholds for net interest and trading income in addition to testing institutions’ resilience and potential to withstand hypothetical events such as sovereign shocks or severe shocks to banks funding costs (see also EBA 2017a on current developments with respect to stress test use and methodology). Earlier, i.e. immediate post-crisis attempts to conduct stress tests similar to those in the US had failed to deliver owing to substantial shortcomings in their design such as the fact that they were conducted independently rather than in a cooperative fashion by national supervisory authorities, they were not explicitly devised to identify institutions in need of recapitalization, or the presentation of their outcomes was limited to aggregate information of only 22 institutions (Pisani-Ferry and Sapir 2010: 360). Post-crisis reforms set out to remedy these flaws. While the EBA now serves as a context within which EU-wide and comparable tests can be conducted, the EBA has instituted comprehensive biennial stress tests.}

\footnote{As discussed in chapter four, stress tests aid both supervisors and financial institutions in assessing and addressing shortcomings in the banking sector and as such can be considered robust and effective tools for the provision of stability in a preventive sense, though they are by no means to be regarded as magic bullets, but rather as helpful additions to the supervisory and regulatory toolkit. Of particular importance is their contribution to transparency if conducted rigorously and hence their potential
The results in the form of aggregate bank-level data i.e. the disclosure of outcomes as well as respective recommendations for adequate supervisory measures to address shortfalls highlighted by both the AQR and the pan-European stress test were published in October 2014 just in time for the handover of authority and implemented throughout 2015.

5.5.2.1 Supervisory Design: Developments and Trade-Offs in Perspective

The issue of the viability of central bank involvement in supervision has been a widely debated and contested topic since the onset of the crisis and its prominence is in large part due to the macroprudential insights generated and the debate prompted by the crisis as well as the concurrent shift in focus to system-wide supervisory and regulatory governance perspectives, which essentially led to central banks being granted more competencies and resources due to the fact that they were perceived to be best placed to tackle the issues exposed by the crisis and afford system-related issues more attention (Ferran 2014a).

Table three provides an overview of the respective supervisory constellations that exist with respect to the functional horizontal dimension of supervision.

Table 3: Models and Variations of Supervisory Design

<table>
<thead>
<tr>
<th>Model</th>
<th>Elements</th>
</tr>
</thead>
<tbody>
<tr>
<td>Functional</td>
<td>Traditional functions of banking, insurance and securities market activity are distributed between corresponding supervisors along the respective lines of business of the supervised institutions.</td>
</tr>
<tr>
<td>Institutional</td>
<td>The supervisor is determined by the legal status of the institution. If the institution engages in additional activities, they are supervised by the same supervisor.</td>
</tr>
<tr>
<td>Integrated</td>
<td>Responsibility for all institutions and functions is consolidated in a single supervisory entity.</td>
</tr>
<tr>
<td>Objectives-based</td>
<td>Supervisory are responsibilities distributed between two supervisors, whereby prudential objectives and conduct of business objectives are separated.</td>
</tr>
</tbody>
</table>

Source: Compilation based on Ferran (2014a)

The focus now turns to issues of relevance with regard to the vertical division of competencies in European, i.e. eurozone financial governance. In tandem with the above it lays the conceptual basis for

to boost confidence in and throughout the financial industry and reinforce regulators' and supervisors' credibility, which in turn feeds into the latter.

378 Developments ultimately reflected “the relearning of lessons about the role of central banks in prudential supervision” (Ferran 2014c: 27). See also Gandrud (2013) and Quaglia (2008) on institutional structures and paradigms in prudential supervision.

379 See Mascianardo et al. (2008), Quintyn and Taylor (2003) and Quintyn et al. (2007) on the issue of the independence of financial supervisors, and in relation to accountability, see Ferran (2014a).
the discussion, analysis and contextualization of the credentials of the ECB as a supervisor and the trade-offs involved in this context in the section thereafter.

5.5.2.2 The Issue of Proximity: Risks and Opportunities of Supervisory Centralization

As alluded to in the previous section, there is a debate in both the academic and regulatory community as regards the optimal constellation for micro-supervisory structures in the supranational context. While the discussion above pertained to the horizontal dimension of supervisory mandates and the division of competencies and degrees of authority, the following focuses on the vertical dimension of authority and mandate division in the supranational supervisory context.

In a nutshell, figure six is a schematic illustration of the trade-offs inherent in institutional design in a multi-level system such as the supranational construct of the European Union (see Ferran 2014a; Ferran and Babis 2013 for an in-depth of the issues at stake in this context).

**Figure 6:** The Trade-off Inducing the Complexity of Institutional Design

![Diagram](source: Own Illustration)

The issue of proximity to the supervised entities is of central importance and is a central challenge in the European cross-border context – as a cross-cutting challenge between order- and knowledge-related determinants. With regards to its potential limitations: Referring to an ECB study which identifies 3,652 eurozone banks of which only 120 groups are within its supervisory jurisdiction, Véron (2014b) provides an overview of Europe’s banking landscape and composition, specifically looking at small institutions. What is relevant in this context, is a central design trade-off. In this context, it is instructive to draw attention to an argument neutralizing the potential of construing this as a genuine limitation and rather cast it in the light of being a pragmatic instance of decentralization and subsidiarity. Though this might be interpreted as a limitation of the banking union in terms of both the SSM and SRM given the fact that most of the eurozone’s banks are not subject to direct ECB supervision and the SRB’s jurisdiction, these institutional and legitimacy-related challenges are, however, not to be taken at face value and rather interpreted in a nuanced light and from a nuanced perspective. Indeed, they have potential advantages, including the fact that they do not overburden the supervisory system, in addition to the fact that these
120 institutions present over 80 percent of total eurozone banking assets. In contrast to larger institutions, the segment of small banks is highly concentrated in countries such as Germany, Austria, Italy and France (see figure seven), with Germany hosting the most at 1,697 of 3,532 given the predominance of locally-oriented savings banks (Sparkassen) and cooperative banks (Volkshanken and Raiffeisenbanken) in its domestic banking market (Véron 2014b). Austria and Italy also host a large share of small local cooperative and savings banks. In other eurozone member states, local banks tend to be consolidated into groups that reach such a size as to be subjected to ECB supervision. Figure seven provides an illustration of the respective constellations in the European context.

**Figure 7: Share of Small Banks in the Eurozone**

![Pie chart showing the share of small banks in the eurozone by country.](image)

**Source:** Figure based on ECB data and Véron (2014b)

As was the case previously in the context of the ESFS, the argument made in this context, i.e. that of proximity and the issue of risks and opportunities inherent in supervisory centralization, is that this division of labor between national and supranational authorities is by no means detrimental to the scheme’s functionality. This interpretation is in line with the interpretation of the fallibility of regulators (see section 6.3 on knowledge-related challenges of financial governance). More specifically, the perspective adopted in this analysis of governance capacity is that with regard to the issue of the division of labor in terms of the supervisory mandate in the eurozone context, the constellation that has been decided on is, in fact, beneficial with regard to the insights of the crisis – with the issue of regulatory and supervisory overload being a case in point in this regard – and the argument being that another constellation, or even an overbearing centralized supervisor would not respect or not be in line with the principle of subsidiarity. Note in this regard that this presents a central compromise or inherent trade-off in supranational supervision, and indeed with regard to supervision in general. Indeed, in order to mitigate the supervisory burden and prevent supervisory overload, national authority in this case remains the best

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380 Véron (2014b) mentions Finnish cooperatives and Spanish savings banks (cajas de ahorros y rurales) as well as French savings banks within the BPCE Group, Dutch cooperatives within Rabobank and Austrian savings banks within Erste Group as well as cooperatives under Österreichische Volksbanken AG.

381 This is, in fact, not necessarily detrimental. Indeed, the EU is unique in terms of the interplay between national and supranational structures and therefore not necessarily comparable. This notwithstanding, regulation – in terms of standard-setting – has largely been Europeanized. With regard to the issue of regulatory policy and standard-setting in general, there is a debate as regards the viability or utility of rules that are defined ex ante, rules devised both at the European and national level, which might be interpreted as inflexible and rigid (Ferran 2012).
option, yet only “provided the latter is efficiently coordinated by the European authority” (Wymeersch 2012b: 317, emphasis added).

5.5.2.3 The European Central Bank as a Prudential Supervisor

Drawing on the insights established above and with reference to the trade-offs elaborated in terms of the horizontal and vertical division of competencies in the previous sections, the following takes an in-depth look at issues specific to the new supervisory governance constellations in the eurozone – with a specific focus laid on the issue of the European Central Bank (ECB) as a prudential supervisor, which includes an examination of the ECB’s evolution throughout the post-crisis era. The aim is ultimately a brief assessment and critical evaluation of its capacity in terms of its mandate and scope of authority against the backdrop of relevant evaluative criteria at stake in this section.

5.5.2.3.1 Fostering Capacity: Credibility and Supervisory Expertise

A key lesson of the financial crisis discussed throughout was the potential threat to stability emanating from large complex institutions that had gained too much leverage vis-à-vis the political system (see section 4.2.3) and the risks an increasingly complex, interconnected and tightly coupled financial system gives rise to – challenging public authority to devise ways to inhibit moral hazard and construct reactive capacities in order to deal with the fallout of crises when they arise.

In this context, transferring the supervisory mandate to both the supranational level (vertical transferal of authority) and the central bank (horizontal transferal of authority) brings with it substantial advantages. In overarching terms, the rationale is that a supranational entity on the one hand (in this case the SSM) and an institution involved in market oversight with macroeconomic – and therefore potentially also to a greater extent macroprudential – credentials, experience and expertise on the other (in this case the central bank), is the most qualified or perhaps best placed to conduct macroprudential regulation and supervision – reflecting the lessons and insights of the crisis with regard to both the governance of the financial system as such and European financial governance in view of the single market in particular (Advisory Scientific Committee 2014; Ferran 2014a; Schoenmaker 2013b).

This is of crucial importance against the backdrop of the systemic risk definition drawn upon throughout and key to the argument put forward. Two central elements are at stake in this section and of relevance in this respect. While (i) with reference to the above regarding the SSM- or eurozone-specific interpretation of the argument regarding the necessity of proximity to the regulated entities, there is indeed a technical rationale for the transferal of authority to a supranational entity in the case of large cross-border institutions to the central bank as the latter is considered to be best placed to conduct macroprudential supervision in the
aftermath of the crisis given its proximity to monetary policy and macroeconomic data and expertise, there is, secondly, (ii) a governance-specific and systemic risk-related argument or governance rationale regarding the transfer of authority to the supranational level and therefore away from the national remit in order to mitigate moral hazard.

5.5.2.3.2 Reconciling Independence, Accountability and Conflicting Policy Objectives

Yet while the transferal of supervisory authority in horizontal and vertical terms can have substantial benefits, it also gives rise to challenges and complications, reflecting and underscoring the fact that there are multiple trade-offs inherent in the design of supervisory governance schemes and no ideal type exists as such (Brunsden and Jones 2016; Ferran 2014a, 2014b; Llewellyn 2006). Indeed, as alluded to above, there are multiple variations in place throughout advanced economies and supervisory constellations have been undergoing constant revision for some time in line with functional pressures, peer pressure and various other influences (see e.g. Gandrud 2013). Central challenges include those of a functional nature and pertain to the division or reconciliation of monetary policy and financial supervision with the argument being that subsuming a mandate for banking supervision could not only jeopardize the central bank’s independence, but could also undermine the credibility and viability of monetary policy. Most scholars, however, maintain that the two spheres can indeed be reconciled and appropriate mechanisms to ensure independence and accountability, while insulating monetary policy can be implemented (see Beck and Gros 2012; Hertig et al. 2009 for in-depth discussions and context with regard to the current debate).382

One issue area, namely the independence versus the accountability of financial supervisors, is particularly relevant in this context. The tensions these themes give rise to are essentially applicable to all supervisory contexts, including those at the national level, implying they are of relevance with regard to the independence of financial supervision and governance as such.383 Though it can be and indeed often is argued that given the political economy tensions at stake in financial regulation – jeopardizing, for instance, the timely and adequate implementation of macroprudential policy tools – independence is indeed beneficial (Interview with Daniel Gros, January 2013, Brussels; see also Willke et al. 2013), the underlying political economy forces and constraints at play make full-scale independence unlikely (Interview with Andrew Bailey, January 2013, London), potentially to the detriment of functional systemic

382 See also Goodhart and Schoenmaker (1995, 1997) and Goodhart et al. (2002) for more general perspectives on the division of monetary and supervisory policy.

383 On the theme of independence in financial supervision, see Masciandaro et al. (2008) and Quintyn et al. (2007), and in relation to accountability see Ferran (2014a).
risk prevention in view of the systemic risk definition employed throughout (see Quintyn and Taylor 2003 on the relation between supervisory independence and financial stability).  

Having briefly reviewed perspectives on issues at stake when devising supervisory constellations in the aftermath of the crisis in order to assess and contextualize the potential as well as the merits and drawbacks of supranational supervision conducted in the context of the ECB, the research now turns to the second leg of the banking union, the Single Resolution Mechanism, which presents one of the most significant attempts of the eurozone to date to mitigate moral hazard, render financial institutions resolvable (Barnier 2014b), and hence crises manageable in order to tackle systemic risk at its roots.  

Sandbu (2017a) even goes as far as to wager that banking union may even “revolutionise European economic and political relations beyond imagination”. The following looks into the resolution component of banking union in more detail.

5.5.3 The Single Resolution Mechanism: An Introduction

As illustrated in chapter four throughout the elaboration of elements and phases of financial governance in terms of crisis prevention and management and on substantive reform elements, resolution is of central importance, while in the realm of financial governance and as regards the attempt to ensure an efficient and equitable financial system via regulatory intervention, supervision and resolution are two sides of the same coin and as such are, effectively, interdependent.  

In June 2013, the European Council endorsed the banking union as a key regulatory priority on the reform agenda, with the Single Resolution Mechanism (SRM) being perceived as a necessary and vital accompanying component to ensure its viability (European Council 2013: 10). Accordingly, on the basis of this acknowledgement the establishment of a supranational supervisory regime for the eurozone, which had been proposed in September 2012, was followed up by a proposal for a common European approach to and supranational framework for resolution designed to complement the Single Supervisory Mechanism described above. More specifically, a proposal for a regulation “for the resolution of credit institutions and certain investment firms in the context of a Single Resolution Mechanism and a Single Bank Resolution Fund” (European Commission 2013a) was advanced in July 2013 by the European Commission, which retains the right of initiative with respect to legislative proposals. Officially adopted and published in the Official Journal of the EU a year later in July 2014, the SRM Regulation (Regulation (EU) No 806/2014) sets out...
to establish uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms via a *Single Resolution Mechanism* (SRM)\(^387\) which serves as an overarching institutional umbrella for the orchestration of resolution activities within the context of an institutional framework comprising two central components: a *Single Resolution Board* (SRB) and a *Single Resolution Fund* which, to a degree, centralize both the competencies and resources required with respect to the management of bank failures in the eurozone and participating member states in order to enhance the efficiency and effectiveness of resolution procedures in the eurozone as well as capacity in this regard, and thereby contribute to the mitigation of systemic risk by offering a necessary complement to enhanced supranational supervision.

Yet given the highly sensitive issues at stake in this context – as alluded to in chapter four regarding the potential budgetary repercussions of resolution, it is inevitably divisive due to its fiscal implications – compromise was by no means forthcoming, i.e. easy to obtain. Indeed, after being proposed, protracted negotiations at the highest political level ensued, frustrating swift action and rendering the originally envisioned aim of 2013 for its completion unfeasible. Not only was the legislative process slow and contentious, but the final outcome diverged from, i.e. the content of the regulation had been significantly revised vis-à-vis the original Commission proposal by the time it was finally adopted.\(^388\) Eventually, however, in December 2013, the Council approved a general approach toward the SRM, whereafter a revised version of the original was adopted in April 2014 by the European Parliament prior to the expiration of the latter’s term in office. This notwithstanding, and in line with our argument and interpretation throughout that substantial agreement and cooperation was in fact attained, it is noteworthy that considerable concessions by pivotal actors were indeed made in order to construct a functional resolution regime as will become clear throughout, though the outcome is by no means to be regarded as optimal. Substantial limitations and challenges remain at the European level, particularly in institutional, not just functional terms – as they do in the national context.\(^389\)

To shed more light on this issue, this section takes an in-depth look at the resolution component of the banking union and the new regulatory and supervisory architecture devised for the governance of the

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\(^387\) Note in this context that entities subsumed under the umbrella of credit institutions and certain investment firms include banks (i.e. banking groups), their parent undertakings and investment firms, though we primarily refer to institutions as *banks* throughout for the sake of simplicity. See also Regulation (EU) No 806/2014 of the European Parliament and of the Council of 15 July 2014 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 Resolution Fund and Amending Regulation (EU) No 1093/2010, [2014] OJ L 225/1.

\(^388\) The highest political level in this case is the European Council (or Council of Ministers), where member state government officials are present.

\(^389\) The point is – and this is central to our argumentation in terms of arguing that we are in fact confronted with *double standards* in the evaluation of European and national schemes – that resolution regimes and approaches to the issue as such are flawed, be it at the national or European level. The transferal of competence, authority and mandates to the European level – irrespective of the degree – is bound to increase capacity in terms of both the *ability to act* and *credibility vis-à-vis private sector actors* by way of creating an additional layer or a backstop to national capacities and national credibility.
eurozone in this respect. After an elaboration of the new regime’s features, including its institutional structure, components, mechanisms and procedures as well the division of mandates, authority and power constellations in general.

5.5.3.1 Definition and Framework: The SRM’s Institutional Structure and Features

The overarching goal of resolution mechanisms and indeed resolution in general – as set out in the previous chapter (section 4.4.1) – is among other aims such as, for instance, the disciplining of firms in the form of an ex ante deterrent of sorts, to prevent contagion from national and international shocks and crises eliciting a wholesale collapse of the banking system. In effect, in a nutshell, the goal is to foster the ability – i.e. build up the capacity – of authorities and the system as such to deal with the failure of individual institutions in order to internalize the damage that results from crises and failure within the financial system – and thereby mitigate systemic risk (as discussed in section 4.2).

The Single Resolution Mechanism (SRM Regulation) entered into full force in January 2016 and encompasses – as its defining institutional feature and central component – a new EU-level agency, the Single Resolution Board (SRB). In a nutshell – and in addition to the tasks relating to resolution planning, including the oversight of the drafting of living wills in the private sector – it is primarily entrusted with devising and executing resolution schemes for significant financial institutions and cross-border banking groups in participating member states.

When dealing with crises and containing systemic risk, the key is the ex post resolution of failed firms and the concurrent allocation of resulting losses (Levitin 2011). For an equitable allocation of losses to occur, however, a functional resolution authority and viable resolution mechanisms are paramount, and in order to be functional – in line with Levitin’s (2011) argument – the authority with the mandate and mechanisms at hand requires both the power and the legitimacy to allocate losses.

The resolution process is depicted below in figure eight.
Recent events during the financial crisis bear witness to theoretical assumptions as regards the fact that myopic national interests prevail in cross-border crisis resolution (Schoenmaker 2012) in a bid to reduce the burden for national taxpayers due to the fiscal implications of burden-sharing (Pisani-Ferry and Wolff 2012). The innovations introduced in the context of the banking union attempt to mitigate the effects of the destructive tendencies or adverse consequences of national regulators’ myopic actions and the reinforcement of moral hazard vis-à-vis the private sector in two respects, i.e. via two mechanisms: (i) by diluting the extent to which resolution decisions and processes are within the exclusive remit of authority of national entities, i.e. moving the sphere of authority in part to the supranational level and thereby potentially inducing an element of objectivity and neutrality (see Ferran 2014c on the specifics of the division of authority in this regard), and (ii) bail-in rules to ensure that the private-sector bears its share of the burden (Sandbu 2017a; see also section 4.4.1). Despite limitations and open questions, these changes are potentially monumental nonetheless (ibid.).

5.5.3.2 The Limitations of Supranational Resolution: Funding and Authority-Related Challenges

The obstacles and challenges involved in constructing a fully functional supranational resolution regime are numerous and multifaceted. With a view to the discussion of systemic risk and the insights established in chapter four, however, the newly established regime’s capacity and potential – one of the most important elements or attributes of which in this context is the projection of credibility so as to curb moral hazard – may perhaps be somewhat limited. Yet not only does the viability of resolution regimes as such remain questionable, issues pertaining to the specific composition and structure as well as the
mandate and remit of the newly devised institutions remain, while further issues and complications revolving around established procedures and the set-up in terms of funding come into play and present potential challenges for resolution at the supranational level.

5.5.4 The Banking Union’s Potential Limitations: Scope- and Treaty-Related Constraints

Though many proclaim that banking union represents a great leap forward (see, for instance, Chang 2015; Howarth and Quaglia 2013a, 2015) and its significance is indeed monumental, the various unions that pervade the debate on further or closer European integration in the eurozone (see Van Rompuy 2012), in which the banking union is included, are nonetheless “beset by ambiguity” (Begg 2012a: 15), implying that as to how the creation of a fully functional and sustainable eurozone is to be achieved remains a matter of debate and contention, is inevitably ambiguous and by no means straightforward, both in theory and in practice.392 This section sets out to shed light on issues of contention concerning the banking union as well as offer insights and present critical perspectives on the potential shortcomings and limitations of the framework that was ultimately devised, serving as a basis for the assessment of the banking union’s significance with respect to issues of relevance in this context and an overarching verdict on institutional policy responses directed at mitigating systemic risk as such as well as an in-depth analysis of challenges in both respects thereafter.

With respect to critique directed at banking union, both institutional components have been subject to substantial criticism on multiple fronts reflecting the compromise inherent in the contentious process and era in which they were constructed at the height of the sovereign debt crisis. Critique pertains in large part either to limits to their autonomy and independence in decision-making and governance (order and legitimacy-related) (particularly in the case of the SRM) or their sectoral and institutional reach (particularly in the case of the SSM). Both factors might undermine their credibility vis-à-vis market actors (curbing moral hazard in the case of the SRM) or their ability to govern holistically and mitigate systemic risk via macroprudential analysis and the implementation of macroprudential tools (in the case of the SSM).

Lastly, and importantly, some lament the incomplete nature of banking union (see e.g. Bini Smaghi 2013; Wyplosz 2012). And indeed, of substantial significance is the fact that the third leg or component of the banking union, the Single Deposit Guarantee Scheme (SDGS), has not yet been finalized and instituted. At the time of writing it is still in the pipeline as it is extremely contentious given its redistributive ramifications, pitting northern against southern states, i.e. primary creditors and debtors against each other. In this context, northern European reticence is based on issues of contention including the fact that

392 In 2012, at the height of the sovereign debt crisis precipitated by the turmoil of the banking crisis, then President of the European Council, Herman Van Rompuy, initiated the debate on genuine economic and monetary union by complementing the latter with the concepts of financial, fiscal and political union (Van Rompuy 2012). His speech was a starting point for the debate on banking union as a response to the shortcomings of EMU that the events following the banking crisis had laid bare.
bad loan ratios are higher in the south and the fact that many banks have more sovereign debt on their balance sheets and therefore a mutualization of liabilities, i.e. via an integrated European guarantee scheme would be regarded as unfair and not viable. This is, however, not necessarily regarded as a fatal flaw significantly detracting from the banking union’s significance. Indeed, as regards the institutional sequencing and related complications in terms of inter alia the fiscal implications and distributive as well as legal issues of banking union, Pisani-Ferry and Wolff (2012) argue that the mutualisation of liabilities is of second-order importance (see Véron 2013a for a similar interpretation).

5.5.5 Evaluating the Significance of Building a Banking Union

In spite of its limitations and the critique it has been subject to from multiple angles, the European banking union, essentially the cornerstone of the post-crisis policy response instituted in the eurozone context, has been described as the most significant and ambitious step in European integration since the introduction of the single currency and the launch of EMU in the early 1990s (see, for instance, Chang 2015; Howarth and Quaglia 2013a: 120, 2015). And indeed, though often portrayed by policymakers as being a largely technical matter, particularly the supervisory component’s implications – as well as banking union’s ramifications in general – reach far beyond this sphere (Begg 2012a: 16; see also Begg 2012b), centralizing large swathes of governance activity and authority, and therefore by default also pervading the political sphere and encroaching upon the fiscal sovereignty of participating member states. In overarching terms, in light of the thirty year experiment in economic integration which resulted in a sophisticated single European market and single currency in which a high degree of integration prevails (Schoenmaker 2012, 2013c), this is highly significant with regard to the degree to which authority has been transferred to the supranational level, attesting to the fact that there has indeed been substantial integration (see also Sandbu 2017a on the implications of the new bail-in rules). As a milestone in terms of European supervision and regulation, the banking union is both an attempt to stabilize the banking system and reinforce EMU by upgrading supranational governance capacities and thereby also attempting to underscore its capacity and hence also its credibility.

In her intricate and insightful analysis of banking union, the legal scholar Eilís Ferran (2014c) called the banking union an “odd compromise,” stating that it is “imperfect, but it can work” (Ferran 2014c: 2). Against the backdrop of the above, this research comes to a similar conclusion. Banking union was indeed “born of compromises” (Ferran 2014c: 2) as it has been subject to substantial constraints pertaining to the legal and EU Treaty-related boundaries and constraints prevalent in the contemporary post-crisis political environment and institutional setting. It is nonetheless highly significant with respect to its potential implications.
5.6 The Pan-European Nexus: Interaction with EU-Wide Institutions and Policies

Before taking stock of and evaluating the reform outcome in overarching terms, a brief examination of banking union’s implications with a view to differentiation in the European context is of utmost importance given the ramifications for coherence and consistency at the supranational level and their potential centrifugal impact. Indeed, the prevalence of differentiation, i.e. the existence of different schemes and degrees of cooperation and integration within the EU – such as, for instance, the eurozone or the Schengen Area – give rise to an uneasy balance in which both centrifugal and centripetal forces are at play simultaneously, thereby potentially threatening to destabilize the system (Haar 2014). To date, however, the Union’s capacity to come to terms with multiple spheres and speeds of integration – often discussed with reference to the concepts of two-speed or multi-speed Europe – can indeed be interpreted as attesting to its adaptive and innovative potential rather than presenting an imminent threat to the Union as such (Dehousse 2012; Ferran 2014b; Leuffen et al. 2013; see also Dinan et al. 2017 for insights on the issue of differentiation within the context of the EU in crisis).

This notwithstanding, multiple policy elements set out to remedy, or at least attenuate the externalities differentiation might have. Attempts to embed the banking union into the overarching pan-European framework and make it dovetail with pan-European institutions and policy elements include the BRRD, the European Banking Authority and the European Systemic Risk Board. And indeed, it appears to be largely positive. The banking group Nordea’s recent decision to relocate its headquarters from Sweden to Finland owing to the latter’s participation in banking union attests to the pull-effect of the banking union as well as the supervisory quality that the ECB has displayed and the credibility that it enjoys (Milne 2017). This may serve as an engine for centrifugal dynamics in future if these assumptions prove credible and developments sustainable – thereby potentially increasing its stability-inducing potential, capacity and EU-wide reach in the process, with supervisory reach and coverage, and the cooperation and integration this implies being potentially significant in terms of systemic risk mitigation (Interview with Dirk Schoenmaker, January 2013, Amsterdam).

5.7 An Overarching Verdict: Taking Stock of Post-Crisis Reform and Integration

As has become clear throughout, credible cross-border governance solutions – including supranational regulation, supervision and resolution mechanisms to effectively counter moral hazard in banking and augment overall reactive capacity in the sector – are of utmost importance to tackle systemic risk in an age of increasingly complex, tightly coupled and integrated financial markets, particularly if nothing is done to

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393 See, for instance, Kölliker (2001, 2006) for theoretical perspectives on differentiation and flexibility in the European context. See also Leuffen et al. (2013) and Stubb (1996) for a categorization thereof.

alter the underlying fundamentals and properties of the system that exists at present, essentially meaning if the financial system as such is not fundamentally and radically overhauled (see section 4.5).

As an attempt to bring coherence to the crisis response in its entirety, this section serves as an overarching yet nuanced verdict with regard to developments pertaining to the reform of the supranational institutional governance architecture. With a view to the verdicts of the analysis on the ESFS (section 5.4.3) and the banking union (section 5.5.5), it sets out to synthesize the conclusions from the preceding analysis of the reform outcome in terms of the dimensions and degrees of convergence and integration that have transpired and assess the significance of pooling sovereignty and centralizing authority and power in the banking union and the ESFS, i.e. in the ESRB and the ESAs, and presents a tentative conclusion in this regard.395

While the European banking union, the cornerstone of post-crisis policy responses in the eurozone context, has been described as the most ambitious and “important step in European integration since the launch of EMU” (Howarth and Quaglia 2013a: 120) with the SSM “in itself, [being] one of the most significant leaps forward since 1999” (ibid.; see also Chang 2015), the pan-European architectural overhaul (ESFS) presents a substantial upward transfer of de facto regulatory authority (Mayntz 2013) with the potential to induce further change in future (Ferran 2011b; Ferran and Kern 2011). In sum, the degree of integration attained in both contexts is therefore both extensive and commendable, though there are undoubtedly not only large discrepancies in terms of the degrees of integration between the respective schemes and frameworks, i.e. as regards the competencies and mandates as well as the degree of autonomy they have been afforded, but also with respect to the substantial limitations inherent in both. Reflecting not only the complex reality of novel sovereignty- and authority-sharing experiments and European integration in general as well as financial governance in particular, a nuanced conclusion is in order. Indeed, reforming and recasting the institutional financial governance structures in the European Union is undoubtedly a step in the right direction in light of our systemic risk definition, but inevitable compromises have been made owing to political pressures and polity and policy-related challenges giving rise to fault lines in terms of determinants of capacity (derivatives and elements of legitimacy, order and expertise) significantly curbing the ensuing governance capacity.

This notwithstanding, in essence, the added value and hence the significance of the ESFS in overarching terms is that it provides pan-European structures within which system oversight can be conducted and coordinated (Interview with Dirk Schoenmaker, January 2013, Amsterdam) so as to increase synergies in crisis prevention and potentially mitigate negative externalities in crisis management – structures that prior to the crisis neither existed at the national nor the European level. This is in itself progress, though it remains to be seen whether this helps curb the myopic and short-sighted tendencies of politically

395 Note that this elaboration will be brief as the limitations were already discussed in previous sections of the analysis, while the corresponding challenges that can be deduced in governance terms are theorized in depth in the following chapter.
motivated prudential regulation (Interview with Andrew Bailey, January 2013, London; Interview with Daniel Gros, January 2013, Brussels). A similar interpretation is conclusive with respect to the banking union.

In 2008, Pauly stated that significant leaps in European integration “have not typically come from functional necessity. More often they have followed crisis moments or, like monetary union, reflected acts of political imagination in unique circumstances”, asking “whether the spectre of catastrophic crisis occasioned by potential troubles in one of Europe’s own LCFIs [large complex financial institutions, CR] is sufficient to stimulate policy innovation” (Pauly 2008: 80). His argument is correct in part, though it must be extended. While it is evident that both substantial innovation and integration has indeed occurred, his take on functional necessity can be seen in another light: The crisis shed light on the functional necessity that existed and induced spillover with regard to what had been neglected in previous episodes of integration – in addition to laying bare the deficiencies of financial regulation as such.

Drawing on the interviews conducted in the context of this research, incorporating insights from relevant actors such as those situated within the respective institutional entities of relevance in terms of cross-border governance and the provision of stability, the following aims to provide a coherent picture of these weaknesses – more specifically, of challenges constraining the new governance architecture’s capacity with respect to the prevention and management of systemic risk and cross-border governance more generally.
6. PART VI: UNDERLYING CHALLENGES AND FAULT LINES OF REFORM

Systemic risk in the context of global finance has proven to be an unprecedented – and to a degree even existential – threat to the modern nation state. Indeed, it is a challenge with few precedents, requiring comprehensive and robust governance responses that match both its unpredictable nature and its cross-border ramifications and externalities. Ultimately, the crisis of 2008 may be interpreted as the first instance of systemic failure in the 21st century (Goldin and Vogel 2010; Willke et al. 2013) in the context of which systemic risk in finance presents a prime example of the weaknesses of both nationally-denominated governance and indeed democratic governance more generally. The ramifications of this conundrum with respect to the challenges of post-crisis reform, which to a degree are effectively thwarting member states’ attempts to address systemic risk are at stake throughout this chapter, and discussed further in the following chapter with respect to the evaluation of progress attained and the need for further integration. Note, however, that many of the challenges apply in the national as well as in the European context.

Having evolved from a loosely coupled to a strictly coupled system, finance has become a complex, knowledge-intensive, interconnected, fragile, and crisis-prone system of global reach. Increasingly vulnerable to the occurrence of extreme high-impact yet low-probability events and normal accidents, integrated governance schemes must inevitably be constructed in an attempt to mitigate and prepare for the imminent threat of systemic risk and systemic crises as systemic risk is not only unpredictable, but preventive and preemptive policy tools and mechanisms inevitably contain “considerable margins of error, uncertainty and non-knowledge” (Willke et al. 2013: 18). As discussed in chapter four, the crisis of 2008 showcased, among other issues, the dangers inherent in finance with respect to its endemic instability, unpredictability and limited governability in general (uncertainty), coinciding with inevitable limitations inherent financial regulation as such given its inherently incomplete nature as well as the complexity, evolutionary potential and dynamic and innovative qualities of the policy sphere at stake (complexity), and finally the ramifications of cross-border finance in terms of the need for integrated and robust governance (incongruence), all of which must be taken into account and factored into the policy response devised.

Multiple issues of relevance are at stake simultaneously in this context, reflecting the very nature of systemic risk. The financial crisis illustrated that there is a rationale for (i) ongoing systemic risk analytics in order to monitor developments in financial markets and foster understanding in this regard in view of a constantly evolving system, as well as for (ii) robust crisis management as crises are essentially unavoidable, and finally (iii) the related issue of cooperation in view of cross-border finance can be deduced, while all three may be subsumed under the heading of the need to build cross-border reactive capacities to construct a modus vivendi of dealing with systemic risk – an objective that is reinforced by the political economy arguments inherent with respect to systemic risk. There is, therefore, as discussed in chapter four a clear rationale for streamlining and upgrading and indeed even simplifying the regulatory framework and overhauling the governance architecture, particularly in the European context.
Yet this has proven harder than it may seem at first sight. Though reforms are no doubt commendable with respect to the integrative potential they display and the capacity they have generated, they are nonetheless insufficient, i.e. do not go far enough. In a nutshell, this chapter – which in combination with chapter seven presents the analytical core of the thesis – discusses governance-related challenges of supranational post-crisis reforms, that is constraints and fault lines of the established institutional structures impacting the capacity of cross-border financial governance and the degree of integration in the European Union against the backdrop of issues set out in the conceptual framework in chapters three and four. In this context, having assessed the instituted reforms in chapter five, it constructs an analytical framework within which to systematize, assess and thereafter synthesize factors impacting the governance schemes constructed in the context of post-crisis reforms and contextualize substantive linkages between the overarching governance challenges, constraints and fault lines of the governance architecture that ultimately emerged. The determinants of the framework are analytical tools selected according to their relevance as determinants in governance theory and are designed to cover the challenges identified in the empirical analysis.396

They pertain to order-, legitimacy- and expertise-related factors inhibiting meaningful integration and reform as well as constraining – or impeding the build-up of – governance capacity397 and may also be defined and framed as institutional, political and knowledge-related elements of governance impacting the new regulatory architecture.398 It is ultimately an analytical attempt to establish whether the status quo of the schemes constructed in their present structural and institutional composition is viable or whether a complex combination of constraints as well as substantive linkages between them renders them untenable, thereby shedding light on the interdependent challenges and repercussions on integration and its potential. Recall – as stated above but particularly relevant here – that the challenge throughout is to balance an assessment of both pan-European as well as eurozone schemes which – though at times arbitrary as different issues are at stake given diverging remits and objectives – is important as both have been put in place to foster cooperation in financial governance, mitigate systemic risk in the form of preventive measures and paradigms and contribute to the build-up of crisis management and governance capacities. This chapter is therefore also an attempt to bring coherence to the challenges of the overarching crisis response and multifaceted attempts at improving governance structures in the aftermath of the crisis.

396 Confer Moravcsik (1998) on the distinction between frameworks and theories.
397 Governance capacity by no means implies or is meant to denote ultimate effectiveness. In effect, a diverse range of intervening variables that cannot be determined ex ante may ultimately impact the effectiveness of regulatory action and thwart attempts to preclude and preempt as well as manage crises. The build-up of governance capacity via the construction of common institutions and venues for cooperation is, therefore, rather to be interpreted as a form of risk management intended to increase the ability of nation states and their respective authorities to cooperate and afford them the capacity to act and the ability to intervene in a cooperative manner.
398 With respect to order-, legitimacy- and expertise-related dimensions of governance impacting capacity, issues include deficient or suboptimal regimes coupled with limited intervention and enforcement capacity, legitimacy issues such as sovereignty concerns and national political economy exigencies, and knowledge-related issues including complexity and system-related constraints which ultimately present the determinants of the analytical framework within which reforms can be assessed.
The question throughout is whether the institutions at stake in this contribution and of relevance to system stability – the ESFS and the banking union – have the requisite resources they need and the institutional positions required to enable viable cross-border governance. This chapter is essentially an attempt to systematize the challenges these institutions face, while the issues are partially drawn from the preceding analysis in chapter five and partially from logical deduction. Note that there are substantial overlaps between the categories set out, while there are issues that apply to both or parts of either of the institutional innovations at stake. The conclusion drawn is, ultimately, that while formidable obstacles and challenges to genuinely robust supranational regimes doubtlessly persist, the institutions are nonetheless to be interpreted as viable in the sense that institutional innovations are essentially at the boundary of what is feasible, both legally and politically in the context of European integration and the limits to which sovereignty transfers are inevitably subject given treaty constraints, and thus present progress vis-à-vis pre-crisis arrangements and in terms of the integrative potential of European integration more generally. The logical conclusion is then, however, that – in order to strengthen these institutions further so as to increase their capacities – further integration is indeed necessary in future, in which case treaty revisions should not be ruled out.

Among others, with respect to governance challenges, issues at stake include (i) treaty limitations and limitations pertaining to scope, (ii) soft law and the non-binding nature of some newly established mechanisms coupled with decentralized implementation (both at the European level), and (iii) political interference (predominantly at the national level) – in addition to regulatory challenges pertaining to system complexity, inevitable non-knowledge, lacking regulatory expertise and the related dependence on industry experts. These then are the screws that could be used to attenuate shortcomings and increase capacity to act in future.

Serving as an introductory section, the following starts out by discussing the key conceptual issues at stake, including theoretical debates, definitions and insights of relevance in the context of designing transnational governance structures (section 6.1), thereafter presenting the analytical framework employed throughout to analyze the governance challenges and shortcomings deduced from the analysis (section 6.2). The established framework essentially serves as a taxonomy for systematizing determinants obstructing financial governance in the supranational context and beyond – including constraints that, to a degree, present inherent governance dilemmas in cross-border schemes.399 Throughout, it is applied to the individual institutional elements of reform, whereafter the chapter is wrapped up by way of a verdict on and synthesis of challenges in their entirety and from an overarching perspective. Building on the latter, chapter seven then goes on to evaluate the significance of the evolution of European governance schemes

399 It thereby revisits notions embedded in the so-called financial trilemma (see e.g. Schoenmaker 2011) discussed in section 5.3, which conceptualizes some the central constraints inherent in the first two categories of the framework – challenges that must, in effect, be overcome in future if governance capacity is to be increased further.
in both theoretical terms with respect to European integration and in practice with regard to financial governance and systemic risk mitigation.

6.1 Designing Governance Structures: The Issues Involved

Despite all its flaws, and though substantial challenges no doubt remain, when analyzing European responses to the financial crisis, the innovative potential of the EU as a transnational governance regime and the novelty, reach and sophistication of its reform efforts as well as the degree of integration it exhibits – especially in comparative terms, that is both with respect to other regional schemes and global regimes – becomes particularly apparent. Indeed, the crisis precipitated fundamental reforms, including transformations of such a magnitude rarely witnessed before in the European jurisdiction and the most transformational in roughly two decades (Ferran 2011b; Howarth and Quaglia 2013a). A closer look, however, exposes the contradictions inherent in schemes that attempt to reconcile cross-border governance imperatives and the prerogatives of national control, authority and sovereignty as well as the inability of governance arrangements – be they national, regional or international – to steer and manage highly complex and tightly coupled systems adequately so as to preclude crises. In this context, the crisis offers an opportunity to assess the challenges national governments face when confronted with cross-border governance dilemmas such as the regulation of the highly complex and tightly coupled global financial system and its constituent institutions, their multi-pronged attempts to come to terms with these as well as the constraints and limitations the latter are subject to. Having (i) analyzed supranational governance responses devised in the aftermath of the crisis as attempts to confront the issues exposed by the crisis, and (ii) having established that in broad terms, despite being unconventional and exhibiting complicated, yet nonetheless sophisticated legal gymnastics (Ferran 2014b: 6) (particularly in the case of banking union), the latter constitute innovative and novel governance solutions to a pressing problem that underscore the EU’s adaptive capacity, the following scrutinizes and takes stock of the key factors obstructing fully integrated and sustainable governance, looking into issues at stake when designing governance structures against the backdrop of which to assess the schemes constructed thereafter in a broader context.

Two issues are of particular importance in this context. While with respect to arrangements in financial governance as such, notions and principles employed to guide regulatory reforms and supervisory overhauls were both questioned and contested in the post-crisis era as many of them had never been implemented before, i.e. were essentially untested (see e.g. Ferran 2014a; see also section 5.5), integrating transnational regimes invariably requires pragmatic political decision-making and compromise. Not only do negotiations generally entail intense tactical maneuvering due to what is at stake, resulting schemes inevitably constitute or are subject to trade-offs, while no templates or ideal types exist. Structural design
and institutional reforms in the European context are therefore always ventures into uncharted territory and usually result in complex, sophisticated and no doubt idiosyncratic constructs – in addition to schemes essentially being the products of evolutionary processes, which are subject to path dependencies (Caporaso and Choi 2002; Caporaso et al. 2003; Pierson 1996) and which can only be designed to a limited degree (Hayek 1988; Young 1991, 1999) as human fallibility inevitably sets limitations on visions regarding grand designs (ibid.; see also Kuper 2014). This ultimately implies that challenges are bound to remain. Not only are the agents constructing these structures and acting within them, i.e. implementing policy tools and mechanisms, boundly rational and inevitably fallible (Kahneman 2011; Kuper 2014; Willke et al. 2013), but reform efforts are inevitably subject to constraints with respect to rational design as uncertainty prevails as to instituted measures’ effects and their ultimate suitability (Forrester 1971) inter alia as no model templates exist – neither in functional nor in vertical terms – in addition to countless political economy pressures.

Constructing Governance Structures: The Theoretical Debates and Issues at Stake

The regulatory schemes devised in the aftermath of the crisis undoubtedly reflect the underlying constraints governments face when attempting to achieve governance capacity and efficacy yet not surrender too much sovereignty and the trade-offs they must accept in this respect. Inhibiting forces encompass sectoral sensitivities, competitiveness concerns, domestic pressures, distributive consequences, diverging institutional frameworks, national constitutional constraints and political expediency to name but a few (Begg 2009; Turner 2012). Nonetheless, the compromises that were made reflect the underlying consensus that something must be done to reconcile domestic and international pressures despite the multiplicity and complexity of preferences as to how this is to occur.

When designing and reforming cross-border governance structures – in this case the architecture of financial governance – multiple issues are of relevance, offering pertinent insights against the backdrop of which reform outcomes can be assessed. For instance, with respect to the design of governance structures, one divide in the theoretical and policy debate revolves around the question or issue of whether and to what extent structures can or rather should be designed deliberately and proactively as opposed to evolving over time and incrementally in response to functional pressures.

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400 With a view to the discussion of finance and its system properties in chapter four, both when designing governance structures and regimes as well as operating within instituted governance architectures and drawing on newly established tools and mechanisms therein, political and regulatory actors’ actions are subject to various constraints or traps inherent in the nature of complex systems such as finance. Forrester (1971: 94) describes these in the following terms: “First, an attempt to relieve one set of symptoms may only create a new mode of system behavior that also has unpleasant consequences. Second, the attempt to produce short-term improvement often sets the stage for a long-term degradation. Third, the local goals of a part of a system often conflict with the objectives of the larger system. Fourth, people are often led to intervene at points in a system where little leverage exists and where effort and money have but slight effect.” See also Willke et al. (2013).
In this context, Hayek (1988), for instance, contradicts proponents of rational design theories, arguing that when designing governance structures it is wrong to assume that agents can improve social welfare by determining specific objectives they find rationally or intellectually appealing ex ante as they cannot predict how the ensuing system-internal causal effects and micro-processes will affect the objectives originally set out. As a result, incremental evolution over time, which, so the argument goes, can lead to valuable institutions, may be preferable to ex ante rational design, drawing on past experiences in order to adjust to uncertainty in a gradual fashion.\textsuperscript{401} Other scholars, however, maintain that explicit attempts at design can be useful in cross-border governance, arguing for instance that it can be preferable to laissez-faire in order to inhibit myopic particularistic taking the upper hand and giving rise to sub-optimal structures (see e.g. North 1990 and Zahrnt 2004 on the potential inefficiencies of path dependence in processes of institutional development in global governance). The latter camp also argues that design and evolution can also be combined as is most often the case with real world institutions (ibid.; see also Young 1999). Ultimately, however, while the ex ante design of institutions may be preferable, it may not always be feasible. Indeed, financial regulation and corresponding architectures have usually evolved in response to crises (Begg 2009; Hennessey 2011), as indeed has the EU as an institution (Monnet 1978; Véron 2013b). Evolution and incrementalism may therefore be inevitable – especially when considering the untested nature of the schemes that are being implemented in technical regulatory terms as well as the novelty inherent in and the experimental nature of the EU as such as a governance regime and legal order beyond the nation state (discussed further in section 7.2).

6.2 Challenges of Supranational Governance: Constructing a Conceptual Framework for Analysis

Notwithstanding the ingenuity of the policy responses devised at the supranational level in the aftermath of the crisis, showcasing the adaptive capacity and innovative potential of the European Union and its member states under extreme pressure and in the face of adversity and functional necessity, thereby illustrating their ability to generate innovative and novel governance solutions when approaching the challenges the crisis laid bare (particularly when viewed from a comparative perspective), substantial challenges and severe constraints, which mirror the inherent tensions and shortcomings transnational governance regimes exhibit and limit governance capacity in the process, remain.\textsuperscript{402} The crisis ultimately marks an opportunity to assess in depth (i) the challenges nation states face when coming to terms with governance dilemmas that extend beyond their borders, including dealing with the system properties of the financial system in its current state, (ii) the obstacles their attempts to come to terms with these are up against, i.e. the limitations governance and reform responses exhibit.

\textsuperscript{401} See Hayek (1988) on the shortcomings or fatal conceit of socialism. See also Zahrnt (2004) on why explicit attempts at design can be useful in cross-border governance applied to the realm of international trade.

\textsuperscript{402} It should, however, be noted at the outset that these limitations are by no means limited to the European jurisdiction – they are, in fact, for the most part just as relevant and destructive at the national level.
Again, the objective throughout chapters six and seven is to gauge the significance of the new supranational regulatory architecture with a view to (i) the challenges and constraints that continue to persist in governance, i.e. interstate or cooperative terms (specifically sections 6.1 and 6.2), 403 and (ii) against the backdrop of and embedded into the issues elaborated and insights set out in the conceptual framework in chapter four, i.e. obstacles at stake with respect to system-related issues, substantive policy and in terms of systemic risk (particularly section 6.3). 404 Bridging the gap between the latter two elements of the analysis and reconciling them is essential – and constitutes an issue of contention in the context of governance analyses and with respect to governance theory. A central point of critique in this regard is the fact that analyses of cross-border governance often neglect the divide between structures and processes of the governance architecture on the one hand, and the substance or content of the issue area at stake on the other. Mügge and Perry (2014), for instance, as proponents of this critique, maintain that analyses of governance architectures are all too often divorced from what is being governed, i.e. the substance of the policy sphere, while overlooking the significance of substantive economic debates. 405 Against this backdrop, the current research effort therefore attempts to bridge the divide and connect the analysis of the reform of European governance structures to the substance of the sphere that is being reformed and governed – more specifically by assessing the suitability of instituted governance structures with regard to, i.e. against the backdrop of the nature and system properties of the contemporary financial system and the governance imperatives the crisis exposed.

The following section presents the analytical framework employed throughout to systematize and analyze particularly pertinent governance challenges in the sphere of financial regulation deduced from the previous assessment – challenges that play into central shortcomings of reform as factors that deter effective systemic risk prevention and obstruct the construction of a sustainable and credible European regulatory governance architecture – or rather limit its viability. 406 Thereby, the section draws on a taxonomy – essentially a scheme of classification – derived from governance theory, dividing elements or factors of relevance in terms of governance – elaborated in the following – along three central lines of arguments (Hewson and Sinclair 1999). These are then applied to both the ESFS and the banking union and their constituent components respectively. Ultimately the taxonomy serves as an analytical framework within which to assess challenges the devised structures exhibit, their confluence and interdependence, as well as their implications in terms of their impact on coordinative potential and governance capacity with respect to crisis prevention and credibility in crisis management. As stressed throughout, a credible crisis response must either upgrade (reactive) governance capacity by way of, for instance, European

403 The focus thereby is on architectural governance-related challenges of post-crisis reform and integration (deduced from the empirical analysis in chapter five) as opposed to shortcomings of substantive policy and system-related aspects of reform.

404 Including substantive, policy-related and system-specific fault lines and shortcomings discussed in chapter four.

405 In a similar vein, Avant et al. (2010) argue that governance analyses tend to analyze structures or processes rather than consider the agents governing.

406 Note that the shortcomings and constraints established throughout the analysis in the previous chapters correlate directly with the challenges set out and analyzed in the following. In addition, recall again that many of facets of the challenges at stake do not only apply at the supranational level, but present challenges of financial governance in general.
integration, thereby potentially increasing the credibility of regulatory authority, including threats and pledges made, cross-border intervention capacities and coordinative processes in order to react to impending crises or change the system’s underlying fundamentals so as to render finance less complex, tightly coupled and contagion-prone.

**Governance Constraints and Shortcomings of Reform: A Taxonomy for Systematizing Challenges**

The taxonomy for the analysis ultimately comprises the elements order, legitimacy and expertise – with all three factors presenting central and defining features of systems of governance, which hence also decisively impact the degree of governance capacity attained in a given governance scheme depending on the nature of their integration in the implemented governance framework. The nature of the former two is particularly decisive for the degree of integration attained in the European context as will become clear throughout, which is essentially equated with governance capacity in the context of this research (see section 4.3.3). While order- or polity-related challenges (section 6.2.1), pertain to the location and division of authority (i.e. relate to intervention capacity), and revolve around institutional constraints such as challenges of institutional design, institutional complexity, and issues of soft law and robust intervention capacities at the European level, the second element of the framework of challenges – highly interdependent with and closely related to the former – is the issue of legitimacy-related or political constraints resulting from politics and political pressures and pertaining to issues revolving around (section 6.2.2), and finally the last element (section 6.2.3) revolves around the multidimensional expertise and knowledge-related governance challenges constraining supranational capacity, including issues related to (non-)knowledge and bounded rationality.

They are portrayed in the following figure (figure 9) depicting issues of relevance in terms of governance.

**Figure 9: Schematic Illustration of the Analytical Framework**

An alternative option for or complementary way of conceptualizing determinants impacting governance capacity is to divide them by means of the concepts of polity, politics and policy, which correspond with the above as institutional, political and substantive policy-related challenges and constraints.
6.2.1 Institutional Challenges: Order- and Autonomy-Related Constraints on Capacity

The insufficiently integrated cross-border, i.e. supranational governance schemes, including the absence of robust and workable resolution mechanisms and crisis management tools as well as inadequately institutionalized mechanisms for cooperation in this regard, coupled with the lack of an overarching system-wide and stability-oriented, i.e. macroprudential approach to financial regulation (both in terms of policy and in terms of governance) were key takeaways drawn from the crisis (De Larosière 2009; FSA 2009). In an attempt to remedy the flaws of the pre-crisis era, and upgrade authorities’ capacity to regulate, mitigate and cope with systemic risk, and their ability to cooperate effectively via institution-building and organizational overhauls, the supranational institutional governance architecture was substantially revamped and transformed into a two-tier pan-European system of micro- and macroprudential supervision and regulation by way of establishing the ESRB as the EU’s macroprudential body and upgrading the EU’s microprudential supervisory entities to independent EU-level authorities with revised mandates and enhanced competencies. In addition to these pan-European reforms, the eurozone’s banking union, which is intended to contribute to the completion of Economic and Monetary Union (EMU), and is relevant with respect to both micro-and macroprudential regulation and supervision in the eurozone, was also established.

In governance terms, challenges resulting from institutional limitations and shortcomings of the reform outcome related to structure, order and authority, including constraints pertaining for instance to resistance as regards and aversion to the conferral of sovereignty to the supranational level, an issue related to legitimacy-related constraints at stake in the following, are essentially the most prominent.

Institutional challenges result at least in part from constraints stemming from political obstacles impeding far-reaching cross-border governance integration. These are at stake in the following, which takes a closer look at these obstacles with respect to their roots and effects.

6.2.2 Politics and Legitimacy: Political Constraints

A second key group of obstacles – closely related to the decisive institutional challenges facing sustainable and robust cross-border governance discussed in the previous section – revolves around is the issue of legitimacy-related or political constraints resulting from politics and political pressures and pertaining to issues revolving around the notions of sovereignty, accountability and political economy issues.

Evidently, political constraints obstructing or impeding European integration and institutional and architectural reform are inevitably intertwined with the latter on institutional challenges facing sustainable cross-border financial governance and systemic risk mitigation. At their core, constraints revolve around issues related to legitimacy, mirroring the issues of authority discussed in the previous section.
Tackling systemic risk and resolving or addressing some of the most pernicious qualities inducing it, requires various simultaneous actions.

Yet despite all its flaws and the general aversion of member states to transfer sovereignty to the supranational level, the following is of crucial importance with respect to both the evaluation and future perspectives and potential trajectories (see chapter seven). In theory, the European jurisdiction is an exemplary model of how to construct a credible governance architecture able to fend off the pressures of at times shortsighted or even counterproductive national political exigencies and demands, particularly in the economic and financial spheres at stake in this contribution. Its institutions’ and governing bodies’ highly sophisticated legally-enshrined mandates bolstered by intricate treaties, its wide-ranging legislative and regulatory competencies (both in terms of the depth and breadth of the functions it fulfills and the issue areas it encompasses) as well as its substantial resources, all of which other schemes largely lack (see e.g. Cameron 2010), underpin and reinforce the EU’s credibility, and in this vein and context its functionality and to a degree also its capacity vis-à-vis, for instance, the international level and even more so other regional schemes. Indeed, it is important to stress that this is particularly the case when cast in a comparative light (see section 6.2.1 above for an application of these insights to the institutional sphere).

The following table is a schematic illustration and conceptualization of the issues at stake in the context of the assessments of relevant actors – in this case national, i.e. member state governments – with respect to integration’s, or more specifically transnational governance schemes’ utility, i.e. the factors they take into account and the pressures they are subject to when the latter evaluate the risks and gains, i.e. the costs and benefits of national versus supranational actions and schemes (see table four). It includes aspects of relevance in the analysis of integration with regard to the respective levels of action and with respect to the assessment of gains that accrue from versus risks of cooperation in relation to national exigencies and pressures.

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407 See Ferran and Kern (2011) for a comparison of the degree to which soft and hard law is implemented at the European and international levels and what the respective implications are.

408 See also chapter two and section 7.4 on this issue, yet note that caveats do apply as the European Union is by no means without its flaws and adherence to common European rules is not always forthcoming. This is, for instance, the case with regard to EMU and the adherence to the stability pact and budget deficit rules to name but a few prominent examples.
Table 4: Stylized Schematic Overview of National versus Supranational Utility Assessments

<table>
<thead>
<tr>
<th>Issues and Levels</th>
<th>National</th>
<th>Supranational</th>
</tr>
</thead>
<tbody>
<tr>
<td>Level of Impact</td>
<td>Immediate national interests, gains and national stability</td>
<td>Regional welfare, stability and prosperity</td>
</tr>
<tr>
<td>Impact Assessment</td>
<td>Immediate national rewards, losses and risk aversion</td>
<td>Long-term regionally distributed (largely positive sum) benefits</td>
</tr>
<tr>
<td>Time Frame</td>
<td>Immediate short-term gains</td>
<td>Long-term gains</td>
</tr>
</tbody>
</table>

Source: Own Construction

In this context, i.e. in the context of utility assessments, integration and regional schemes are conceptualized in terms of a divide between the perception of cooperation as an instrument – and schemes of integration as a forum to advance national interests versus ensuring regional welfare, growth and prosperity, inter alia in the issue area at hand by contributing to the provision of financial stability – a semi-public good from which all participating nations profit.

When attempting to conduct an evaluation, the question as to whether the outcome of reforms, i.e. the institutional governance schemes devised are doomed, i.e. merely represent an instance of symbolic politics (Edelman 1964; Suárez 2014). It is argued throughout that the truth lies somewhere in between.

Institutional and political constraints, the primary cross-border governance challenges of central importance, are compounded by an issue that pertains to all spheres of policy-making, but the issue are of finance in particular as evidenced by the crisis: the increasing complexity and knowledge-intensity of financial institutions and activities as well as their regulation, which gives to issues of expertise and knowledge-related challenges of governing an increasingly complex and tightly coupled system in addition to issues of dependence and capture.

To a degree, the final category of the analytical framework at stake in the following is the odd one out of sorts.

6.2.3 Policy and Expertise: Knowledge-Related Constraints

The third and final category in the analytical framework pertains to expertise-related challenges and constraints. It comprises issues of insufficient data, information and knowledge as well as non-knowledge and their implications in terms of systemic risk governance. In this context, two issues are of particular importance. Knowledge- and expertise-related challenges are present in both policy-related and
coordinative governance terms. The former applies as much to the national and global level as it does to the supranational level.

Inevitably, and as is to be expected in view of the insights of chapter four on the nature of systemic risk and the evolution of the financial system throughout the past decades, in terms of financial regulation and supervision in the post-crisis era, challenges with respect to knowledge-related deficiencies in the reformed governance architecture remain. As stressed throughout, in the pre-crisis era the financial system evolved from a loosely coupled into a strictly coupled system, characterized by its knowledge-intensity and unpredictability, its crisis-prone and complex nature as well as its interconnectedness and global reach. Exhibiting among other factors high degrees of opaqueness, non-linearity, self-referentiality, ignorance and counter-intuitive behavior, it has become increasingly vulnerable to the occurrence of low-probability yet high-impact events and normal accidents (Perrow 1984; Taleb 2007; Willke et al. 2013) and thus made financial governance all the more demanding. A core dilemma for the latter is ultimately that preventive policy with respect to both risk assessments and oversight as well as the corresponding policy tools employed invariably contain “considerable margins of error, uncertainty and non-knowledge” (Willke et al. 2013: 18). Regimes and mechanisms for systemic risk prevention and system oversight are therefore inevitably fallible.

These expertise-related challenges and knowledge deficiencies in the context of systemic risk are particularly relevant with respect to system-oriented macroprudential regulation, i.e. within the ESRB and the SSM, and supervision, i.e. within the ESFS and the banking union within which the ECB is the prudential supervisor. In the following, general issues and concepts are first discussed, whereafter they are applied to the elements of the reformed governance architecture at stake.

Throughout this research it has been stressed that crises reoccur periodically and tend to exhibit parallels (El-Erian 2016; Goodhart 2014; Reinhart and Rogoff 2009), while they often follow similar patterns in terms of their regulatory consequences with the history of financial reform, therefore, essentially being a history of financial crises and post-crisis reform. Yet though continuous reform is inevitable in view of regulatory failures that are bound to occur given the nature of systemic risk – note again in this context that given the incapacity to anticipate all future contingencies and legislate accordingly as uncertainty in the issue area of finance is particularly high and regulatory outcomes are extremely unpredictable, financial regulation is an inherently recursive and repetitive process (Hart 1961; Hennessey 2011) – financial governance frameworks require reactive adaptive regulatory and supervisory capacities and mechanisms to cope with crises to preempt, mitigate and contain them and elements of crisis cycles – capable of continuous modifications and adjustments – as long as the system remains as complex as it is. Of importance in this context is that in view of these challenges and constraints, it is precisely European integration and reactive capacity that are required as argued throughout (see e.g. section 4.3.3).
The crisis was a catalyst for more stringent re-regulation as well as the integration of governance schemes and the construction or overhaul of the cross-border regimes in place. Though it is no doubt too simplistic to state that there has been a holistic and fundamental paradigm shift or a “massive rethinking of the role of the government and of the market” (Stiglitz 2009b: 345), particularly with respect to the fundamentals of the financial system as such, there was indeed a revision of regulatory paradigms in the post-crisis era. At its heart is the concept of macroprudential regulation and supervision which reflects the insight that safeguarding financial stability essentially implies taking account of system-related and macro-level developments in financial markets to attain the stability of the system in its entirety rather than merely ensuring stability at the micro-level, i.e. the soundness of institutions and market infrastructures that due to their size, interconnectedness or political centrality and the like pose potential threats to the system, and was integrated into the new European governance architecture (De Larosière 2009). It is at the heart of tackling systemic risk. 

Yet while microprudential supervision and the corresponding regulatory toolkit has been implemented and under scrutiny as well as continually adapted for some time, macroprudential policy is in its infancy. Not only does designing and implementing the tools and mechanisms as well as operating the institutional macroprudential framework put in place remain challenging, but the understanding of their respective effects and impact is limited (El-Erian 2017b; Tucker 2014; Wolf 2014b) despite advances made to date. 

The implications in terms of policy are significant. Also of considerable importance, however, is its implementation – i.e. the interplay of macroprudential bodies, which are in charge of systemic risk analysis, macroprudential policy development and system oversight with the supervisory institutions responsible for the implementation of respective policy measures is bound to be fraught by substantial difficulties in regulatory, political, organizational and technical terms – both in horizontal and vertical governance terms. 

So what are the implications in terms of policy? As argued throughout regimes and mechanisms for systemic risk prevention and system oversight are inevitably fallible. They are, however, essential nonetheless as are integrated governance schemes for crisis management as systemic crises will no doubt happen again. The point in this context is not that preventive policy, regulation and supervision are futile, but rather that regulatory restraint, caution and reflexivity is of utmost importance (see e.g. Mügge and Perry 2014) and must prevail in the long-term over stringent reform followed by regulatory complacency – the so-called regulatory confidence cycle (Roe 2014; see also Johnson and Kwak 2011). 

6.3 Contextualizing Substantive Linkages between Challenges and Constraints 

The analysis throughout has attempted to adopt a holistic perspective on the highly complex, multifaceted and interdependent challenges facing the regulatory and supervisory financial governance regime devised
in the European Union in the aftermath of the financial crisis, while the following aims to briefly contextualize the limitations of conducted reforms arising from the confluence of these determinants, more specifically the substantive linkages of identified constraints against the backdrop of the structural and system-related challenges facing attempts to govern the system, among them the system properties of contemporary finance, including its inherent instability and the high degree of complexity discussed in chapter four. Indeed, before progressing, the research briefly revisits the latter in order to put the challenges of reform into context and make clear yet again why supranational reforms and attempts at integrating governance schemes are required notwithstanding the limitations current endeavors and structures exhibit and why the post-crisis reforms are valuable despite their shortcomings though further integration is required nonetheless – an issue that is discussed further in chapter seven.

Structural Constraints and System-Related Challenges Revisited: Instability, Complexity and Uncertainty in Context

System-related challenges and their specific implications in terms of governance capacity were not discussed separately in the above as they do not constitute a challenge of the governance architecture as such, but rather the structural backdrop against which or in the context of which governance challenges should be discussed and assessed. As stressed throughout, the modern day financial system can be characterized as highly complex, tightly-coupled and contagion-prone, and its structural fundamentals have not been altered sufficiently in the post-crisis era in order for the reforms directed at the structure and fundamental nature of finance, i.e. its system properties and how it functions to qualify as a genuine transformation (El-Erian 2017b; see also section 4.5). This, i.e. the persistence of these qualities, frustrates attempts to govern the financial system (see chapter 4.3 for an in-depth discussion of the system’s evolution and its properties) and presents governance institutions in general with substantial obstacles, while having crucial implications with respect to governance imperatives as stressed throughout. As such, overarching challenges in the form of underlying system-related issues, i.e. that crises are not preventable, serve as a backdrop for the more specific governance challenges discussed above, against which structures must function and agents acting within them must operate, and constitute one of – if not the – critical group of challenges and limitations, which regional and European integration aims to overcome.

With respect to the overarching contextualization of constraints and their respective substantive linkages, though exemplary in comparative terms, reforms have, i.e. the degree of integration that has transpired has, nonetheless, either remained minimal or been insufficient to mitigate systemic risk in its entirety. The following is a more sceptical take on the instituted reforms, though in general it is argued throughout that reforms have no doubt been laudable and undoubtedly present a step in the right direction.

Linkages between the determinants discussed do not necessarily bode well for the effective governance potential with respect to systemic risk, despite substantial advances in the institutional architecture that
have been put in place. Ultimately, efficacy is likely to be frustrated by uncertainty regarding the adequacy of institutional design and the stringency of the corresponding regulatory content (capacity and capability in line with order-related determinants), the limited transferal of authority to the European level (sovereignty and legitimacy) which might result in damaging instances of regulatory forbearance and limited responsive, i.e. effective and timely crisis prevention and management, and lastly potential complications associated with expertise-related dilemmas that apply to the issue area of financial regulation (non-knowledge and credibility). In addition to the interdependence between these factors (potential feedback loops and spillovers between challenges), the inherent instability of finance exacerbates regulatory challenges and jeopardizes advancements made to date.

Ultimately, against the backdrop of the underlying structural deficiencies inherent in globalized finance, and given the limited competence transferal that has taken place in pan-European terms as well as the complex institutional compromises embodied in eurozone and pan-European regimes, the devised architecture is unlikely to deliver the envisioned benefits – or rather enable member states and the EU to attain the objectives and produce the desired effects of meaningful cooperation, and will hence be unable to engender the sustainability and viability of the financial system and credibility of the regulatory architecture without sustainable structures and mechanisms. In the case of the latter, unilateral recourse to nationalistic crisis management measures in the event of a systemic crisis, which despite an institutionalized framework for resolution is by no means inconceivable, would have catastrophic implications for the credibility of the system.409

6.4 Governance Capacity in the European Context: Evaluating the Implications of Challenges

The above shed a critical light on regulatory reforms in the European context in view of the formidable obstacles facing financial governance at the supranational level. As is to be expected, however, challenges are bound to arise as they do in national contexts and some tensions are inevitable due to the unique nature of the EU construct as a hybrid of sorts – an untested experiment in power-sharing and integrated governance without precedent.

On the basis of the analysis in the preceding chapter, i.e. the verdicts, it is argued that though substantial challenges remain, progress has transpired nonetheless. This section serves as a basis for contextualizing the challenges and their linkages with a view to their impact on what we define as governance capacity, i.e. the utility and viability of supervisory mechanisms and macroprudential tools can only be assessed in the future when applied to post-crisis developments, i.e. those that are no longer directly related to the great recession of 2008 and its causes? An additional unknown is whether non-intervention would have precipitated a systemic crisis. Are rigid pre-defined structures detrimental to financial stability due to their negative externalities and is there a trade-off between regulatory credibility and regulatory flexibility? These are all research questions that will have to be assessed in future research with more context and the benefit of hindsight.

409 Was intervention in Italy, for instance, detrimental to systemic risk in terms of supporting bailout expectations and increasing moral hazard assessed in terms of our definition, especially given the fact that Monte dei Paschi is not necessarily considered systemically significant? Or are we dealing with legacy issues that cannot be solved by mechanisms put in place, meaning the utility and viability of supervisory mechanisms and macroprudential tools can only be assessed in the future when applied to post-crisis developments, i.e. those that are no longer directly related to the great recession of 2008 and its causes? An additional unknown is whether non-intervention would have precipitated a systemic crisis. Are rigid pre-defined structures detrimental to financial stability due to their negative externalities and is there a trade-off between regulatory credibility and regulatory flexibility? These are all research questions that will have to be assessed in future research with more context and the benefit of hindsight.
degree of European integration that has been achieved as regards the governance architecture and is essentially an overarching yet focused recapitulation.

With respect to the evolution of supranational financial governance throughout the post-crisis era and in light of landmark reforms enacted, the question arises as to whether the EU has indeed managed to eschew precedents with regard to the degree of integration attained (Véron 2014a: 3).

The conclusion is ultimately that in terms of reform efforts and integration developments, we are indeed witnessing progress. It is not, however, sufficient. The following chapter sets out to theorize progress and – on the basis of the assessment of the challenges – make the case for increased integration.

On the basis of the insights presented above, i.e. the analysis of reforms, the limitations regulatory schemes exhibit and the challenges regulators and policymakers in the European Union faced in terms of constructing a viable regulatory architecture for the governance of finance in an era of hypercomplexity and fundamental change, the following now turns to assess the ramifications of reform in terms of European integration and the resulting cross-border governance capacity. The goal thereby is to embed reform developments into the theoretical framework set out in chapter two in order to theorize developments, account for the policy outcomes and assess both the limitations they exhibit and their potential in general terms with a view to the systemic risk definition.
7. PART VII: Governance Capacity and Order Beyond the Nation State

As one of the first and indeed most dramatic examples of systemic failure in the 21st century (Goldin and Vogel 2010; Willke et al. 2013), systemic risk in finance is – on an abstract level – one of the most complex and multifaceted societal dilemmas facing public authority in the present era, testing the limits of both democratic governance and static regulatory regimes due to both its cross-border as well as its ever-evolving nature (Willke et al. 2013: 7). Indeed, the developments that transpired throughout the past decades have not only compromised regulators’ capacity to govern the complex, tightly coupled and unpredictable system that emerged in the aftermath of the Bretton Woods era, but have increasingly undermined the nation state’s exclusive authority and its hold on power vis-à-vis the private sector. In terms of finance and its governance, the challenges of the incongruence arising from discrepancies between political and economic spheres (Kissinger 2009) is manifested in the mismatch between global – and in this case European – finance on the one hand and largely nationally-denominated policymaking, regulation and governance schemes on the other (as set out in chapter two and as is common in the governance of complex cross-border issue areas). The crisis of 2008 is a prime example of the consequences this constellation can have. In short, as systemic risk symbolizes the failure of nation states to come to terms with progressively complex and knowledge-intensive as well as increasingly borderless and ungovernable policy spheres (Willke et al. 2013), it ultimately requires intricate and novel governance solutions and innovative policy responses in both substantive and institutional terms (Grande and Pauly 2005) – a feat that the EU has, at least to a degree, achieved.

The question, however, arises as to how exactly supranational post-crisis governance responses are to be interpreted in this regard. The following sets out to theorize the reform outcomes in the supranational sphere in order to assess both the degree and nature of integration that transpired in overarching terms and thereby evaluate the significance and prospects of reform and integration against the backdrop of the challenges presented and in light of the limitations the respective reform elements exhibit. Drawing on the insights established in the theoretical and conceptual foundation, the goal is essentially to evaluate and theorize the degree of progress attained in terms of the integration and evolution of the European governance architecture in the aftermath of the crisis in an attempt to discuss and put issues at stake throughout into context – more specifically, assessing the latter against the backdrop of the nature and system properties of the modern-day financial system and the definition of systemic risk employed. Throughout, the developments in the European context are put into perspective in order to highlight the significance of the European architecture as an institutional order with structures vested with authority beyond the nation state, while also underscoring the case for a further extension of integration in future given the limitations and challenges identified in the previous chapter.410

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410 This contextualization in turn is based on the verdicts deduced from the analysis with respect to reform achievements and the evolution of the European institutional governance architecture as such.
7.1 Theorizing the Evolution of Integration: Functional Spillover Despite Political Spillover?

To begin, one contention is that despite all its flaws, the European response has exhibited a remarkable capacity of the Union to adapt to changing circumstances. There can be no doubt that the crisis acted as a catalyst, yet from a comparative perspective – that is with a view to international and other regimes – the sophistication of the European model and the degree to which it has proven capable of innovating and adapting to changing circumstances should not be underestimated (Ferran 2014b; Véron 2014a).

Assessing the Nature and Degree of Advances in European Regulatory Integration

At the height of an existential crisis and during a period of extreme political and economic turbulence in the post-crisis era, marked by highly complex, contentious and heated intergovernmental negotiations and decision-making in the public eye, the fact that substantial institutional and policy integration has taken place presents us with multiple paradoxes. The question is ultimately (i) how can the developments be theorized, and (ii) what is the significance that can be deduced from these developments, i.e. what are their implications? In this context, European integration theory offers valuable insights and can be drawn upon to theorize both the advances made and the progress that has transpired as well as the challenges that persist and shortcomings that the analysis highlighted, thereby shedding light on the significance of European integration in this context as well as the potential for future advances and adjustments to the governance constellations that exist at present.

Conceptualizing Financial Governance Reforms: An Application of Theoretical Perspectives

European integration theory offers insights for theorizing the trajectory and significance of European integration in this sphere. In this context neofunctionalism and liberal intergovernmentalism are both viable. Though they have slightly different implications, there is cause for optimism as regards governance capacity and potential for the future extension of integration.

Given the highly politicized environment of the post-crisis regulatory era, including that of the sovereign debt crisis, the consensus reached is striking and of significance. Have we been witnessing functional spillover despite political spillback, and if so what does this imply? Though still exhibiting substantial intergovernmental elements, with the banking union’s SRM and the ESFS’s ESRB, for instance, leaving substantial authority and discretion with national governments and regulators, the developments still appear to confirm that spillover has indeed taken place as slowly but surely there has indeed been a step-

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411 Which implies on the one hand that moral hazard remains to a degree (in the case of the SRM), and that insufficient sovereignty transfer has taken place, and this should potentially be changed, though the question remains as to whether systemic risk prevention would function better at the supranational level (in the case of the ESRB) as it is just as subject to human fallibility, so it would be potentially harmful to the legitimacy of EU institution if it is given tasks it is not able to fulfill for the most part as it it is bound to fail at times.
by-step transfer of competencies and authority toward the center, though one drawback to this explanatory approach is indeed the initiative on the part of member states in precipitating and enacting change, rather than supranational entrepreneurship, especially in the case of banking union.

Nonetheless, a nuanced and balanced verdict is in order despite our cautious optimism. We are indeed confronted by a patchwork in which a partial shift toward simultaneous intergovernmental coordination and supranational integration in tandem is taking place, which ultimately justifies the combination of liberal intergovernmental and neofunctionalist perspectives.

Ultimately, though the analysis does not support or rather confirm widespread integration across the board, which early neo-functionalists had predicted, i.e. the functional widening and deepening in various issue areas including spillover between them on a grand scale, implying the crisis did not necessarily deliver a carte blanche for reform and extensive authority transfers, it does go to show and lend weight to functional theses and approaches when accounting for, in our case, institutional progress and consolidation. Not only has the European project exhibited far more evolutionary potential and resilience than realist scholars would give it credit for, indeed it has in fact reached a “stable middle ground between the cooperation of existing nations and the breaking in of a new one” (Hoffmann 1966: 910) that early intergovernmentalists and realist scholars had considered unattainable (see also Scharpf 1998; 2010).

Yet notwithstanding the advances to date, and though one might argue that banking union was indeed a grand bargain of sorts (Howarth and Quaglia 2013a), a great leap with respect to post-crisis reforms in their entirety was not necessarily attained, at least not to the extent that would be required in terms of our definition of systemic risk which would require more integration and more robust schemes. Rather, we are witnessing incremental adaptation, implying that piecemeal advancements have become the dominant political reality. These are ultimately in line with the neofunctionalist narrative. Only time will tell whether this is sufficient in terms of the governance capacity constellations give rise to. This issue is addressed in more detail in the following section.

7.2 Incrementalism vs. Great Leaps: Innovation and Experimentation in European Governance

Perhaps somewhat paradoxically, developments in European financial governance may not only signify a great leap or grand bargain in terms of European integration, but also present an instance of muddling through and incrementalism. Though some might argue this is potentially disastrous with respect to the resulting

412 One exception of particular relevance is of course the spillover between financial and macroeconomic spheres, the interdependence of which became increasingly clear in the direct aftermath of the banking crisis and throughout the sovereign debt crisis, resulting in legislative action, reform and integration which addresses both domains and is intended to be interdependent and mutually reinforcing.

413 In this context, it is prescient to distinguish between institutional governance innovation, reform and integration on the one hand and regulatory and policy innovation and reform on the other, and important to bear in mind that there is essentially a divide between the two. While the former is at stake in this section, the latter will be addressed in the context of the following. The argument
With respect to the reform of its institutional governance structures and the innovation this signifies the EU has no doubt entered unchartered territory in multiple respects. Not only has it instituted unconventional and untested structures as well as measures divorced from standard practice in technical terms in line with post-crisis paradigms in other jurisdictions such as the close alignment of monetary policy and financial supervision, but also developed intricate power- and sovereignty-sharing arrangements. Of particular significance in this regard is the issue of potential – and with respect to piecemeal evolution the potential for – path-dependencies in view of the adaptive capacity the Union has already exhibited. As Ferran and Kern (2011: 33) note in the case of the ESRB, i.e. with respect to the extension of capacity in terms of macroprudential regulation at the supranational level, these developments may be beneficial, i.e. be a harbinger of potential change, modifications and adjustments in the long run.

7.3 Transnational Governance Capacity: The Regulatory Imperatives of Systemic Risk Revisited

Returning again to the issue of what this entails in practice, at stake throughout is an analysis of the governance evolution and innovation that has transpired as well as the obstacles and challenges that persist with a view to the technicalities discussed throughout.

Systemic risk has been conceptualized throughout as the emergent property of a complex, dynamic, inherently unstable, highly interconnected, cross-border, contagion-prone and strictly coupled system, which has become increasingly vulnerable to the occurrence of low-probability yet high-impact events and

throughout is ultimately that while from a comparative and historical perspective there has indeed been a great leap or grand bargain with respect to integration in institutional terms, reforms can still be interpreted as incrementalism in the grand scheme of things as complete integration has transpired and as there is contention as to what would be the adequate model in functional terms. In contrast, with respect to developments in terms of policy innovation and structural reform, post-crisis changes might rather be characterized as muddling through as system fundamentals largely remain in tact (see chapter 4.5).

414 With reference to the so-called fatal coexist of socialism, Hayek (1988), for instance, contradicts proponents of rational design theories, arguing that it is wrong to assume governance structures can be designed to improve social welfare by determining specific objectives perceived as rationally or intellectually appealing ex ante, and therefore incremental evolution over time, which can lead to valuable institutions, may be preferable to rational design. See also Zahrnt (2004) for an application of these insights to the realm of international trade and why explicit attempts at design can be useful in cross-border governance.
normal accidents (Perrow 1984; Taleb 2007; Willke et al. 2013), making financial governance all the more demanding.

Indeed, as established in chapter four, the transformation of the financial system which commenced in the 1970s catapulted the latter “from an (almost) trivial system into a decidedly non-trivial system” (Willke et al. 2013: 56). The system properties and qualities that this development gave rise to produce unpredictable dynamics and limit both the ability of regulators to govern global finance comprehensively and holistically and the ability of the markets to govern themselves in spite of the pervasive belief in system governability amongst most policymakers and market participants alike – a fact that the crisis highlighted and which Kahneman (2011: 245) refers to as the planning fallacy (see Willke et al. 2013: 57 for examples of other complex policy arenas to which this applies).

In this context, the crisis has demonstrated that self-regulation is only viable if finance does not impinge on other systems, i.e. failure only has system-internal ramifications and is therefore in the vein of “creative destruction” (Kay 2013, 2016; Schumpeter 1942, 1978).

On the Governance Implications of the Political Economy Approach to Systemic Risk

To theorize systemic risk, the research employed an integrated political economy approach, which integrates economic and political elements (Willke et al. 2013). The governance implications thereof are discussed in more detail in the following. Systemic crises are low in frequency, yet have broad societal ramifications (International Risk Governance Council 2010), while affecting various stakeholders simultaneously and eluding the control of any one regulator or jurisdiction. The imperative is therefore that it must be addressed holistically and cooperatively, i.e. across national borders. This is as relevant in the national and functional, i.e. horizontal regulatory context (regulatory dimension) as it is in the transnational, i.e. vertical context (governance dimension).

It has been argued throughout that system fundamentals and properties remain largely unaltered and substantive flaws persist, implying the system remains both crisis-prone and susceptible to systemic risk. To name just two examples, though multiple European banks have decreased in size in the post-crisis era, it is widely agreed that too big to fail and hence also institutional complexity throughout the sector remains an issue – both in Europe and beyond (Bott and Jenkins 2017), while post-crisis attempts at constructing robust national and cross-border resolution regimes may still fall short when faced with another Lehman-style bankruptcy (Bair 2014; Miller and Horwitz 2012; Vickers 2016; Wolf 2014a, 2014c). Governance cooperation, therefore, becomes all the more important as there will surely be another crisis of systemic proportions, while it is unclear whether the mechanisms in place will be fit for purpose.
7.4 The European ‘Rescue’ of the Nation State: The Case for Supranational Integration

As discussed at length in chapter two and in the introduction to chapter five, in spite of the strain the liberal world order is under at present and what that might have us believe as regards an apparent resurgence of the nation state and the concurrent retreat of Western nations from globalization, cross-border cooperation remains as much an imperative as it has been throughout the past decades. Steadily progressing globalization, technological advances and the increasing knowledge-intensity of the policy issues at stake in the age of the post-industrial knowledge society (Willke 2007) as well as the heightened complexity of the modern world and the degree of global interdependence that prevails to date, have increasingly undermined the ability of the nation state to govern effectively and cope with the governance challenges the 21st century presents, and will most likely continue to do so in the future.415

Against the backdrop of the global disintegration alluded to throughout (see specifically chapter two and five), European integration, including cooperation and coherence in regulatory and governance terms, has become all the more significant in multiple respects. In addition to the increase in complexity and interdependence described above, fragility and system evolution entails the need for reactive capacities and institutionalized cooperation mechanisms and schemes. It is not only required to mitigate the negative externalities of globalization, and indeed European market integration which might have similar effects, with both therefore presenting two sides of the same coin, and in order to extend regulatory capacity vis-à-vis the financial industry, but also in order to counter the tendencies of weakening multilateral arrangements, and strengthen the position of European member states and the interests of the Union on a global stage, increasing its clout and influence in the process and potentially mitigating the potential for and effects of regulatory competition, competitive deregulation and the like. In short, turbulence in global terms only strengthens the case for European integration in order to offer a potential counterweight to forces jeopardizing the liberal world order (De Gauwe 2017).

This is the only way sufficiently robust mechanisms can be constructed and predictability for market participants and regulatory capacity can be ensured. These very institutions were instituted to maintain stability. Declining influence in the global arena – the mitigation of which is only possible via integration in the European context – implies governance cooperation is required to counteract systemic fragmentation, regulatory competition, competitive deregulation and the like.416 Not only does European integration foster credibility and capacity vis-à-vis private sector actors, it also increases and leverages nation states’ status and strengthens their hand at the global level which – in view of the emerging and

415 See for instance Deaton (2017) on the roots of the current critique directed at globalization as well as its dimensions and ramifications. Deaton (2017) argues the issues at stake are being trivialized and globalization is being mistakenly blamed for many of the ailments of modern Western economies. Rather, the latter are grappling with the effects of increasing automation and economic transformations in the age of artificial intelligence and fundamental technological advances.

416 This is all the more relevant in times like these, in which the principle of divide and conquer seems to be the new preferred strategy employed by the new US administration and applies explicitly to financial regulation, regulatory arbitrage, regulatory competition and sanctions-related issues. It also leads back to the issue of gaining sovereignty by way of integration.
increasingly power-oriented multipolar world order – is increasingly ruthless and cut-throat.\textsuperscript{417} It is in this context that Milward (1992) coined the phrase of the European rescue of the nation state.

\textit{The European ‘Rescue’ of the Nation State: Interdependence and Sovereignty in a Globalized System}

It has been argued throughout that European nations are strengthened substantially by way of their participation in the Union if integration is conducted equitably (Beck 2013a, 2013b; De Grauwe 2017). Not only have participating nations been afforded high degrees of autonomy, they have also attained substantial prosperity and reaped the considerable benefits that generally go hand in hand with membership in such schemes.\textsuperscript{418} This notwithstanding, European integration has clearly come under fire in recent years. In the current era, global – and to a degree also European – discord and disintegration is palpable. Discussed in the introduction to chapter five and described as being the result of pervasive nationalism rooted in dangerous misconceptions and flawed notions, which De Grauwe (2017) summarizes as being fuelled by (i) the myth of oppression by an external force arbitrarily imposing its will upon the allegedly oppressed, (ii) arguments in favor of independence and the desire for sovereignty which are often based on a monolithic concept of identity, refuting the possibility of multi-layered identities and allegiances (or indeed loyalties – an essential component of the neofunctionalist argument and paradigm), and finally (iii) the fallacy that independence will automatically generate economic prosperity. This is evidently a dangerous fallacy as nation states are, and will most like remain, semi-sovereign at best (Kissinger 2009; Willke et al. 2013). European integration, including cooperation and coherence in regulatory and governance terms, therefore, becomes all the more significant. Not only to mitigate the negative externalities of globalization and European market integration and extend regulatory capacity vis-à-vis the financial industry, but also in order to counter the tendencies of weakening multilateral arrangements, and strengthen the position of European member states and the interests of the Union on a global stage, increasing its clout and influence in the process and potentially mitigating the potential for and effects of regulatory competition.

\textsuperscript{417} The paradox is ultimately that pushback against these schemes is taking place despite the fact that it is precisely the system in place which affords advanced nations substantial advantages in global fora in the context of which they wield substantial – and perhaps even disproportionate – influence on the rules and practices governing the global economy. The venues within which this applies include financial institutions such as the FSB and BCBS which are in essence exclusive clubs that can dictate the rules to their benefit, yet their actions are making the system “less effective, collaborative, and more vulnerable to ad hoc tinkering” (El-Erian 2017a), damaging the very system they benefit from. As alternative (e.g. China-led) institutions to those of the Bretton Woods era come into existence, indicative of and reflecting the shifts with respect to evolving power constellations, the concern is ultimately that these “alternative approaches could undermine, rather than reinforce, a predictable and [mutually] beneficial rules-based system of cross-border interactions” (El-Erian 2017a). For instance, open liberal, and most importantly small, economies – the biggest beneficiaries of multilateralism – will suffer most as the system becomes less dependable and participation is not guaranteed. As of yet, it is not clear whether this is temporary or an enduring challenge to global economic governance (ibid.). What is evident, however, is that it is undermining what has been taken for granted for decades and underscores the need for European nations to retain if not reinforce their collective potential and capacities.

\textsuperscript{418} Beck (2013a, 2013b) argues in his manifesto against a so-called German Europe – i.e. a European Union in which one actor, namely Germany, becomes the dominant and overbearing force in its construction and evolution – that European nations are strengthened substantially by way of their participation in the Union if integration is conducted equitably.
competitive deregulation and the like. As discussed extensively throughout chapter two, globalization undermines national sovereignty. The pressures nation states face and ramifications in this regard have been a perennial issue in political science throughout the past decades (Sassen 1999, 2000; Willke 2006). Among many others, an example of significance in this context pertains to rule-making and standard-setting for international commerce and economic governance in which only three jurisdictions are actually capable of defining and indeed dictating the standards and rules, and these are essentially the US, the EU and China. Therefore, as De Grauwe (2017) argues, rather than delivering unprecedented prosperity and more formal i.e. de jure sovereignty, European disintegration, including Brexit will paradoxically entail less real i.e. de facto sovereignty. The take away – and indeed the underlying premise throughout (see section 2.3.2) – is that in a globalized world taking back control, or pursuing formal sovereignty ultimately amounts to assuming less control and, as a result, also less real sovereignty. The corollary of this paradox is that when member states renounce formal sovereignty, they are afforded more real sovereignty (in comparative terms) and capacity (in governance terms) (ibid).

Revisiting the Need for Cooperative Governance and Cross-border Governance Capacities

With a view to the elaboration in chapter two with respect to the limitations of autonomous governance on the one hand, and with regard to the need for regulatory integration, common governance frameworks and reactive supranational crisis prevention and crisis management capacities (De Larosière 2009; FSA 2009) due to the financial trilemma (Schoenmaker 2011) and the level of financial integration in the European context on the other, the underlying assumption throughout is ultimately that interdependencies are undoubtedly on the rise, while the capacity of autonomous action is limited, and indeed on the decline. Cooperation and integration in this respect yield material benefits and serve to offset the adverse consequences of forces beyond the control of single entities. Both qualities attest to the relative capacity – and thus also the likelihood of the relative effectiveness – of EU governance vis-à-vis autarky and autonomous or nationally-denominated governance. In other words, depending on the sphere and jurisdiction at stake, autonomous governance is for the most part costly if not entirely futile in attaining regulatory governance objectives.

419 It is important to note in this context that globalization and European integration are two sides of the same coin, implying that they have similar ramifications and are both subject to the so-called globalization trilemma (Rodrik 2007) which denotes that democracy, national sovereignty and global economic integration are incompatible and can never be achieved simultaneously and in full which in turn mirrors the trilemma in both the monetary and financial policy context (discussed in the following).

420 In terms of (i) reaping the economic benefits of integration and, (ii) reaping the benefits from integrated governance such as lowering transaction costs for the private and public sector, increasing stability, governance predictability and confidence by increasing policy certainty, which are essential for trust and interaction with and between governments and market agents. Particularly as protectionism and isolationism at the international level are on the rise since the financial crisis, while cross-border capital flows are declining (Atkins and Fray 2014) – making cooperation in this regard all the more important due to the increase in external threats (Stubb 2017).
The question throughout is ultimately whether the national level is better equipped to tackle the challenges at hand. In this context, Werner and Wilde (2001) caution against idealizing nation states’ performance in governance terms (see also Zahrnt 2004). And indeed, governance dysfunctionality is not the exclusive preserve of the EU (Véron 2014a), as glaring deficiencies in terms of the pre-crisis supervisory framework as well as the crisis management architecture were revealed at both the European and the national level with both being in dire need of revision and reform. To attribute failure in terms of the response to the crisis – and indeed pre-crisis financial governance in general – to European institutions and the inability to cooperate would be incorrect, and would ultimately constitute a case of applying double standards. Despite shortcomings and challenges of reform at the European level, in view of the system properties of the contemporary financial system, and as reactive capacities to deal with systemic risk that mirror its cross-border nature in the form of both preventive frameworks and crisis management regimes at the supranational level must be constructed, it is conclusive to hypothesize that these present the superior alternative.

And indeed, despite the multiple remaining challenges of governance schemes at the supranational level and the flaws substantive reform exhibit, there has demonstrably been substantial progress in terms of strengthening the supranational governance architecture, while the research findings show that it would be a mistake to underestimate both the ambition and the potential of European integration in this respect (ibid.). The crisis, therefore, may also be interpreted as having been an opportunity for European integration (Thornhill 2015). In this sense, crisis management efforts acted as a catalyst for a stronger and more integrated Union, while rather than having been a crisis of European institutions and governance, the crisis laid bare a crisis of the nation-state vis-à-vis the financial system in this case, essentially requiring a European rescue of sorts (Milward 1992).

Order and Authority Beyond the Nation State: The Significance of European Integration

Ultimately, the developments of the past three to four decades and the evolution of the financial system against the backdrop of steadily increasing interdependence in the wake of financial globalization have, in essence, increasingly undermined the nation state’s exclusive authority with respect to both its claim to and hold on power, challenging scholars and practitioners alike to redefine traditional notions of sovereignty (Acharya 2002; Chayes and Chayes 1995; Grande and Pauly 2005; Kurtulus 2004; Willke 2009).

The European Union has long been – and will most likely remain – the most developed instance and indeed model of regional integration in the foreseeable future in spite of the various deep-seated flaws it exhibits and the multidimensional – and to a degree even existential – crises it has been confronted with throughout the past decade, which have made skeptics question its integrity and long-term viability – in its
current state at least.\footnote{Though after almost a decade of recession the economic recovery is picking up, the multifaceted economic and political risks dogging Europe linger on.} This notwithstanding, its singular success in terms of constructing a single market and integrated cross-border governance architecture is undeniable. It has also proven to be resilient and has shown time and again throughout its history that it is capable of progressing and evolving in response to crises (Cameron 2010).

Even now – and in spite of the existential crises the Union faces – European integration remains indispensable for member states to retain their sovereignty and the Union as a whole to attain governance capacity and credibility both vis-à-vis the private sector and other jurisdictions and remain competitive in an increasingly multipolar and power-focused international order characterized by seismic power and wealth shifts (Cameron 2010; De Grauwe 2017; El-Erian 2017a) as well as in view of the fundamental structural changes taking place in the global economy (Deaton 2017). This is inter alia due to the comparative advantages it enjoys. Only time will tell, however, whether the centrifugal forces at play in the European context as a result of the crisis and its enduring ripple effects will prevail and create momentum for further integration in future (Sandbu 2017b; Stubb 2017), or whether centripetal forces will dominate and induce fragmentation and disintegration – to the detriment of governance capacity vis-à-vis financial markets and the global economy as a whole.
8. Part VIII: Conclusion: Concluding Perspectives and Future Challenges

Throughout the pre-crisis era, the financial system – with respect to the degree of its sophistication, complexity, global reach and centrality to the functioning of advanced capitalist economies – evolved at a pace and to an extent that was largely inconceivable at the time, particularly with respect to its destructive potential. Ultimately, the consequences of this development in terms of the potential for systemic risk that it gave rise to as well as the ensuing wealth destruction that could flow from it, i.e. the havoc financial instability and the disruption of elemental services at the heart of market capitalism could cause, were unanticipated by most actors involved, including market participants, regulators and policymakers.\footnote{Though one must add that – in retrospect and with the benefit of hindsight – some developments could have been predicted or were indeed even pointed out, yet were not taken seriously or underestimated. See, for instance, El-Erian (2017b) or Johnson and Kwak (2011) on lessons that could have, in theory, been learned from previous crises, especially those at the turn of the millennium in countries that were still developing at the time, such as for instance countries in Asia.} The crisis essentially exposed the mirage or misconception of self-regulating markets\footnote{A notion that had long prevailed in the developed world and guided its regulatory actions as well as infusing its regulatory paradigms was that of the viability of laissez-faire capitalism (Stiglitz 2009b).} as well as the illusion that the West was, for instance vis-à-vis developing countries, given their susceptibility to crony capitalism, in a superior position as regards its capacity to harness the financial system and provide for financial stability, ushering in a period of intense upheaval and reform at all levels of governance.

Much has in fact changed, particularly in the European context. The analysis has shown that, in principle, reform efforts and advances in terms of integration are commendable with respect to their governance implications, i.e. in terms of their potential with respect to increasing governance capacity at the European level – at the very least presenting a step in the right direction if viewed through the lens of the systemic risk definition set out in and employed throughout this research.\footnote{In this context, the research drew on a refined definition of systemic risk set out by Willke et al. (2013) with the novelty of the contribution delivered throughout being that the analysis of post-crisis governance reforms at the supranational level was conducted against this backdrop and embedded therein.} Indeed, on the governance front or from a governance perspective, the contribution has shown that despite the challenges identified, rather than discrediting the significance and implications of the reform outcome and the evolution of the governance architecture outright, a more nuanced verdict and balanced conclusion is in order than may seem warranted at first glance.\footnote{Yet neither is the conclusion of the analysis unequivocally positive. In spite of the encouraging signs that can be deduced from post-crisis developments, we are by no means out of the woods yet. At best, as stated, a step in the right direction has been taken.}

This notwithstanding, and in spite of the significant governance and integration-related advances achieved to date, the reform outcome – in overarching terms – nonetheless presents a paradox of sorts. The issue of genuine change as opposed to mere symbolic tweaking in substantive and systemic terms arises as the fundamentals of the system, i.e. the system properties described in depth in chapter four, which evolved throughout the past decades and gave rise to the first truly systemic crisis (Levitin 2014: 1) to challenge the capacities and coping mechanisms of the modern regulatory state, and which may ultimately be
interpreted as the first instance of systemic failure in the 21st century (Goldin and Vogel 2010; Willke et al. 2013), by and large remain intact.427

In this context and in line with this view, El-Erian (2017b) argues the lessons of the crisis have yet to be learned. Many policymakers, so the argument goes, tend to treat the crisis as simply having been a cyclical blip, implying they tend to believe that the crisis was merely a typical gyration in – or turning point of – a cyclical cycle as opposed to having been a systemic crisis (Levitin 2014) and having exhibited genuinely new qualities and qualitatively new phenomena (Willke et al. 2013) as has been argued throughout. This evidently has repercussions for the ensuing reform approach adopted. While, in theory, taking the insights and implications of the latter interpretation to heart would have implied that a more fundamental structural solution would essentially have been required, the former can be interpreted as supporting and rationalizing the assumption that tweaking arrangements to stabilize the system (Admati and Hellwig 2013; Wolf 2014b, 2017; see also section 4.5) and ratcheting up the complexity of regulation as a response to the crisis would suffice.428 Ultimately, rather than tackling or altering the underlying system properties conducive to systemic risk as such, the response to the crisis has, on the substantive front, therefore largely focused on fighting “financialization by more financialization through quantitative easing” (Sheng 2013) on the one hand, and tackling complexity by way of more regulatory complexity (ibid.), including increasingly intrusive and knowledge-intensive rules and regulations that attempt to match the complexity of the system as such on the other – though it is precisely this approach that is misguided as argued throughout (Becker 2016; Haldane and Madouros 2012; Sheng 2013; see also chapter four).

With a view to the above, when attempting to make sense of the post-crisis developments and draw an overarching and comprehensive, yet nonetheless nuanced conclusion, the complex reality of the reform outcome essentially presents a contradiction of sorts, in the sense that it is a somewhat ambiguous case of two steps forward, one step back.429 While the degree of governance integration and the innovative potential, adaptive capacity and pragmatism it signifies has been striking – despite remaining unresolved institutional

427 Indeed, notwithstanding progress from a governance perspective, substantial structural impediments and system-related obstacles to a sustainable financial system persist, implying the underlying fundamentals discussed, i.e. those conducive to systemic risk largely remain in place, in part giving credence to the view that the regulatory response to the crisis has been an instance of symbolic politics – or at the very least an example of systemic failure as indeed the crisis itself was. Ultimately, the question must be whether the necessary wide-ranging and far-reaching transformative structural and substantive reform measures have been instituted in order to attain economic, financial, and social sustainability. See, for instance, Das (2016) who challenges the notion of perpetual growth and thus also excessive debt and loose monetary policy in the aftermath of the crisis and laments that the political will to enact the changes needed is lacking. See also Sheng (2013) and El-Erian (2017b) for similar interpretations of shortcomings on the macroprudential front.

428 Indeed, to a degree the notion that the crisis was merely a cyclical blip could be interpreted as a mandate for the more lenient approach to reform that ultimately transpired. Whether the outcome is sufficient, sustainable and can deliver in the long run remains to be seen. This could, in theory, rationalize the response and imply that it does not present an instance of symbolic politics. Rather, it would appear policymakers simply do not fully understand the significance of the crisis and its systemic implications.

429 Despite still being a moving target to a degree as some changes have yet to take full effect and institutions have yet to evolve, while mechanisms are being implemented for the first time and precedents are being set (see, for instance, Sandbu 2017a on the resolution of Spanish and Italian banks in 2016 under the banking union’s new framework), with the benefit of hindsight and ten years since the onset of the crisis, preliminary conclusions as regards the reform outcome are indeed possible.
challenges and shortfalls on various other fronts – structural and substantive change falls short and remains deficient.

Against this backdrop and on these grounds, it is conclusive to assume that another systemic crisis is bound to arise. As a consequence, reactive cross-border capacity and robust crisis management tools become all the more significant and must be extended in future. An overarching theme throughout has been the imperative of cooperation, i.e. the claim that cross-border cooperation is a necessity given cross-border finance, while integrated governance is a necessity in the European context due to the existence of a single market. In light of the multifaceted issues exposed by the crisis, the objective of reform – in order to mitigate systemic risk – must ultimately be to eliminate the binary choice between large-scale public intervention and market chaos (Levitin 2011), while the imperative that flows from this is robust ex ante regulation and the build up and projection of credibility coupled with the fostering of ex post reactive capacity – for instance, via integrated crisis management tools. Though progress has no doubt been attained, it still remains deficient as it cannot mitigate perverse incentives and remedy the prevailing degree of instability and fragility that still remains in the system.

8.1 Synopsis: The Policy Implications of Post-Crisis Reforms in the EU

The global financial crisis of 2008 – a crisis of such proportions that it called the very nature of the modern regulatory state into question, presenting the greatest test the financial regulatory system had faced to date (Levitin 2014: 1) – was undoubtedly an epochal event that shook the foundations of advanced market economies to their core. The objective of the research has been to assess the evolution and significance of the governance reforms instituted in the aftermath of the crisis with a view to their significance both with respect to and against the backdrop of the systemic risk definition developed and employed throughout. The dependent variable at stake was ultimately the outcome or degree of reform and integration in terms of governance schemes instituted at the European level. From the level of integration, impacted by order, legitimacy and expertise-related challenges, the degree of reactive governance capacity could then be inferred.

Though, as has been argued throughout, the fundamentals of the system and its regulation as such have not been altered fundamentally, i.e. the impetus that the crisis delivered was not sufficient to engender a wholesale paradigm change with regard to the financial system and its governance, the institutional and architectural regime changes at the European level have indeed been transformational. The radical overhaul of the regulatory and supervisory system will undoubtedly influence the conduct of financial governance and future developments for years to come. This notwithstanding, substantial limitations remain in structural, substantive and systemic terms, and it is these shortcomings that regulators must
tackle if a credible and sustainable governance response to systemic risk is to be devised. In view of the analysis conducted throughout, this is of utmost importance and must take precedence.

8.2 Outlook: Future Challenges for Cross-Border Financial Governance and EU Integration

Arguably the worst financial meltdown since the 1930s (Financial Crisis Inquiry Commission 2011) and one of the worst crises in the EU’s history, i.e. since its inception in the 1950s, the crisis of 2008 – as the first and manifestly one of the most conspicuous examples of “systemic failure” (Goldin and Vogel 2010: 5) in the 21st century – can ultimately be interpreted as a failure of liberal democracies to come to terms with progressively complex and knowledge-intensive (Willke et al. 2013) as well as increasingly ungovernable and borderless policy spheres that threaten the social fabric of which they are part (Carney 2014) and the very foundations of the advanced market economies and the contemporary system of democratic capitalism (Streeck 2011) in which they are embedded. This ultimately implies that the issue of systemic risk – the central theme and defining feature of the crisis – is of paramount importance, rendering the comprehensive and cooperative tackling thereof an imperative and a priority on the policy agenda – in addition to presenting one of the many intractable problems and governance challenges of the modern age for which common solutions must be found, implying shared responsibility must be acknowledged and acted upon accordingly.

The governance rationale and imperatives flowing from this conundrum are as significant and relevant at the global level as they are at the European level – though perhaps even more so in the case of the latter due to the prevailing level of market integration and the potential for negative externalities with respect to both other policy spheres within the Union and the knock-on effects of non-cooperative behavior. Two issues are of particular importance in this respect, essentially presenting two sides of the same coin when it comes to tackling systemic risk. On the one hand, an upgrade of the cross-border governance architecture is required in order to strengthen public authorities’ capacity and credibility vis-à-vis the financial sector, while on the other more stringent regulation and a rethink of conventional paradigms is required to reinforce the latter. If this does not transpire, the next crisis could be even worse than the last. Ultimately, to conclude, the overarching risks and threats emanating from the system in its current state – more specifically, from an overly complex, tightly coupled, integrated and contagion-prone system characterized by high-speed financial innovation and rapid financial sector growth – must be heeded at all costs, i.e. must be taken seriously and dealt with accordingly. The remaining conundrum is essentially that appropriate safeguards are not yet in place and adequate risk- and burden-sharing mechanisms are not

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430 Indeed, with respect to the former, appropriate safeguards will perhaps never be forthcoming due to the inherent lag or disadvantage of regulators vis-à-vis the financial industry in terms of expertise (Becker 2016; Weber 2012), which Kane (1986) frames as the regulatory dialectic. With respect to the latter, attempts to enforce market discipline vis-à-vis the private sector such as, for instance, attempts to reduce the systemic relevance of certain institutions have faltered, while the banking union has yet to be completed and burden-sharing in the eurozone has yet to evolve fully.
forthcoming as they remain highly contentious, both with respect to the division of risk between the public and private sector as well as burden-sharing within the Union as such, that is amongst the member states. The consequences of neglecting these risks and their implications by disregarding the need to address the externalities resulting from the system properties, i.e. arising from the way in which the system has evolved throughout the past decades by tackling the system’s underlying shortcomings, instituting credible mechanisms and structures for comprehensive preemptive systemic risk monitoring and oversight, as well as devising credible cross-border coping mechanisms and crisis management tools, were devastating and could be well observed during the crisis of 2008, while the costs of doing so again would most likely be even more dire in future. Time will tell whether the adopted approach to regulatory reform and the corresponding governance structures that were instituted are up to the task of keeping such a system in check. Evident, however, is that the continual adaptation and revision of governance schemes and further integration will no doubt be required – both in substantive terms and with respect to institutional governance in view of the dynamic nature and evolutionary potential of the policy sphere at stake, and coupled with increasing degrees of interdependence. Complacency is, thereby, to be avoided at all costs. It is precisely this tendency that would likely lead to the implosion of the system in future and in view of the magnitude and externalities of the previous recession, including among other factors the rise of populism, the prevailing degree of complexity and uncertainty within the system at present, and the limited firepower of central banks due to the fact that they are only just now unwinding their loose post-crisis monetary policies, it is unclear whether advanced economies would actually be able to recover from this. The consequences could be very dire indeed. Systemic risk, therefore, may well be one of the most pressing challenges and tests of our time.
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